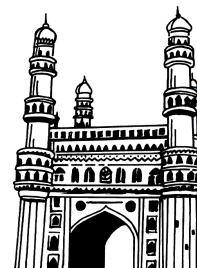


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UNIT - I

1. What is financial system? What are the characteristics of good financial system?

Ans : (July-21, Imp.)

Refer Unit-I, Q.No. 1

2. Discuss the structure of Indian Financial System.

Ans : (Oct.-20, June-19, Imp.)

Refer Unit-I, Q.No. 2

3. Explain the various components of Indian financial system.

Ans : (July-21, Oct.-19, June-19, Imp.)

Refer Unit-I, Q.No. 3

4. Write a short note on financial markets and its types.

Ans : (June-19, Imp.)

Refer Unit-I, Q.No. 8

5. Define financial services. Explain the objectives of financial services.

Ans : (June-19)

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6. Describe the various functions of financial system.

Ans : (June-19(MGU), Imp.)

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7. Explain the role of financial system in economic development.

Ans : (June-19(MGU), Imp.)

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8. Explain the Recent changes in Indian financial system.

Ans : (June-19, Imp.)

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UNIT - II

1. Define Commercial Banks. Bringout the characteristics features of a commercial banks.

Ans : (July-21, Oct.-20, June-19, June-19(MGU), Imp.)

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2. Explain the functions of commercial banks.

Ans : (June-19(MGU), Imp.)

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3. What are the agency functions of commercial banks.

Ans : (Oct.-20)

Refer Unit-II, Q.No. 5

4. Explain the growth of commercial banks in India.

Ans : (July-21, Imp.)

Refer Unit-II, Q.No. 7

5. Define Merchant banking. Explain the evolution of merchant banking.

Ans : (Oct.-20, June-19(MGU), Imp.)

Refer Unit-II, Q.No. 8

6. Explain the functions of merchant banker.

Ans : (June-19(MGU), Imp.)

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7. Define venture capital. Explain the features of venture capital.

Ans : (July-21, Oct.-20, Oct.-19, Imp.)

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8. Define Leasing. Explain the characteristics of leasing.

Ans : (Oct.-20, June-19, Imp.)

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UNIT - III

1. Define Money market.

Ans : (July-21, June-19, June-19(MGU))

Refer Unit-III, Q.No. 1

2. Explain the functions of money market.

Ans : (July-21, June-19, Imp.)

Refer Unit-III, Q.No. 3

3. Define Commercial Paper. State the features and advantages of a Commercial Paper.

Ans : (Oct.-20)

Refer Unit-III, Q.No. 12

4. What are Certificate of Deposits? State the features of Certificate of Deposits.

Ans : (Oct.-20)

Refer Unit-III, Q.No. 14

5. What do you mean by Treasury Bills Market ? Discuss the classification of Treasury Bills Market.

Ans : (Oct.-20)

Refer Unit-III, Q.No. 19

6. What are the functions of Reserve Bank of India?

Ans : (Oct.-20, June-19, June-19(MGU), Imp.)

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7. Write short notes on liquidity adjust-ment facility.

Ans : (July-21)

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UNIT - IV

1. What is a debt market. Explain the evolution of debt market in India.

Ans : (Oct.-20, June-19(MGU), Imp.)

Refer Unit-IV, Q.No. 1

2. Explain the features of debt market.

Ans : (Oct.-20, June-19(MGU))

Refer Unit-IV, Q.No. 2

3. Describe the risk associated with debt market.

Ans : (Oct.-20)

Refer Unit-IV, Q.No. 3

4. What are debt instruments ? Discuss its types.

Ans : (July-21, Imp.)

Refer Unit-IV, Q.No. 8

5. Define Government securities. Explain the features of government securities.

Ans : (Oct.-20, June-19, June-19(MGU))

Refer Unit-IV, Q.No. 12

6. Explain the various Forms of government securities.

Ans : (Oct.-20)

Refer Unit-IV, Q.No. 13

7. Define corporate bonds. and explain the characteristics of corporate bonds.

Ans : (June-19)

Refer Unit-IV, Q.No. 16

UNIT - V

1. Define primary market. Explain the function of primary market.

Ans : (Oct.-20, June-19(MGU), Imp.)

Refer Unit-V, Q.No. 3

2. Explain the features of primary market.

Ans : (Oct.-20, Imp.)

Refer Unit-V, Q.No. 4

3. List out the products of primary market.

Ans : (Oct.-20)

Refer Unit-V, Q.No. 5

4. Discuss the various methods involved in IPO.

Ans : (June-19(MGU), Imp.)

Refer Unit-V, Q.No. 9

5. What do you understand by secondary market. Explain the instruments of secondary market.

Ans : (June-19, Imp.)

Refer Unit-V, Q.No. 27

6. Explain the various functions of stock exchange.

Ans : (July-21, June-19, Imp.)

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7. Explain the functions of SEBI.

Ans : (June-19(MGU), Imp.)

Refer Unit-V, Q.No. 44

UNIT I

INDIAN FINANCIAL SYSTEM:

Components - Functions - Flow of Funds Matrix - Financial System and Economic Development - Recent Developments in Indian Financial System- Weaknesses of Indian Financial System

1.1 INDIAN FINANCIAL SYSTEM

Q1. Define financial system. Discuss the characteristics of Indian financial system.

(OR)

What is financial system. What are the characteristics of good financial system.

Ans :

(July-21, Imp.)

Introduction

The economic growth of a nation is dependent on the way the saving that is generated in the economy is transferred to the investment, which gets converted to fruitful production process. This in turn, generates gross output in the economy. This becomes an important point in the measurement of the growth of the national economy.

This above method is known as the capital formation where, it goes through three distinct stages, i.e., Saving, Finance and Investment. Funds flow from the surplus saving to the deficit areas of the economy.

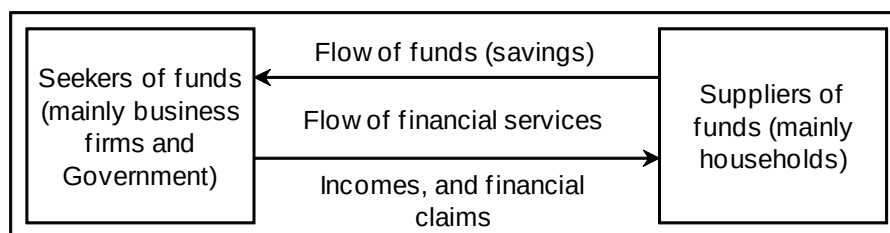
In order to enable capital formation, there is a requirement of intermediation or a system, which will create and channelize saving, leading to capital formation. The system, which does this function in the economy, is called the financial system.

Meaning

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Definitions

- (i) According to Amit Chaudhary,** "Financial system is the integrated form of financial institutions, financial markets, financial securities, and financial services which aim is to circulate the funds in an economy for economic growth.
- (ii) According to Dhanilal,** "Financial system is the set of interrelated and interconnected components consisting of financial institutions, markets, and securities."



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

Characteristics

1. Low Risk

The financial intermediation should ensure low risk for the supply of the funds in the economy. We all know that human beings are risk-averse and would prefer to work for lower risk, even if that means lower returns. However, if the financial intermediation provides only for low risk opportunities for the use of the fund, there will be very few takers of their services after some time, as the return will reduce. Hence, they should diversify the risk in as many financial instruments as possible, so that the fund provides have a balanced growth of their saving at the end of the process.

2. Convenience

Financial intermediation should provide convenience for mobilizing saving to be converted into investment. Convenience, in this regard, means that the avenues to save should be such, that they are affordable (in small units), should involve less paperwork and should be very transparent in terms of legal contract. It should provide the maturity (payable) in the convenience of the person, who does the saving.

3. Efficient Management

Financial intermediation should provide for an efficient management of funds which come to them. Efficient management means they should have expert investment system which understands the risk and return of the market, takes the decision in favour of the person who saves and ensures proper return of the money being used. The efficient system should also ensure that the intermediation makes best use of the fund available to them. One way to do that is to see that the economy of scale is achieved. Since they operate with a huge amount of money, they generally have the advantage of making the financial market move along their requirement optimally due to their size.

Q2. Discuss the structure of Indian Financial System.

(OR)

Write about Indian Financial system focusing on financial services.

(OR)

Write about Indian Financial system focusing on organized sector.

Ans :

(Oct.-20, June-19, Imp.)

The Indian financial system refers to the system of borrowing and lending of funds or the demand for and the supply of finance of all individuals, institutions, companies and of the government. The Indian financial system is broadly classified into two categories.

1. Organized/formal financial system
2. Unorganized/informal financial system.

The figure below gives a clear understanding about the structure of Indian financial system.

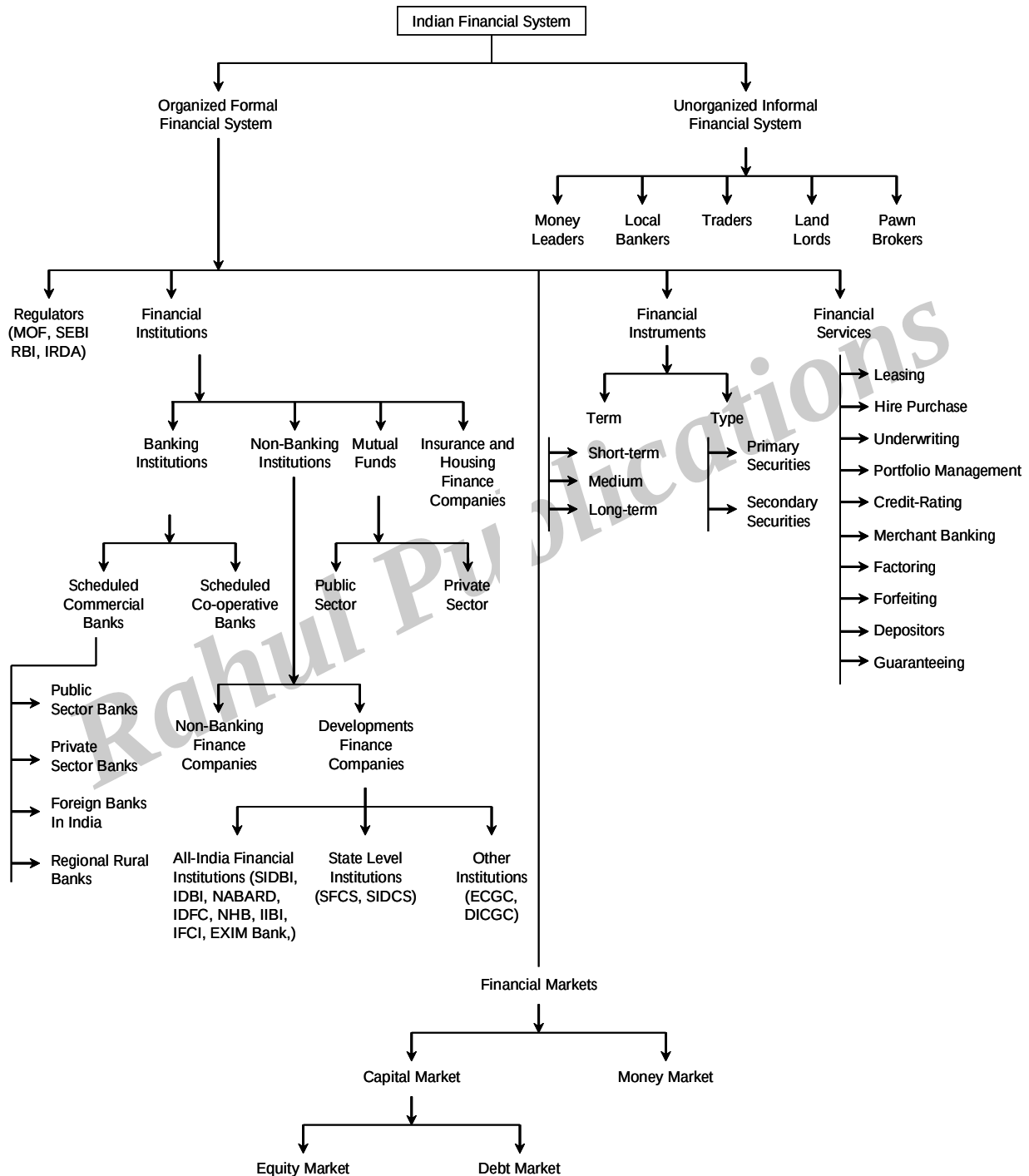


Fig.: Structure of the Indian Financial System

1. Organized/Formal Financial System

The organized or the formal financial system consists of a network of banks, financial institutions, investment institutions and a range of financial instruments, that function in developed capital and money markets. Organized financial system comes under the responsibility of MOF-Ministry of Finance, RBI-Reserve Bank of India, SEBI-Securities and Exchange Board of India and some other regulatory bodies. The organized financial system is divided into four components. They are,

(i) Financial Institutions: Financial institutions are intermediaries that mobilize savings and help in the allocation of funds in an appropriate way. Financial institutions are classified into four segments - Banking Institutions, non-banking Institutions and Investment Institutions like-mutual funds and housing finance companies. Financial institutions include,

- (a) Non-banking financial institutions like DFIs, NBFCs, FIFCs etc.
- (b) Term-finance institutions like IDBI, ICICI, IFCI, SIDBI and IIBI.
- (c) Specialized Financial Institutions like EXIM, TFCI, IDFC, NABARD, NHB.
- (d) Mutual Funds such as UTI.
- (e) Insurance Activities such as LIC, GIC.
- (f) State Level Financial Institutions such as SFCs and SIDCs.

(ii) Financial Markets

These are intermediations where the general public or the business organization come together to get their fund requirement fulfilled. These may be primary market, where the givers and takers of fund meet for the first time and the secondary market, where the investment procured in the primary market are bought and sold. The financial markets are of two kinds, capital

market and the money market. The capital market helps in raising the long term funds for business and the money market helps in raising short term finance for the business.

(iii) Financial Instruments

Financial instruments refer to those documents which represent financial claims on assets. financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: Bill of exchange, Promissory Note, Treasury Bill, Government Bond, Deposit receipt, Share, Debenture, etc.

Financial instruments can also be called financial securities.

Financial securities can be classified into:

- (i) Primary (or) direct securities.
- (ii) Secondary (or) indirect securities.

(i) Primary Securities: These are securities directly issued by the ultimate investors to the ultimate savers.

Example: Shares and debentures issued directly to the public.

(ii) Secondary Securities: These are securities issued by some intermediaries called financial intermediaries to the ultimate savers.

Example: Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows:

- (i) Short-term securities
- (ii) Medium-term securities
- (iii) Long-term securities.

(i) Short-term securities

Short-term securities are those which mature within a period of one year.

E.g., Bill of Exchange, Treasury bill, etc.

(ii) Medium-term securities

Medium-term securities are those which have a maturity period ranging between one and five years. E.g., Debentures maturing within a period of 5 years.

(iii) Long-term securities

Long-term securities are those which have a maturity period of more than five years.

E.g., Government Bonds maturing after 10 years.

(iv) Financial Services

The term “Financial Services” in a broad sense means “mobilizing and allocating savings”. Thus, it includes all activities involved in the transformation of saving into investment.

The ‘financial service’ can also be called ‘financial intermediation’. Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key area and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilise the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

2. Unorganized/Informal Financial System

An unorganized financial system consists of money lenders, local bankers, traders, landlords, pawn brokers who are less controlled. Unorganized financial systems are not directly responsive to the Reserve Bank of India (RBI). The informal financial system is divided into,

- (i) Individual money lenders like Neighbours, Relatives, Traders, Landlords etc.
- (ii) Groups of individuals operating in a combined way as funds/associations are fixed fund, association, saving club etc.,
- (iii) Partnership firms including pawn brokers, non-financial institutions like chif-fund, finance and investment companies.

1.2 COMPONENTS OF FINANCIAL SYSTEM**Q3. Explain the various components of Indian financial system.****(OR)**

Discuss the components of Indian financial system.

Ans :

(July-21, Oct.-19, June-19, Imp.)

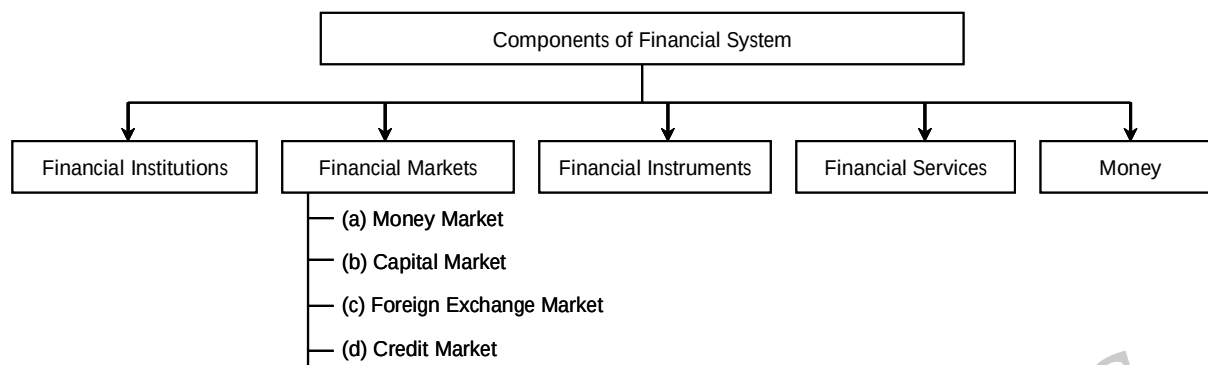
A financial system refers to a system which enables the transfer of money between investors and borrowers. A financial system could be defined at an international, regional or organizational level. The term “system” in “Financial System” indicates a group of complex and closely linked institutions, agents, procedures, markets, transactions, claims and liabilities within an economy.

There are five components of Financial System which is discussed below:

1. Financial Institutions

It ensures smooth working of the financial system by making investors and borrowers meet. They mobilize the savings of investors either directly or indirectly via financial markets by making use of different financial instruments as well as in the process using the services of numerous financial

services providers. They could be categorized into Regulatory, Intermediaries, Non-intermediaries and Others. They offer services to organizations looking for advises on different problems including restructuring to diversification strategies. They offer complete series of services to the organizations who want to raise funds from the markets and take care of financial assets, for example deposits, securities, loans, etc.



2. Financial Markets

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represent a claim to the payment of a sum of money sometime in the future and /or periodic payment in the form of interest or dividend. There are four components of financial market are given below:

- (a) Money Market:** The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.
- (b) Capital Market:** The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.
- (c) Foreign Exchange Market:** The Foreign Exchange market deals with the multicurrency requirements which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated markets across the globe.
- (d) Credit Market:** Credit market is a place where banks, Financial Institutions (FIs) and Non Bank Financial Institutions (NBFCs) purvey short, medium and long-term loans to corporate and individuals.

3. Financial Instruments

Financial instruments refer to those documents which represent financial claims on assets. financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: Bill of exchange, Promissory Note, Treasury Bill, Government Bond, Deposit receipt, Share, Debenture, etc.

4. Financial Services

It consists of services provided by Asset Management and Liability Management Companies. They help to get the required funds and also make sure that they are efficiently invested. They assist to

determine the financing combination and extend their professional services up to the stage of servicing of lenders. They help with borrowing, selling and purchasing securities, lending and investing, making and allowing payments and settlements and taking care of risk exposures in financial markets. These range from the leasing companies, mutual fund houses, merchant bankers, portfolio managers, bill discounting and acceptance houses.

The financial services sector offers a number of professional services like credit rating, venture capital financing, mutual funds, merchant banking, depository services, book building, etc. Financial institutions and financial markets help in the working of the financial system by means of financial instruments. To be able to carry out the jobs given, they need several services of financial nature. Therefore, financial services are considered as the 4th major component of the financial system.

5. Money

It is understood to be anything that is accepted for payment of products and services or for the repayment of debt. It is a medium of exchange and acts as a store of value. It eases the exchange of different goods and services for money.

Q4. Elucidate the importance of financial instruments in Indian Financial System.

Ans :

Generally speaking, financial instruments possess the following characteristic features:

- (i) Most of the instruments can be easily transferred from one hand to another without many cumbersome formalities.
- (ii) They have a ready market, i.e., they can be bought and sold frequently and thus trading in these securities is made possible.
- (iii) They possess liquidity, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.

- (iv) Most of the securities possess security value, i.e., they can be given as security for the purpose of raising loans.
- (v) Some securities enjoy tax status, i.e., investments in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits. E.g., Public Sector Tax free Bonds, Magnum Tax Saving Certificates.
- (vi) They carry risk in the sense that there is uncertainty with regard to payment of principal or interest or dividend as the case may be.
- (vii) These instruments facilitate futures trading so as to cover risks due to price fluctuations, interest rate fluctuations, etc.
- (viii) These instruments involve less handling costs since expenses involved in buying and selling these securities are generally much less.
- (ix) The return on these instruments is directly in proportion to the risk undertaken.
- (x) These instruments may be short-term or medium-term or long-term depending upon the maturity period of these instruments.

Q5. Explain various types of financial instruments.

Ans :

1. Deposits

Deposits include all claims on the central bank and other depository corporations, represented as bank deposits. In some cases, other financial corporations may also accept deposits. Deposits of depository corporations can fall into two categories: transferable deposits and other deposits (non-transferable deposits). Normally, separate sub-categories are used for deposits denominated in national currency and for those in foreign currency.

2. Special Drawing Rights (SDRs)

SDRs are international reserve assets created by the IMF and allocated to member countries to supplement existing official reserves. SDRs are not treated as the IMF's liability. SDRs are held only by the IMF

member countries and by a limited number of international financial organizations. SDR holdings are held exclusively by official authorities, which are normally the central banks. Transactions in SDRs between the IMF members or between the IMF and its members are treated as financial transactions. SDR holdings represent unconditional rights to holders to obtain foreign exchange or other reserve assets from other IMF members.

3. Loans

Loans are financial assets that are :

- Created when a creditor lends funds directly to a debtor (borrower),
- Evidenced by non-negotiable documents.

(i) **Short-term loans** - short-term loans normally involve loans with maturity of one year or less. However, for reconciliation of different practices between the countries, short-term loans can be defined including loans with maturity of up to two years. All loans that will mature upon request are classified as short-term, even if it is expected that these loans will not be repaid within one year.

(ii) **Medium-term loans** - depending on practices applied in countries, loans with maturity from 1 to 5 years are classified as medium-term loans.

(iii) **Long-term loans** - long-term loans include the loans with maturity that exceeds those of short- and medium-term loans.

According to statistical classification, repo agreements, financial leasing, factoring operations and other similar agreements are classified under the category of loans.

4. Shares and Other Equity

Shares are financial instruments that represent or provide evidence on ownership rights of the holders over enterprises or

organizations, including financial institutions. Shares and other equity comprise all instruments and records acknowledging, after the claims of all creditors have been met, claims on the residual value of a corporation (companies, corporations). Normally, these instruments entitle the holders both of distributed profits of enterprises or organizations, and the residual value of the assets in the event of liquidation. Ownership of equity is usually evidenced by shares, stocks, participation's and similar documents. This category also includes preferred shares that provide for participation in the residual value on dissolution of an enterprise.

Types of equity are:

- **Ordinary shares** - That provide for ownership right in an enterprise or corporation;
- **Preferred shares** - That provide right for claim over residual value of an enterprise,
- **Equity participation** - It is deals with limited liability companies.

5. Debentures (or) Bonds

The term 'creditorship securities' also known as 'debt capital' represents debentures and bonds. They occupy a significant place in the financial plan of the company. A debenture (or) a bond is an acknowledgment of A debt. It is a certificate issued by a company under its seal acknowledging A debt due by its holders.

Types of debentures and bonds

- Unsecured and secured debentures
- Redeemable and irredeemable debentures
- Zero interest bonds/debentures
- Zero coupon bonds
- Guaranteed debentures
- Collateral debentures

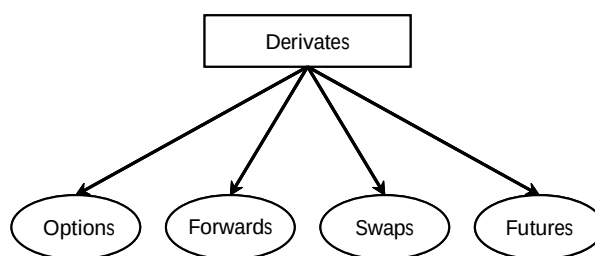
6. Other Account Receivables and Payables

Accounts receivable/payable include trade credits, advances and other receivables or payables. Trade credits comprise trade credit extended directly to buyers of goods and services (enterprises, government, NPISHs, households, and nonresidents). Advances are prepayments made for work that is in progress or for purchase of goods and services. Any agreement, which does not assume direct payment by cash or other financial instrument to purchase goods or services, will create a trade credit extended by the seller to the buyer. Here, it does not involve loans acquired to finance the trade credit since these credits are classified under the category of loans. This category includes only direct trade credits and advances. This category includes also items such as debtors and creditors, tax liabilities and other accounts receivable/payable.

7. Financial Derivatives

Financial derivatives are financial instruments that are linked to specific assets (other financial instruments, goods). By nature, these instruments are similar to contingent instruments. Claims and liabilities related to financial instruments will arise after a specific period of time. In this case, contingency of an instrument relates only to the time regardless of occurrence of any other event or condition. Derivative instruments are not considered a financial claim or liability for the holder thereof at the given moment.

However, financial derivatives can be traded in the market and thus they will obtain a market value, which will depend on the market price of the underlying financial or nonfinancial asset. Thus, the price of a derivative instrument 'derives' from the price of the underlying asset. In the event when the contract price of the underlying financial asset is preferable to the current market price, the derivative would have a positive market value. If a financial derivative instrument has a market value it must be recorded in the balance sheet as a financial asset.



(i) Forwards

In a forward contract, the counterparties agree to exchange, on a specified date, a specified quantity of an underlying item (financial or real asset) at an agreed-upon contract price. Execution of a forward contract is mandatory but only in the case of expiry of the period specified in the contract. Each of the counterparties has both claim and liability upon execution. The net value of the instrument (difference between claims and liabilities) is zero.

(ii) Futures

A future contract is an agreement between seller and the buyer that calls for the seller to deliver to the buyer a specific quantity, grade of an identified commodity at a fixed time in the future and at a price agreed to when the contract is first entered into.

(iii) Options

The buyer of an option acquires the right but not the obligation to purchase or sell a specific asset. Options too, contain contingency: the acquire of an option may not wish to exercise it. The buyer pays a certain amount to the seller of the option and thus acquires the right but not the obligation to sell or purchase a specified item at an agreed-upon price in a specified period. The buyer of an option can sell the option contract, i.e. the right to exercise the option, whereby the option obtains a market value. The statistical recording of options should be carried out in the same way as for the forwards.

(iv) Swaps

A swap represents a spot purchase (sale) of a financial asset with a condition of forward sale (purchase).

Swap agreement is a type of a forward, in which the parties agree to exchange different currencies, that is to buy (sell) any currency for another currency in spot market and concluding at the same time a repurchase agreement on sale (purchase) of these currencies in forward market at prices determined beforehand, pursuant to the rules specified.

Types of SWAPs

- Interest rate Swaps
- Currency Swaps

8. Letter of Guarantee

Guarantee involves an obligation by the economic entity to assume the other entity's financial obligation if that other party defaults. To issuer, a guarantee is not treated as a financial liability as far as the party, to whom the guarantee has been issued, has not shown its inability to meet such a liability. Therefore, until availability of this condition, letters of guarantee will be recorded as off-balance sheet items.

9. Letter of Credits

A letter of credit is an obligation to make payment against documents received. The amounts to be paid upon receipt of the documents become liabilities of the bank. Letters of credit are used to finance international trade operations.

Q6. What are the innovative financial instruments devised for raising new funds? Explain.

Ans : (Imp.)

- (i) Equity Warrants** - The equity warrants is a paper attached to a bond preferred stock that gives the holder the right to buy a fixed number of company's equity shares at a predetermined price at a future date.

- (ii) Secured Premium Notes (SPNs)** - The secured premium note is a tradable instrument with detachable warrant against which the holder gets equity shares after a fixed period of time.

- (iii) Callable Bond** - A callable bond is a bond that can be called in and paid off by issuer at a price, called the 'call price' stipulated in the bond contract. It gives the advantage to issuer company to call the existing bonds if the interest rates fall in the market below the bond's coupon rate.

- (iv) Floating / Variable or Adjustable Rate Bonds** - The rate of interest payable on these bonds varies periodically depending upon the market rate of interest payable on the gift-edged securities.

- (v) Deep Discount Bonds (DDBs)** - The deep discount bond does not carry any interest but it is sold by the issuer company at a deep discount from its eventual maturity (normal) value.

- (vi) Inflation Adjusted Bonds (IABs)** - These are the bonds on which both interest as well as principal are adjusted in line with the price level changes or the inflation rate.

Q7. What are ADR's and GDR's?

Ans :

(i) American Depositary Receipt (ADR)

American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares - or as little as one share - investment in a foreign company's stock. The ADR trades on markets in the U.S. as any stock would trade.

ADRs represent a feasible, liquid way for U.S. investors to purchase stock in companies abroad. Foreign firms also benefit from ADRs, as they make it easier to attract American investors and capital - without the hassle and expense of listing themselves on U.S. stock exchanges. The certificates also provide access to foreign listed companies that would not be open to U.S. investment otherwise.

(ii) Global Depositary Receipt (GDR)

A global depositary receipt (GDR) is very similar to an American depositary receipt (ADR). It is a type of bank certificate that represents shares in a foreign company, such that a foreign branch of an international bank then holds the shares. The shares themselves trade as domestic shares, but, globally, various bank branches offer the shares for sale. Private markets use GDRs to raise capital denominated in either U.S. dollars or euros. When private markets attempt to obtain euros instead of U.S. dollars, GDRs are referred to as EDRs.

Investors trade GDRs in multiple markets, which they generally refer to as capital markets as they are considered to be negotiable certificates. Investors use capital markets to facilitate the trade of long-term debt instruments and for the purpose of generating capital. GDR transactions in the international market tend to have lower associated costs than some other mechanisms that investors use to trade in foreign securities.

Q8. Write a short note on financial markets and its types.**(OR)****Brief on the classification of financial markets.****Ans : (June-19, Imp.)**

A financial market is a market in which people and entities can trade financial securities, commodities and other fungible assets at prices that are determined by pure supply and demand principles. Markets work by placing the two counterparts, buyers and sellers, at one place so they can find each other easily, thus facilitating the deal between them.

1. Capital market

The capital market aids raising of capital on a long-term basis, generally over 1 year. It consists of a primary and a secondary market and can be divided into two main subgroups – Bond market and Stock market.

- The Bond market provides financing by accumulating debt through bond issuance and bond trading
- The Stock market provides financing by sharing the ownership of a company through stocks issuing and trading

A primary market, or the so-called “new issue market”, is where securities such as shares and bonds are being created and traded for the first time without using any intermediary such as an exchange in the process. When a private company decides to become a publicly-traded entity, it issues and sells its stocks at a so-called Initial Public Offering. IPOs are a strictly regulated process which is facilitated by investment banks or finance syndicates of securities dealers that set a starting price range and then oversee its sale directly to the investors.

A secondary market, or the so-called “aftermarket” is the place where investors purchase previously issued securities such as stocks, bonds, futures and options from other investors, rather from issuing companies themselves. The secondary market is where the bulk of exchange trading occurs and it is what people are talking about when they refer to the “stock market”. It includes the NYSE, Nasdaq and all other major exchanges.

2. Money market

The money market enables economic units to manage their liquidity positions through lending and borrowing short-term loans, generally under 1 year. It facilitates the interaction between individuals and institutions with temporary surpluses of funds and their counterparts who are experiencing a temporary shortage of funds.

Q9. Define financial services. Explain the objectives of financial services.**Ans : (June-19)****Meaning**

The term “Financial Services” in a broad sense means “mobilizing and allocating savings”. Thus, it includes all activities involved in the transformation of saving into investment.

The 'financial service' can also be called 'financial intermediation'. Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key area and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilise the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

Objectives

The major objectives of financial services can be summarised as follows,

(i) Fund Raising

Raising of funds is the primary function of financial services. It raises funds from investors, individuals and institutions through a wide range of instruments. The funds raised are again made available to the needs of individuals, corporate and institutions.

(ii) Funds Deployment

Financial services help in effective and optimum deployment of funds raised. A major function of financial services is assisting in deciding to optimum financing mix for their corporate clients.

(iii) Specialisation

Specialised services like credit research and credit rating, leasing, venture factoring capital financing, book building etc., are also performed by financial services besides the regular banking and insurance functions. Stock exchanges, specialised and general financial institutions, non-banking also provides these services.

(iv) Economic Growth

It also performs the function of accelerating economic growth through mobilisation of savings. Financial services aim at developing an economy through channelising the savings into profitable investments.

(v) Regulation

Financial services activities are regulated by SEBI, RBI and the development of banking and insurance of government of India, through names and rules of legislations.

Q10. Discuss the various functions rendered by Indian financial services.

Ans :

- (i) Facilitating transactions (exchange of goods and services) in the economy.
- (ii) Mobilizing savings (for which the outlets would otherwise be much more limited).
- (iii) Allocating capital funds (notably to finance productive investment).
- (iv) Monitoring managers (so that the funds allocated will be spent as envisaged).
- (v) Transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it).

Q11. Elucidate the importance of financial services in Indian financial system.

Ans :

The successful functioning of any financial system depends upon the range of financial services offered by financial service organisations. The importance of financial services may be understood from the following points:

1. Economic growth

The financial service industry mobilises the savings of the people, and channels them into productive investments by providing various services to people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. Promotion of savings

The financial service industry mobilises the savings of the people by providing transformation services. It provides liability, asset and size transformation service by providing huge loan from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. Capital formation

Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. Creation of employment opportunities

The financial service industry creates and provides employment opportunities to millions of people all over the world.

5. Contribution to Gross National Product (GNP)

Recently the contribution of financial services to GNP has been increasing year after year in almost countries.

6. Provision of liquidity

The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.

1.3 FUNCTIONS OF FINANCIAL SYSTEM

Q12. Describe the various functions of financial system.

(OR)

Explain the functions of financial system.

Ans : (June-19(MGU), Imp.)

1. Provision of Liquidity

The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. The term liquidity refers to cash or money and other assets which can be converted into cash readily without loss.

Hence, all activities in a financial system are related to liquidity – either provision of liquidity or trading in liquidity. In fact, in India

the RBI has been vested with the monopoly power of issuing coins and currency notes. Commercial banks can also create cash (deposit) in the form of 'credit creation' and other financial institutions also deal in monetary assets. Over supply of money is also dangerous to the economy. In India the RBI is the leader of the financial system and hence it has to control the money supply and creation of credit by banks and regulate all the financial institutions in the country in the best interest of the nation. It has to shoulder the responsibility of developing a sound financial system by strengthening the institutional structure and by promoting savings and investment in the country.

2. Mobilization of Savings

Another important activity of the financial system is to mobilise savings and channelise them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of saving into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

3. Size Transformation Function

Generally, the savings of millions of small investors are in the nature of a small unit of capital which cannot find any fruitful avenue for investment unless it is transformed into a perceptible size of credit unit. Banks and other financial intermediaries perform this size transformation function by collecting deposits from a vast majority of small customers and giving them as loan of a sizeable quantity. Thus, this size transformation function is considered to be one of the very important functions of the financial system.

4. Maturity Transformation Function

Another important function of the financial system is the maturity transformation function. The financial intermediaries accept deposits from public in different maturities according to their liquidity preference and

lend them to the borrowers in different maturities according to their need and promote the economic activities of a country.

5. Risk Transformation Function

Most of the small investors are risk-averse with their small holding of savings. So, they hesitate to invest directly in stock market. On the other hand, the financial intermediaries collect the savings from individual savers and distribute them over different investment units with their high knowledge and expertise. Thus, the risks of individual investors get distributed. This risk transformation function promotes industrial development. Moreover, various risk mitigating tools are available in the financial system like hedging, insurance, use of derivatives, etc.

1.4 FLOW OF FUNDS MATRIX

Q13. Describe the working of flow of funds matrix.

(OR)

Explain the working mechanism of Flow of Funds Matrix.

Ans :

(Imp.)

Introduction

Accounting of flow of funds is used to analyse borrowings and lendings in financial markets. It traces financial transactions by recording the payments each sector makes to other sectors and the amounts it receives from them.

Meaning

Flow of funds accounting is a record of payments between various sectors of the economy. This record is prepared with the help of "sources and uses of funds" statements of the various sectors.

Uses

Flow of funds accounting is put to different uses.

- It is very useful in analysing what happens in various financial markets.
- It traces the financial flows that interact with and influence the "real" saving-investment process.
- It records the financial transactions underlying, real saving and investments.

Sources and Uses of Funds

A "sources and uses of funds" statement for a sector is simply the integration of its income statement with its balance sheet.

A simplified income statement for any sector would look like as follows:

Uses of Funds (on current account)	Sources of Funds (on current account)
Current Expenditure/Savings (Addition to net worth)	Current Receipts
Total	Equals Total

Table (a) : An Income Statement for a Single Sector

An income statement like the one in Table (a) above simply records a sector's receipts during a period of time as a source (inflows) of funds, and its current expenditure as its uses (outflows) of funds.

Current receipts would be different for different sectors of the economy.

For the Household Sector, current receipts consist mainly of wages and salaries for the Business Sector, these would consist of sales receipts, and for the Government Sector, these would consist of tax revenues.

Likewise, the current expenditures of different sectors also differ. Saving, on the 'use' side, is defined as an excess of current receipts of a sector over its current expenditure.

Saving, hence, serves as a balancing entry in an income statement. Thus, the sum of the uses of funds equals the sum of the sources of funds.

Income statements show current receipts and expenditures over a period of time (say, during the year 2000). A balance sheet, on the other hand, shows assets and liabilities at a point of time (say, - on December 31, 2000). A simplified balance sheet for a single sector would look like in Table (b)

Assets	Liabilities and Net Worth
Financial Assets (a) Money (b) Others Real Assets	Liabilities Net Worth
Total	Equals Total

Table (b) : Balance Sheet for a Single Sector as on (say December 2000)

As with income statements, the principal difference between the balance sheets of different sectors relates to the composition of assets and liabilities. Like income statements, balance sheets always balance i.e., the sum of assets equals the sum of liabilities and net worth. Net worth is defined as the difference between assets and liabilities.

To analytical numerical trends during a year, we need data on flows over a period of time. We cannot work with stocks as listed in a balance sheet. The stocks listed in a balance sheet can be converted into flows. For this purpose, we need two balance sheets of the same sector at two different points of time for example, Balance Sheet as on 31.12.2000 and as on 31.12.2001. By comparing them, and recording the changes that have taken place in the values of each of the items, we can convert stocks into flows.

The change (Δ) between two dates could be represented like as in Table (c)

Uses of Funds (on Capital Account)	Sources of Funds (on Capital Account)
Δ Real Assets (Investment)	Δ Net Worth (Saving)

Table (c) : Sources and Uses of Funds Statement on Capital Account

On the uses side, the change in real assets refers to capital expenditure. Capital expenditures involve the purchase of real assets, or what is also called investment.

On the sources side, the change in a sector's net worth during a period is exactly the same thing as "saving on its income statement covering that time interval".

It may further be noted that the totals on the two sides, i.e. uses side and sources side, may not tally. It means that an individual unit or sector may or may not invest just equal to its current saving. If a unit or sector invests an amount equal to its current saving, it is called a Balanced Budget Sector.

If it saves more than it invests, it is called a Surplus Sector.

If it invests more than it saves, it is called a Deficit Sector.

We can now identify the sources and uses of funds for a sector as under :

(i) Sources of funds consist of:

- (a) current receipts
- (b) any increase in a liability item (borrowing)
- (c) any decrease in an asset item (selling off assets, dishoarding)

(ii) Uses of funds consist of :

- (a) current expenditures
- (b) any increase in an asset item – increased holdings of real assets (investment) or financial assets (Lending), or of money (hoarding), (or)
- (c) any decrease in a liability item (debt repayment)

(iii) For any one sector :

Investment + lending + hoarding = saving + borrowing

So if :

Saving > investment, then lending + hoarding > borrowing

And if :

Investment > saving, then borrowing > lending + hoarding

Flow of Funds Matrix for the Whole Economy

We can prepare flow of funds matrix for the whole economy by piecing together uses and sources of funds statements for individual sectors. One sector's payments become another sector's receipts. When we put all these individual sector statements together, we get a flow of funds matrix for the economy as a whole. It is an interlocking grid that reveals financial relationships among all the sectors.

Assuming a total of three sectors, the flow of funds matrix would appear as follows:

Flow of Funds Matrix for the whole economy

	Sector A	Sector B	Sector C	All Sectors
Saving (Δ NW)	μ S s	u S s	u S s	u S s
Investment (Δ RA)	i	i	i	i
Borrowing (Δ L)	b	b	b	B
Lending (Δ FA)	/	/	/	/
Hoarding (Δ M)	$\Sigma^h = \Sigma$	$\Sigma^h = \Sigma$	$\Sigma^h + \Sigma$	$\Sigma^h + \Sigma$

Note : 'The small letters within the matrix represent the data

s = savings,

i = investment,

b = borrowing,

/ = lending,

h = hoarding

and are placed in the appropriate spaces where such data would be entered.

The capital letters simply represent the aggregate sum totals for the whole economy.

Thus, $s + s + s = S$, $i + i + i = L$, etc.

The letters represent uses and sources of funds.

For the whole economy :

Investment + lending + hoarding = saving + borrowing

But since one sector's financial asset is another sector's liability:

Lending + hoarding = borrowing

Therefore Investment = saving

Q14. Explain the Importance of Flow of Funds Matrix.

Ans :

1. The flow of funds accounts is superior to the national income accounts. Even though the latter fairly comprehensive, yet they do not reveal the financial transactions of the economy which the flow of funds accounts do.

2. They provide a useful framework for studying the behavior of individual financial institutions of the economy.
3. According of Prof. Goldsmith, they bring "the various financial activities of an economy into explicit statistical relationships with one another and with data on the non-financial activities that generate income and production.
4. They trace the financial flows that interact with and influence the real savings-investment process. They record the various financial transactions underlying savings and investment.
5. They are essential raw materials for any comprehensive analysis of capital market behaviour. They help to identify the role of financial institutions in the generation of income, savings and expenditure, and the influence of economic activity on financial markets.
6. The flow of funds accounts show how the government finances its deficit and surplus budget and acquires financial assets.
7. They also show the results of transactions in government and corporate securities, net increase in deposits and foreign assets in the economy.
8. The flow of funds accounts help in analysing the impact of monetary policies on the economy as to whether they bring stability or instability or economic fluctuations.

Q15. Explain the limitation of flow of funds matrix.

Ans :

The flow of funds accounts are beset with a number of problems which are discussed as under:

1. The flow of funds accounts are more complicated than the national income accounts because they involve the aggregation of a large number of sectors with their very detailed financial transactions.
2. There is the problem of valuation of assets. Many assets, claims and obligations have no fixed value. It, therefore, becomes difficult to have their correct valuation.

3. The problem of inclusion of non-reproducible real assets arises in the flow of funds accounts. Economists have not been able to decide as to the type of reproducible assets which may be included in flow of funds accounts.
4. Similarly, economists have failed to decide about the inclusion of human wealth in flow of funds accounts.

Despite these problems, the flow of funds accounts supplements the national income accounts and help in understanding social accounts of an economy.

1.5 FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

Q16. Explain the role of financial system in economic development.

(OR)

Write a short note on role of financial system in country's economic development.

Ans : (June-19(MGU), Imp.)

The financial system plays a significant role in the process of economic development of a country. The financial system comprises of a network of commercial banks. Non-banking companies, development banks and other financial and investment institutions offer a varieties of financial products and services to suit to the varied requirements of different categories of people. Since they function in a fairly developed capital and money markets, they play a crucial role in spurring economic growth in the following ways:

(i) Mobilising Savings

The financial system mobilises the savings of the people by offering appropriate incentives and by deepening and widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system, all savings would remain idle in the hands of the savers and they would not have flown into productive ventures.

(ii) Promoting Investments

For the economic growth of any nation, investment is absolutely essential. This, investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods and services and incomes in the country. The financial system collects the savings and channels them into investment which contributes positively towards economic development.

(iii) Encouraging Investments in Financial Assets

The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money and monetary assets) as against physical assets (land, gold and other goods and services). The investments in physical assets are speculative and would breed inflation.

On the other hand investments in financial assets are non-inflationary in nature and would aid growth in the economy. The larger the proportion of the financial assets, the greater is the scope for economic growth in the long run.

(iv) Allocating Savings on the Basis of National Priorities

Above all, the financial system allocates the savings in a more efficient manner so that the scarce capital may be more efficiently utilised among the various alternative investments. In other words, it gives preference to certain sectors, from the social and economic point of view, on the basis of national priorities.

(v) Creating Credit

Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system not only in the form of liquid cash but also in the form of 'created money' (or) 'deposit money' by creating credit and thereby

making available large resources to finance trade, production, distribution, etc. Thus, it accelerates economic growth by facilitating the transactions of trade, production and distribution on a large-scale.

(vi) Providing a Spectrum of Financial Assets

The financial system provides a spectrum of financial assets so as to meet the varied requirements and preferences of household. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity and risk. Thus, it contributes to the economic development of a country.

(vii) Financing Trade, Industry and Agriculture

All the financial institutions operating in a financial system take all efforts to ensure that no worthwhile project be it in trade or agriculture or industry suffers due to lack of funds. Thus, they promote industrial and agricultural development which have a greater say on the economic development of a country.

(viii) Encouraging Entrepreneurial Talents

The financial institutions encourage the managerial and entrepreneurial talents in the economy by promoting the spirit of enterprise and risk taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.

(ix) Providing Financial Services

Sophistication and innovations have started appearing in the arena of financial intermediations as well. The financial institutions play a very dynamic role in the economic development of a country not only as a provider of finance, but also as a departmental store of finance by offering varieties of innovative financial products and services to meet the ever increasing demands of their clients both corporates and individuals.

(x) Developing Backward Areas

The integral policy of the national development plans of every country concentrates on the development of relatively less developed areas called backward areas. The financial institutions provide a package of services, infrastructure and incentives conducive to a healthy growth of industries in such backward areas and thus they contribute for the uniform development of all regions in a country.

Q17. Discuss the indicators of financial development.

Ans :

The various measures or indicators to denote the extent, stage, degree of financial development are:

- (a) Finance Ratio (FR):** The ratio of total issues of primary and secondary claims to national income.
- (b) Financial Interrelation Ratio (FIR) :** The ratio of financial assets to physical assets in the economy.
- (c) New Issue Ratio (NIR):** The ratio of primary issues to the physical capital formation which indicates how far investment has been financed by direct issues to the savers by the investing sectors.
- (d) Intermediation Ratio (IR):** The ratio of secondary issues to primary issues, which indicates the extent of development to financial institutions as mobilisers of funds relative to real sectors as direct mobilisers of funds. It indicates institutionalization of the financial activity in the economy.
- (e) Ratio of money to national income:** The higher this ratio the greater the financial development because it indicates the extent monetization and the size of exchange economy in the country.
- (f)** The proportion of current account deficit which is financed by market related flows. The higher this ratio, the greater the financial

development, while the reliance on official economic assistance for financing such deficit dentures financial underdevelopment.

- (g)** Developed financial sector is fully integrated domestically as well as internationally. In such a system, the risk-adjusted rate of return on any one investment would not differ significantly from the rate of return on any of the other investments.
- (h)** The lower the transaction cost and information cost, the higher the financial development.
- (i)** In a developed financial system, private banking and not public sector banking is predominant, there is little Government intervention in credit allocation, and concentration of banking is absent.
- (j)** The functioning of the developed financial markets is characterized by the effective and quick enforcement of financial contracts, recovery of loans and property rights.
- (k)** The greater the financial development, the greater the openness of the economy reflected in a high level of current and capital account openness, minimum restrictions on foreign ownership of assets and repatriation of earnings and the absence of parallel foreign exchange market.
- (l)** A developed financial structure is characterized by the presence of strong, active, large-sized non-bank financial sector comprising stock market, debt market, insurance companies, pension funds, mutual funds etc.

1.6 RECENT DEVELOPMENTS IN INDIAN FINANCIAL SYSTEM
Q18. Explain the Recent changes in Indian financial system.

(OR)

Explain the Recent developments in Indian financial system.

(OR)

Give your views on developments in Indian financial system since independence.

Ans : (June-19, Imp.)

India has a diversified financial system with a rapid growth in both existing financial services firms and new institutions entering in the market. The financial system of India plays a significant role in the development of Indian economy. It consists of commercial banks, insurance companies, non-banking financial companies, co-operatives, pension funds, mutual funds and other small financial companies .

The recent developments of Indian financial system by the government and the Reserve Bank of India (RBI) are as below,

- (i) The Indian Mutual Fund (MF) industry experiencing a rapid growth in Assets under Management (AUM). In February 2018, the Mutual Fund (MF) equality portfolio's acquired a record of 2.27 billion and in April 2018, the total AUM of the industry has ` 23.26 (lakh crore).
- (ii) It is forecasted that, there is a rise in investments in the mutual funds, financial instruments and the brokerage industry upto 15 to 20% in a way to reach ` 18,000 to 19,000 crore.
- (iii) Insurance industry which is considered as the significant component of Indian financial industry has a growth of 17.35% every year inorder to reach US \$ 25.44 billion for the year April-2017 to February 2018.
- (iv) The initial public offerings has experienced a rapid growth of ` 84,357 crore (US \$ 13,089 million) by the end of financial year 2018.
- (v) The mergers and acquisitions has experienced a growth of 53.3% in tic past few years.
- (vi) India's leading stock exchange i.e., Bombay Stock Exchange (BSE) is going to initiate a joint venture with Ebix Inc, to setup of strong insurance distribution network.
- (vii) In 2017, there is a growth of 59% to US \$ 24.4 billion with average deal size of US \$ 42.8 in the Private Equity (PE) investments.
- (viii) The total equity funding's of micro finance sector rised 39.88 to ` 96.31 billion in May 2018.

1.7 WEAKNESSES OF INDIAN FINANCIAL SYSTEM

Q19. Explain the weaknesses of Indian financial system.

(OR)

Discuss the deficiencies of Indian financial system.

(OR)

Write the consequences of Indian financial system.

Ans : (Imp.)

(i) Lack of Co-ordination between different Financial Institutions

There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

(ii) Monopolistic Market Structures

In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance the entire life insurance business is in the hands of LIC. The UTI has more or less monopolised the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilising savings of the public and so on. Ultimately it would retard the development of the financial system of the country itself.

(iii) Dominance of Development Banks in Industrial Financing

The development banks constitute the backbone of the Indian financial system

occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds from their sponsors. As such, they fail to mobilise the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalisation of personal savings through media like banks, LIC, pension and provident funds, unit trusts and so on. But they play a less significant role in Indian financial system, as far as industrial financing is concerned. However, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and so on. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

(iv) Inactive and Erratic Capital Market

The important function of any capital market is to promote economic development through mobilisation of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

(v) Imprudent Financial Practice

The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make matters worse, when corporate enterprises face any financial crisis, these financial institutions permit a greater use of debt than is warranted. It is against the traditional concept of a sound capital structure.

However, in recent times all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian financial system has become a developed one.

Q20. Explain the role of Indian financial institutions in promoting capital formation.

Ans :

(Imp.)

The financial system of India plays a significant role in the development of Indian economy, with the help of savings and investment process which is also known as capital formation. Due to this reason, the financial system is also called as financial market. The main objective of the financial market is to mobilize or assemble the savings adequately and distribute it among the ultimate investors.

A high rate of capital formation is the prerequisite for attaining rapid economic development. The capital formation process relies on the following factors,

- (i) Increase in savings which means the resources which were utilized for the purpose of consumption, can be available for other purposes.

- (ii) Collection or mobilization of savings which means the domestic savings mobilized by banks and financial institutions, are available for the investors to use.
- (iii) Investment which means the production of the capital goods.

The real capital formation is the third stage in the capital formation process, which can arise only after the completion of first two stages. Therefore, the people must save and release the resources from consumption goods to capital goods. The banking and financial institutions should collect or mobilize the savings of the individuals and ultimately, these savings must be placed at the disposal of the investors for producing the capital goods. These three stages, inspite of being independent of each other are needed for the capital formation. The banking and financial institutions play a significant role in the formation of capital, as in India, the savers and investors are not the same institutions or same persons. Thus, the savers and investors are brought together by the banking and financial institutions.

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Short Question and Answers

1. Write about Indian Financial system focusing on financial services.

Ans :

The term "Financial Services" in a broad sense means "mobilizing and allocating savings". Thus, it includes all activities involved in the transformation of saving into investment.

The 'financial service' can also be called 'financial intermediation'. Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key area and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilise the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

2. Write a short note on role of financial system in country's economic development.

Ans :

The financial system plays a significant role in the process of economic development of a country. The financial system comprises of a network of commercial banks. Non-banking companies, development banks and other financial and investment institutions offer a varieties of financial products and services to suit to the varied requirements of different categories of people. Since they function in a fairly developed capital and money markets, they play a crucial role in spurring economic growth in the following ways:

- (i) Mobilising Savings
- (ii) Promoting Investments
- (iii) Encouraging Investments in Financial Assets
- (iv) Allocating Savings on the Basis of National Priorities

- (v) Creating Credit
- (vi) Providing a Spectrum of Financial Assets
- (vii) Financing Trade, Industry and Agriculture
- (viii) Encouraging Entrepreneurial Talents
- (ix) Providing Financial Services
- (x) Developing Backward Areas

3. What are ADR's and GDR's?

Ans :

- (i) **ADR:** An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares - or as little as one share - investment in a foreign company's stock. The ADR trades on markets in the U.S. as any stock would trade.

ADRs represent a feasible, liquid way for U.S. investors to purchase stock in companies abroad. Foreign firms also benefit from ADRs, as they make it easier to attract American investors and capital - without the hassle and expense of listing themselves on U.S. stock exchanges. The certificates also provide access to foreign listed companies that would not be open to U.S. investment otherwise.

- (ii) **GDR:** A global depositary receipt (GDR) is very similar to an American depositary receipt (ADR). It is a type of bank certificate that represents shares in a foreign company, such that a foreign branch of an international bank then holds the shares. The shares themselves trade as domestic shares, but, globally, various bank branches offer the shares for sale. Private markets use GDRs to raise capital denominated in either U.S. dollars or euros. When private markets attempt to obtain euros instead of U.S. dollars, GDRs are referred to as EDRs.

Investors trade GDRs in multiple markets, which they generally refer to

as capital markets as they are considered to be negotiable certificates. Investors use capital markets to facilitate the trade of long-term debt instruments and for the purpose of generating capital. GDR transactions in the international market tend to have lower associated costs than some other mechanisms that investors use to trade in foreign securities.

4. Write about Indian Financial system focusing on organized sector.

Ans :

The organized or the formal financial system consists of a network of banks, financial institutions, investment institutions and a range of financial instruments, that function in developed capital and money markets. Organized financial system comes under the responsibility of MOF-Ministry of Finance, RBI-Reserve Bank of India, SEBI-Securities and Exchange Board of India and some other regulatory bodies. The organized financial system is divided into four components. They are,

(i) Financial Institutions: Financial institutions are intermediaries that mobilize savings and help in the allocation of funds in an appropriate way. Financial institutions are classified into four segments - Banking Institutions, non-banking Institutions and Investment Institutions like-mutual funds and housing finance companies. Financial institutions include,

- (a) Non-banking financial institutions like DFIs, NBFCs, FIFCs etc.
- (b) Term-finance institutions like IDBI, ICICI, IFCI, SIDBI and IIBI.
- (c) Specialized Financial Institutions like EXIM, TFCI, IDFC, NABARD, NHB.
- (d) Mutual Funds such as UTI.
- (e) Insurance Activities such as LIC, GIC.
- (f) State Level Financial Institutions such as SFCs and SIDCs.

(ii) Financial Markets

These are intermediations where the general public or the business organization come together to get their fund requirement fulfilled.

These may be primary market, where the givers and takers of fund meet for the first time and the secondary market, where the investment procured in the primary market are bought and sold. The financial markets are of two kinds, capital market and the money market. The capital market helps in raising the long term funds for business and the money market helps in raising short term finance for the business.

5. Write a short note on financial markets and its types.

Ans :

A financial market is a market in which people and entities can trade financial securities, commodities and other fungible assets at prices that are determined by pure supply and demand principles. Markets work by placing the two counterparts, buyers and sellers, at one place so they can find each other easily, thus facilitating the deal between them.

(i) Capital market

The capital market aids raising of capital on a long-term basis, generally over 1 year. It consists of a primary and a secondary market and can be divided into two main subgroups – Bond market and Stock market.

- The Bond market provides financing by accumulating debt through bond issuance and bond trading
- The Stock market provides financing by sharing the ownership of a company through stocks issuing and trading

A primary market, or the so-called “new issue market”, is where securities such as shares and bonds are being created and traded for the first time without using any intermediary such as an exchange in the process. When a private company decides to become a publicly-traded entity, it issues and sells its stocks at a so-called Initial Public Offering. IPOs are a strictly regulated process which is facilitated by investment banks or finance syndicates of securities dealers that set a starting price range and then oversee its sale directly to the investors.

A secondary market, or the so-called “aftermarket” is the place where investors purchase previously issued securities such as stocks, bonds, futures and options from other investors, rather from issuing companies themselves. The secondary market is where the bulk of exchange trading occurs and it is what people are talking about when they refer to the “stock market”. It includes the NYSE, Nasdaq and all other major exchanges.

(ii) Money market

The money market enables economic units to manage their liquidity positions through lending and borrowing short-term loans, generally under 1 year. It facilitates the interaction between individuals and institutions with temporary surpluses of funds and their counterparts who are experiencing a temporary shortage of funds

6. Define financial system.

Ans :

Introduction

The economic growth of a nation is dependent on the way the saving that is generated in the economy is transferred to the investment, which gets converted to fruitful production process. This in turn, generates gross output in the economy. This becomes an important point in the measurement of the growth of the national economy.

This above method is known as the capital formation where, it goes through three distinct stages, i.e., Saving, Finance and Investment. Funds flow from the surplus saving to the deficit areas of the economy.

In order to enable capital formation, there is a requirement of intermediation or a system, which will create and channelize saving, leading to capital formation. The system, which does this function in the economy, is called the financial system.

Meaning

A financial system or financial sector functions as an intermediary and facilitates the flow of funds

from the areas of surplus to the areas of deficit. A Financial System is a composition of various institutions, markets, regulations and laws, practices, money manager, analysts, transactions and claims and liabilities.

Definitions

- (i) **According to Amit Chaudhary**, “Financial system is the integrated form of financial institutions, financial markets, financial securities, and financial services which aim is to circulate the funds in an economy for economic growth.
- (ii) **According to Dhanilal**, “Financial system is the set of interrelated and interconnected components consisting of financial institutions, markets, and securities.”

7. Discuss the various functions rendered by Indian financial services.

Ans :

- (i) Facilitating transactions (exchange of goods and services) in the economy.
- (ii) Mobilizing savings (for which the outlets would otherwise be much more limited).
- (iii) Allocating capital funds (notably to finance productive investment).
- (iv) Monitoring managers (so that the funds allocated will be spent as envisaged).
- (v) Transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it).

8. Importance of Flow of Funds Matrix.

Ans :

- (i) The flow of funds accounts is superior to the national income accounts. Even though the latter fairly comprehensive, yet they do not reveal the financial transactions of the economy which the flow of funds accounts do.
- (ii) They provide a useful framework for studying the behavior of individual financial institutions of the economy.

- (iii) According to Prof. Goldsmith, they bring "the various financial activities of an economy into explicit statistical relationships with one another and with data on the non-financial activities that generate income and production.
- (iv) They trace the financial flows that interact with and influence the real savings-investment process. They record the various financial transactions underlying savings and investment.
- (v) They are essential raw materials for any comprehensive analysis of capital market behaviour. They help to identify the role of financial institutions in the generation of income, savings and expenditure, and the influence of economic activity on financial markets.

9. Financial Institutions

Ans :

Financial institutions are intermediaries that mobilize savings and help in the allocation of funds in an appropriate way. Financial institutions are classified into four segments - Banking Institutions, non-banking Institutions and Investment Institutions like mutual funds and housing finance companies. Financial institutions include,

- (a) Non-banking financial institutions like DFIs, NBFCs, FIFCs etc.
- (b) Term-finance institutions like IDBI, ICICI, IFCI, SIDBI and IBI.
- (c) Specialized Financial Institutions like EXIM, TFCI, IDFC, NABARD, NHB.
- (d) Mutual Funds such as UTI.
- (e) Insurance Activities such as LIC, GIC.
- (f) State Level Financial Institutions such as SFCs and SIDCs.

10. Financial Instruments

Ans :

Financial instruments refer to those documents which represent financial claims on assets. financial asset refers to a claim to the

repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: Bill of exchange, Promissory Note, Treasury Bill, Government Bond, Deposit receipt, Share, Debenture, etc.

Financial instruments can also be called financial securities.

Financial securities can be classified into:

- (i) Primary (or) direct securities.
- (ii) Secondary (or) indirect securities.

(i) Primary Securities

These are securities directly issued by the ultimate investors to the ultimate savers.

Example : Shares and debentures issued directly to the public.

(ii) Secondary Securities

These are securities issued by some intermediaries called financial intermediaries to the ultimate savers.

Example : Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows:

(i) Short-term securities: Short-term securities are those which mature within a period of one year.

E.g., Bill of Exchange, Treasury bill, etc.

(ii) Medium-term securities: Medium-term securities are those which have a maturity period ranging between one and five years. E.g., Debentures maturing within a period of 5 years.

(iii) Long-term securities: Long-term securities are those which have a maturity period of more than five years.

E.g., Government Bonds maturing after 10 years.

Choose the Correct Answer

1. Banks implement the RBI's _____ policies. [d]
(a) Monetary (b) Credit
(c) Commercial (d) Both a and b
2. _____ is basically a savings and investment corporation. [a]
(a) UTI (b) IDBI
(c) SBI (d) RBI
3. Financial services through the network of elements such as _____, serve the needs of individuals, institutions and Corporate. [d]
(a) Financial institutions (b) Financial markets
(c) Financial instruments (d) All of the above
4. _____ is regarded as the fourth element of the financial system. [a]
(a) Financial services (b) Financial markets
(c) Financial instruments (d) Financial institutions
5. The term _____ is defined as a central location for keeping securities on deposit. [a]
(a) Depository (b) Instrument
(c) Institutions (d) None of the above
6. Functions of financial services exclude _____. [d]
(a) Mobilization of savings (b) Allocation of fund
(c) Specialized services (d) Collection of tax.
7. Financial service companies exclude _____. [c]
(a) Commercial banks (b) Insurance companies
(c) Sole proprietorship (d) Crepitating agencies.
8. The following one is a financial asset : [c]
(a) gold (b) silver
(c) share (d) land.
9. Which one of the following is a cash asset? [a]
(a) deposit created out of loans (b) share
(c) bond (d) post office certificate.
10. The component of a capital market is : [b]
(a) Treasury Bill Market (b) Government securities Market
(c) Commercial Bill Market (d) (a) and (b) together.

11. The money market instrument is: [d]
(a) Bond (b) Debenture
(c) Stock certificate (d) Certificate of deposit.
12. Government Bond is a : [b]
(a) Short-term security (b) Long-term security
(c) Medium term security (d) Either short-term or long-term security.
13. Financial service institutions pool up savings of small investors to raise funds is _____ [a]
(a) Mutual funds (b) Factoring
(c) Leasing (d) Hire purchase
14. In India, the challenges faced by financial service sector are _____ [d]
(a) No transparency (b) Outdated database
(c) Need for specialisation (d) All the above
15. Debt market comprises of _____ [d]
(a) Corporate debt market (b) Govt, securities market
(c) Money market (d) All the above
16. Which of the following is not a fund-based activity? [b]
(a) Underwriting of shares
(b) Capital issue management
(c) Underwriting of secondary market securities
(d) Foreign exchange activities
17. The capital market involves, [c]
(a) Primary market (b) Secondary market
(c) Both (a) and (b) (d) Money market
18. Financial markets improve economic welfare because _____. [d]
(a) They allow funds to move from those without productive investment opportunities to those who have such opportunities.
(b) They allow consumers to time their purchase better.
(c) They weed out inefficient firms.
(d) They do (a) and (b) of the above.
19. A breakdown of financial markets can result in _____. [c]
(a) An efficient allocation of capital (b) Rapid economic growth
(c) Political instability (d) Stable prices

20. Which of the following can be described as direct finance? [b]
- (a) You take out a mortgage from your local bank.
 - (b) You borrow ` 2500 from a friend.
 - (c) A pension fund lends money to General Motors.
 - (d) You buy shares in a mutual fund.
21. Commercial Bills are a part of which of the following markets? [a]
- (a) Organized money market
 - (b) Unorganized money market
 - (c) Stock market
 - (d) None of the above
22. Reserve Bank of India's functions are classified into _____. [a]
- (a) Supervisory and Regulatory
 - (b) Promotional and Developmental
 - (c) Refinance Activities
 - (d) All of the above

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Fill in the blanks

1. _____ assets are mostly useful for consumption.
2. The market for new issues is called _____ market.
3. Loan against the security of immovable property is called _____.
4. _____ guarantee cover the payment of earnest money, retention money and advance payments.
5. The SHCIL was set up in the year _____.
6. _____ is the set of interrelated and interconnected components consisting of financial institutions, markets, and securities.
7. _____ intermediation should provide convenience for mobilizing saving to be converted into investment.
8. _____ are intermediations where the general public or the business organization come together to get their fund requirement fulfilled.
9. Financial instruments can also be called _____.
10. _____ securities directly issued by the ultimate investors to the ultimate savers.
11. _____ securities are those which mature within a period of one year.
12. _____ securities are those which have a maturity period of more than five years.
13. A _____ market can be defined as the market in which financial assets are created or transferred.
14. The _____ market is designed to finance the long-term investments.
15. NBFC stands for _____.
16. SDR stands for _____.
17. In a _____ contract, the counterparties agree to exchange, on a specified date, a specified quantity of an underlying item.
18. A _____ is an obligation to make payment against documents received.
19. ADR stands for _____.
20. Private markets use _____ to raise capital denominated in either U.S. dollars or euros.
21. _____ statement for a sector is simply the integration of its income statement with its balance sheet.
22. _____ is defined as the different between assets and liabilities.

ANSWERS

1. Physical
2. Primary
3. Mortgage
4. Performance
5. 1987
6. Financial system
7. Financial
8. Financial Markets
9. Financial securities
10. Primary
11. Short-term
12. Long-term
13. Financial
14. Capital
15. Non Bank Financial Institutions.
16. Special Drawing Rights.
17. Forward
18. Letter of credit
19. American Depositary Receipt.
20. GDRs
21. Sources and uses of funds
22. Net worth

UNIT II

FINANCIAL INSTITUTIONS:

Commercial Banking: Types - Functions - Lending by Commercial Banks - Recent Developments - Merchant Banking – functions - Venture Capital – objectives - Private Equity -role in start-ups - Hire purchase and leasing - Non-banking Finance Companies: Types - Functions.

2.1 COMMERCIAL BANKING

Q1. Define Commercial Banks. Bringout the characteristics features of a commercial banks.

Ans : (July-21, Oct.-20, June-19, June-19(MGU), Imp.)

Meaning

Commercial banks are an organization which normally performs certain financial transactions. It performs the twin task of accepting deposits from members of public and make advances to needy and worthy people from the society. When banks accept deposits its liabilities increase and it becomes a debtor, but when it makes advances its assets increases and it becomes a creditor. Banking transactions are socially and legally approved. It is responsible in maintaining the deposits of its account holders.

Definitions

While defining the term banks it is taken into account that what type of task is performed by the banks. Some of the famous definitions are given below:

- i) **According to Prof. Sayers**, "A bank is an institution whose debts are widely accepted in settlement of other people's debts to each other." In this definition Sayers has emphasized the transactions from debts which are raised by a financial institution.
- ii) **According to the Indian Banking Company Act 1949**, "A banking company means any company which transacts the business of banking . Banking means accepting for the purpose of lending of investment of deposits of money from the public, payable on demand or other wise and withdraw able by cheque, draft or otherwise."

Commercial Banks are business enterprises which are involved in finances, financial instruments and provide financial services for a price which maybe in the form of interest, commission or a discount and so on. "They accept deposits of money from the public (savings), for the purpose of lending or investment (to meet working capital requirements or corporates)".

Commercial banks have to perform various functions in the middle of a country's financial system.

Characteristics

i) **Ownership Characteristic of Commercial Bank**

Commercial banks can be formed on the basis of any ownership, such as a proprietorship, partnership or company. If it is formed on a partnership basis, its membership will be up to 10 people. If formed as a company, then it has to be formed according to the law of 1994. Ownership is the best characteristic of the commercial bank. It's a first and the best feature of the bank.

ii) **Taking Deposit Characteristic of Commercial Bank**

One of the main features of the commercial bank is to take the savings of people's money through different types of accounts. People can open their accounts according to their convenience and submit their accumulated money to the bank. These accounts are the current accounts, savings accounts, and permanent accounts.

iii) **Encourage to Savings Characteristics of Commercial Bank**

A prominent feature of the commercial bank is that people are more interested in saving

through extensive publicity. This ensures that more saving storage is collected. It is possible to form capital in the country. Encourage saving is the most effective characteristics of a commercial bank. Increasing the attractiveness of the customer's mind has resulted in an increase in the amount of storage.

2.1.1 Types

Q2. Explain the classification of commercial banks.

Ans :

Commercial banks are categorized as,

- (a) Public sector banks
- (b) Private sector banks
- (c) Foreign banks
- (d) Regional rural banks.

- (a) **Public Sector Banks:** In India, public sector banks are regulated by the various laws and statutes proposed by the parliament. The board of public sector banks comprises directors in the form of chairman, managing director government nominee director, RBI's nominee director and some other elected directors and so on. Till the end of March 2009, the number of public sector banks in India were numbered to 27. (Out of which 20 were nationalised banks was State Bank of India (SBI) and 6 were associates banks of SBI).

Example : State bank of India (SBI), Central Bank of India, Andhra Bank, Bank of Baroda, Punjab National Bank etc.

- (b) **Private Sector Banks:** In March 2009 the number of private sector banks in India were found to be 22. Among them, 15 constituted the old banks while the remaining 7 were new private sector banks. The main purpose behind the allowance of private sector to own and operate banks was to ensure the diversification of ownership and control. New private sector banks are also permitted to enter the market with an initial capital of about 200 crores, which would increase to a total of about 300 crores in the next three

consecutive years. In India for any private sector bank, the aggregate foreign investment is restricted to only 76% of the paid up capital, (i.e., the remaining capital must be contributed by the residents of a country).

Examples : Global Trust Bank Ltd., ICICI Banking Corporation Bank Ltd., Axis Bank, HDFC etc.

- (c) **Foreign Banks:** In India, foreign banks can operate through any one of the following options.

- (i) They can operate through the establishment of their own branches (may be in same country or in some other country).
- (ii) They can also enter the market by establishment of the wholly owned subsidiaries.
- (iii) They can also establish the partly owned subsidiaries with an maximum aggregate investment of about 74 percent (in any private sector bank).

Any foreign bank on establishing its first branch in India is required to invest an initial capital of about 25 million U.S dollars. In March 2009, the number of foreign banks in India were found to be only 32.

Examples: Bank of Tokyo Ltd., Citi Bank N.C, Standard Chartered Bank Ltd., American Express Bank etc.

- (d) **Regional Rural Banks:** There were only 84 Regional Rural Banks in India by the end of March 2009. The main purpose of regional rural banks was to at deliver the rural credit facilities to the backward areas. Thereby, ensuring their financial soundness. Central government respective state government and sponsors (Commercial banks) are responsible for the contribution of initial capital base of RRBs. The regulatory framework of regional rural banks (RRB 's) has been proposed by the Reserve Banks of India (RBI) and NABARD which helps in supervising their operations with some supervisory powers.

Examples: Andhra Pradesh Gra-meena Vikas Bank, Arunachal Pradesh Rural Bank, Baroda Gujrat Bank, Himachal Gramin Bank etc.

Q3. What are the objectives of commercial Bank.**Ans :**

1. To establish as an institution for maximizing profits and to conduct overall economic activities.
2. To collect savings or idle money from the public at a lower rate of interests and lend these public money at a higher rate of interests.
3. To create propensity of savings amongst the people.
4. To motivate people for investing money with a view to bringing solvency in them .
5. To create money against money as an alternative for enhancing supply of money.
6. To build up capital through savings.
7. To expedite investments.
8. To extend services to the customers.
9. To maintain economic stability by means of controlling money market.
10. To extend co-operation and advices to the Govt. on economic issues.
11. To assist the Govt. for trade & business and socio-economic development.
12. To issue and control notes and currency as a central bank.
13. To maintain and control exchange rates as a central bank.

2.1.2 Functions**2.1.2.1 Lending by Commercial Banks****Q4. Explain the functions of commercial banks.****(OR)****Elucidate the functions of commercial banks.****Ans :****(June-19(MGU), Imp.)**

The main functions of commercial banks are accepting deposits from the public and advancing them loans. However, besides these functions there

are many other functions which these banks perform. All these functions can be divided under the following heads:

1. Accepting deposits
2. Giving loans
3. Overdraft
4. Discounting of Bills of Exchange
5. Investment of Funds
6. Agency Functions
7. Miscellaneous Functions

1. Accepting Deposits

The most important function of commercial banks is to accept deposits from the public. Various sections of society, according to their needs and economic condition, deposit their savings with the banks.

For example, fixed and low income group people deposit their savings in small amounts from the points of view of security, income and saving promotion. On the other hand, traders and businessmen deposit their savings in the banks for the convenience of payment.

Therefore, keeping the needs and interests of various sections of society, banks formulate various deposit schemes. Generally, there are three types of deposits which are as follows:

(i) Current Deposits

The depositors of such deposits can withdraw and deposit money whenever they desire. Since banks have to keep the deposited amount of such accounts in cash always, they carry either no interest or very low rate of interest. These deposits are called as Demand Deposits because these can be demanded or withdrawn by the depositors at any time they want.

Such deposit accounts are highly useful for traders and big business firms because they have to make payments and accept payments many times in a day.

(ii) Fixed Deposits

These are the deposits which are deposited for a definite period of time. This period is

generally not less than one year and, therefore, these are called as long term deposits. These deposits cannot be withdrawn before the expiry of the stipulated time and, therefore, these are also called as time deposits..

(iii) Saving Deposits

In such deposits, money up to a certain limit can be deposited and withdrawn once or twice in a week. On such deposits, the rate of interest is very less. As is evident from the name of such deposits their main objective is to mobilize small savings in the form of deposits. These deposits are generally done by salaried people and the people who have fixed and less income.

2. Giving Loans

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income.

Banks advance loans not only on the basis of the deposits of the public rather they also advance loans on the basis of depositing the money in the accounts of borrowers. In other words, they create loans out of deposits and deposits out of loans. This is called as credit creation by commercial banks.

(i) Cash Credit

In this type of credit scheme, banks advance loans to its customers on the basis of bonds, inventories and other approved securities. Under this scheme, banks enter into an agreement with its customers to which money can be withdrawn many times during a year. Under this set up banks open accounts of their customers and deposit the loan money. With this type of loan, credit is created.

(iii) Demand loans

These are such loans that can be recalled on demand by the banks. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower, and thus entire loan becomes chargeable to interest with immediate effect.

(iv) Short-term loan

These loans may be given as personal loans, loans to finance working capital or as priority sector advances. These are made against some security and entire loan amount is transferred to the loan account of the borrower

3. Over-Draft

Banks advance loans to its customer's up to a certain amount through over-drafts, if there are no deposits in the current account. For this banks demand a security from the customers and charge very high rate of interest.

4. Discounting of Bills of Exchange

This is the most prevalent and important method of advancing loans to the traders for shortterm purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

5. Investment of Funds

The banks invest their surplus funds in three types of securities - Government securities, other approved securities and other securities. Government securities include both, central and state governments, such as treasury bills, national savings certificate etc.

Other securities include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks units of UTI, shares of Regional Rural banks etc.

6. Agency Functions

Banks function in the form of agents and representatives of their customers. Customers give their consent for performing such functions. The important functions of these types are as follows:

- (i) Banks collect cheques, drafts, bills of exchange and dividends of the shares for their customers.
- (ii) Banks make payment for their clients and at times accept the bills of exchange: of their customers for which payment is made at the fixed time.

7. Miscellaneous Functions

Besides the functions mentioned above, banks perform many other functions of general utility which are as follows:

- (i) Banks make arrangement of lockers for the safe custody of valuable assets of their customers such as gold, silver, legal documents etc.
- (ii) Banks give reference for their customers.
- (iii) Banks collect necessary and useful statistics relating to trade and industry.
- (iv) For facilitating foreign trade, banks undertake to sell and purchase foreign exchange.
- (v) Banks advise their clients relating to investment decisions as specialist
- (vi) Bank does the under-writing of shares and debentures also.
- (vii) Banks issue letters of credit.
- (viii) During natural calamities, banks are highly useful in mobilizing funds and donations.
- (ix) Banks provide loans for consumer durables like Car, Air-conditioner, and Fridge etc.

Bank Subsidiaries

- Bank Controls One (or) More Subsidiaries.
- Subsidiaries Offer Other Services Such as Insurance and Security Brokerage Services.
- Profits and Losses of Each Subsidiary Impact Parent Bank.

Q5. What are the agency functions of commercial banks.

Ans : (Oct.-20)

Agency Services (or) Agency functions of commercial banks are elaborated in detail below

- 1. Collection of Cheques, Dividends, Interests etc.:** Collecting cheques, drafts, bill of exchange, dividends, interests etc. on behalf of its customers and credit the amount in their account is one of the most important agency services rendered by the banks.

Banker accepts standing instructions from the customers and arranges to collect dividend, interest, pension, salaries, bills etc. on behalf of his customers.

2. Payment of Subscription, Rent, Insurance Premium etc.:

Banks undertake the payment of subscriptions, rent, insurance premium etc. on behalf of the customers and debit the account with the amount. It accepts the standing instructions of the customer and arranges for. The payment of such expenses on their behalf. It charges a small amount by way of commission for these services.

3. Conduct of Stock Exchange Transactions:

Banks purchase and sell various securities such as shares, debentures, bonds etc. of joint stock companies both private and Government on behalf of their customers.

4. Acting as Executor, Trustees, Attorneys etc.:

Banks act as executors of will, trustees, attorneys and administrators. As an executor it preserves the Wills of the customers and executes them after their death. As a trustee, it takes care of the funds of the customers. As an attorney, it signs transfer forms and documents on behalf of the customer.

5. Preparation of Income Tax Returns:

Banks prepare income tax returns for their customers through their tax service departments.

6. Conducting Foreign Exchange Transactions:

Commercial banks purchase and sell foreign exchange for their customers.

7. Banker acts as an agent to the customer:

When a customer deposits cheques, drafts, bills or any other promissory notes, the banker collects them and on realization credits the account of the customer. For this activity, the banker is given commission. Banks also act as a correspondent, representative of their customers. Some banks may even get the travelers' tickets, passport etc. for their customers.

Q6. Explain the limitations of Commercial Banks.

Ans :

Commercial Banks though have the power to create credit, their powers are not unlimited. Certain points affect the process of credit creation. They are termed as limitations to credit creation by commercial banks.

The limitations of credit creation by commercial banks are as follows :

1. Amount of Deposit

The most important factor which decides credit creation is the amount of deposits made by the depositors. Higher is the amount of deposits, greater is the supply of credit and vice versa.

2. Cash Reserve Ratio (CRR)

There exists an indirect relationship between Credit Creation and Cash Reserve Ratio (CRR). Higher is the Cash Reserve Ratio (CRR) more will be the reserves to be maintained and less credit will be created by banks. The CRR is fixed by the RBI in India. It ranges between 3% to 15%.

3. Banking Habits of People

If the banking habits of the people are well-developed, then all their transactions would be through banks, and this will lead to expansion of credit and vice-versa.

4. Supply of Securities

Loans are sanctioned on the basis of the securities provided to the banks. If securities are available then the credit creation will be more and vice-versa.

5. Willingness of people to borrow

Commercial banks may have enough money to lend. Customers should be willing to borrow from the banks to facilitate credit creation. If they are willing to borrow, then the credit created by banks will be less.

6. Monetary Policy of Central Bank

While credit is created by commercial banks, it is controlled by the Central Bank. Credit control is one important function of the central bank. Central Bank uses various methods of Credit Control from time to time and thus influences the banks to expand or contract credit.

7. External Drain

External Drain refers to withdrawal of cash from the banking system by the public. It lowers the reserves of the banks and limits the credit creation.

8. Uniform Policy

If all the commercial banks follow a uniform policy related to CRR, then credit creation would be smooth. If some banks follow liberal and others follow a conservative one, then credit creation would be affected.

2.1.3 Recent Developments

Q7. Explain the growth of commercial banks in India.

(OR)

Give your views on developments in commercial banks since independence.

Ans :

(July-21, Imp.)

1. Nationalization of Banks

The role of the public sector in commercial banking has been greatly enhanced through progressive nationalisation of banks. The first to be nationalised was the RBI, the country's central bank, from 1 January 1949. Then came the takeover of the (then) Imperial Bank of India and its conversion into the State Bank of India in July 1955, the conversion of eight major state-associated banks into subsidiary banks of the SBI in 1959, merger of two such banks into one from the beginning of 1963, thus reducing the number of the associate banks to seven, nationalisation of 14 other major Indian scheduled banks in July 1969 and of 6 more in April 1980.

The regional rural banks from their inception are being set up in the public sector. As a result, the public-sector banks occupy a position of dominance in commercial banking in India. Among the public-sector banks, the SBI group of banks is the largest chain of commercial banks in the country, controlling more than a quarter of total bank deposits.

Two main tasks were set before the public-sector banks, namely:

- (a) Mobilisation of deposits through a massive programme of branch expansion, especially in unbanked rural and semi-urban areas, and

- (b) Diversification of bank credit to ensure flow of financial assistance to the neglected sectors and sections of the economy in an increasing measure.

2. Regulation of Banks by the RBI

The RBI has come to play an increasingly important role in the regulation, control, and development of banking in all its aspects. This has been made possible by the Banking Regulation Act (formerly called the Banking Companies Act), 1949 and its several amendments from time to time. Under the Act, the RBI has been vested with extensive powers of supervision and control over banks.

These powers cover all important aspects of banking from the licensing of banks to their liquidation. The RBI has made good use of these powers and several of the features discussed below are, to a large extent, the result of the systematic exercise of these powers.

3. Liquidation and Amalgamation of Banks

The number of commercial banks has gone down considerably from 566 at the end of 1951 to 271 (including 188 RRBs) at the end of 1990. This is a result of a deliberate policy of the RBI of systematic weeding out of substandard non-viable banks through delicensing and amalgamations and liquidations.

During World War II there had been a mushroom growth of small and ill-managed banks. They were a source of great weakness to the whole banking system. Their frequent failures were possibly the most important reason for the slow spread of banking habits among the public. Therefore, the strengthening of the banking system required a vigorous implementation of the aforesaid policy.

This has not been an unmixed blessing. Whereas with the weeding out of the non-viable units, bank failures have now become a thing of the past a great achievement, no doubt the progressive replacement of small banks by large banks has denied the small borrower the special attention he used to get more easily from a small local bank.

Moreover, a small local bank used to enjoy the advantage of adapting its working to the special conditions prevailing in the small area of its operation, which the branch of a big national bank managed under an all-India policy does not have.

4. Branch Expansion

The geographical coverage of banking facilities has improved markedly, especially after the nationalisation of 14 major banks in July 1969. Till 1956 the RBI was very cautious in giving licenses for new branches. Its major effort was devoted to the consolidation and strengthening of the banking system, and not to expansion.

Consequently till 1954 there was a continuous decline in the total number of banking offices, mainly due to the amalgamation of smaller banks with larger banks and closure of the offices of non-scheduled and smaller banks.

1956-61 was a period of slow expansion of banking offices, the number of banking offices increasing from 4,067 to only 5,012. From July 1962 the RBI followed a systematic programme of branch expansion, encouraging banks to open their offices in semi-urban, rural, and other unbanked areas. Under the programme, up to December 1970, the number of banking offices more than doubled from about 5,000 to about 11,000.

The nationalisation of 14 major banks in July 1969 imparted a new sense of urgency and major impetus to branch expansion in unbanked, especially rural and semi-urban, areas expeditiously. One of the major objectives of bank nationalisation has been this kind of expansion of banking facilities in the country. For, the private-sector banks all along had hesitated opening bank offices in small centres, as they did not expect such offices to be remunerative for several years.

Since nationalization of banks, the number of bank offices has multiplied rapidly from 8,300 in July 1969 to more than 62,000 at end June 1995. This has improved substantially the availability of banking facilities

in the country. Whereas in 1969 there was only one bank to serve 65,000 population; by the end of 1995, there were five banks for the same number of persons.

The picture becomes much more impressive when we look at the striking increase in the number of bank-offices in rural areas from a mere 1860 in July 1969 to more than 47,000 in June 1995. Taking rural and semi-urban centres together, the number of bank-offices increased from about 4,200 in July 1969 to more than 47,000 in June 1994, whereas the number of bank-offices in urban and metropolitan and port towns increased from 3,100 in July 1969 to 8,300 in June 1994.

5. Lead Bank Scheme

The branch expansion programme of banks in the post- nationalisation phase was supposed to be interwoven with the Lead Bank Scheme of the RBI, adopted in December 1969. The Scheme was recommended by a Study Group (known as the Gadgil Group) of the National Credit Council. The Group was of the view that because of the diversity of conditions all over the country, an area approach was essential for appropriate credit arrangements on the basis of local conditions.

Accordingly, it suggested making major scheduled banks responsible for providing integrated and all-round banking facilities under their leadership in all the districts of the country in a well-planned and phased manner. It was hoped that through the instrumentality of credit, these banks would act as catalysts of local development.

Under the Scheme, as adopted, all the 398 districts in the country have been distributed among major scheduled banks (in the public sector). They were supposed to play the lead role in the expansion of banking facilities and to act as consortium leaders for coordinating the activities of co-operative, commercial banking and other financial institutions in their respective districts.

Each lead bank is expected to survey the district, identify unbanked centres, and set up

branches in a phased manner. It is also expected to identify and study local problems, evolve an integrated credit plan for the supply of inputs and processing, storage and marketing facilities and other services, which may be locally needed and provide for participation among financing and development agencies operating in the district.

6. Deposit Growth

The total bank deposits have swiftly grown from being 2,0116 in 1961 to being 5,1735 in 1969 at current prices in nominal terms. In real terms, the growth of bank deposits is due to spreading of banking facilities, habits, growth of real income, increased rates of interest on bank deposits and strengthening of banking system.

7. Changes in the Composition of Deposits

The relative proportions of demand and time deposits have undergone significant changes. Over the period covered, the share of time deposits in total deposits has shot up from 33% to 82%. The rise in this ratio has been relatively more spectacular over the last 20 years.

The recorded shift in the composition of deposits is due to several factors, such as changes in the composition of bank depositors in favour of households in place of firms, spread of banking facilities in the country, liberalisation of withdrawal conditions in respect of savings deposits, increases in the rates of interest paid on fixed and savings accounts, ban on the payment of interest on current deposits after 1961, and change in the 'division of savings deposits between demand and time deposits favouring the latter since 1978.

8. Bank Staff, Productivity and Profits

With the expansion of banking offices and banking operations, the number of bank employees has increased several-fold from 79,000 in 1958 to 10 lakh in 1990. The productivity of their services and the quality of customer service is said to have gone down.

This is a genuine cause for concern for the public as well as authorities. It has affected adversely, among other things, the profitability of banks per rupee of their total earnings. The decline in this profitability (in the short-run) can also be attributed partly to rapid branch expansion.

2.2 MERCHANT BANKING

Q8. Define Merchant banking. Explain the evolution of merchant banking.

Ans : (Oct.-20, June-19(MGU), Imp.)

Meaning

Merchant Banking is defined differently in different countries. Though there is no universal definition for merchant banking functions and services offered by a merchant banker. It is also called as investment banking.

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So 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, acceptance credit, counselling, insurance etc.

The Notification of the Ministry of Finance defines a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

Evolution

Though it is non-banking financial activity but resembles banking function, originated in Europe. The Dutch and Scottish merchants started financing foreign by accepting bills.

The concept was developed in London. When the merchants started floating bonds in London Money Markets to aid government of under-developed countries. The funds were raised for the long-term needs of the developing economies. Later, merchants moved to domestic business through syndication of short-term and long-term finance. With time, the scope of merchant bankers extended

to underwriting of new issues, serving as registrars and share transfer agents, debenture trustees, portfolio managers etc. They also undertook specific functions like negotiating agents for mergers and takeover. The growing concept of merchant banking gained prominence in America and other countries also. Euro dollar and other innovative instruments were introduced and new financial centers were established in Singapore, Hong Kong, Dubai etc.

Merchant Banking in India

Upto 1970, there were only two foreign banks which performed merchant banking operations in the country. SBI was the first Indian commercial bank and ICICI the first financial institution to take up the activities in 1972 and 1973 respectively. As a result of buoyancy in the capital market in 1980's some commercial banks set-up their subsidiaries to operate exclusively in merchant banking industry. In addition, a number of large stock broking firms and financial consultants also entered into business. Thus, by the end of the 1980's there were 33 merchant bankers belonging to three major segments viz., commercial banks, all India financial institutions, and private firms. Merchant banking functions of these institutions was related only to management of new capital issues.

Merchant banking industry which remained almost stagnant and stereotyped for over two decades, witnessed an astonishing growth after the process of economic reforms and deregulation of Indian economy in 1991. The number of merchant banks increased to 115 by the end of 1992- 93, 300 by the end of 1993-94 and 501 by end of August, 1994. All merchant bankers registered with SEBI under four different categories include 50 commercial banks, 6 all India financial institutions - ICICI, IFCI, IDBI, IRBI, Tourism Finance Corporation of India, Infrastructure Leasing and Financial Services Ltd. and private merchant bankers.

In addition to Indian Merchant Bankers, a large number of reputed international Merchant Bankers like Merrill Lynch, Morgan Stanley, Goldman Sachs, Jardie Fleming, Kleinwort Benson etc. are operating in India under authorisation of SEBI. As a result of proliferation, Indian Merchant Bankers are faced with severe competition not only among themselves but also with the well developed global players.

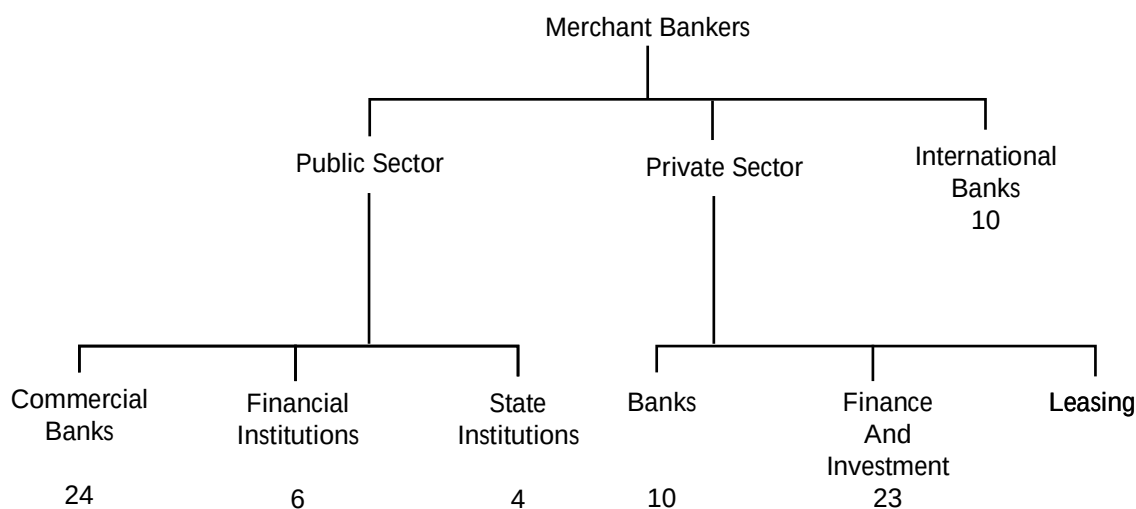


Fig.: Merchant Banking in India

Q9. Explain the scope of merchant banking in India.**Ans :**

In the present day capital market scenario, the merchant banks play the role of an encouraging and supporting force to the entrepreneurs, corporate sectors and the investors. There is vast scope for merchant bankers to enlarge their operations both in domestic and international market.

1. Growth of New Issues Market

The growth of new issue market is unprecedented since 1990-91. The amount of annual average of capital issues by non-government public companies was only about 90 crores in the 70s, the same rose to over Rs. 1,000 crs in the 80s' and further to Rs. 12,700 crores in the first four years of 1990's. This figure could be well beyond Rs. 40,000 crores by the end of 1994-95. The number of capital issues has also increased from 363 in 1990-91 to 900 in 1993-94. The trend is expected to continue in future.

2. Entry of Foreign Investors

An outstanding development in the history of Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian companies to directly tap foreign capital through euro issues. Within two years to March 1994, the total inflow of foreign capital through these routes reached to about \$5 billion. It is estimated that this figure may go up to \$ 35-40 billion by the turn of this century. Further, foreign direct investment as also investment by NRIs have risen considerably due to number of incentives offered to them. They need the services of Merchant Bankers to advise them for their investment in India. The increasing number of joint ventures abroad by Indian companies also require expert services of Merchant Bankers.

3. Changing Policy of Financial Institutions

With the changing emphasis in the lending policies of financial institutions from security orientation to project orientation, corporate enterprises would require the expert services of merchant bankers for project appraisal, financial management etc. The policy of decentralisation and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided by merchant bankers.

4. Development of Debt Market

The concept of debt market has set to work through National Stock Exchange and the Over the Counter Exchange of India. Experts feel that of the estimated capital issues of Rs. 40,000 crores in 1994-95, a good portion may be raised through debt instruments. The development of debt market will offer tremendous opportunity to Merchant Bankers.

5. Innovations in Financial Instruments

The Indian capital market has witnessed innovations in the introduction of financial instruments such as non-convertible debentures with detachable warrants, cumulative convertible preference shares, zero coupon bonds, deep discount bonds, triple option bonds, secured premium notes, floating rate bonds, auction rated debentures etc. This has further extended the role of Merchant Bankers as market makers for these instruments.

6. Corporate Restructuring

As a result of liberalisation and globalization the competition in the corporate sector is becoming intense. To survive in the competition, companies are reviewing their strategies, structure and functioning. This had led to corporate restructuring including mergers, acquisitions, splits, disinvestment and financial restructuring. This offers good opportunity to Merchant Bankers to extend the area of their operations.

7. Disinvestment

The government raised Rs. 2000 crores through disinvestment of equity shares of selected public sector undertakings in 1993-94. The government proposes to shift the present method of periodic sale of public sector shares to round the year off loading of shares directly on the stock exchange from the year 1995-96. The government will sell the shares of identified public sector at any time during the year when they get a good price above minimum stipulated level. This is likely to provide good business to Merchant Bankers in future.

2.2.1 Functions

Q10. Explain the functions of merchant banker.

(OR)

Describe the functions of merchant banker.

(OR)

Explain the functions of merchant banking in India.

Ans : (June-19(MGU), Imp.)

The financial institutions in India could not meet the demand for long-term funds required by the ever expanding industry and trade. The corporate sector enterprises, therefore, meet their requirements through issue of shares and debentures in the capital market. To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering multifarious services. The merchant bankers also advise the investors of the incentives available in the form of tax reliefs and other statutory obligations.

The services of merchant bankers are described in detail in the following section.

(i) Corporate Counselling

Corporate counselling covers the entire field of merchant banking activities viz. project coun-selling, capital restructuring, project management, public issue management, loan syndication, working capital, fixed deposit, lease financing, acceptance credit etc. The scope of corporate counselling is limited to giving suggestions and opinions to the client and help taking actions to solve their problems. It is provided to a corporate unit with a view to ensure better performance, maintain steady growth and create better image among investors.

(ii) Project Counselling

Project counselling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and

appraising project report with the financial institutions or banks. Project reports are prepared to obtain government approval, get financial assistance from institutions and plan for the public issue. The financing mix is to be decided keeping in view the rules, regulations and norms prescribed by the government or followed by financial institutions. The projects are appraised, as to the location, technical, commercial and financial viability of the project. Project counselling also includes filling up of application forms with relevant information for obtaining funds from financial institutions.

(iii) Loan Syndication

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. Merchant Bankers help corporate clients to raise syndicated loans from commercial banks.

(iv) Issue Management

Management of issue involves marketing of corporate securities viz., equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it.

The issue function may be broadly divided into preissue management and post issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be co-ordinated.

(i) Public Issue through Prospectus

- (a) The most common method of public issue is through prospectus. In 1991-92, of new capital issues of Rs. 5750.8 crores, Rs. 1903.7 crores (33 per cent) was made through prospectus.
- (b) Offers for sale are offers through the intermediary of issue house or firm of stock broker. The company sells the

entire issue of shares or debentures to the issue house at an agreed price which is generally below the par value.

- (c) The direct sale of securities by a company to investors is called private placement. The investors include LIC, UTI, GIC, SFC etc.

To bring out a public issue, merchant bankers have to co-ordinate the activities relating to issue with different government and public bodies, professionals and private agencies. They have to ensure that the information required by the Companies Act and SEBI are furnished in the prospectus and get it vetted by reputed solicitor.

(ii) Marketing

After despatch of prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of board meeting to approve and sign prospectus and pass the necessary resolutions.

Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the press, radio, TV, investors conference etc. The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear.

(iii) Pricing of Issues

The SEBI guidelines 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. Pricing of issue is part of pre issue management.

(iv) Post Issue Management

The post issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in post issue management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the Board, the auditor/company secretary has to certify that the allotment has been made by the company as per the basis of allotment approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent within 70 days of the close of the issue.' The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by co-ordinating the above activities.

(v) Underwriting of Public Issue

Underwriting is a guarantee given by the underwriter that in the event of under subscription the amount underwritten, would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

All public issues have to be fully under written. Only Category I, II and III merchant bankers are permitted to underwrite an issue subject to the limit that the outstanding commitments of any such individual merchant banker at any point of time do not exceed five times of his net worth (paid-up capital and free reserves excluding revaluation reserves). This criteria is applicable to brokers also. Lead managers have to underwrite mandatorily 5% of the issue or Rs. 2.5 lakh whichever is less. Banks/ Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

(vi) Managers, Consultants (or) Advisers to the Issue

The managers to the issue assist in the drafting of prospectus, application forms and completion of formalities under the Companies Act, appointment of Registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies are free to appoint one or more agencies as managers to the issue. SEBI guidelines insist that all issues should be managed by atleast one authorised merchant banker. Ordinarily, not more than two merchant bankers should be associated as lead managers, advisers and consultants to a public issue. In issues of over Rs. 100 crores, upto a maximum of four merchant bankers could be associated as managers.

(vii) Portfolio Management

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely, a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

Merchant bankers provide portfolio management service to their clients. Today the investor is very prudent. Every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. They need expert guidance. Merchant bankers have a role to play in this regard. They have to conduct regular market and economic surveys to know.

- (i) Monetary and fiscal policies of the government.
- (ii) Financial statements of various corporate sectors in which the investments have to be made by the investors.
- (iii) Secondary market position, i.e., how the share market is moving.

- (iv) Changing pattern of the industry.
- (v) The competition faced by the industry with similar type of industries.

(viii) Advisory Service Relating to Mergers and Takeovers

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A take over is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offeree and offeror. Being a professional expert they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approval from the government/RBI, drafts scheme of amalgamation and obtains approval from financial institutions.

(ix) Off Shore Finance

The merchant bankers help their clients in the following areas involving foreign currency.

- (i) Long-term foreign currency loans
- (ii) Joint venture abroad
- (iii) Financing exports and imports and
- (iv) Foreign collaboration arrangements.

The bankers render other financial services such as appraisal, negotiations and compliance with procedural and legal aspects.

(x) Non-Resident Investment

The services of merchant bankers include investment advisory services to NRI in terms of identification of investment opportunities, selection of securities, investment management etc. They also take care of the operational details like purchase and sale of securities, securing necessary clearance from RBI for repatriation of interest and dividend.

Q11. Explain the problems of merchant banker.

Ans :

1. SEBI guidelines have authorised merchant bankers to undertake issue related activities only with an exception of portfolio management. These guidelines have made the merchant bankers either to restrict their activities or think of separating these activities from the present one and float new subsidiary and enlarge the scope of its activities.
2. SEBI guidelines stipulate a minimum net worth of Rs. 1 crore for authorisation of merchant bankers. Small but professional and specialised merchant bankers who do not have a net worth of Rs.1 crore may have to close down their business. The entry is denied to young, specialised professionals into merchant banking business.
3. Non-co-operation of the issuing companies in timely allotment of securities and refund of application money is another problem of merchant bankers. The guidelines have put the responsibility on the merchant bankers. They have to seek the co-operation of the issuing company to shoulder the responsibility.

2.3 VENTURE CAPITAL

Q12. Define venture capital. Explain the features of venture capital.

(OR)

Discuss the features of venture capital.

Ans : (July-21, Oct.-20, Oct.-19, Imp.)

Introduction

The term 'Venture Capital' is understood in many ways. In a narrow sense, it refers to, investment in new and tried enterprises that are lacking a stable record of growth.

In a broader sense, venture capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a

simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

Meaning

Venture capital is long-term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

Definition

A venture capital company is defined as "a financing institution which joins an entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprise".

Features

Some of the features of venture capital financing are as under :

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2. Investment is made only in high risk but high growth potential projects.
3. Venture capital is available only for commercialization of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.
4. Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.
5. There is continuous involvement in business after making an investment by the investor.
6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.
7. Venture capital is not just injection of money but also an input needed to set-up the firm, design its marketing strategy and organise and manage it.
8. Investment is usually made in small and medium scale enterprises.

Q13. Bringout the significance of venture capital.

(OR)

Explain the importance of venture capital.

Ans :

(July-21)

Importance

- It helps new products with modern technology become commercially feasible.
- It promotes export oriented units to earn more foreign exchange.
- It not only provide the financial institution but also assist in management, technical and others.
- It strengthens the capital market which not only improves the borrowing concern but also creates a situation whereby they can raise their own capital through capital market.

- It promotes modern technology through the process where financial institutions encourage business ventures with new technology.
- Many sick companies get a turn around after getting proper nursing from such Venture Capital institutions.

Q14. Explain the Benefits of Venture Capital.

(OR)

What are the advantages of venture capital.

Ans :

Venture capital is of great practical value to every corporate enterprise in modern times.

1. Advantages to investing Public

- (i) The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.
- (ii) Investors or have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyse the prospects of the business.
- (iii) The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

2. Advantages to Promoters

- (i) The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

- (ii) Public issue of equity shares has to be proceeded by a lot of efforts viz. Necessary statutory sanctions, under-writing and brokers arrangement, publicity of issue etc. The new entrepreneurs find it very difficult to make underwriting arrangements require a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.
- (iii) Costs of public issues of equity share often range between 10 percent to 15 percent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs, for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

3. Advantages to General

- (i) A developed venture capital institutional set-up reduces the time lag between a technological innovation and its commercial exploitation.
- (ii) It helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.
- (iii) Venture capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with inadequate margin of equity capital.
- (iv) Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing

business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilisation etc.

- (v) The economy with well developed venture capital network induces the entry of large number of technocrats in industry, helps in stabilizing industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.
- (vi) A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start ups.
- (vii) It also paves the way for private sector to share the responsibility with public sector.

Q15. Explain the dimensions of Venture Capital.

Ans :

Venture capital is available in four forms. They are :

- (a) **Equity Participation** : The venture capital finances up to 49% of the equity capital and the ownership remains with the entrepreneur.
- (b) **Conventional Loan** : Under this, a lower fixed rate of interest is charged to the unit till its commercial operation. After normal rate of interest paid, loan is to be repaid as per the agreement.
- (c) **Conditional Loan** : A conditional loan is repayable in the form of royalty ranging between 2 and 15% after the venture is able to generate sales and no interest is paid on such loans.
- (d) **Income Notes** : The income note combines the features of conventional and conditional loans in a way that the entrepreneur has to pay both interest and royalty on sales at low rates.

Q16. Discuss the various methods of Valuation of Venture Capital.

Ans :

The evaluation of venture capital investments is generally idea-based and growth-based, in contrast with the conventional investments, which are asset-based. Venture capitalists employ the following methods in order to evaluate their investments :

1. Conventional Method

Under this method of valuation, venture capitalists take into account the time at which the investee companies start the venture and the time at which such companies exit their investments. The exit may take place in the form of sale to public/third party and so on. The value of the venture for the purpose of investment involves the following computations:

- i) **Annual Revenue** : The annual revenue at the time of liquidation of the investments is calculated as follows :

Present annual revenue in the beginning, compounded at an expected annual growth rate for a certain holding period.

- ii) **Expected Earnings Level: The expected earnings level is computed as follows:**
Future earnings level x After-tax margin percentage at the time of liquidation.

- iii) **Future Market Valuation** : The future market valuation of the venture capitalist is ascertained as follows:

Earnings levels x Expected P/E ratio on the date of liquidation.

- iv) **Present Value of VC:** The present value of the venture capital using a suitable discount factor is determined.

- v) **Minimum Percentage of Ownership:** The minimum percentage of ownership required is calculated as follows:

$\frac{\text{Finance sought} \times 100}{\text{Calculated present value of the venture capitalist}}$
--

2. First Chicago Method

This method gives allowance to the nature of the path between the starting point and the exit point/ date, and considers the entire earnings stream. Following steps are involved in the calculation of the value of venture capital investment:

- i) **Alternative Scenarios:** The three alternative scenarios such as 'success', 'sideways survival' and 'failure' are to be identified. Probability rating to each of the scenarios is then assigned.
- ii) **Present Value of VC:** The present value of the venture capital investment using a suitable discount factor is determined.
- iii) **Expected Value of VC:** The expected pre-sent value of the venture capital investment is computed as follows:
Present value Respective probability
- iv) **Minimum Percentage of Ownership:** The minimum percentage of ownership required is calculated as follows:

$\frac{\text{Finance sought} \times 100}{\text{Expected present value of the venture capitalist}}$
--

3. Revenue Multiplier Method

Under this method, a revenue multiplier is used as a factor to estimate the value of the venture capital investments. The venture capital investment is calculated as follows:

Annual revenue of the company $\times$ Estimated revenue multiplier.

This method is generally used in the case of early-stage/start-up venture capital investments, where earnings based on after-tax profits may be low/negative in the early years, but where there may be revenue/sales income. The drawback of this method is that it is difficult to estimate the revenue multiplier.

Q17. Explain the process of venture capital financing.

(OR)

Explain the various stages of venture capital financing through it.

Ans :

(Oct.-19, Imp.)

Venture capital industry selects an investment on the basis of the stages and the type of investment. The stages of an investment varies and depends upon the time period, risk assumptions and other related features of the investment decision process of the venture capital industry. The stages of financing in the venture capital industry is classified into two broad categories,

1. Early stage and
2. Later stage.

Further the early stage and the later stage are classified as follows,

1. Early Stage

- (a) Seed-capital (or) pre-start up.
- (b) Start-up
- (c) Second-round financing.

2. Later Stage

- (a) Mezzanine/development capital
- (b) Bridge/expansion
- (c) Buyouts
 - (i) Management buyouts
 - (ii) Management buyins
- (d) Turnarounds.

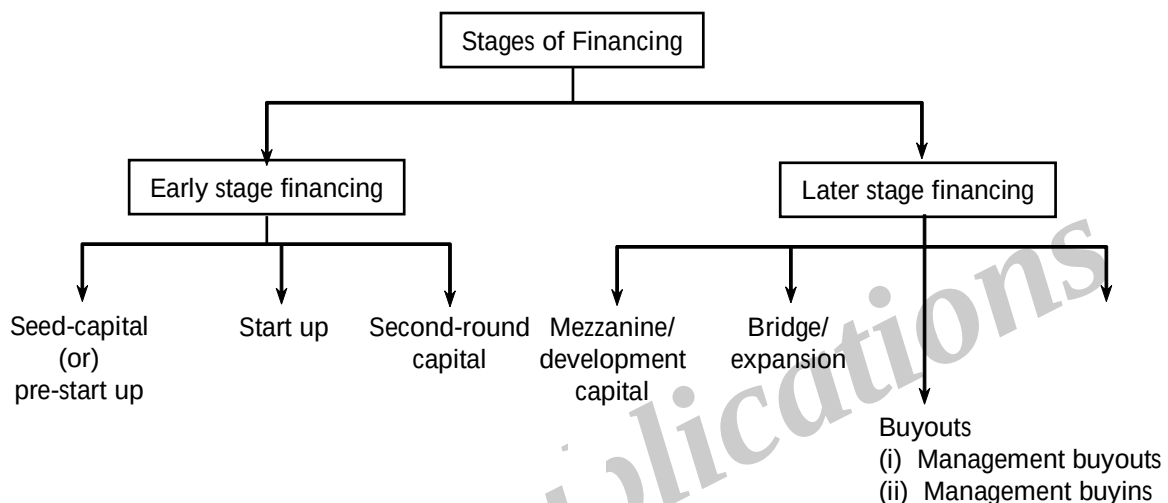


Fig.: Stages of Venture Capital Financing

1. Early Stage Financing

The early stage financing comprises of the following,

(a) Seed-capital / Pre-start Up

Seed capital is the first stage of early stage financing wherein new ideas and concepts of the promoters form the basis of a pre-commercialization research project which is mostly expected to result in a prototype which may or may not lead to the establishment of the business. This stage is basically an “applied research” phase and it moves towards the development stage further resulting in prototype product testing and ultimately to the commercialisation process. VCs have to make sure while evaluating the project that the technical competencies of the entrepreneur are as per the specifications and standards required in the market.

This stage involves greater marketing risk. The promoter’s commercial decisions such as making optimum utilisation of the market opportunity, knowledge about competition, product launch time etc., all these form the essential components of the appraisal. Higher levels of risk prevail at this stage. As a result, only few venture capital institutions make the seed-capital investment in the pre-commercialisation stage of product development.

(b) Start-up

Start-up stage of VC financing enables the commercial manufacturing to begin. Venture capitalists provide finance in this stage mainly for the product development and initial marketing. This stage holds greater significance because the product/service is commercialised for the first time in collaboration with the VCs.

It comprises of different types of projects like,

- (i) The greenfield projects which are either based on high technology or are new.
- (ii) New business in which entrepreneur holds good knowledge about the work.
- (iii) New projects by established companies.
- (iv) A new company promoted by an existing company with scarce or meagre capital to commercialise new technology.

This stage indicates the availability of potential markets for the introduction of new product/service. The participation level of VCs in start-up projects is usually less/minimal due to partial equity dilution syndrome which results because of two reasons firstly, promoter's resistance to the dilution of control of the business and secondly, due to the unviability of the small amount of equity investment. The risk levels are also high.

(c) Second-round Financing

This stage indicates that the product has already been launched in the market, but the business has not grown enough to make public offerings in order to attract new customers. The promoter has already invested his own funds in the business but also requires the funds from venture capital institutions. The time period is less when compared to start-up investment. The VCs provides/makes huge investment at this stage than at any other stage. A part of financing is also done in the form of debt, in order to provide some income to them.

2. Later Stage Financing

Later stage financing includes already existing businesses which needs additional financial support but cannot make public offerings. It includes the following,

(a) Mezzanine/Development Capital

Mezzanine capital provides finance to those existing businesses which have already gone through the high-risk early stage, have gained profits but not that enough to make public offerings and raise money from the capital market/conventional sources. Venture capital financing helps in purchasing new plant and machinery, widening the marketing and distribution facilities, refinance of an existing

debt, capturing new areas, establishing new management and so on.

The development capital is usually provided for a time period of one to three years and holds medium risk level. It forms an important part of venture capital institution's activities.

(b) Bridge/Expansion

Bridge or expansion capital is financed for a period ranging from one to three years and holds lower levels of risk. Bridge capital or expansion capital is used for expanding business by growing their own productive assets or by acquiring other firm's assets. In simple words, it depicts the last round of financing before a planned exit.

(c) Buyouts

Buyouts means transfer of management control. Buyouts are basically of two types,

- (i) Management Buyouts (MBOs)
- (ii) Management Buyins (MBIs).

(i) Management Buyouts (MBOs)

In MBOs, venture capital institutions provides finance to allow smooth functioning of the business and helps the existing operating management and the investors to acquire an existing product line or business. They form an important part of VCs activities.

(ii) Management Buyins (MBIs)

MBIs are the funds which are offered to allow an outside group or a third party usually managers to form a group and buy an ongoing company. MBIs pull in together three important elements,

- A management team
- A target company
- An investor.

Management buyins are. not popular as management buyouts. Basically, MBIs are more riskier than MBOs because of the difficulty faced by the outside management to judge or acumen the real potential of the target company. Mostly, MBIs target the weaker or underperforming companies.

The time period for buyouts ranges from one to three years with usually low risk perception.

(d) Turnarounds

Turnarounds are a sub-set of buyouts and includes buying the authority or control of a sick company. Turnarounds need two types of inputs, 'money' and 'management'. The venture capital institutions need to recognize good management and operation leadership. Turnarounds have medium to high levels of risks and their time period ranges from three to five years. Turnarounds are becoming popular day by day and are being accepted on large scale and draws major part of VCI's attention.

Q18. Explain the Exit strategies of venture capital financing.

Ans :

Exit strategies are followed by VCF as the last stage, in order to realize the investment and make profit and minimize or avoid losses. The exit strategies to be followed by the VCIs must be pre-planned at the starting time of venture capital financing. The formulation of exit strategies depends upon various factors like ventures nature, extent and type of financial stake, the actual and potential competition conditions of market, functioning style as well as the perception of VCIs and so on.

For instance, early stage financing basically takes a long time to reap the investment in the form of profit i.e., nearly five to seven years. While in the later stage financing the investment is usually reaped in three to five years.

The important element to be considered in the exit stage of venture -capital financing is the decision relating to disinvestment/realization alternatives which are linked to the different types of investment such as equity/quasiequity-and debt instruments.

I. Disinvestment of Equity/Quasi-Equity Investments

The equity/quasiequity investments can be made in five different ways.

1. Going public
2. Sale of shares to entrepreneurs/employees earnout

3. Trade sales/sale to another company
4. Selling to a new investor/takeout
5. Liquidation/receivership.

The first four alternative routes are voluntary

in

1. Going Public

Going public is the general form of disinvestment by a venture capital institution where in VCUs capital is issued publicly inclusive of its own holdings. There are several advantages of public issues such as liquidity of the investments by listing on stock exchange, higher price of securities in comparison to private placement, develops good image and credibility with public, managers, customers, financial institutions and so on. However, the companies which are going public are subjected to the reporting requirements stock exchange regulations and disclosure requirements, the cost of issue is higher, the shareholders accountability increases and so on. Moreover, the public issue method is the most common one and a popular exit route for VCIs.

OTCEI route (Over The Counter Exchange of India) is one of the exit route followed by the public issue channel. A VCI can exit by way of a boughtout deal to an OTCEI member who would offer the shares thus acquired to the public at a future date. Going public is also called as Initial Public Offering (IPO) and flotation.

2. Sale of Shares to Entrepreneurs/Employees Earnout

The shares or the stakes of VCIs can be sold to the entrepreneurs or the companies themselves who are allowed to buy their own equity. The entrepreneurs can get the shares from VCIs via employees by forming an, "employees stock ownership trust". This trust can acquire the VCIs shareholdings by the employees contribution and borrowing from financial institutions and banks.

Similar type of other alternative is "exit by puts and calls", Where in the VCI's can enter into a formal exit agreement on the basis of price which is already determined with the help of a formula by the entrepreneurs. The put option is the right to sell and the call option is the right of the entrepreneurs to buy. This channel is also a popular exit route. The following are the important call and put options formulae.

- (i) Book value method
- (ii) P/E ratio
- (iii) Percentage of sales method
- (iv) Multiple of cash flow method
- (v) Independent valuation
- (vi) Agreed price.

(i) Book Value Method: Book value method is usually used by the nature companies who have achieved a good track record i.e., they have maintained a reasonable degree of stable operations.

(ii) P/E Ratio : P/E ratio is used to access the put and call option. The price is equal to the earnings per share multiplied by the P/E ratio.

(iii) Percentage of Sales Method: This method is the latest version of the P/E ratio on the basis of the before-tax earnings/profits before tax as a percentage of sales for the industry, the assumed/national profit prior to tax for the VCU's is calculated as also earnings per share. The shares value is calculated by multiplying the assumed earnings per share with the P/E ratio of an industry. This method is appropriate for the early stages of financing where in the levels of profits are lower but the levels of sales are justifiable.

(iv) Multiple of Cash Flow Method: This method makes use of cash flow instead of the earnings or sales. The cash flow

is multiplied by the industry multiplier to compute the value of the company's shares.

(v) Independent Valuation : The independent valuation is conducted by a third party, taking into consideration the basis of any one of these methods i.e., earnings potential method, price-earning ratio method or the liquidation method. On taking the liquidation method into account a VCU calculates its net value on the basis of the net value of all the assets minus liabilities.

(vi) Agreed Price: This is a price which is agreed upon between the VCI's and the entrepreneurs at the time of making investment only.

3. Trade Sales/Sale to Another Company

In this method the complete business or the company is sold away to another company or a third party. This method is a popular method and mostly the trade sales is done via management buyouts or buyins. Selection of a suitable method in trade sales would differ from one case to another taking into consideration taxation and other factors. The trade sales can be made in any of the following three alternatives.

- (i) Cash sales of equity ownership of both the parties which would attract heavy tax burden.
- (ii) Ensuring proper tax planning by receiving cash in the form of predetermined instalment against the buyer company's asset.
- (iii) In consideration for the shares of the buying company with no tax liability.

4. Selling to a New Investor/Takeout

The VCI's can sell away their equity shares to a new investor which may be either a corporate body or another venture capital institution. The corporate investors may be interested in acquiring the stake in order to develop a business relationship because of the synergy of operations.

Another venture capital institution may be interested to buy the equity shares of the existing VCI due to the similar nature of its business and objectives.

5. Liquidation/Receivership

Unlike the first four, this exit strategy is involuntary in nature. Liquidation is done at the time when the entire business has failed or when the venture is not performing well and is not in a position to recover due to the presence of cut-throat competition, obsolescence of technology, poor management and so on.

II) Exit of Debt Instrument

Exit of the debt instrument is not like the exit of equity instrument, they need to follow a predetermined route. For example in case of a loan the loan can be terminated only at the completion of its time period. If the loan allows then a part of it may be converted into equity shares. In case of conditional loans, the exit before the determined period is possible only on the basis of lumpsum amount repayment consistent with the expectations of the VCI of the likely return on the loan.

Q19. State the disadvantages of venture capital.

Ans :

1. Acquiring a contract with a venture capital might be a lengthy and a complicated process.
2. The borrowers are supposed to frame a complete business plan which is inclusive of the financial projections for which the entrepreneur needs the professional help.
3. It is compulsory to pay legal and accounting fees if VC passes through the negotiation stage i.e., whether he may or may not be successful in acquiring funds.
4. As the risk is taken over by venture capitalist, he may also have management control as it passes from the hands of entrepreneur to the venture capitalist.
5. The venture capitalists need to share even the benefits which he earned from business.

2.4 PRIVATE EQUITY

Q20. Define private equity. Explain the various reasons opting private equity.

Ans : (Imp.)

Private equity is 'hands-on' investing. In private equity fund, partners become the directors of the invested companies. Private equity can be used to make investment in a newly introduced businesses or sick or struggling businesses. In case of private equity financing, funding is usually for long-term period i.e., for 4 to 12 years. Private equity financing is usually opted in management buyouts and leveraged buyouts, so as, to get control over the company. Private equity investors are capable of earning high internal rate of returns at the same time they assume high levels of risk.

Reasons Behind Companies Opting Private Equity financing

1. In case of private equity financing, companies can grab the management and financial expertise of the private equity investors who give their suggestions on operational, financial and strategic activities. This expertise helps the company in raising debt and equity finance, optimizing the exit price and in preparing the financial structure of the company.
2. The long-term equity capital invested by the private equity investor brings stability in the company and makes the company available with enough finance to invest in further expansion plans.
3. Private equity financing might be the one and only source of finance of the company.
4. Private equity investors usually have lengthy business network which helps the companies in expanding their business operations, for increasing the sales level and for recruiting the important persons.

2.4.1 Private Equity role in start-ups

Q21. Explain briefly the role of private equity in start-ups.

Ans :

Financing an enterprise whether large or small enterprise is an important element for the success of business. It is the availability of finance that facilitates an entrepreneur to bring together land, labour, machinery and raw material to produce the

desired goods. It is observed that many enterprises fail because they are under-capitalized. Thus, it is essential for a business to define its future financial requirements in the initial stages itself, this is called as 'financial planning'.

Financial planning deals with future prospectus of present decisions in terms of financial aspects of an enterprise, in short, it is a financial forecast made for the enterprise in the beginning itself.

In financial planning, the entrepreneur should be aware of the following facts,

- Finance needed
- Source of finance
- Availability of finance.

The capital needed can be determined by the statement of different assets required by the firm. While estimating the capital required, the entrepreneur must take care of the following three things,

- Availability of adequate amount of capital to pay for purchase of an asset.
- Availability of sufficient capital to support the business operations in the three initial month of the business.
- Finally, an adequate provision must be made for meeting unforeseen expenses. Usually, 10-15% of purchase consideration is reserved as provision for meeting such expenses.

Venture capital industry is at the take-off stage in India. Venture capital financing can play a catalytic role in developing those entrepreneurial skills and talents which remains unexploited in the young and energetic talented people. It can also develop new technology and hi-tech industries, which holds greater levels of risk but also at the same time yields high rate of interest.

The venture capital industry in India originated recently. Prior to its emergence DFIs (Development Finance Institutions) used to play the role of venture capitalists by providing assistance for direct equity participation to ventures in pre-public issue stage and by assisting the selected new technologies.

The need of VCF was felt in 1985 when the investors had great losses by investing in newly formed enterprises which were not even commercialized and listed on stock exchange as their equity capital was less than ` 3 crores. As a result, venture capital fund was announced in the document on Tong term fiscal policy' presented by the ministry of finance in December, 1985. This came into implementation from the fiscal budget of 1987-88, a part of the funds were drawn by IDBI for providing financial assistance under its venture capital fund scheme. The guidelines provided by the Government of India (GOI) helped venture capital in providing equity capital for technology improvement and commercialization of technology developed by new entrepreneurs.

Keeping in mind the growing importance of venture capital as one of the source providing finance to the Indian industry especially the smaller and the unlisted companies, the GOI announced a policy governing the establishment of domestic VCFs/Cs.

The GOI issued certain guidelines on September 20, 1995 for overseas venture capital investment in India. The SEBI Venture Capital Fund Regulations were issued in 1996, identifying the need for higher investment in venture capital activities, SEBI appointed the Chandrasekhar Committee to recognize the hurdles in the venture capital growth and recommend few suggestions for its growth.

2.5 HIRE PURCHASE

Q22. Define Hire purchase? Explain the features of hire purchase?

Ans :

Introduction

The term 'hire purchase' originated in the United Kingdom and this is similar to rent-town system in the United States of America. Hire Purchase System is a method of purchasing the goods with an arrangement to make payment (of the purchase price) in installments over time. The purchaser is, therefore, leasing the goods and does not obtain the ownership of the goods until he pays the full amount of the contract. However, physical

possession of goods is given by the seller to the buyer immediately after the finalization and signing of the agreement called, hire purchase agreement.

Hire purchase is a system for purchasing merchandise such as cars, furniture, etc., in which the buyer takes possession of the merchandise on payment of a deposit and completes the purchase by paying a series of regular installments while the seller retains the ownership of the merchandise until the final instalment is paid.

Definitions

- (i) Hire purchase system is also defined as a system by which a buyer pays for a thing in regular installments while enjoying the use of it. During the repayment period, ownership (i.e., title) of the item does not pass to the buyer. Upon the full payment of the amount/loan, the title passes to the buyer.
- (ii) Hire purchase system is a method of paying for something in which the buyer pays part of the cost immediately and then makes small regular payments until the debt is completely paid.
- (iii) Hire purchase system is a system of purchase wherein the seller gives the physical possession of the goods to the buyer immediately after signing of the agreement on the condition that the purchase price should be paid by the buyer in a specific number of instalments and the ownership of the goods will be transferred after the receipt of all instalments.

Features

- 1. There is an agreement between the seller (called, hire seller or hire vendor) and the buyer (called, hire purchaser or hirer) and this agreement is called, hire purchase agreement.
- 2. Purchase price of the goods and services is paid in a number of agreed instalments (also called, hire). That means, purchase price is not paid in one lump sum either at the time of signing the agreement or at a future date. Instead, it is paid in a few instalments over a period of time.
- 3. As the purchase price is not paid in one lump sum at the time of time of purchase, it (i.e., hire purchase) is a kind of credit purchase.

- 4. Under the system of hire purchase, though the full amount is not paid at the time of purchasing (i.e., at the time of signing the agreement), the seller hands over the goods to the buyer on signing the agreement. In other words, the hire purchaser takes possession of the goods purchased on hire purchase basis. Therefore, the buyer is able to start using these goods for the intended purpose immediately after signing the agreement. And the hire purchaser has the right to use the goods purchased on hire purchase basis as the bailer.
- 5. However, the legal ownership of the goods (i.e., title to the goods) remains with the seller and it is passed on to the hire purchaser only after the receipt of all instalments including the last instalment as per the agreement. As a result, the hire vendor continues to be the owner of the goods till the receipt of last instalment from the hire purchaser.
- 6. As the title to the goods is not transferred from seller to buyer till the receipt of last instalment in accordance with the Provisions of the agreement, all earlier instalments paid (prior to the payment of last instalment) are considered as hire charges (till the payment of last instalment). And the hire purchaser becomes the owner of the goods only after the payment of all instalments as per the Provisions of the agreement (i.e., after the payment of last instalment, the hire vendor transfers the ownership of the goods to hire purchaser).
- 7. As already stated, the legal ownership of the goods sold on hire purchase system is not transferred to the buyer by the seller until the receipt of last instalment from the buyer. Therefore, if the hire purchaser fails to pay any of the instalments, the hire vendor has the right to take back (i.e., repossess) the goods from the hire purchaser.
- 8. Similarly, the hire purchaser also has an option to terminate the agreement any time but before the payment of last instalment and return the goods to the seller (if he is not willing and/or not able to pay the remaining instalments).

Q23. Explain the Legal and tax Framework for Hire Purchasing System.

Ans :

There is no exclusive legislation dealing with hire purchase transaction in India. The Hire purchase Act was passed in 1972. An Amendment bill was introduced in 1989 to amend some of the provisions of the act. However, the act has been enforced so far. The provisions of are not inconsistent with the general law and can be followed as a guideline particularly where no provisions exist in the general laws which, in the absence of any specific law, govern the hire purchase transactions. The act contains provisions for regulating:

1. The format / contents of the hire-purchase agreement
2. Warrants and the conditions underlying the hire-purchase agreement,
3. Ceiling on hire-purchase charges,
4. Rights and obligations of the hirer and the owner.

In absence of any specific law, the hire purchase transactions are governed by the provisions of the Indian Contract Act and the Sale of Goods Act.

Sale of Goods Act

In a contract of hire purchase, the element of sale is inherent as the hirer always has the option to purchase the movable asset by making regular payment of hire charges and the property in the goods passes to him on payment of the last installment. So in this context we will discuss the provisions of Sales of Goods Act, which apply to hire purchase contract.

Contract of Sale of Goods

A contract of sales of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. It includes both an actual sale and an agreement to sell.

Essential Ingredients of a Sale

A contract of sale is constituted of following elements:

- i) **Two parties:** namely the buyer and the seller, both competent to contract to effectuate the sale.
- ii) **Goods:** The subject matter of the contract.
- iii) **Money consideration:** price of the goods.
- iv) **Transfer of ownership:** of the general property in goods from the seller to the buyer.
- v) **Essentials** of a valid contract under the Indian Contract Act.

Tax Framework for Hire Purchase System

The taxation aspects of hire-purchase transactions can be divided into three parts:

1. Income tax
2. Sales tax
3. Interest tax

1. Income Tax

Hire-Purchase, as a financing alternative, offers tax benefits both to the hire-vendor, (hire-purchase finance company) and the hire-purchaser (user of the asset).

a) Assessment of Hire-Purchaser (Hirer)

According to circular issued by the Central Board of Direct Taxes in 1943 and a number of court rulings, the hirer is entitled to the tax shield on depreciation calculated with reference to the cash purchase price and

b) The tax shield on the 'consideration for hire' (total charge for credit)

In other words, though the hirer is not the owner of the asset, he is entitled to claim depreciation as a deduction on the entire purchase price. Similarly, he can claim deduction on account of 'consideration for hire' that is, finance charge. The finance charge is difference between the hire-purchase price and cash price. The amount of finance charge to be deducted each year is to be spread evenly over the term of the management.

c) Assessment of Owner (Hire Vendor)

The consideration for hire/ hire charge/ income received by the hire vendor is liable to tax under the head profits and gains of

business and profession where hire purchase constitute the business of the assessee, otherwise as income from other sources. The hire incomes from the house property. Normal deduction (except depreciation) are allowed while computing the taxable income.

d) Tax planning in Hire-Purchase

The Hire-Purchase transaction can be used as a tax planning device in two ways:

- (i) First, the net income (finance income less interest on borrowings by the hire-vendor) can be inflated at the rear end of the transaction and thereby defer tax liability.
- (ii) Secondly, another possible area of tax planning is to use hire-purchase as a bridge between the lessor and the lessee. Instead of a direct lease an intermediate financier is introduced.

2. Sales Tax

The Salient Features of Sales Tax are as follows:

a) Higher purchase as Sale

Higher-purchase, though not sale in the true sense, is deemed to be sale such transactions are liable to sales tax. The sales tax is payable once the goods are delivered by the owner (hire vendor) to the hirer (hire purchaser) even if the transaction does not result in a sale. There is no provision for the refund of sales tax on the unpaid installment. Full tax is payable irrespective of whether the owner gets the full price of the goods or not.

b) Delivery vs Transfer of property: Taxable Event

A hire-purchase deal is regarded as a sale immediately the goods are delivered and not on the transfer of the title to the goods. That is, a taxable event is the delivery of the goods and not transfers of the title of the goods. For the purpose of levying sales tax, a sale is deemed to take place only when the hirer exercises the option to purchase.

c) Taxable Quantum

The quantum of sales tax is related to the sales price. It must be determined to be the consideration for the transfer of the goods when the delivery of the goods takes place. The consideration for the sale of the goods is the total amount which is agreed to be paid before the transfer of the goods takes place in a hire purchase contract. In other words, sales tax is levied on the entire amount payable under the agreement by deeming it to be the sale price of the goods instead of reducing the amount by the hire charges assumed to be included and by depreciation in the value of the goods for the period when the goods were on hire.

d) States Entitled to Impose Tax

When a hire-purchase transaction is entered in the state where the goods are lying, the concerned state is entitled to impose sales-tax. In case where the contract of hire-purchase is entered into one state and goods are in another state, the entitlement to tax vests with the state in which the goods are delivered by the hire-vendor to the hirer even though the goods may be transported/ transferred to a different state subsequently.

e) Rate of Tax

The rates of sales tax on hire-purchase deals vary from state to state. There is, as a matter of fact, no uniformity even regarding the goods to be taxed. If the rates undergo a change during the currency of a hire-purchase agreement, the rate in force on the date of delivery of the goods to the hirer is applicable.

3. Interest-Tax

The hire-purchase finance companies, like other credit/finance companies, have to pay Interest-Tax Act, 1974. According to this Act, interest tax is payable on the total amount of interest earned less bad debts in the previous year @ 2 per cent. The tax is treated as a tax-deductible expense for the purpose of computing the taxable income under the Income-tax Act.

Q24. Explain the advantages and disadvantages of Hire Purchase System.

(OR)

Describe the advantages and disadvantages of Hire Purchasing.

(OR)

State the merits and demerits of Hire Purchasing.

Ans :

Advantages

Hire-purchase is a mode of financing wherein the price of goods that needs to be sold is paid on some future date in the form of lease installments/ lease rentals. In a hire purchase transaction, the goods are let on hire, the purchase price is to be paid in installments and hirer is allowed with an option of purchasing them by paying the last installment.

The main advantages of hire purchase system are:

a) Advantages to Hire Purchaser

1. Use of Expensive Goods

In hire purchase system, people can fulfill their dream of owning luxurious and expensive goods such as cars, machineries, and so on.

2. Easy Payment

In this method, goods are paid in the form of monthly installments.

3. Encouragement to Savings

In leasing, as the payment of goods need to be made over a long period of time, it requires buyer to avoid other expenses in order to pay installments. As a result, it develops savings among them.

4. Facility of Free Repairs

In spite of buyer using the goods carefully if damage occurs then it is the responsibility of the owner to make arrangements for facilitating normal repairs free of cost till the termination of the lease contracts by paying last installment.

b) Advantages to Seller

1. Increase in Sales: People get attracted are facilitated to valuable goods through the hire purchase financing which also increases the sales of valuable goods in the market.

2. Recovery of Instalment Easily: If purchaser makes default in the payment of instalment then hire vendor can take back his goods from the buyer without refunding amount received in past. In order to overcome this issue, the buyer himself makes the payment on time.

3. Established Good Relation between the Buyer and Seller

Good relationship is established between the buyer and seller due to regular transaction and it helps the seller to get the information about the goods. Defective goods must be removed.

4. Possibility of Sales of other Goods

When buyer visit the showroom to make payment of installment, other attractive goods can also be offered to him. In this manner, additional sales can be generated.

5. Facility to Get Capital at Lower Rate

Creditors provide capital to the seller at low rate with full confidence so as to recover instalment amount regularly from the buyer,

c) Advantages to Society

1. More Production

In hire purchase transaction, there is a rise in sales which results in increase of production, employment and income.

2. Facilitate in Business

In hire purchase, payments are made in installments, which requires less capital in business. So business can be done easily.

3. Increase in Standard of Living

The hire purchase system facilitates the person to use the valuable goods which increases his standard of living.

Disadvantages

Some of the main disadvantages of hire purchase system are:

a) Disadvantages to Buyer

1. **Costly:** In a hire purchase transaction, a buyer has to pay additional charges which are usually more than the actual price of such goods. As the hire purchase price is inclusive of interest on unpaid installments of the goods.
2. **Risky for Hire Buyer:** If the buyer is failed to pay the required installments then the seller will take back the goods sold by him on the basis of hire purchase even without paying back the amount paid by buyer in past.
3. **Promotion of Wasteful Competition:** It is easy to get possession of expensive goods from hire purchase traders as a result people get attracted towards luxurious life which is beyond their scope. This results in extravagance and wasteful competition among them.
4. **No Right to Sale or Mortgage the Goods:** In hire purchase, ownership is transferred after the payment of the last installment. During installments, if the buyer sells or mortgages the goods then the new party is devoid of getting a better title.

b) Disadvantages to Vendor

1. **Large Capital:** The business concerns involved in hire purchase transactions need to have large capital to finance their business as its considerable part of capital is held in the form of book-debts (debtors).
2. **Difficulty in Repossession of Goods:** Seller is entitled to take back the goods from the buyer in case of default in the payment of hire purchase installment. Because, seller has to face lot of difficulty in fulfilling the legal requirements.
3. **More Expenses for Accounting:** Hire purchase system has to bear more expenses if it involves the selling of goods

to customer who are living in remote areas. As a result it creates problem of correspondence and also creates the problem of accounting.

4. **Loss on Sale of Goods:** Even though, seller can take back the goods let out on hire purchase on account of default payment instalment, he has to incur actual loss as goods taken back may not yield reasonable price on resale.

c) Disadvantage to Society

It is easy to get expensive things through hire purchase traders. People of medium and lower income group get attracted to luxury goods and even purchase unnecessary goods. They curtail other necessary expenses watch result.

2.6 LEASING

Q25. Define Leasing. Explain the characteristics of leasing.

(OR)

What is a Lease Agreement ? State the features of Leasing.

(OR)

What is Leasing ? Describe the features of leasing.

Ans : (Oct.-20, June-19, Imp.)

Meaning

Leasing has emerged as a new source of financing capital assets. It is a financing concept. It is an arrangement between two parties, the leasing company or lessor and the user or lessee. The lessor arranges to buy capital equipment for the use of the lessee for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to mutual convenience of both the parties. The lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Definitiiions**A Lease is Defined as follows**

- i) **According to Dictionary of Business and Management**, 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'
- ii) **According to James C. Van Horne** 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'
- iii) **According to Equipment Leasing Association of UK** 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

Characteristics

The following are the characteristics of a lease:

1. The Parties

Lease agreement involves two parties i.e., the lessor and the lessee. Lessor is the person who transfers the right to use an asset in consideration of a periodical rental payment whereas lessee is the person who acquires the right to use an asset from the lessor for periodical rental payment for an agreed period (pre-determined) of time.

2. The Asset

Leasing is mostly used to finance the use of fixed assets of high value. The asset is the property which is to be leased out such as automobile, an aircraft, plant and machinery,

building, and so on. In leasing the ownership of an asset is segregated from the use of the asset. During the lease period, ownership lies with the lesser where as it use is being transferred to the lesser.

3. The Term

The term of lease agreement is known as lease period. It considered as illegal to have a lease without a specified period of term. In case of a perpetual lease, lease period is for an infinite period of time and in case of financial lease, lease period is in connection with the economic life of the asset. Quite a few times the lease period is being divided into primary lease period and secondary lease period.

4. The Lease Rentals

Lease rentals forms the consideration which is payable by the lessee as being mentioned in the lease transaction. Rentals are ascertained in order to cover up such cost i.e., interest on the less or's investment, any repairs and maintenance costs which forms the part of the lease package, depreciation on the leased asset and any other service charges in relation to the lease

Q26. Explain the Essential Elements of Leasing.**(OR)****Describe the various elements of lease financing.****Ans : (Imp.)****1. Parties to the Contract**

There are essentially two parties to a contract of lease financing, namely, the owner and the user, called the lessor and the lessee respectively. Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial institutions. Sometimes there may be joint lessors or joint lessees, particularly where the properties or the amount of finance involved is enormous.

2. Asset

The asset, property or equipment to be leased is the subject-matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft and so on. The asset must, however, be of the lessee's choice suitable for his business needs.

3. Ownership Separated from User

The essence of a lease financing contract is that during the lease-tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

4. Term of Lease

The term of lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e., financial lease) or a period shorter than the useful life of the asset (i.e., operating lease). The lease may be perpetual, that is, with an option at the end of lease period to renew the lease for the further specific period.

5. Lease Rentals

The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the to rest on the investment, repairs and so forth-borne by the lessor and servicing charges over the lease period.

6. Modes of Terminating Lease

The lease is terminated at the end of the lease period and various courses are possible, namely,

- i) The lease is renewed on a perpetual basis or for a definite period or
- ii) The asset reverts to the lessor or
- iii) The asset reverts to the lessor and the lessor sells it to a third party or
- iv) The lessor sells the asset to the lessee.

The parties may mutually agree to and choose, any of the aforesaid alternatives at the beginning of the lease term.

Q27. Explain the classification of leasing.

(OR)

Explain the various kinds of leases.

(OR)

Explain the different types of leasing.

(OR)

What are the various types of leasing.

(OR)

Discuss the various types of lease rentals.

Ans :

(Oct.-20, June-19, Imp.)

The lease is broadly classified into three types:

1. Financial lease
2. Operating lease
3. Other types of lease

1. Financial Lease

The financial lease, usually covers the complete economic life of the asset. During the lease period the lessor receives the lease rental in order to not only recover the full cost of the asset, but also the reasonable return on the funds which are being to buy the asset. Infact finance lease is also known as capital lease.

Finance lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance. The asset would be returned to the lesser (or) managed as per the lease contract at the end of the period. Lease rental is usually considered as a payment for the usage of the asset only and a responsibility of repairing and maintain-ing the asset usually lies with the lessee.

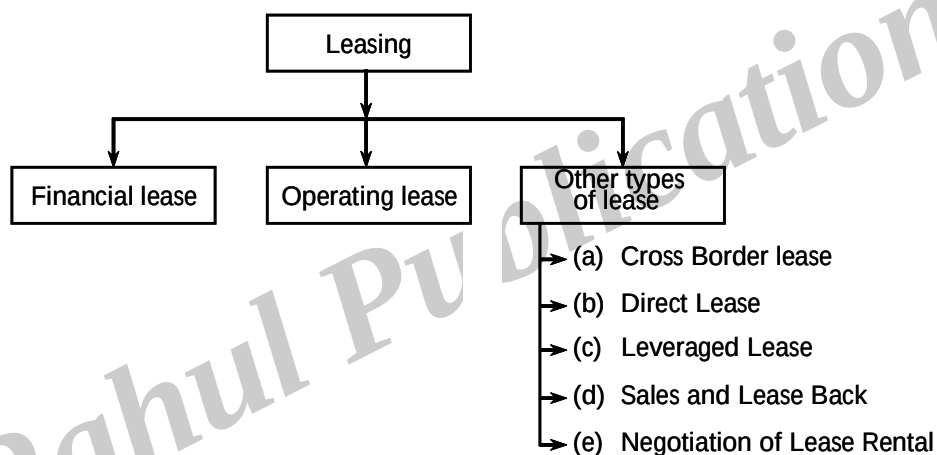


Fig.: Classification of Leasing

2. Operating Lease

An operating lease is an agreement where in the lessee obtains the use of an asset on a periodical basis. It is a lease arrangement for a period which is usually shorter than the life of an asset. An asset may be leased by the lesser to the different lessees one after the other. During the lease period the lease rental payable by one lessee is insufficient to completely cover the asset cost plus return. Therefore the present value of lease payment is usually lower than the actual price of the asset.

3. Other types of lease

(a) Cross Border lease

A cross border lease refers to the situation when a lessor leases an equipment to a lessee who does not come under the jurisdiction of the lessors territory. The important reasons behind the recourse to cross border leasing is that in greater number of cases like the operation which provides finance to an international commercial transaction, where the user not only procures 100% financing, but also includes the finance which includes a longer time period than government export credit. Under the cross border lease on the basis of the circumstances in the international capital market the attitude of the parties changes.

(b) Direct Lease

Direct lease is one of the type of finance lease where in lessor purchases the asset and transfers it to the lessee. Under the lease agreement, a manufacturer can also act as lessor and deliver the assets to the lesser.

(c) Leveraged Lease

When the lessor borrows a part of the purchase price from any leading institution then such a lease is known as leveraged lease. Under this lease, with the help of assets and the lease rentals the loan is being secured. The lessee (or) the lessor directly repay the loan out of the lease rentals.

In this leveraged lease the lender finances the as-set. Initially the lease rentals are distributed for payment to the lender in order to satisfy the debt obligation and any surplus and the remaining amount would be sent back to the lessor.

For costly assets the leveraged lease may be more useful.

(d) Sales and Lease Back

Under sale and lease back the lessee is already con-sidered as the owner of the asset. In this type of lease agreement, lessee sells the asset to the lessor, who further a leases back the asset to the owner i.e., the lessee.

The lessee not only retains the use of the asset, but also receives the funds from the sale of the asset to the lessor. This lease is usually opted by those firms having fixed assets, but shortage of funds. This agreement helps greatly the lessee as they can create the funds to enhance- the liquidity position.

(e) Negotiation of Lease Rental

The degree of acceptable level of rentals is repre-sented by the break even rental of the lessor and the les-see. The lower limit is fixed by the break even lease rental of the lessor whereas the upper limit is fixed by the break even lease rental of the lessee.

The real rental needs to be negotiated within the range. A rental within the range for both the lessor and the lessee would refer to a positive benefit of leasing. The range between the break even lease rental for both the lessor and the lessee shows the bargaining power for the negotiation of the actual lease rental for a lease proposal.

Q28. What are the differences between Financial Lease and Operating Lease.

(OR)

Compare and contrast Financial Lease and Operating Lease.

(OR)

Distinguish between Financial Lease and Operating Lease.

Ans :

Financial Lease	Operating Lease
1. A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period of time. The lessee commits to a series of payment which in total exceed the cost of the equipment. 2. It excludes provisions for maintenance or taxes which are paid separately by the lessee. 3. The risk of obsolescence is assumed by the lessee. 4. Contract period ranges from medium to long term. 5. Contracts are usually non cancellable. 6. Air crafts, land and building heavy machinery are leased. 7. The lease involves a financial commitment similar to a loan by a leasing company. It places the lessee in a position of borrow. 8. The lessor fulfills financial function.	1. An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period. 2. Operating lease provides for maintenance expenses and taxes of the lessor. 3. Leasing company assumes risk of obsolescence. 4. Contract period ranges from intermediate to short-term. 5. Contracts are usually cancellable either by the lessor or by the lessee. 6. Computers, office equipments, auto-mobiles, truck etc. are leased. 7. The financial commitment is restricted to regular rental payment. The rentals find a place in the P & L A/c of the lessee. 8. The lessor fulfills service function.

Q29. Explain the steps involved in Leasing.**(OR)****Outline the process of leasing agreements.**

Ans :

(Imp.)

Leasing is a financial arrangement between the two parties which provides an opportunity to a lessor to avail the benefits of using an asset without owning or purchasing it. The process of leasing involves the following steps:

1. Lease Selection

In a lease transaction, the first step is to select an asset which has to be taken on lease. The lessee select an asset after considering various requirements like lease payments, duration of leasing period, its terms and conditions and so on. After finalizing the nature and type of asset, the lessee then approaches the leasing company or the lease broking company with the objective of finalizing the lease deal. A lease agreement is negotiated broadly.

2. Order and Delivery

Depending on the selection made by the lessee, the lessor places an order with the manufacture of the asset which is to be leased. The asset must be delivered by the manufacturer to the concerned site of a lessee. After the receipt of the asset, the lessee is required to issue an acceptance notice to the lessor.

3. Lease Contract

A lease agreement is signed by both the parties after deciding the terms of the lease contract. Generally, leases are full payout with different terms and conditions. Usually, lease period ranges between 3 to 5 years.

4. Lease Period

During lease period, the lessee make regular payment of lease on which both the parties have to agree. The lessee ensures the lessor by run on the leased asset would be properly maintained.

In addition, the lessee must get warranties and after- sales services from the lessor. The lessee may either renews or terminates the leasing contract at the end of the lease period. The lessee is not provided with the purchase option in the lease agreement itself.

Q30. Explain the factors affecting growth of Indian Leasing.

Ans :

The following factors have been responsible for the growth of Indian leasing, in no particular order:

1. No Entry Barriers

Any one could float a leasing entity, and even an existing company not in leasing business can write a lease purely for tax shelters.

2. Buoyant Growth in Capital Expenditure by Companies

The post- liberalization era saw a spate of new ventures and fresh investments by existing ventures. Though primarily funded by the capital markets, these ventures relied upon leasing as a source of additional or stand-by funding. Most leasing companies, who were also merchant bankers, would have funded their clients who hired them for issue management services.

3. Fast Growth in Car Market

Needless to state with facts, the growth in car leasing volume has been the highest over these years - the spurt in car sales with the entry of several new models was funded largely by leasing plans.

4. Tax Motivations

India continues to have unclear distinction between a lease that will qualify for tax purposes, and one which would not. In retrospect, this is being realized as an unfortunate legislative mistake, but the absence of any clear rules to distinguish between true leases and financing transactions, and no bars placed on deduction of lease tax breaks against non-leasing income, propelled tax-motivated lease transactions. There was a growing market in sale and leaseback transactions, which, if tested on principles of technical perfection or financial prudence, would appear to be a shame on everyone's face.

5. Optimistic Capital Markets

Data would establish a clear connection between bullish stock markets and the growth in both number of leasing entities and lease volumes. Year 1994-1995 saw the peak of primary market activity where a company, even if a new entrant in business, could price itself on unexplainable premium and walk out with pride.

6. Access to Public Deposits

Most leasing companies in India have relied, some heavily, on retail public funds in the form of deposits. Most of these deposits were raised for a one year tenure, and on premise of high rates of interest, at times even more than the regulated rate (which was lifted in 1996 to be reintroduced in 1998).

7. Generally Go-Go Business Environment

At the backdrop of all this was a general euphoria created by liberalization and the economic policies of Dr. Manmohan Singh.

Q31. Explain the advantages and disadvantages of Leasing.

(OR)

What are the merits of leasing for a lessee and lessor.

(OR)

What are the benefits of leasing.

(OR)

What are the merits and demerits of leasing finance.

(OR)

Describe the merits and demerits of leasing.

Ans : (Oct.-20, Oct.-19, Imp.)

Advantages of Leasing

1. To the lessee

- (i) It is a simple agreement, free from cumbersome procedures therefore, it saves time and effort.
- (ii) It helps in financing of capital goods like land, building, machinery etc. with small initial investment.
- (iii) It acts as an additional source of finance and helps the lessee to expand his business operations
- (iv) It is a cheaper source of finance than other alternatives
- (v) A lease agreement allows for flexibility in rental payments and negotiation of agreement terms at the convenience of the lessee
- (vi) The lessee receives tax benefits
- (vii) Risk of Obsolescence of asset is avoided as the lessee has the option to replace the asset with the latest one.

2. To the Lessor

- (i) The lessor is fully secure as in case of default by lessee, the lessor can take back the asset as the ownership lies with him
- (ii) The lessor can lease assets with high depreciation rate and enjoy tax benefits by way of depreciation
- (iii) It is a highly profitable business, the lessor usually pays less interest on borrowings than what he charges from the lessee as premium
- (iv) The ultimate return on initial investment is very high.

Disadvantages of Leasing

The disadvantages of the lease to the lessee and to the lessor are as follows:

1. To the Lessee

- i) **High Cost :** The lease rentals include a margin for the lessor as also the cost of risk of obsolescence. It is, thus, regarded as a form of financing at higher cost.
- ii) **Loss of Moratorium Period :** The lease rentals do not take care of the gestation period. It usually takes a long-time before the asset generates funds to pay it back. The term loan provides certain suspension period in repayments for that reason. But no such moratorium is permitted under lease arrangements.
- iii) **Risk of being Deprived of the Use of Asset :** The lessee may be deprived of the use of the asset due to the deterioration in the financial position of the lessor or winding up of the leasing company.
- iv) **No Alteration or Change in Asset :** As the lessee is not the owner of the asset, he cannot make any substantial changes in the asset. Contrary to it, in case of outright purchase, the buyer can modify or alter the asset to increase its utility.
- v) **Loss of Ownership Incentives :** There are certain advantages of owning the assets, such as depreciation and investment allowance. In case of lease, the lessee is not entitled to such benefits.
- vi) **Penalties on Termination of Lease:** The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.
- vii) **Loss of Salvage Value of the Asset:** An asset generally has certain salvage value at the expiry of the useful life. As the lessee does not become the owner of the asset, he cannot realize the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

2. To the Lessor

- i) **High Risk of Obsolescence** : The lessor has to bear the risk of obsolescence especially in the present era of rapid technology developments.
- ii) **Competitive Market** : As a number of leasing companies have emerged in recent years in India, the lessor has to face a tough competition from Indian as well as foreign companies. Due to this competition, the lessor may not be able to obtain sufficient lease rentals to recover the cost of the asset and his expected profit on investment as well as taking the risk.
- iii) **Price-Level Changes** : In spite of the increase in prices of assets due to inflation, the lessor gets only fixed rentals based on previous costs.
- iv) **Management of Cash Flows** : The success of a leasing business depends to a large extent upon efficient use of cash flows which are very difficult to manage because of unexpected market fluctuations.
- v) **Increased Cost due to Loss of User Benefits** :
The lessor is not entitled to certain benefits available to buyers who are actual users of the assets such as concession in sales tax, duties, etc. This increases the cost of the asset and compels the lessor to charge higher lease rentals.
- vi) **Long-term Investment** : It usually takes a long-time to recover the cost of the lessor in the capital outlays through lease rentals. Thus, lease rentals received may not represent actual realized profits because of inherent risks involved. Payment of dividends out of present earnings may ultimately result into payment out of capital.

Q32. What are the basic principles of lending.

Ans :

- (i) **Liquidity**: Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice.
- (ii) **Safety**: The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing.
- (iii) **Diversity**: In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies. Diversification aims at minimizing risk of the investment portfolio of a bank.
- (iv) **Stability**: Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest its funds in the shares of reputed companies where the possibility of decline in their prices is remote.

Q33. Explain the Regulatory mechanism for leasing system in India.

Ans :

In India, equipment lease financing does not have an exclusive-legislative or regulatory framework for controlling the mechanism. The relevant provisions of various allied legislations

comprises the legislative framework of lease transactions. The lease agreements provide various of obligations on leasee which may not form an implied obligations under the legislative framework. The regulatory framework of lease financing in India is provided by legislative framework and the lease agreements.

The contract act, the vehicles act, the stamp Act and the RBI NBFCs directions under the RBI act. Forms the basis for the establishment of legislative framework of leasing.

Contract Act

The provisions of law of contract is applicable to all types of contracts which also includes leasing and hire purchase. There are certain provisions which are specifically designed for leasing transactions. The main features of such provisions of the law of contracts i.e., general and special are as follows:

General Provisions

The general provisions of contract act as follows:

Contract

It is an agreement which is enforceable by law. Some of the essential elements of a valid contract are:

1. Every contract has a legal obligation made through an offer and acceptance which shows the interest of offerer and offeree to enter into an agreement.
2. A contract must have a lawful consideration i.e., each of the parties to the agreement must give/get something.
3. Contract must be made between competent parties i.e., of 18 years of age and of sound mind.
4. The parties involved in contract must give free parties involved in contract must give free consent which must be free from coercion, fraud, mistake, etc.
5. The agreement must not be void if so it cannot be legally enforced.

Discharge of Contracts

There are different ways to discharge a contract, some of them includes:

1. By performance
2. By frustration
3. By mutual agreement
4. By operation of law and
5. By remission.

Remedies for a Breach of Contract

If a contract is not performed then it leads to a "Breach of contract". When any party of a contract is failed to fulfill his obligations, then the other party has a right to terminate the contract, on account of breach by the first party. The outcome of breach of contract must be borne by the party whose actions have created the breach of contract with whose action the other party has suffered. The following are the remedies for an aggrieved party.

1. Damages/compensation
2. Specific performance
3. Suit for injunction
4. Suit for quantum merit.

Indemnity and Guarantee

The provisions relating to indemnity and guarantee involved in the contract act are essential for leasing and hire-purchase contracts.

Indemnity

Indian contract Act defines contract of indemnity as "A contract by which are party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person is called a contract of indemnity" The person who promises to make good the loss is called the indemnifier (promisor) and the person whose loss is to be made good is called the indemnified or indemnity-holder (promisee). A contract of indemnity is really a class of contingent contracts.

Guarantee

Definition of contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default.

The person who gives the guarantee is called the surety and the person in respect of whose default the guarantee is given is called the principal debtor and the person to whom the guarantee is given is called the creditor.

A Guarantee may be oral or written, express or implied and may also be inferred from the course of conduct of the parties concerned.

Special Provisions

The provisions of the law of contract which are related to bailment are particularly applicable to even leasing contracts/transactions. In fact, a leasing agreement is a form of bailment agreement. Whereas, the hire-purchase agreement is a combination of bailment and sales agreement.

Leasing as a Bailment Agreement

Both leasing and bailment agreement possess similar elements. They are :

1. In bailment agreement, there are two parties i.e., a bailor, an individual who is entitled to deliver the goods to a bailee for use, like wise, in leasing transactions, the role of a bailor is same as that of a lessor while the lessee plays the same role as that of a bailor.
2. There is a transfer of goods which may be actual or constructive, between the bailor (lessor) and the bailee (lessee). However, the ownership remains to continue with the bailor (lessor).
3. In bailment agreement, goods are transferred for specific purpose whereas, in lease agreement, lessee is allowed to use the asset during lease period by the lessor.
4. In both the agreements, goods are returned back to the bailor (lessor) or disposed off as per his directions.

Liabilities of Lessee (Bailee)

The liabilities of a lessee are same as that of bailee. These are:

1. A lessee must take care of goods leased to him similarly, as an ordinary person takes care of his own goods.
2. The lessee must not use the leased goods for any other purpose other than the provisions mentioned in lease agreement and must not indulged into any unauthorized activities relating to the goods.
3. The lessee must return back the goods as soon as the lease time is over or if the purpose of the leased goods has been accomplished.
4. The lessee need to protect the lessors's title against any adverse claim.
5. The lessee must pay the lease rentals as mentioned in the lease agreement.
6. Some lease agreement require a lessee to insure or repair goods as per the provisions of the lease contract. However, if agreement does not specify any provision relating under to the repair then lessee is under no obligation to do the same.

Liabilities of the Lessor (Bailor)

The obligations of a lessor/bailor are as follows:

1. It is the responsibility of lessor to make sure that goods and necessary documents are delivered to lessee so as to use the goods lawfully.
2. During lease agreement, the lessee is allowed to use the goods only for economic purpose.
3. The lessor must see that goods are in a good operating condition for the purpose with which lessee takes them.
4. The lessor must disclose all the defects or faults of goods which are in his knowledge to the lessee.

Q34. Distinguish between Hire purchase and Lease financing.

(OR)

Compare and contrast Hire purchase and Lease financing.

(OR)

What are the differences between Hire purchase and Lease financing ?

Ans :

Table: Difference between Hire Purchase and Lease Financing

Sl. No.	Basis	Hire-Purchase	Lease Financing
1.	Ownership	Hirer becomes owner on payment of last installment	The lessor is the owner and ownership never passes to the lessee
2.	Down payment	20-25% of the cost is paid as down payment	No down payment
3.	Depreciation	Charged in the books of the hirer	Charged in the books of the lessor
4.	Maintenance	Borne by Hirer	Operating lease - Lessor Finance lease - Lessee
5.	Capitalization	In the books of the hirer	In the books of the leasing company
6.	Tax Benefits	On depreciation and finance charges to Hirer	On lease rentals to lessee On depreciation to lessor
7.	Risk of obsolescence	Borne by the Hirer	Operating lease - Lessor Finance lease - Lessee
8.	Reporting	The asset is shown in the balance sheet of hirer and the installment payable as a liability	The asset is shown in the balance sheet of the lessee in case of finance lease

2.7 NON-BANKING FINANCE COMPANIES

2.7.1 Types

Q35. Define Non-banking Finance Companies Explain the classification of Non-banking Finance Companies.

(OR)

Write about Non-banking finance company. Discuss its types.

Ans :

(Oct.-19, June-19)

Meaning

NBFC is referred to as a financial company which is registered under the Indian Companies Act, 1956. It collects deposits from the public and offers different type of financial help/support in the way of loans and investment. The primary function of NBFC is to accept deposits and deliver credit. They are responsible for channeling financial resources which may be scarce for capital information. They aid the banking sector in meeting the financial requirements of the small scale and retail sectors. As compared to banks, NBFC'S are flexible, quick, efficient and provide customize services as per the requirements of the clients.

Types of Non-Banking Financial Companies

The RBI has classified NBFC's under four categories as follows,

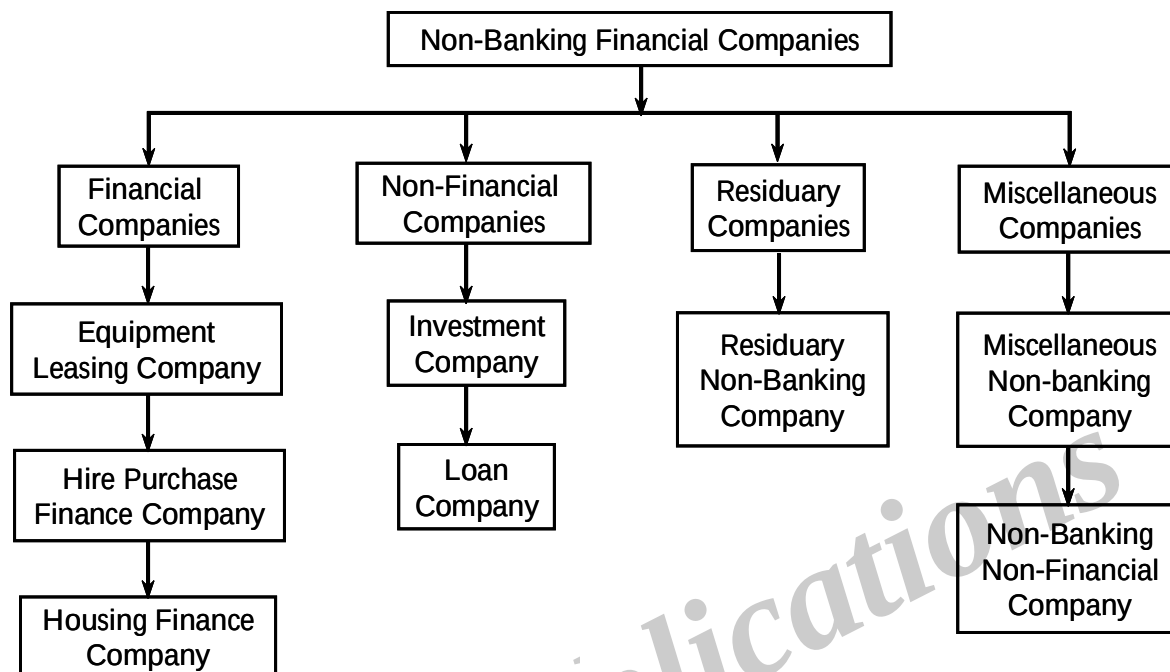


Fig.: Types of Non-Banking Financial Companies

1. Financial Companies

The financial companies are further classified as,

(a) Equipment Leasing Company

Any company which carries out its principal business, the activity of leasing of equipment or financing of such activity is considered as an equipment leasing company. This leasing business normally carries out by a contract between the lessor and the lessee.

The Equipment leasing company is categorized as,

- (i) **Operating Leasing:** The producer of capital equipment who offers his product directly to the lessee without any middle men on a lease basis is known as operating leasing.
- (ii) **Finance Leasing:** The producer of the capital equipment who sells the equipment to a leasing company and leases it to the user of that equipment where it involves three parties and the leasing company itself acts as a middle man between the losses and producer is known as finance leasing.

(b) Hire Purchase Finance Company

Any company which carries out its principal business, the hire purchase transactions or financing of such transactions is known as Hire purchase finance company. It assists small transport operators, professionals and middle income group people to buy the product on the basis of hire purchase system. It is considered as low risk business as the goods purchased on hire purchase acts as securities till the last installment.

(c) Housing Finance Company

The collection of all financial arrangements that have been made by Housing Finance Companies (HCFs) in order to meet the need of housing is termed as a housing finance company. They accept deposits and lend money only for the purpose of housing.

2. Non-Financial Companies

The non-financial companies are further classified as,

- (a) Investment Company:** Any company which purchases, sells and under writes securities, creates a market for government securities is known as investment company.
- (b) Loan Company:** Any company which carries out its principal business i.e., providing of finance loan for any activity is known as a loan company. They provide loans generally to wholesalers, retailers, small-scale industries and the self-employed. The loan companies charges huge rates of interest on loan amount as they are unsecured and risky.

3. Residuary Companies

The residuary companies includes,

- (a) Residuary Non-Banking Company:** The company which does not belong to any category mentioned above is considered as residuary Non-Banking Company. It carries out its business by different names in different regions. It receives deposits either in lump sum amount or in installments or sale of units or certificates etc.

4. Miscellaneous Company

The miscellaneous finance company includes,

- (a) Miscellaneous Non-Banking Company:** A company which carries out its business on managing business, conducting or supervising as a promoter, agent of any transactions in any form of chit fund is termed as miscellaneous non-banking company.
- (b) Non-Banking Non-Financial Company:** Any company which carries out its principal business activity in agricultural operations or trading in goods and services or real estate and is not related to financial or miscellaneous or residuary non-banking companies is known as a non-banking non-financial company.

2.7.2 Functions

Q36. Explain the various functions of Non-banking Finance Companies.

(OR)

Describe the various functions of Non-banking Finance Companies.

Ans :

Following are the functions of NBFCs,

1. Accepting Deposits

The main function of NBFC is to collect/accept deposits from the public which might be either money or a loan or in any other form like unit certificates, savings certificates and so on. NBFCs can not accept the demand deposits or offer cheque facilities to their customers. Deposits are of two types,

- (a) **Regulated Deposits:** The deposits which are regulated by RBI are termed as regulated deposits. RBI regulates the deposits of NBFCs by perommanding certain ceilings or by charging certain restrictions.
- (b) **Exempted Deposits:** The deposits which are exempted from the regulations laid down by RBI are termed as exempted deposits. These deposits include,
- (i) Inter company borrowings
 - (ii) Borrowings from banks and other financial institutions
 - (iii) Security deposits
 - (iv) Money received from the Government (state/central/foreign)
 - (v) Money received from local authorities/directors etc.

2. Giving Loans

NBFC's offers financial support in different forms like hire purchase, finance, leasing finance, consumer loans, purchasing of equipment and financing of social activity.

3. Investment of Money

NBFC's basically makes investment of their surplus funds in different instruments such as portfolio of securities and disseminates its advantages among the small investors.

Q37. What are the differences between NBFC and Bank ?

Ans :

Basis	NBFC	Bank
Meaning	NBFC provides banking services to people without holding a bank license	Bank is a government authorized financial intermediary which provides banking services to the general public
Incorporated under	Companies Act 1956 and 2013.	Banking Regulation Act, 1949.
Demand Deposit	Not Accepted	Accepted
Foreign Investment	Allowed upto 100%	Allowed up to 74% for private sector banks
Payment and Settlement system	Not a part of system.	Integral part of the system
Deposit insurance facility	Not available	Available
Credit creation	NBFC do not create credit.	Banks create credit.
Transaction services	Not provided by NBFC.	Provided by banks.

Short Question and Answers

1. What are the basic principles of lending?

Ans :

(i) Liquidity

Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice.

(ii) Safety

The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing.

(iii) Diversity

In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies. Diversification aims at minimizing risk of the investment portfolio of a bank.

(iv) Stability: Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest its funds in the shares of reputed companies where the possibility of decline in their prices is remote.

2. What is Portfolio Management?

Ans :

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely, a collection of unrelated assets but a carefully blended asset combination within a unified framework. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return with minimum risk.

Merchant bankers provide portfolio management service to their clients. Today the investor is very prudent. Every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. They need expert guidance. Merchant bankers have a role to play in this regard. They have to conduct regular market and economic surveys to know.

- (i) Monetary and fiscal policies of the government.
- (ii) Financial statements of various corporate sectors in which the investments have to be made by the investors.
- (iii) Secondary market position, i.e., how the share market is moving.
- (iv) Changing pattern of the industry.
- (v) The competition faced by the industry with similar type of industries.

3. Bringout the characteristics features of a commercial banks.

Ans :

i) Ownership Characteristic of Commercial Bank

Commercial banks can be formed on the basis of any ownership, such as a proprietorship, partnership or company. If it is formed on a partnership basis, its membership will be up

to 10 people. If formed as a company, then it has to be formed according to the law of 1994. Ownership is the best characteristic of the commercial bank. It's a first and the best feature of the bank.

ii) Taking Deposit Characteristic of Commercial Bank

One of the main features of the commercial bank is to take the savings of people's money through different types of accounts. People can open their accounts according to their convenience and submit their accumulated money to the bank. These accounts are the current accounts, savings accounts, and permanent accounts.

iii) Encourage to Savings Characteristics of Commercial Bank

A prominent feature of the commercial bank is that people are more interested in saving through extensive publicity. This ensures that more saving storage is collected. It is possible to form capital in the country. Encourage saving is the most effective characteristics of a commercial bank. Increasing the attractiveness of the customer's mind has resulted in an increase in the amount of storage.

4. "Banker acts as an agent to the customer"

Ans :

When a customer deposits cheques, drafts, bills or any other promissory notes, the banker collects them and on realization credits the account of the customer. For this activity, the banker is given commission. Banks also act as a correspondent, representative of their customers. Some banks may even get the travelers' tickets, passport etc. for their customers.

5. Explain the classification of commercial banks.

Ans :

(a) Public Sector Banks: In India, public sector banks are regulated by the various laws and statutes proposed by the parliament. The board of public sector banks comprises directors in the form of chairman, managing

director government nominee director, RBI's nominee director and some other elected directors and so on. Till the end of March 2009, the number of public sector banks in India were numbered to 27. (Out of which 20 were nationalised banks was State Bank of India (SBI) and 6 were associates banks of SBI).

Example : State bank of India (SBI), Central Bank of India, Andhra Bank, Bank of Baroda, Punjab National Bank etc.

(b) Private Sector Banks: In March 2009 the number of private sector banks in India were found to be 22. Among them, 15 constituted the old banks while the remaining 7 were new private sector banks. The main purpose behind the allowance of private sector to own and operate banks was to ensure the diversification of ownership and control. New private sector banks are also permitted to enter the market with an initial capital of about 200 crores, which would increase to a total of about 300 crores in the next three consecutive years. In India for any private sector bank, the aggregate foreign investment is restricted to only 76% of the paid up capital, (i.e., the remaining capital must be contributed by the residents of a country).

Examples : Global Trust Bank Ltd., ICICI Banking Corporation Bank Ltd., Axis Bank, HDFC etc.

(c) Foreign Banks: In India, foreign banks can operate through any one of the following options.

- (i) They can operate through the establishment of their own branches (may be in same country or in some other country).
- (ii) They can also enter the market by establishment of the wholly owned subsidiaries.
- (iii) They can also establish the partly owned subsidiaries with an maximum aggregate investment of about 74 percent (in any private sector bank).

Any foreign bank on establishing its first branch in India is required to invest an initial capital of about 25 million U.S dollars. In March 2009, the number of foreign banks in India were found to be only 32.

Examples: Bank of Tokyo Ltd., Citi Bank N.C, Standard Chartered Bank Ltd., American Express Bank etc.

- (d) **Regional Rural Banks:** There were only 84 Regional Rural Banks in India by the end of March 2009. The main purpose of regional rural banks was to deliver the rural credit facilities to the backward areas. Thereby, ensuring their financial soundness. Central government respective state government and sponsors (Commercial banks) are responsible for the contribution of initial capital base of RRBs. The regulatory framework of regional rural banks (RRB 's) has been proposed by the Reserve Banks of India (RBI) and NABARD which helps in supervising their operations with some supervisory powers.

6. Define Merchant banking.

Ans :

Merchant Banking is defined differently in different countries. Though there is no universal definition for merchant banking functions and services offered by a merchant banker. It is also called as investment banking.

There is no universal definition for merchant banking. It assumes diverse functions in different countries. So 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, acceptance credit, counselling, insurance etc.

The Notification of the Ministry of Finance defines a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management".

7. Underwriting of Public Issue

Ans :

Underwriting is a guarantee given by the underwriter that in the event of under subscription the amount underwritten, would be subscribed by him. It is an insurance to the company which proposes to make public offer against risk of under subscription. The issues packed by well known underwriters generally receive a high premium from the public. This enables the issuing company to sell securities quickly.

All public issues have to be fully under written. Only Category I, II and III merchant bankers are permitted to underwrite an issue subject to the limit that the outstanding commitments of any such individual merchant banker at any point of time do not exceed five times of his net worth (paid-up capital and free reserves excluding revaluation reserves). This criteria is applicable to brokers also. Lead managers have to underwrite mandatorily 5% of the issue or Rs. 2.5 lakh whichever is less. Banks/ Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

By ensuring a direct stake in the underwriting, the merchant bankers make raising of external resources easy.

8. Define venture capital.

Ans :

Introduction

The term 'Venture Capital' is understood in many ways. In a narrow sense, it refers to, investment in new and tried enterprises that are lacking a stable record of growth.

In a broader sense, venture capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

Meaning

Venture capital is long-term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

Definition

A venture capital company is defined as “a financing institution which joins an entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprise”.

9. Dimensions of Venture Capital.

Ans :

Venture capital is available in four forms. They are :

- (a) **Equity Participation :** The venture capital finances up to 49% of the equity capital and the ownership remains with the entrepreneur.
- (b) **Conventional Loan :** Under this, a lower fixed rate of interest is charged to the unit till its commercial operation. After normal rate of interest paid, loan is to be repaid as per the agreement.
- (c) **Conditional Loan :** A conditional loan is repayable in the form of royalty ranging between 2 and 15% after the venture is able to generate sales and no interest is paid on such loans.
- (d) **Income Notes :** The income note combines the features of conventional and conditional loans in a way that the entrepreneur has to pay both interest and royalty on sales at low rates.

10. Define private equity.

Ans :

Private equity is 'hands-on' investing. In private equity fund, partners become the directors of the invested companies. Private equity can be used to make investment in a newly introduced businesses or sick or struggling businesses. In case of private equity financing, funding is usually for long-term period i.e., for 4 to 12 years. Private

equity financing is usually opted in management buyouts and leveraged buyouts, so as, to get control over the company. Private equity investors are capable of earning high internal rate of returns at the same time they assumes high levels of risk.

11. Demerits of Hire Purchasing.

Ans :

Some of the main disadvantages of hire purchase system are:

a) Disadvantages to Buyer

1. **Costly:** In a hire purchase transaction, a buyer has to pay additional charges which are usually more than the actual price of such goods. As the hire purchase price is an inclusive of interest on unpaid installments of the goods.
2. **Risky for Hire Buyer:** If the buyer is failed to pay the required installments then the seller will take back the goods sold by him on the basis of hire purchase even without paying back the amount paid by buyer in past.
3. **Promotion of Wasteful Competition:** It is easy to get possession of expensive goods from hire purchase traders as a result people gets attracted towards luxurious live which is beyond their scope. This results in extravagance and wasteful competition among them.
4. **No Right to Sale or Mortgage the Goods:** In hire purchase, ownership is transferred after the payment of the last installment. During installments, if the buyer sells or mortgages the goods then the new party is devoid of getting a better title.

b) Disadvantages to Vendor

1. **Large Capital:** The business concerns involved in hire purchase transactions need to have large capital to finance their business as its considerable part of capital is held in the form of book-debts (debtors).
2. **Difficulty in Repossession of Goods:** Seller is entitled to take back the goods from the buyer in case of

default in the payment of hire purchase installment. Because, seller has to face lot of difficulty in fulfilling the legal requirements.

3. **More Expenses for Accounting:** Hire purchase system has to bear more expenses if it involves the selling of goods to customer who are living in remote areas. As a result it creates problem of correspondence and also creates the problem of accounting.

4. **Loss on Sale of Goods:** Even though, seller can take back the goods let out on hire purchase on account of default payment instalment, he has to incur actual loss as goods taken back may not yield reasonable price on resale.

c) Disadvantage to Society

It is easy to get expensive things through hire purchase traders. People of medium and lower income group get attracted to luxury goods and even purchase unnecessary goods. They curtail other necessary expenses with result.

12. Define Leasing.

Ans :

Meaning

Leasing has emerged as a new source of financing capital assets. It is a financing concept. It is an arrangement between two parties, the leasing company or lessor and the user or lessee. The lessor arranges to buy capital equipment for the use of the lessee for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to mutual convenience of both the parties. The lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Definitions

A Lease is Defined as follows

- i) **According to Dictionary of Business and Management,** 'Lease is a form of contract transferring the use or occupancy of land, space, structure or equipment, in consideration of a payment, usually in the form of a rent.'
- ii) **According to James C. Van Horne** 'Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset usually for an agreed period of time in return for the payment of rent.'
- iii) **According to Equipment Leasing Association of UK** 'A Contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has possession and use of the asset on payment of specified retain over the period.'

Thus in a contract of lease there are two parties involved (i) lessor and the lessee. The lessor can be a company, a co-operative society, a partnership firm or an individual in manufacturing or allied activities. The lessee can be even a doctor or any other specialists who use costly equipment for the practice of his profession.

13. Financial Lease

Ans :

The financial lease, usually covers the complete economic life of the asset. During the lease period the lessor receives the lease rental in order to not only recover the full cost of the asset, but also the reasonable return on the funds which are being to buy the asset. In fact finance lease is also known as capital lease.

Finance lease is generally noncancellable in nature and the lessor provides for the proper asset maintenance. The asset would be returned to the lessor (or) managed as per the lease contract at the end of the period. Lease rental is usually considered as a payment for the usage of the asset only and a responsibility of repairing and maintaining the asset usually lies with the lessee.

14. What are the differences between Financial Lease and Operating Lease?*Ans :*

Financial Lease	Operating Lease
1. A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period of time. The lessee commits to a series of payment which in total exceed the cost of the equipment. 2. It excludes provisions for maintenance or taxes which are paid separately by the lessee. 3. The risk of obsolescence is assumed by the lessee. 4. Contract period ranges from medium to long term.	1. An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of equipment during contractual period. 2. Operating lease provides for maintenance expenses and taxes of the lessor. 3. Leasing company assumes risk of obsolescence. 4. Contract period ranges from intermediate to short-term.

15. Merits of leasing for a lessee and lessor.*Ans :***Advantages of Leasing****1. To the lessee**

- (i) It is a simple agreement, free from cumbersome procedures therefore, it saves time and effort.
- (ii) It helps in financing of capital goods like land, building, machinery etc. with small initial investment.
- (iii) It acts as an additional source of finance and helps the lessee to expand his business operations
- (iv) It is a cheaper source of finance than other alternatives
- (v) A lease agreement allows for flexibility in rental payments and negotiation of agreement terms at the convenience of the lessee
- (vi) The lessee receives tax benefits
- (vii) Risk of Obsolescence of asset is avoided as the lessee has the option to replace the asset with the latest one.

2. To the Lessor

- (i) The lessor is fully secure as in case of default by lessee, the lessor can take back the asset as the ownership lies with him
- (ii) The lessor can lease assets with high depreciation rate and enjoy tax benefits by way of depreciation
- (iii) It is a highly profitable business, the lessor usually pays less interest on borrowings than what he charges from the lessee as premium
- (iv) The ultimate return on initial investment is very high.

16. Functions of Non-banking Finance Companies.

Ans :

Following are the functions of NBFCs,

1. Accepting Deposits

The main function of NBFC is to collect/accept deposits from the public which might be either money or a loan or in any other form like unit certificates, savings certificates and so on. NBFCs can not accept the demand deposits or offer cheque facilities to their customers. Deposits are of two types,

- (a) Regulated Deposits:** The deposits which are regulated by RBI are termed as regulated deposits. RBI regulates the deposits of NBFCs by perommanding certain ceilings or by charging certain restrictions.
- (b) Exempted Deposits:** The deposits which are exempted from the regulations laid down by RBI are termed as exempted deposits. These deposits include,
 - (i) Inter company borrowings
 - (ii) Borrowings from banks and other financial institutions
 - (iii) Security deposits
 - (iv) Money received from the Government (state/central/foreign)
 - (v) Money received from local authorities/directors etc.

2. Giving Loans

NBFC's offers financial support in different forms like hire purchase, finance, leasing finance, consumer loans, purchasing of equipment and financing of social activity.

3. Investment of Money

NBFC's basically makes investment of their surplus funds in different instruments such as portfolio of securities and disseminates its advantages among the small investors.

Choose the Correct Answer

1. A merchant bank is a financial institution conducting money market activities and: [d]
(a) Lending (b) Underwriting and financial advice
(c) Investment service (d) All of the above
2. Formal merchant banking activity in India was originated in _____. [b]
(a) 1978 (b) 1969
(c) 1769 (d) 1987
3. State Bank of India started merchant banking in _____ followed by ICICI in _____. [c]
(a) 1972, 1974 (b) 1978, 1980
(c) 1973, 1974 (d) 1980, 1981
4. The early growth of merchant banking in the country is assigned to the _____. [b]
(a) FEMA (b) Foreign Exchange Regulation Act, 1973
(c) Securities Contracts Act (d) Income-tax Act
5. Developmental activities of merchant banking: [d]
(a) Sources of funds forever
(b) Expanding industry and trade
(c) Leaving a widening gap unbridged between supply and demand of investible funds.
(d) All of the above
6. The term 'Merchant Bank' is used in: [b]
(a) United States (b) United Kingdom
(c) America (d) India
7. Issue management is an important function of _____ and _____. [a]
(a) Merchant banker, lead manager (b) Public banker, Merchant banker
(c) Lead banker, Private banking (d) None of the above
8. Role of merchant bankers _____. [d]
(a) Mobilization of funds (b) Promotional function
(c) Innovation (d) All of these
9. _____ is a long term risk capital to finance high technology projects which involve risk but at same time has strong potential for growth. [a]
(a) Venture capital (b) Hedge finance
(c) Merchant banker (d) Hire purchaser

10. _____ act as an intermediary to link up the sources of ideas and the sources of fund. [a]
(a) Venture capital (b) Merchant banking
(c) Leasing (d) None of these.
11. Which of the following is not a fee based financial service? [b]
(a) Corporate counseling (b) Lease financing
(c) Profit management (d) Issue management
12. A person who agrees to take up party subscribed securities is, [a]
(a) Underwriter (b) Debenture trustee
(c) Portfolio manager (d) Registrar
13. Generally, a maximum of _____ lead managers are appointed as lead managers for issues less than ` 50 crores. [a]
(a) Two (b) Three
(c) Four (d) Five
14. Underwriter should subscribe the issue within _____ days of the date of receiving an intimation from the issuer. [c]
(a) 30 days (b) 60 days
(c) 45 days (d) 15 days
15. A type of lease where the lessor is not related to the repairs and maintenance of the leased asset is known as, [a]
(a) Net lease (b) True lease
(c) Full payout lease (d) Financial lease
16. Companies which enters into leasing business for the purpose of taking the advantage of huge depreciation and tax benefits is, [b]
(a) Specialized leasing companies (b) One-off lessors
(c) Manufacturer lessors (d) Financial institutions
17. Select the benefits for lessor. [d]
(a) Stable business (b) Second-hand market
(c) Wider distribution (d) All the above
18. The following are the step of the leasing process, [d]
(a) Lease selection (b) Lease contract
(c) Lease period (d) All the above
19. Parties involved in hire purchase transaction are, [c]
(a) Hirer (b) Hire-vendor
(c) Both (a) & (b) (d) Lessor
20. The initial amount paid in hire purchase transaction is known as, [a]
(a) Down payment (b) Interest
(c) Depreciation (d) Cost of asset

Fill in the blanks

1. In financial lease, _____ bears the risk of obsolescence.
2. _____ lease is for a limited period.
3. The leased asset is shown on the Balance sheet of the _____
4. An equipment lease transaction is regarded as a contract of _____
5. The entire lease rental is treated as _____ in the books of lessor.
6. The minimum size of VC Fund is Rs _____.
7. Venture capital originated in _____
8. In the implementation stage of a project venture capital firms provide _____ finance.
9. VC firms are allowed to invest in leasing upto _____ of the total funds deployed.
10. VC firms usually invest in _____ and _____ scale industries.
11. In _____ the ownership of asset is separated from economic use of an asset or equipment.
12. The consideration paid by the lessee as mentioned in the lease transaction is called as _____.
13. In _____ the parties stays in different countries.
14. A means of financing the price of goods to be sold on a future date is _____.
15. _____, and _____ are included in taxation aspects of hire-purchase transactions.
16. The rate of interest which is charged in HP as a percent of the original cash price of the asset is _____.
17. _____ is the balance amount which is by the hirer after making the down payment.
18. _____ refers to the total holding of securities of an investor.
19. The marketing of corporate securities by offering then to the public is known as _____.
20. Portfolio managers have to obtain certificate of registration from the _____ to act as portfolio mangers.

ANSWER

1. Lessee
2. Operating lease
3. Lessor

4. Bailment
5. Income
6. Rs. 10 crs.
7. USA
8. Start up
9. 15%
10. Small and Medium
11. Leasing
12. Lease rentals
13. International lease
14. Hire-purchase
15. Income tax, sales tax and interest tax
16. Add-on rate of interest
17. Equated Monthly Installments (EMIs)
18. Portfolio
19. Issue management
20. SEBI

UNIT III

MONEY MARKET:

Functions of Money Market - Organization of Money Market - Dealers - Money Market Instruments - RBI - Functions - Role of RBI in Money Market- LAF (Liquidity Adjustment Facility), MSF (Marginal Standing Facility), Repo, and Reverse Repo - MPC (Monetary Policy Committee) - Structure and Functions.

3.1 MONEY MARKET

Q1. Define Money market.

(OR)

What is Money market ?

Ans : (July-21, June-19, June-19(MGU))

Meaning

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short term funds. As the name implies, it does not actually deal in cash or money. But it actually deals with near substitutes for money or near money like trade bills, promissory notes and Government papers drawn for a short period not exceeding one year. These short term instruments can be converted into cash readily without any loss and at low transaction cost.

Money market is the centre for dealing mainly in short-term money assets. It meets the short-term requirements of borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government.

The money market does not refer to a particular place where short-term funds are dealt with. It includes all individuals, institutions and intermediaries dealing with short-term funds. The transactions between borrowers, lenders and middlemen take place through telephone, telegraph, mail and agents. 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, the London money market operates from Lombard street and the New York money market operates from Wall street. But, they attract funds from all over the world to be lent to borrowers from all over the globe. Similarly, the Mumbai money market is the centre for short-term loanable funds of not only Mumbai, but also the whole of India.

Definitions

- (i) **According to Geottery Crowther**, "The money market is the collective name given to the various firms and institutions that deal in the various grades of near money".
- (ii) **According to RBI** defines the money market as, "a market for short term financial assets that are close substitutes for money, facilitates the exchange of money for new financial claims in the primary market as also for financial claims, already issued, in the secondary market".

Q2. Explain the features of money market.

(OR)

Describe the features of money market.

Ans : (June-19(MGU))

1. Existence of Unorganized Money Market

This is one of the major defects of Indian money market. It does not distinguish between short term and long term finance, and also between the purposes of finance. Since it is outside the control and supervision of RBI, it limits the RBI's control of over money market.

2. Lack of Integration

The Indian money market is broadly divided into two sectors, the organized money market and the unorganized market. The organized market constitutes several institutions such as RBI, State Bank of India, commercial banks, cooperative banks and financial institutions. RBI as an apex body regulates their working. The unregulated sector is not homogenous in itself. It constitutes indigenous bankers, loan companies, money lenders, etc. There is no uniformity in their practices and there is multiplicity of functionaries.

3. Multiplicity in Interest Rates

There exists too many rates of interest in the Indian money market such as the borrowing rate of government, deposits and lending rates of cooperative and commercial banks, lending rates of financial institutions, etc. This is due to lack of mobility of funds from one section of the money market to another. The rates differ for funds of same durations lent by different institutions.

4. Inadequate Funds

Generally there is shortage of funds in Indian money market on account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy, etc. However, the banking development particularly branch expansion, has improved the mobilization of funds to some extent in the recent years.

5. Seasonal Stringency of Money

The seasonal stringency of money and high rate of interest during the busy season (November to June) is a striking feature of Indian money market. There are wide fluctuations in the interest rates from one season to another. RBI has been taking various measures to avoid such fluctuations in the money market by adding money into the money market during the busy season and withdrawing the funds during the slack season.

6. Absence of Bill Market

A well organized bill market is necessary for linking up various credit agencies effectively to RBI. The bill market is not yet developed on account of many factors such as the practice of banks keeping a large amount of cash for liquidity purposes, preference for borrowing rather than discounting bills, dependence of indigenous bankers on one another, widespread practice of using cash credit, high stamp duty on usance bill, etc.

7. Inadequate Credit Instruments

The Indian money market did not have adequate short term paper instruments till 1985-86. There were only call money and bill markets. Moreover there were no specialist dealers and brokers dealing in the money market. After 1985-86, RBI has introduced new credit instruments such as 182-day treasury bills, 364-day treasury bills, CDs and CPs. These instruments are still in underdeveloped state in India. The above defects of Indian money market clearly indicate that it is relatively less developed and has yet to acquire sufficient depth and width. Thus, it cannot be compared with developed money markets such as London and New York money markets.

3.1.1 Functions of Money Market**Q3. Explain the functions of money market.****(OR)****Describe the functions of money market.****(OR)****What are the functions of money market.****(OR)****Explain the functions of money market in India.****Ans : (July-21, June-19, Imp.)**

The money market contributes to the economic stability and development of a country by providing short-term liquidity to governments, commercial banks, and other large organizations. Investors with excess money that they do not need can invest it in the money market and earn interest.

Here are the main functions of the money market:

1. Financing Trade

The money market provides financing to local and international traders who are in urgent need of short-term funds. It provides a facility to discount bills of exchange, and this provides immediate financing to pay for goods and services. International traders benefit from the acceptance houses and discount markets. The money market also makes funds available for other units of the economy such as agriculture and small-scale industries.

2. Central Bank Policies

The central bank is responsible for guiding the monetary policy of a country and taking measures to ensure a healthy financial system. Through the money market, the central bank can perform its policy-making function efficiently. For example, the short-term interest rates in the money market represent the prevailing conditions in the banking industry and can guide the central bank in developing an appropriate interest rate policy. Also, the integrated money markets help the central bank to influence the sub-markets and implement its monetary policy objectives.

3. Growth of Industries

The money market provides an easy avenue where businesses can obtain short-term loans to finance their working capital needs. Due to the large volume of transactions, businesses may experience cash shortages related to buying raw materials, paying employees, or meeting other short-term expenses. Through commercial paper and finance bills, they can easily borrow money on a short-term basis. Although the money market does not provide long-term loans, it influences the capital market and can also help businesses obtain long-term financing. The capital market benchmarks its interest rates based on the prevailing interest rate in the money market.

4. Commercial Banks Self-Sufficiency

The money market provides commercial banks with a ready market where they can invest their excess reserves and earn interest while maintaining liquidity. The short-term investments such as bills of exchange can easily be converted to cash to support customer withdrawals. Also, when faced with liquidity problems, they can borrow from the money market on a short-term basis as an alternative to borrowing from the central bank. The advantage of this is that the money market may charge lower interest rates on short-term loans than the central bank typically does.

Q4. Explain the importance of money market.

Ans :

A developed money market plays an important role in the financial system of a country by supplying short-term funds adequately and quickly to trade and industry. The money market is an integral part of a country's economy. Therefore, a developed money market is highly indispensable for the rapid development of the economy. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

(i) Development of Trade and Industry

Money market is an important source of financing trade and industry. The money market, through discounting operations and commercial papers, finances the short-term working capital requirements of trade and industry and facilitates the development of industry and trade both - national and international.

(ii) Development of Capital Market

The short-term rates of interest and the conditions that prevail in the money market influence the long-term interest as well as the resource mobilisation in capital market. Hence, the development of capital market depends upon the existence of a developed money market.

(iii) Smooth Functioning of Commercial Banks

The money market provides the commercial banks with facilities for temporarily employing their surplus funds in easily realisable assets. The banks can get back the funds quickly, in times of need, by resorting to the money market. The commercial banks gain immensely by economizing on their cash balances in hand and at the same time meeting the demand for large withdrawal of their depositors. It also enables commercial banks to meet their statutory requirements of cash reserve ratio (CRR) and Statutory Liquidity Ratio (SLR) by utilizing the money market mechanism.

(iv) Effective Central Bank Control

A developed money market helps the effective functioning of a central bank. It facilitates effective implementation of the monetary policy of a central bank. The central bank, through the money market, pumps new money into the economy in slump and siphons it off in boom. The central bank, thus, regulates the flow of money so as to promote economic growth with stability.

(v) Formulation of Suitable Monetary Policy

Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence, it serves as a guide to the Government in formulating and revising the monetary policy then and there depending upon the monetary conditions prevailing in the market.

(vi) Non-inflationary source of Finance to Government

A developed money market helps the Government to raise short-term funds through the treasury bills floated in the market. In the absence of a developed money market, the Government would be forced to print and issue more money or borrow from the central bank. Both ways would lead to an increase in prices and the consequent inflationary trend in the economy.

Q5. Explain the objectives of money market.**(OR)****Describe the objectives of money market.****Ans : (Imp.)**

The following are the important objectives of a money market:

- (i) To provide a parking place to employ short-term surplus funds.
- (ii) To provide room for overcoming short-term deficits.
- (iii) To enable the Central Bank to influence and regulate liquidity in the economy through its intervention in this market.
- (iv) To provide a reasonable access to user of short-term funds to meet their requirements quickly, adequately and at reasonable costs.

Q6. State the defects of money market.**Ans :**

The following are the defects of Indian money market,

1. Existence of Unorganized Market

One of the main defect of the Indian money market is the presence of indigenous bankers who do not differentiate between the short-term finance or long-term finance. Similarly, NBFC's (Non-Banking Financial Companies) raises funds from public but are not under the control and regulation of RBI. The indigenous bankers and NBFC's carry out their operations outside the organized market. The control and supervision of RBI is limited in unorganized sector.

2. Lack of Integration

The other significant drawback of money market is lack of integration. The Indian money market is divided into different heads which not have any cordial relationship with each other. The various heads in money market such as, SBI and its subsidiaries, foreign exchange banks, Urban Cooperative Banks and Indigenous Bankers restricts

themselves in their respective business and are independent in their respective fields. The Indian banks and foreign banks presently does not have friendly relations with each other. After enacting the Banking Regulation Act 1949, the banks are becoming slowly united with each other.

3. Presence of Several Interest Rates

The other drawback of Indian money market is the presence of several interest rates such as government rate for borrowing, lending and deposit rates of commercial banks and cooperative banks, lending rates of DFHI's and so on. The reason behind the presence of several interest rates is immobility of funds from one area to another area.

4. Seasonal Stringency of Money

Another defect of Indian money market is the seasonal stringency of money within an year. The period from November to June was considered as busy season, as funds were significantly needed to and for transferring the crops from villages to cities and towns and high interest rates was charged under this season. The period from July to October is considered as slack-season or off-season in which the banks have excess funds and low-interest rates were charged during this season. For this reason, more fluctuations exists in the interest rates within a year.

5. Non-existence of Bill Market

One more defect of Indian money market is the absence of commercial bill market or discount market especially for short-term commercial bills. This absence is due to some historical disasters like bank practices storing huge amount of cash for liquidity purposes, improper drafting of bazar hundi, lack of warehousing facilities for strong agricultural products etc.

6. Highly Sensitive Call Money Market

The funds borrowed in call money market are based on the call money rates which are market determined and there are wide

fluctuations in these rates. RBI made efforts to reduce these fluctuations in the call-money-rates which was continued to be highly volatile.

7. Non-existence of Well-organized Banking System

Well developed banking system in India is still lacking. This is the main defect of the Indian money market. Before nationalization of banks (1969), branch banking was very slow in India. There are very less banks and were focussing themselves in large cities and mandi towns.

3.2 ORGANIZATION OF MONEY MARKET

Q7. Describe briefly about the Money Market Organization.

Ans :

The money market organization of India can be described from the deficiency periods as below:

1. First deficiency period
2. Second deficiency period
3. Third deficiency period.

1. First Deficiency Period

During mid 1980's, Indian money market has undergone with serious deficiencies. Banks, LIC and UTI are the only participants apart from the RBI. Some participants are restricted because of their uneven operations. Though the borrowers are huge in number, still there were no virtual participants who can act as alternative for lending and borrowing. In spite of all these participants SBI, LIC and UTI are considered as crucial leaders.

2. Second Deficiency Period

The money market organization lack short-term maturity of financial instruments during pre-1987. Money at call and short notice, inter-bank deposits/loans and bills discounting and 91-day T-bills are the only participants of financial instruments during the second deficiency period.

3. Third Deficiency Period

During the third deficiency period, the RBI or Indian Bank Association (IBA) managed the interest rates directly or by a voluntary agreement between the participants.

In accordance to these deficiencies of the Indian money market, a scheme was defined by the Chakravarty and Vaghul Committees for its development.

Q8. Explain the structure of Indian money market.

(OR)

What are the functions of organized money market ?

(OR)

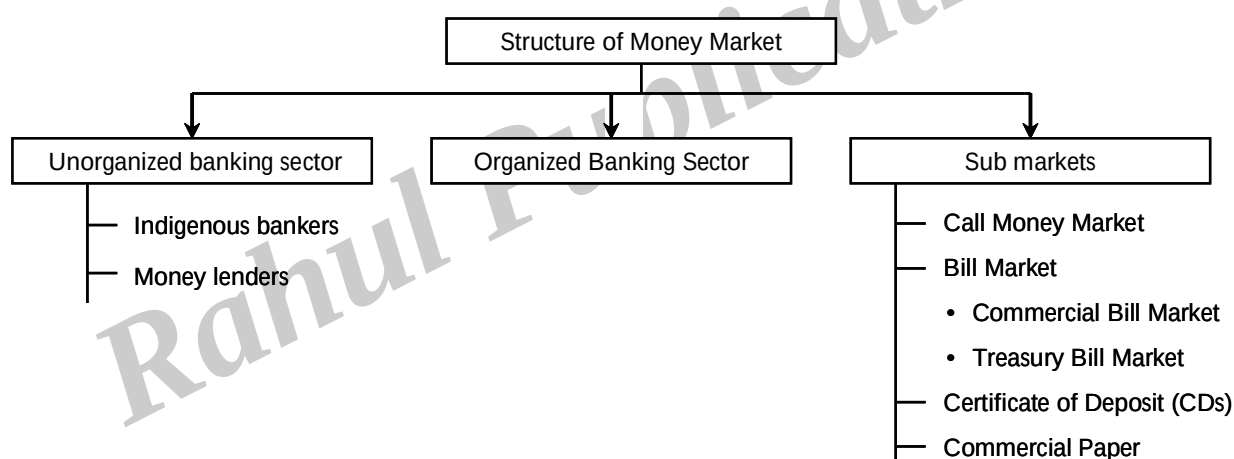
Explain the various sectors of money market in detail.

Ans :

(Imp.)

The main components of Indian money market are :

1. Unorganized banking sector,
2. Organized banking sector
3. Sub markets



1. Unorganized banking sector

It consists of indigenous bankers and moneylenders in all the country who pursue banking business on traditional lines.

(i) Indigenous bankers

The Indian Central Banking Enquiry Committee defined Indigenous banks as “an individual or private firm receiving deposits and dealing in hundies or lending money”.

They accept deposits on current accounts and fixed deposits. They lend money to small farmers and traders. Along with this they deal in hundies. They charge exorbitant rate of interest on loans. Certain communities such as Marwaris, Bengalese, Gujarathies, Chettiars and Kallida Kurichi Brahmins do indigenous banking business in India. The main limitation of indigenous bankers is that they follow conservative practices and are not governed by Reserve Bank of India.

(ii) Money lenders

Money lenders constitutes one of the components of the organized money market of our country. Money lenders are those persons who do not accept deposits from public, but merely lend their own funds. They lend money mainly for consumption and other domestic purposes.

They are mainly two categories of money lenders

(a) Professional money lenders: They are those persons whose main business is to lend money. It may be of two types.

- **Resident money lenders :** Maharaja, Sahukars, Seths or Banias.
- **Itinerant money lenders:** Pathans, Kabulis and Qustwalas.

(b) Non-professional money lenders: These are those persons who combine money lending with other activities.

Defects

- (i) Their resources are limited to meet the requirement of the rural people.
- (ii) They charge high rate of interest.
- (iii) They grant loans for consumption and unproductive purposes.
- (iv) They provides loans against crops. In this way they compel the consumers to supply the crops to them.

2. Organized Banking Sector

It consists of Reserve Bank of India, the State Bank of India and its seven subsidiaries, 19 nationalized banks, the other joint stock banks including commercial banks, co-operative banks, regional Rural Banks, special institutions like LIC, UTI, IDBI, SFCs, NABARD, Exim bank etc. DFHI, non-banking companies and quasi Government bodies and large companies which supply funds in the money market through banks. Reserve Bank of India (RBI) is the central bank and monetary authority of our country. So RBI is the leader of Indian money market.

3. Sub markets

It consists of call money market and bill market. Bill market consists of commercial bill market and Treasury bills market, certificates of deposits, and commercial papers.

(i) Call Money Market

Call money market consists of overnight financing and money needed at short notice for periods upto 14 days. It is meant to balance the short-term needs of the banks. Call money markets exist in all developed money markets, in fact, it is the most sensitive part of the financial system. In India, the call money market is centered in Mumbai.

In 1998, DFIT was setup which operated in both markets. Other institutions like IDBI, GIC, NABARD participate in the call money market.

(ii) Bill Market**(a) Commercial Bill Market**

Commercial bill market is the secondary market, which deals with trade bills or commercial bills. Commercial bills are the credit instruments which helps the business organizations and banking organizations. The commercial bill legally aims at repaying the seller in case of late payments by the purchaser. Usually, commercial bills emerge from local transactions.

(b) Treasury Bill Market

Treasury bill market is mainly concerned with the treasury bills. The treasury bills are referred as the short term liability of the central government in India. These bills are offered for settling the temporary deficits faced by the government. In India, the treasury bill market is still developing. Only the RBI is the primary holder of the treasury bills.

Non-banking financial intermediaries such as LIC, UTI and corporate firms do not hold treasury bills. At present the following types of treasury bills are issued,

- (i) 14 days intermediate treasury bills
- (ii) 91 days treasury bills
- (iii) 364 days treasury bills.

(iii) Certificate of Deposit (CDs)

A certificate of deposit is a type of certificate given by the bank to its depositors for a particular time period. These certificates are same like conventional term deposits but with the only difference that they are to be negotiated and trade in short-term money market.

(iv) Commercial Paper

It is a short-term instrument of raising funds by corporate. It is a sort of unsecured promissory note sold by the issuer to the investor, the maturity of the CPs is flexible. Usually, borrowers and lenders adopt the maturity of CPs to their needs. Highly rated corporate which can obtain funds at a cost lesser than the cost of borrowing from banks are particularly interested in issuing CPs.

3.3 DEALERS OF MONEY MARKET

Q9. Describe the various dealers involved in money market.

(OR)

Brief on the participants of money market.

Ans :

(Imp.)

Till 1971, the call money market is broadly referred as an inter-bank market. Lenders and borrowers in large number are the participants there on. Meanwhile, LIC and UTI are permitted to operate as lenders in order to utilize their float money and improve the supply of short-term funds in the market. In 1990's, there is a gradual increase in the list of participants involving,

- DFHI
- STCI
- GIC
- NABARD
- IDBI
- MMMF's
- Corporates
- Private Sector Mutual Funds.

The participants who played the role of lenders and borrowers are,

- Scheduled Commercial Banks
- Non-Scheduled Commercial Banks
- Foreign Banks
- State Banks
- District Banks
- Urban Cooperative Banks
- DFHI

Apart from these, other borrowing participants involves,

- Brokers and dealers in securities/bill market and
- Individuals of high financial status.

In 1996-97, RBI enabled primary dealers to participate as both borrowers and lenders. It allowed the access of non-bank entities with huge lendable resources. In May 9,1998, the minimum size of operation of primary dealers for routing transactions were reduced gradually from ` 20 crore to ` 3 crore.

The RBI has introduced the recommendations of the Narasimham Committee II (NC II) in 1998 to bring significant changes in participants of money market. NC II recommendations are,

- Non-Bank participants other than primary dealers are to be excluded.
- Developing pure inter-bank call market including primary dealers.
- However, free access is enabled to non-bank participants, other money market instruments including Treasury bills.

- Redeemed limits for the banks depending on call market are to be defined in a clear manner.
- The RBI should support the money market through the operations of LAF.

These recommendations are implemented by RBI in a phased manner. In May 2001, a four-phase exit of non-bank participants from the call market are inaugurated. Finally, at present the call market is a pure inter-bank market.

The participants of the current money market are listed below,

- All Scheduled Commercial Banks.
- Life Insurance Corporation of India (LIC).
- General Insurance Corporation (GIC) of India and its Subsidiaries.
- ICICI (Industrial Credit and Investment Corporation of India Ltd.).
- UTI (Unit Trust of India).
- IRBI (Industrial Reconstruction Bank of India).
- Export Credit Guarantee Corporation Ltd (ECGC).
- IDBI (Industrial Development Bank of India).
- IFCI (Industrial Finance Corporation of India).
- NABARD (National Bank of Agriculture and Rural Development).
- DFHI (Discount and Finance House of India Ltd.).

Q10. Explain the concept of primary dealers involved in Money Market.

Ans :

Primary Dealers are registered entities with the RBI who have the license to purchase and sell government securities. They are entities who buy government securities directly from the RBI (The RBI issues Government securities on behalf of the government), aiming to resell them to other buyers. In this way, the Primary Dealers create a market for government securities.

The Primary Dealers system in the government securities market was introduced by the RBI in 1995. The Primary Dealers are thus created to promote transactions in Government Securities Market. A facilitating arrangement is essential for selling of Government Securities as government is the single largest borrower in the market who borrows through the issue of its securities - Treasury Bills and Bonds.

The RBI instructs Primary Dealers to have a minimum turnover ratio, bidding ratio, underwriting ratio, secondary market participation, etc., to ensure that they are active in supporting the trade in government securities. Primary Dealers are active in the stock market also for enhancing the trading of government securities.

Eligibility

1. Subsidiary of scheduled commercial bank/s and all India financial institutions
2. Subsidiaries/Joint ventures set up in India by entities incorporated abroad
3. Company incorporated under the Companies Act, 1956 and does not fall under (a) or (b).
 - The applicant for Primary Dealer should register as an NBFC for at least one year prior to the submission of application. Other conditions like net owned fund, etc. are mentioned by the RBI.
 - The decision to authorize Primary Dealers will be taken by RBI based on its perception of market needs, suitability of the applicant and the likely value addition to the system. Some other functions besides trading in government securities are also assigned to them.

Role and Functions

The role of Primary Dealers is to:

1. Commit participation as principals in Government of India issues through bidding in auctions.
2. Provide underwriting services.
3. Offer firm buy - sell/bid ask quotes for T-Bills and dated securities.
4. Development of secondary debt market.

Primary Dealers are performing an exceptional role in giving marketability to government securities. The RBI has elaborated the role of Primary Dealers in the following words "Primary Dealers are expected to play an active role in the government securities market, both in its primary and secondary market segments through various obligations like participating in Primary auction, market making in government securities predominance of investment in government securities achieving minimum secondary market turnover ratio, maintaining efficient internal control system for fair conduct of business etc. A Primary Dealer is required to have a standing arrangement with RBI based on the execution of an undertaking and the authorization letter issued by RBI based on the execution of an undertaking on the authorization letter issued by RBI every three years. Undertaking will be based on passing of a fresh Board Resolution by the Primary Dealer every 3 years.

As on January 2015, there was 21 Primary Dealers in the country. Most of the Primary Dealers are started by scheduled commercial banks and are registered as NBFCs. Operations of the Primary Dealers are subject to prudential and regulatory guidelines issued by RBI from time to time.

3.4 MONEY MARKET INSTRUMENTS

Q11. Explain briefly about various Money market instruments.

Ans : (Imp.)

1. Treasury Bills (T-Bills)

Treasury bills (or) T-Bills are issued by the Reserve Bank of India on behalf of the Central Government for raising money. They have short term maturities with highest upto one year. Currently, T- Bills are issued with 3 different maturity periods, which are, 14 days T-Bills, 91 days T-Bills, 182 days T- Bills, and 1 year T – Bills.

T-Bills are issued at a discount to the face value. At maturity, the investor gets the face value amount. This difference between the initial value and face value is the return

earned by the investor. They are the safest short term fixed income investments as they are backed by the Government of India.

2. Commercial Papers

Large companies and businesses issue promissory notes to raise capital to meet short term business needs, known as Commercial Papers (CPs). These firms have a high credit rating, owing to which commercial papers are unsecured, with company's credibility acting as security for the financial instrument.

Corporates, primary dealers (PDs) and All-India Financial Institutions (FIs) can issue Commercial Papers.

Commercial Papers have a fixed maturity period ranging from 7 days to 270 days. However, investors can trade this instrument in the secondary market. They offer relatively higher returns compared to that from treasury bills.

3. Certificates of Deposits (CD)

Certificates of Deposits are financial assets that are issued by banks and financial institutions. They offer fixed interest rate on the invested amount. The primary difference between a Certificate of Deposits and a Fixed Deposit is that of the value of principal amount that can be invested. The former is issued for large sums of money (1 lakh or in multiples of 1 lakh thereafter).

Because of the restriction on minimum investment amount, Certificate of Deposits are more popular amongst organizations than individuals who are looking to park their surplus for short term, and earn interest on the same.

The maturity period of Certificates of Deposits ranges from 7 days to 1 year, if issued by banks. Other financial institutions can issue a Certificate of Deposit with maturity ranging from 1 year to 3 years.

4. Call Money Market

Call money market deals with the trading of excess funds. It is a unit of national money

market. The loans issued in this market are for short period and the maturity period of these loan varies from one day to a fortnight. These loans are highly liquid as they are repayable on demand and are at the option of either the lender or the borrower.

5. Commercial Bills Market

Commercial bills are the credit instruments which helps the business organizations and banking organizations. The commercial bill legally aims at repaying the seller in case of late payments by the purchaser. Usually, commercial bills emerge from local transactions.

6. Participation Certificates (PCs)

Like certificates of deposits, banks also issue participation certificates normally for periods ranging 6 months to one year. The purpose of developing participation certificates is to allow a bank to obtain funds from other banks and financial institutions when needed. There are two types of PCs, 91 days PCs and 91-180 days PCs.

7. Money Market Mutual Funds (MMMF's)

A scheme of money market mutual funds was introduced by the Reserve Bank of India in April 1992. The objective of the scheme was to provide an additional short-term avenue to the individual investors.

MMMFs are permitted to make investments in rates corporate bonds and debentures with residual maturity of up to one year. Resources mobilized by the MMMFs could earlier be invested exclusively in call money, treasury bills, CDs, CPs, commercial bills arising out of genuine trade/ commercial transactions and government securities having an unexpired maturity upto 1 year.

3.4.1 Commercial Paper

Q12. Define Commercial Paper. State the features and advantages of a Commercial Paper.

Ans : (Oct.-20)

Introduction

During the 1980s a wave of financial liberalisation and innovation in financial instruments

swept across the world. A basic feature of the many innovations is the trend towards securitisation, i.e., raising money direct from the investors in the form of negotiable securities as a substitute for bank credit. The companies found it cheaper to borrow directly from public by way of short term paper. The cost of fund is cheaper for the companies as it involved lower information and transaction cost. This also suits the interest of many investors as it provides them with a wide spectrum of financial instruments to choose from and in placing their funds at reasonably high rates of return. Commercial paper is a new instrument used for financing working capital requirements of corporate enterprises.

Meaning

A commercial paper is an unsecured promissory note issued with a fixed maturity by a company approved by RBI, negotiable by endorsement and delivery, issued in bearer form and issued at such discount on the face value as may be determined by the issuing company.

Participants

- **Issuers:** All private sector company, public sector unit, non-banking company etc.
- **Investors:** Individuals, banks, corporates and also NRIs. Usually banks, large corporate bodies and public sector units with investible funds participate in CP market.

Features

1. Commercial paper is a short-term money market instrument comprising unsecured promissory note with a fixed maturity.
2. It is a certificate evidencing an unsecured corporate debt of short term maturity.
3. Commercial paper is issued at a discount to face value basis but it can also be issued in interest bearing form.
4. The issuer promises to pay the buyer some fixed amount on some future period but pledges no assets, only his liquidity and established earning power, to guarantee that promise.
5. Commercial paper can be issued directly by a company to investors or through banks/ merchant bankers.

Q13. Describe the RBI Guidelines on issue of Commercial Papers.**Ans :**

The important guidelines are:

1. A company can issue commercial paper only if it has:
 - (i) a tangible net worth of not less than Rs. 10 crores as per the latest balance sheet;
 - (ii) minimum current ratio of 1.33 : 1
 - (iii) a fund based working capital limit of Rs. 25 crores or more;
 - (iv) a debt servicing ratio closer to 2
 - (v) the company is listed on a stock exchange
 - (vi) subject to CAS discipline
 - (vii) it is classified under Health Code No. 1 by the financing banks
2. Commercial paper shall be issued in multiples of Rs. 25 lakhs but the minimum amount to be invested by a single investor shall be Rs. 1 crore.
3. The commercial paper shall be issued for a minimum maturity period of 7 days and the maximum period of 6 months from the date of issue. There will be no grace period on maturity.
4. The aggregate amount shall not exceed 20% of the issuer's fund based working capital.
5. The commercial paper is issued in the form of usance promissory notes, negotiable by endorsement and delivery. The rate of discount could be freely determined by the issuing company. The issuing company has to bear all flotation cost, including stamp duty, dealers' fee and credit rating agency fee.
6. The issue of commercial paper cannot be underwritten (or) co-opted in any manner. However, commercial banks can provide standby facility for redemption of the paper on the maturity date.

7. Investment in commercial paper can be made by any person or banks or corporate bodies registered or incorporated in India and un-incorporated bodies too. Non-resident Indians can invest in commercial paper on non-repatriation basis.
8. The companies issuing commercial paper would be required to ensure that the relevant provisions of the various statutes such as Companies Act, 1956, the IT Act, 1961 and the Negotiable Instruments Act, 1981 are complied with.

3.4.2 Certificate of Deposits**Q14. What are Certificate of Deposits? State the features of Certificate of Deposits.****Ans :** (Oct.-20)**Meaning**

Certificate of Deposits are short term deposit instruments issued by banks and financial institutions to raise large sums of money.

CDs are issued in the form of Usance Promissory Notes. They are negotiable and are in marketable form bearing specific face value and maturity. The CDs are transferable from one party to another. Due to their negotiable nature, they are also known as Negotiable Certificate of Deposit. The issuers of Certificate of Deposits are commercial banks, financial institutions etc. CDs are available for subscription by individuals, corporations, trusts, Associations and NRIs.

Features

1. Document of title to time deposit.
2. Unsecured negotiable pronotes.
3. Freely transferable by endorsement and delivery.
4. Issued at discount to face value.
5. Repayable on a fixed date without grace days.
6. Subject to stamp duty like the usance promissory notes.

Q15. Describe the guidelines of RBI for issue of Certificate of Deposits.**Ans :**

1. The denomination of CDs could be in multiples of Rs. 5 lakh subject - ,To a minimum size of an issue to a single investor being Rs. 25 lakh. The CDs above Rs. 25 lakh will be in multiples of Rs. 5 lakh. The amount relates to face value (not maturity value) of CDs issued.
2. The CDs are short-term deposit instruments with maturity period ranging from 3 months to one year. The banks can issue at their discretion, the CDs for any number of months/days beyond the minimum usance period of three months and within the maximum usance of one year.
3. CDs can be issued to individuals, corporations, companies, trust funds, associations, etc. Non-resident Indians (NRIs) can also subscribe to CDs but only on a non-repatriation basis.
4. CDs are freely transferable by endorsement and delivery but only after 45 days of the date of issue to the primary investor. As such, the maturity period of CDs available in the market can be anywhere between 1 day and 320 days.
5. They are issued in the form of usance promissory notes payable on a fixed date without days of grace. CDs are subject to payment of stamp duty like the usance promissory notes.
6. Banks have to maintain CRR and SLR on the issue price of CDs and report them as deposits to the RBI. Banks are neither permitted to grant loans against CDs nor to buy them back prematurely.
7. From October 17, 1992, the limit for issue of CDs by scheduled commercial banks (excluding Regional Rural Banks) has been raised from 7 per cent to 10 per cent of the fortnightly aggregate deposits in 1989-90. The ceilings on outstanding of CDs at any point of time are prescribed by the Reserve Bank of India for each bank. Banks are

advised by the RBI to ensure that the individual bankwise limits prescribed for issue of CDs are not exceeded at any time.

Q16. State the merits of Certificate of Deposits.**Ans :**

The following are the merits of certificate of deposits :

1. Certificate of Deposits are the most convenient instruments to depositors as they enable their short term surpluses to earn higher return.
2. CDs also offer maximum liquidity as they are transferable by endorsement and delivery. The holder can resell his certificate to another.
3. From the point of view of issuing bank, it is a vehicle to raise resources in times of need and improve their lending capacity. The CDs are fixed term deposits which cannot be withdrawn until the redemption date.
4. This is an ideal instrument for banks with short term surplus funds to invest at attractive rates.

3.4.3 Commercial Bills Market**Q17. Define Commercial Bills Market. Explain the different types of Commercial Bills.****Ans :****Meaning**

Commercial bills are the credit instruments which helps business organizations and banking organizations. The commercial bill legally aims at repaying the seller in case of late payments by the purchaser. Usually, commercial bills emerge from local transactions.

Types

The different types of commercial bills are as follows,

1. Demand and Usance Bills

Demand bills are also known as sight bills because no time period is specified for

payment of this bills. These bills can be paid immediately as soon it is given to the drawee.

Usance bills are also known as time bills. These bills can be paid immediately after the expiry date specified on the bill.

2. **Clean Bills and Documentary Bills**

The documentary bills consist of railway receipt, lorry receipt, bill of lading etc. These bills are sub-divided into D/A bills and D/P bills.

The bills which are drawn by accompanying any document are known as 'clean bills'.

3. **Inland and Foreign Bills**

Inland bills are the bills drawn and paid by the person present in India. Whereas the foreign bills are the bills which are drawn by the person who resides in and outside India. In simple words it can be said as, the foreign bills can be drawn in India and payable outside India.

4. **Export Bills and Import Bills**

Export Bills are the bills drawn by Indian exporters on importers outside India. Whereas, import bills are the bills drawn on Indian importers by exporters of outside India.

5. **Indigeneous Bills**

The bills drawn and accepted based on native custom or trade usage is referred as indigeneous bills. The indigeneous bankers usually uses these bills known as 'Hundis'.

6. **Accommodation Bills and Supply Bills**

If the bills are received through unfair trade transactions then they are known as accommodation bills. These bills are also known as 'kite bills' or 'wind bills'.

Supply bills are the bills drawn by suppliers on government departments for the supply of goods.

Q18. State the advantages and disadvantages of commercial bills.

Ans :

Advantages

1. Liquidity

Bills are highly liquid assets. In times of necessity, bills can convert into cash readily using rediscounting them with the central bank. Bills are self-liquidating in character since they have fixed tenure. Moreover, they are negotiable instruments and hence they can transfer freely by mere delivery or by endorsement and delivery.

2. The certainty of Payment

Bills draw and accept by business people. Generally, business people use to keeping their words and the use of the bills imposes strict financial discipline on them. Hence, bills would honor on the due date.

3. Ideal Investment

Bills are for periods not exceeding 6 months. They represent advances for a definite period. This enables financial institutions to invest their surplus funds profitably by selecting bills of different maturities. For instance, commercial banks can invest their funds on bills in such a way that the maturity of these bills may coincide with the maturity of their fixed deposits

4. High and Quick Yield

The financial institutions earn a high quick yield. The discount deducts at the time of discounting itself whereas, in the case of other loans and advances, interest is payable only when it is due. The discounts rate is also comparatively high.

Disadvantages

1. The Absence of Bill Culture

Business people in India prefer OD and cash credit to bill financing, therefore, banks usually accept bills for the conversion of cash credits and overdrafts of their customers. Hence bills are not popular.

2. The absence of Rediscounting Among Banks

There is no practice of re-discounting of bills between banks who need funds and those who have surplus funds. To enlarge the rediscounting facility, the RBI has permitted financial institutions like LIC, UTI, GIC, and ICICI to rediscount genuine eligible trade bills of commercial banks. Even then, bill financial is not popular.

3. Limited Foreign Trade

In many developed countries, bill markets have been establishing mainly for financing foreign trade. Unfortunately, in India, foreign trade as a percentage to national income remains small and it is reflected in the bill market also.

4. The Absence of Acceptance Services

There is no discount house or acceptance house in India. Hence specialized services are not available in the field of discounting or acceptance.

5. The attitude of Banks

Banks are shy rediscounting bills even the central bank. They tend to hold the bills till maturity and hence it affects the velocity of the circulation of bills. Again, banks prefer to purchase bills instead of discounting them.

3.4.4 Treasury Bills Market

Q19. What do you mean by Treasury Bills Market ? Discuss the classification of Treasury Bills Market.

Ans : (Oct.-20)

Meaning

Treasury bill is a short term government securities usually of the duration of 91 days sold by the central bank on behalf of the government. There is no fixed rate of interest payable on the treasury bills. These are sold by the central bank on the basis of competitive bidding. Treasury bills are highly secured and liquid because of guarantee of repayment assured by the RBI who is always willing to purchase or discount them.

Classification of Treasury Bills Market

The treasury bills market is classified as follows,

1. 91-Day Treasury Bills Market

These treasury bills are issued at a discount. RBI acts as an agent of central government to issue these bills. Till 1965, these bills were sold to public by tenders or at weekly auctions at the rates decided by RBI and had 91 days of maturity time. From 12 July 1965, treasury bills were obtainable on top. Treasury bills were sold in the entire week at different rates declared from time to time rather than initiating tenders on weekly basis which leads to investment in them from commercial banks. From January 1993, auction system was initiated for trading these bills in order to enhance the T-bill market. The scheme, date of auction and the notified amount are declared by RBI from time to time. The bills which are in the form of promissory note or credit are available for any economic unit.

From August 1994, state governments, state run pension funds and eligible provident funds were been allowed to take part in the auction based on non-competitive bid. In order to bid, the application must be filed and it must be paid at the cut-off rate which is determined by RBI. RBI may offer limited rediscounting facility to the holders of these bills. The interest rates on auctioned 91-day treasury bills are greater than the interest rates on top bills and acts as money market reference rates.

2. 182-Day Treasury Bills Markets

In November 1986, a new money market i.e., 182- day treasury bill market was introduced for enlarging the short-term money market and for creating more outlets for temporary excess funds through various channels. GOI contributed towards the development of short-term money market which resulted in the initiation of this bill and paved a way for the government to increase the financial resources for the purpose of its budgetary expenditure. Initially these bills were sold monthly by RBI in auctions. But from July 1988, they were sold fortnightly.

The market participants are provided with the facility to invest all the funds available with them. The 182-day T-bills are issued at a discount to face value for the minimum amount of ₹ 1 lakh and its multiples thereafter.

These bills can be purchased by the residents of India involving individuals, firms, banks, companies and financial institutions except state government, provident funds and RBI. The returns were very high in this market.

In April 1992, the issue and trading of this bill was discontinued due to some reasons and therefore the bill existed only for a span of six years approximately.

3. 364-Day Treasury Bills Market

After the end of 182-day treasury bill, a new bill was introduced from April 1992 by authorities called as 364-day treasury bill. The characteristics of this bill are similar to that of 182-day bill. The RBI do not buy and rediscount this bill. The response from investors for these bills was better as the number of bids and the amount agreed was large. The yield on these bills was higher than the 182-day treasury bill and 91-day treasury bill.

4. 14-Day Treasury Bills Market

Recently, authorities introduced two kinds of 14-day treasury bills, one on April 1st, 1997 namely 'Intermediate Treasury Bill' (ITB) and the other on 20th May, 1997. 91-day treasury bill was replaced by 14-day bill (i.e., ITB). The purchasing parties of ITB are -state governments, foreign central banks and other specified bodies. It is issued in the form of book entry that is credited to the Subsidiary General Ledger Account. It can be repaid or renewed at the face value on the maturity of 14 days from the date of issue. The discount rate is fixed after every three months so that the earnings are effective and equal to the interest rate on Ways and Means

Advances (WMA) to the Union Government. Earlier, State Government and

other investors used to get a fixed rate of 4.6 percent on their investments on 91-day treasury bill but now they get a market-related rate of interest. The demerits of 14-day ITB is that it cannot be traded or transferred. The yield of 14-day ITB on 8th August 1997 was ₹ 7848 crore.

Due to the need of cash management of different segments of the economy, the second type of 14-day treasury bill was introduced based on auction. Its first auction was on 6th June, 1997 and the yield was ₹ 6114 crore on 11th August 1997.

Q20. What are the advantages and disadvantages of treasury bill market ?

Ans :

Advantages

1. Risk-free

Treasury bills are one of the most popular short-term government schemes issued by the RBI and are backed by the central government. Such tools act as a liability to the Indian government as they need to be repaid within the stipulated date.

Hence, individuals enjoy comprehensive security on the total funds invested as they are backed by the highest authority in the country, and have to be paid even during an economic crisis.

2. Liquidity

A government treasury bill is issued as a short-term fund-raising tool for the government and has the highest maturity period of 364 days. Individuals looking to generate short term gains through secure investments can choose to park their funds in such securities. Also, such G-secs can be resold in the secondary market, thereby allowing individuals to convert their holding into cash during emergencies.

3. Non-competitive bidding

Treasury bills are auctioned by the RBI every week through non-competitive bidding,

thereby allowing retail and small-scale investors to partake in such bids without having to quote the yield rate or price. It increases the exposure of amateur investors to the government securities market, thereby creating higher cash flows to the capital market.

Disadvantages

1. Poor Yield

The yield form Treasury Bills is the lowest. Long-term Government securities fetch more interest and hence subscriptions for Treasury Bills are on the decline in recent times.

2. Absence of Competitive Bids

Though Treasury Bills sell through auction to ensure market rates for the investors, in actual practice, competitive bids are conspicuously absent. The RBI compels to accept these non-competitive bids. Hence adequate return is not available. It makes Treasury Bills unpopular.

3. Absence of Active Trading

Generally, the investors hold Treasury Bills till maturity and they do not come for circulation. Hence, active trading in Treasury Bills adversely affects.

3.4.5 Call Money Market

Q21. Discuss in detail call money market.

Ans :

Meaning

Call money market deals with the trading of excess funds. It is a unit of national money market. The loans issued in this market are for short period and the maturity period of these loans is from one day to a fortnight. These loans are highly liquid as they are repayable on demand and are at the option of either the lender or the borrower.

Structure

The structure of call money market differs from country to country. They are as follows,

1. Structure of Call Money Market in the US

The call money market in the US comprises of two markets. They are,

(i) Federal Funds Market

Monholn J.R defined federal funds transaction as "any transaction between banks involving the purchase or sale of bank deposits at federal reserve banks for one business day at a specified rate of interest". The reserves of the banks are adjusted by carrying out transactions in this market and the supply of funds to the market emerges out of the reserves of the banks with the central banking system. Some member banks have surplus reserves, which leads to the supply of federal funds. If there is shortage of reserves in other member banks on the similar date then it leads to the demand of funds. The maturity period of funds is one day.

(ii) Call Money Market Proper

The bankers in call loan market provides loans for short period to security brokers and dealers so as to finance their customer's purchases of common stock. The banks also provide loans to dealers in government securities. These loans are secured loans and can be terminated by a call either from a lender or borrower on one day notice.

2. Structure of Call Money Market in the UK

Call money market involves three parts in the UK. They are,

- (i) Clearing bank's loans to discount houses
- (ii) Inter-bank loans
- (iii) Mobilization of surplus money by discount houses between themselves prior to their consultation with the bank of England for financial accommodation. Discount houses is a unique feature of the British money market which exists in between the Bank of England and commercial banks.

3. Structure of Call Money Market in India

S.K Muranjan stated that the call loans in India are provided,

- (i) To the bill market.
- (ii) For dealing in the bullion markets and stock exchanges.
- (iii) Between banks.
- (iv) Often to individuals with high financial status in Mumbai for the purpose of ordinary trade so as to save interest on cash credits and overdrafts. From the above uses, the inter-bank use is regarded as the most important and their use on stock exchanges and other markets has been adequate.

Transactions in the call money market were mostly influenced by the brokers till March 1978. But since then RBI restricted the banks to involve brokers in call money market.

The maturity period of call loans differs from one day to a fortnight. These loans are highly liquid and unsecured. Trading on the call money market in India is characterised by seasonal variations as the money and credit conditions are effected by seasonal fluctuations every year. The seasonal nature of call money market may be represented by two signs its,

- (a) Decrease in money at call and short notice must be greater in the slack season than in the busy season.
- (b) An increases in money at call and short notice must be greater in the busy season than in the slack season.

The borrowings in the call money market is found high in March every year due to the withdrawals of deposits for paying taxes and withdrawals of funds by financial institutions to fulfil their statutory obligations.

Participants

The participants of call money market includes the scheduled commercial banks, non-scheduled commercial banks, foreign banks, state, district and urban co-operative banks, Discount and Finance House of India (DFHI) and Securities Trading

Corporation of India (STCI). DFHI and STCI acts as banks and primary dealers in the call money market and deals with lending and borrowing.

According to the latest policy of RBI, LIC, UTI, GIC, IDBI and NABARD are allowed to participate in call money market.

In April 1991, RBI declared that all entities with proof that they have huge resources to lend and have no payable amount towards the banks can participate in the call market.

Call money markets are situated in large industries and commercial centres such as Mumbai, Calcutta, Chennai, Delhi and Ahmedabad. Besides big cities, there are also large number of local call markets which are developed and operated by indigenous local bankers.

Size of Call Money Market

The call loans in India increased from ` 9.3 crore in 1955-56 to ` 7,147 crore in 1995-96. The information about market turnover can provide appropriate size of call market which was ` 16,450 billion in 1991-92, ` 22,510 billion in 1993-94, ` 17,030 billion in 1994-95, ` 20,980 billion in 1995-96 and ` 15,450 billion in 1996-97.

Functions

The basic functions of call money market are as follows,

1. It provide funds to banks when there is shortage of funds in banks.
2. It provide funds to banks to help them in maintaining their Cash Reserve Requirements (CRR) and Statutory Liquidity Ratio (SLR).
3. It allows banks to discount their commercial bills.

Q22. What are the features of call money market?

Ans :

- The call market enables the banks and institutions to even out their day to day deficits and surpluses of money.
- Commercial banks, co-operative Banks and primary dealers are allowed to borrow and lend in this market for adjusting their cash reserve requirements.

- Specified All Indian Financial Institutions, Mutual Funds and certain specified entities are allowed to access call/ Notice money only as lenders.
- It is a complete inter-bank market hence non-bank entities are not allowed access to this market.
- Interest rates in the call and notice money markets are market determined.
- The borrowers and the lenders are required to have current accounts with Reserve Bank of India.
- It serves as an outlet for deploying funds on short-term basis to the lenders having steady inflow of funds.

Q23. State the advantages and disadvantages of call money market ?

Ans :

Advantages

The advantages of call money market are as follows:

(i) Liquidity

In a call money market, lent money has high liquidity and it can be taken back whenever required. Addition to this, it also helps the commercial banks to pay large amounts by means of call on the market.

(ii) Profitability

In this market, banking institutions can lend their surplus funds for earning high level of profit only when rates of call are high.

(iii) Statutory Liquidity Ratios (SLR)

In this market, commercial banks are authorized to maintain their requirements of statutory reserve.

(iv) Safe and Cheap

As the participants have strong financial standing, the call loans said to be safe which were usually not secured. Moreover, brokers are restricted in the call market which makes the call loans very cheap.

(v) Central Bank Operations

The variations made in the demand and supply of funds affects the call money rates as a result central bank get the indication to adopt effective monetary policy. Apart from this, the presence of call market helps the central bank to carry their operations more efficiently.

Disadvantages

The disadvantages of call money market are as follows:

(i) Uneven Development

The call money market is only helpful to large industrial and commercial sectors of India like Mumbai, Kolkata, Chennai, Delhi, Bengaluru and Ahmedabad.

(ii) Integration

The call markets are not totally integrated in all sectors, there are some local call markets which exist without any integration.

(iii) Volatility in Call Money Rates

The call money rates are volatile in nature due to which call rates differs in various centres and seasons on different days. The differences could be between 12% to 15%.

3.5 RESERVE BANK OF INDIA (RBI)

Q24. Explain briefly about Reserve Bank of India.

(OR)

What is Reserve Bank of India ?

Ans :

Reserve Bank of India (RBI) is the central bank of India. It came in to reality after many difficulties. Imperial Bank of India founded in 1921 was considered as the leader of Indian banks. Any way RBI came in to reality by the passing of Reserve Bank of India Act in 1934 and started its functions from 1935.

At the beginning of the RBI, it was owned by private individuals with government. Finally in 1948 the central government become the whole owner of RBI.

Today, economic system should be favor, then only they can shine before other nations. So, it is very essential for a central bank to deal with the financial resources of the country. RBI is the one of the strongest central bank performing many functions.

Q25. Explain the organizational structure of RBI.

Ans :

The affairs of the bank are controlled by a central board of directors, The central board consists of the following members,

1. One governor and not more than four deputy governors appointed by the central government for such periods not exceeding five years as may be fixed by the central government at the time of their appointment.
2. Four directors nominated by central government one each of the four local boards. The term of office of the directors is related to their membership in the local boards.

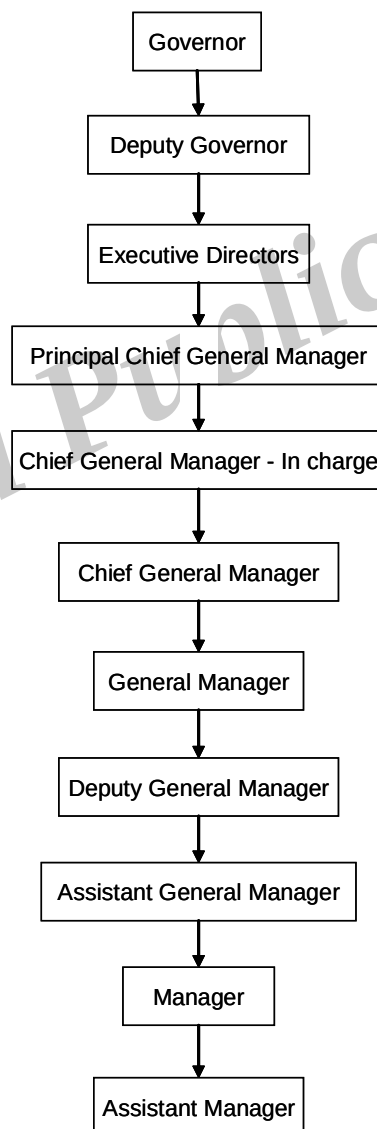


Fig. : Structure of RBI

3. The other ten directors are nominated by central government. These directors hold office for four years and there is provision in the Act for their retirement by rotation.
4. One government official to be nominated by the central government. He/she shall hold office during the pleasure of the central government.

Besides the central board, there are local boards for the four regions of the country with headquarters at Mumbai, Calcutta, Chennai and Delhi. Local board consists of five members appointed by central government for a term of four years to represent as well as possible territorial and economic interests as well as interests of the cooperative and indigenous banks. The functions of the local boards are to advise the central board on such matters as may generally or specifically be referred to them and to perform such duties as the central board may by regulations delegate to them.

3.5.1 Functions of RBI

Q26. What are the functions of Reserve Bank of India?

(OR)

Give a detailed note on functions of Reserve Bank of India.

(OR)

Explain the functions of Reserve Bank of India.

(OR)

Describe the functions of Reserve Bank of India.

(OR)

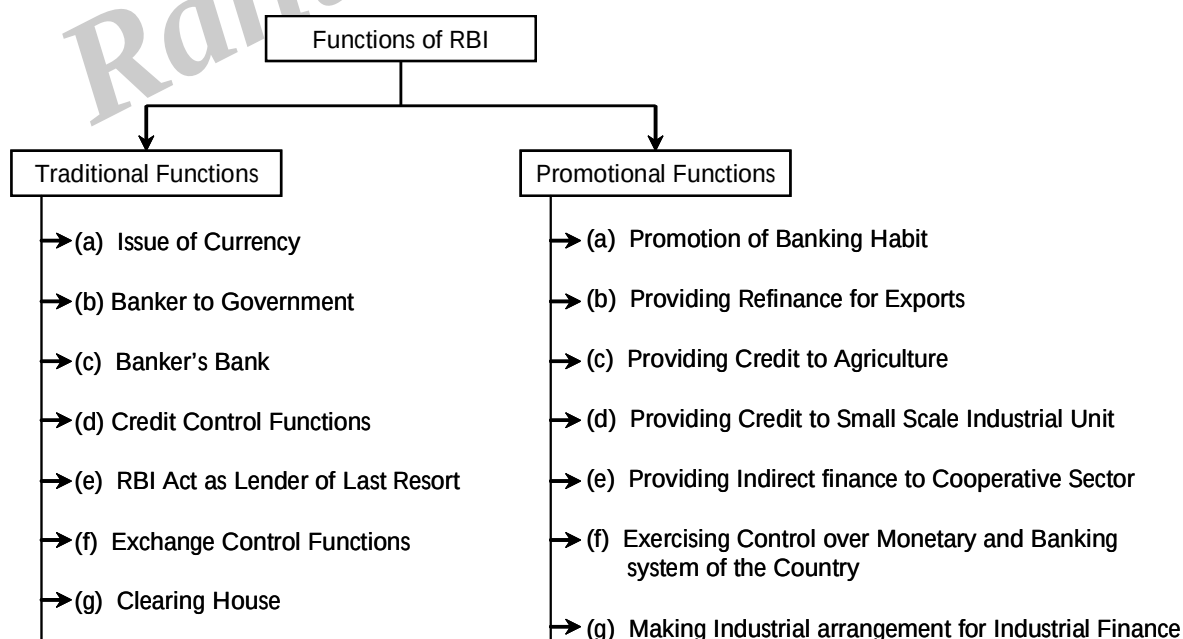
Elaborate the various functions of Reserve Bank of India.

Ans :

(Oct.-20, June-19, June-19(MGU), Imp.)

The functions of RBI mainly classified into two types :

- A) Traditional Functions
- B) Promotional Functions



A) Traditional Functions

The traditional functions of Reserve Bank of India includes Issue of Currency, Banker to Govt, Bankers Bank, Credit control Measures, lender of last resort, exchange control, clearing house etc.

1. Issue of Currency

RBI undertakes issue of currency and the system adopted in India is the minimum reserve system. All the currency notes from Rs. 2, Rs 5, Rs. 10, Rs. 50, Rs. 100, Rs. 500 and Rs. 1,000 are issued by RBI and they carry the signature of Reserve Bank of India Governor. They are called unlimited legal tender and any amount of payment can be made with these currencies subject to the regulations of Income Tax Act, 1961. The one rupee note and smaller coins are issued by the government and they are called limited legal tender which means that they can be demanded as a medium of payment only to a limited extent. The one rupee note carries the signature of secretary to the Ministry of Finance.

2. Banker to Government

Reserve Bank of India acts as a banker to the government by maintaining the account of Central government and also that of the State government. It also provides overdraft facility to both State and Central governments. The public borrowings of government are done through Reserve Bank of India. Payments to the government such as income tax are also accepted by Reserve Bank of India.

3. Bankers' Bank

The other traditional function of RBI consisting of bankers' bank is done in the following manner:

- (i) Issuing license to banks and allowing them to open branches under the provisions of Banking Regulation Act.
- (ii) RBI also controls the working of commercial banks and undertakes periodical inspection of these banks.

(iii) In case of violation of the Banking Regulation Act by any of the commercial banks, RBI will order for the closure of these banks.

(iv) The management of the commercial banks will also be controlled by Reserve Bank of India. All the top level management appointments of commercial banks require prior approval of RBI.

(v) The credit requirements of commercial banks are met by discounting and rediscounting eligible securities at the bank rate.

4. Credit Control functions

RBI exercise the following credit control measures

- The quantitative weapons of bank rate, open market operation and variable reserve ratio are exercised by Reserve Bank of India.
- The modern weapon of selective credit control is also being exercised by RBI particularly on agricultural commodities.
- The seasonal fluctuations in the money market is balanced by Reserve Bank of India through adequate finance during a period of financial stringency.

5. RBI acts as lender of last resort

The commercial banks have to maintain as a part of statutory requirements certain percentage of their deposits with RBI which is called cash reserve ratio.

By increasing or decreasing this percentage of cash reserve ratio, RBI allows adequate funds for lending purpose by commercial banks. When all the commercial banks are depositing with Reserve Bank of India in the form of cash reserve ratio, a sizable amount of fund is available with RBI. This fund will be extended by RBI to any commercial bank which is facing crisis.

6. Exchange control function

In India, we have the exchange control since independence and RBI is given enough powers to exercise exchange control. Without the license of Reserve Bank of India no one can deal in foreign exchange. The exchange rate with different foreign currencies is provided by RBI to its authorized dealers consisting of nationalized and other private commercial banks.

All the foreign exchange earnings in the country are kept by RBI in the form of foreign exchange reserve. RBI also has the responsibility of maintaining the value of domestic currency and take adequate measures so that its value does not depreciate abnormally in relation to foreign currencies.

7. Clearing house

In all big cities Reserve Bank of India has its branches and clearing house operations are undertaken. Where RBI does not have its branch, the clearing house operations are undertaken by State Bank of India and its subsidiary banks. All the commercial banks in India are members in clearing house and they take part in the clearing of cheques.

B) Promotional Functions

Various promotional functions performed by the Reserve Bank of India are given below

1. Promotion of Banking Habit

The Reserve Bank of India helps in mobilizing the savings of the people for investment. It expanded banking system throughout the nation by setting up of various institutions like UTI, IDBI, IRCI, NABARD etc. Thereby it promoted banking habit among the people.

2. Providing Refinance for Exports

The Reserve Bank of India is providing refinance for export promotion. The Export Credit and Guarantee Corporation (ECGC) and Export Import Bank were established initially by the Reserve Bank of India to finance the foreign trade of India. They finance foreign trade in the form of insurance

cover, long-term finance and foreign currency credit. However, they are now functioning separately.

3. Providing Credit to Agriculture

The Reserve Bank of India makes institutional arrangements for rural or agricultural finance. For example, the bank has set up special agricultural credit cells. It has promoted regional rural banks with the help of commercial banks. It has also promoted NABARD.

4. Providing Credit to Small Scale Industrial Unit

Commercial banks lend loans to smallscale industrial units as per the directives issued by the Reserve Bank of India time to time. The Reserve Bank of India encourages commercial banks to render guarantee services also to small-scale industrial sector. The Reserve Bank of India considers advances given to smallscale sector as priority sector advances. It also directed commercial banks to open specialized branches to provide adequate financial and technical assistance to small-scale industrial branches.

5. Providing Indirect finance to Co-operative Sector

The RBI has directed NABARD to give loans to State Cooperative Banks, which in turn lend loans to cooperative sector. Hence, the Reserve Bank of India provides indirect finance to cooperative sector in India.

6. Exercising Control over Monetary and Banking system of the Country

The Reserve Bank of India is vested with enormous and extensive powers regarding supervision and control over commercial banks, cooperative banks and also non-banking institutions receiving deposits. The Banking Regulation Act prescribes extensive requirements as minimum regarding the paid-up capital, reserves, cash reserves and liquid assets.

The operation of the bank, the management, amalgamation, reconstruction

and liquidation etc. are thoroughly supervised by the officials of the Reserve Bank of India. Every scheduled bank is required to furnish to the Reserve Bank a weekly statement showing the principal items of its liabilities and assets in India.

7. Making Industrial arrangement for Industrial Finance

The Reserve Bank of India makes institutional arrangement for industrial finance. For instance, it has brought into existence several development banks such as the Industrial Finance Corporation of India, the Industrial Development Bank of India, which provide long-term finance to industries.

Q27. Write briefly on prohibitory functions of RBI.

Ans :

1. It cannot provide any direct financial assistance to any industry, trade or business.
2. RBI cannot purchase its own share.
3. It cannot purchase shares of any commercial and industrial undertaking.
4. RBI cannot purchase any immovable property.
5. It cannot give loans on the security of shares and property.

3.5.2 Role of RBI in Money Market

Q28. Explain the role of RBI in money market. (OR)

**State the role of RBI in Money Market.
(OR)**

Explain briefly about the reform undertaken in money market.

Ans :

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

The RBI has been taking several measures to develop money market in India. A committee to review the working of the monetary system under the chairmanship of Sukhamoy Chakravorty was set up in 1985. It underlined the need to develop money market instruments.

As follow up, the RBI set up a working group on the money market under the chairmanship of N.Vaghul. The committee submitted its report in 1987. This committee laid the blueprint for the institution of a money market. Based on its recommendations,

The RBI initiated the following measures:

1. The DFHI was set up as a money market institution jointly by the RBI, public sector banks, and financial institutions in 1988 to impart liquidity to money market instruments and help the development of a secondary market for such instruments.
2. Money market instruments such as the 182-day T-bill, CD and interbank participation certificate were introduced in 1988-89. CP was introduced in January 1990.
3. To enable price discovery, the interest rate ceiling on call money was freed in stages from October 1988. As a first step, operations of the DFHI in the call/notice money market were freed from the interest rate ceiling in 1988. Interest rate ceiling on interbank term money, rediscounting of commercial bills and interbank participation without risk were withdrawn in May 1989. All the money market interest rates are, by and large, determined by market forces.

In August 1991, the RBI set up a high level committee under the chairmanship of M.Narasimham (the Narasimham Committee) to examine all aspects relating to structure, organization, functions and procedures of the financial system. The committee made several recommendations for the development of the money market. Based on its recommendations, the RBI initiated the following measures:

- The Securities Trading Corporation of India was set up in June 1994, to provide an active secondary market in government securities.

- Barriers to entry were gradually eased by
 - (a) setting up the primary dealer system in 1995 and satellite dealer system in 1999 to inject liquidity in the market,
 - (b) enabling market evaluation of associated risks by withdrawing regulatory restrictions such as bank guarantees in respect of CPs, and
 - (c) increasing the number of participants by allowing the entry of foreign institutional investors.
- Several financial innovations in instruments and methods were introduced. T- bills of varying maturities and RBI repos were introduced. Auctioned T-bills were introduced leading to market-determined interest rates.
- The development of a market for short term funds at market-determined rates has been fostered by a gradual switch from a cash credit system to a loan based system.
- Adhoc and on-tap 91-day T-bills were discontinued.
- Liquidity Adjustment Facility (LAF) was introduced in June 2000.
- The minimum lock in period for money market instruments was brought down to 7 days.
- The RBI started repos both on auction and fixed interest rate basis for liquidity management.
- New money market derivatives such as forward rate agreements and interest rate swaps were introduced in 1999.
- Money market instruments such as CDs and CPs are freely accessible to non- bank participants.
- The payment system infrastructure was strengthened with the introduction of the negotiated dealing system (NDS) in February 2002, setting up of the Clearing Corporation of India Ltd. (CCIL) in April 2002, and the implementation of Real time Gross settlement system from April 2004.

- Collateral Borrowing and Lending Obligations was operationalising as a money market instruments through the CCIL in June 2003.

Q29. Write about the credit control measures adopted by RBI.

Ans : **(Imp.)**

The Monetary Policy of RBI is not merely one of credit restriction, but it has also the duty to see that legitimate credit requirements are met and at the same time credit is not used for unproductive and speculative purposes RBI has various weapons of monetary control and by using them, it hopes to achieve its monetary policy.

I) Quantitative Credit Control Methods

In India, the legal framework of RBI's control over the credit structure has been provided

Under Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. Quantitative credit controls are used to maintain proper quantity of credit of money supply in market. Some of the important general credit control methods are:-

1. Bank Rate Policy

Bank rate is the rate at which the Central bank lends money to the commercial banks for their liquidity requirements. Bank rate is also called discount rate. In other words bank rate is the rate at which the central bank rediscounts eligible papers (like approved securities, bills of exchange, commercial papers etc.) Held by commercial banks.

Bank rate is important because its is the pace setter to other market rates of interest. Bank rates have been changed several times by RBI to control inflation and recession. By 2003, the bank rate has been reduced to 6% p.a.

2. Open market operations

It refers to buying and selling of government securities in open market in order to expand or contract the amount of money in the banking system. This technique is superior to

bank rate policy. Purchases inject money into the banking system while sale of securities do the opposite. During last two decades the RBI has been undertaking switch operations. These involve the purchase of one loan against the sale of another or, vice-versa. This policy aims at preventing unrestricted increase in liquidity.

3. Cash Reserve Ratio (CRR)

The Cash Reserve Ratio (CRR) is an effective instrument of credit control. Under the RBI Act of, 1934 every commercial bank has to keep certain minimum cash reserves with RBI. The RBI is empowered to vary the CRR between 3% and 15%. A high CRR reduces the cash for lending and a low CRR increases the cash for lending. The CRR has been brought down from 15% in 1991 to 7.5% in May 2001. It further reduced to 5.5% in December 2001. It stood at 5% on January 2009. In January 2010, RBI increased the CRR from 5% to 5.75%. It further increased in April 2010 to 6% as inflationary pressures had started building up in the economy. As of March 2011, CRR is 6%.

4. Statutory Liquidity Ratio (SLR)

Under SLR, the government has imposed an obligation on the banks to, maintain a certain ratio to its total deposits with RBI in the form of liquid assets like cash, gold and other securities. The RBI has power to fix SLR in the range of 25% and 40% between 1990 and 1992 SLR was as high as 38.5%. Narasimham Committee did not favour maintenance of high SLR. The SLR was lowered down to 25% from 10th October 1997. It was further reduced to 24% on November 2008. At present it is 25%.

5. Repo and Reverse Repo Rates

In determining interest rate trends, the repo and reverse repo rates are becoming important. Repo means Sale

and Repurchase Agreement. Repo is a swap deal involving the immediate Sale of Securities and simultaneous purchase of those securities at a future date, at a predetermined price. Repo rate helps commercial banks to acquire funds from RBI by selling securities and also agreeing to repurchase at a later date.

Reverse repo rate is the rate that banks get from RBI for parking their short term excess funds with RBI. Repo and reverse repo operations are used by RBI in its Liquidity Adjustment Facility. RBI contracts credit by increasing the repo and reverse repo rates and by decreasing them it expands credit. Repo rate was 6.75% in March 2011 and Reverse repo rate was 5.75% for the same period. On May 2011 RBI announced Monetary Policy for 2011-12. To reduce inflation it hiked repo rate to, 7.25% and Reverse repo to 6.25%.

II) Selective / Qualitative Credit Control Methods

Under Selective Credit Control, credit is provided to selected borrowers for selected purpose, depending upon the use to which the control try to regulate the quality of credit - the direction towards the credit flows. The Selective Controls are :-

1. Ceiling On Credit

The Ceiling on level of credit restricts the lending capacity of a bank to grant advances against certain controlled securities.

2. Margin Requirements

A loan is sanctioned against Collateral Security. Margin means that proportion of the value of security against which loan is not given. Margin against a particular security is reduced or increased in order to encourage or to discourage the flow of credit to a particular sector. It varies from 20% to 80%. For agricultural commodities it is as high as 75%. Higher the margin lesser will be the loan sanctioned.

3. Discriminatory Interest Rate (DIR)

Through DIR, RBI makes credit flow to certain priority or weaker sectors by charging concessional rates of interest. RBI issues supplementary instructions regarding granting of additional credit against sensitive commodities, issue of guarantees, making advances etc.

4. Directives

The RBI issues directives to banks regarding advances. Directives are regarding the purpose for which loans may or may not be given.

5. Direct Action

It is too severe and is therefore rarely followed. It may involve refusal by RBI to rediscount bills or cancellation of license, if the bank has failed to comply with the directives of RBI.

6. Moral Suasion

Under Moral Suasion, RBI issues periodical letters to bank to exercise control over credit in general or advances against particular commodities. Periodic discussions are held with authorities of commercial banks in this respect.

interest rates in the interbank call market where it can establish its Repo and reverse Repo rates. In accordance with these recommendations in April 1999, the Interim Adjustment Liquidity Facility (ILAF) was introduced, which was followed by the implementation of a full fledged LAF in June 2000.

LAF is operated through Repo and reverse Repo rate. Under Repo the banks borrow money from RBI by providing government securities to meet their short term necessities. Under reverse Repo RBI borrows money from banks by lending securities. The Repos get matured from day 1 to 14 days. All scheduled banks and PD's are allowed to participate in the auctions of Repo and Reverse Repo. LAF aids RBI to adjust the structure of interest rates in retort to sudden liquidity shocks and evolving market conditions. It facilitates a systematic movement of interest rates. It aids banks in adjusting day-to-day liquidity management.

The Repo/Reverse Repo auctions are carried out on daily basis except on Saturdays. Interest rates of Repos and reverse Repos are concluded by RBI through cut-off rates from auctions. Earlier, uniform price auction method is followed to conduct auction. But at present multiple price auction method is used for auction.

In August 2000, the tenor of Repo auctions are introduced as three to seven days. In October 2003, Repos were conducted for a long venture of 28 days for 5 consecutive days, the RBI can even introduce long-term Repos upto 14 days when required. The LAF has reduced the minimum bid size from ` 10 crore to ` 5 crore in a way to provide entry for small operators. The operations of LAF are conducted from 9:30 am to 10:30 am.

3.5.3 Liquidity Adjustment Facility (LAF)**Q30. Write short notes on liquidity adjustment facility.**

Ans : (July-21)

Liquidity Adjustment Facility (LAF) is one of the most important instrument of monetary policy. It is introduced by RBI in June 5, 2000. It operates through Repo and reverse Repo auctions of securities. As a lender, RBI provides various general and sector-specific refinance facilities to banks such as,

- Export-Credit Refinance (ECR)
- Collateralized Lending Facility (CLF)

The Narasimham (Committee II (NC-II) (1998) suggested that the RBI support to the market should be through LAF for an effective flow of

Q31. Explain the advantages of liquidity adjustment facility.

Ans :

- LAF is a new short-term liquidity management technique.
- It is a flexible instrument in the hands of RBI to modulate, even out (or) to adjust or to manage short-term market liquidity fluctuations on a daily basis and to help to create stable or orderly conditions in the overnight/ call money market.

- It is meant to help monetary authorities to transmit the short-term interest rate signals to other money markets, financial markets, and the long-end of the yield curve.
- The repo operations also provide liquidity and breadth to the underlying treasury securities markets.
- They help the banking system also by providing it with an outlet for short-term liquidity, and thereby to optimize the return on short-term surplus funds.
- The LAF operations combined with OMOs and Bank Rate changes have become the major technique (operating procedure) of monetary policy in India.

3.5.3.1 Repo, and Reverse Repo

Q32. Define Repo, and Reverse Repo rate.

(OR)

What is a Repurchase agreement?

Ans : (July-21, Oct.-20, Imp.)

Reserve Bank of India formulates the monetary policies and executes them to achieve a few specific objectives. Monetary policy refers to the policies formulated for the purpose of controlling monetary supply and rate of interest/cost of money in the economy to stimulate the growth. The primary objective of such monetary policies are promoting economic development through price stability, regulation of the volume of bank credits, improving efficiency of the financial system, promoting investments and reducing the rigidity to encourage diversification etc. Repo rate and reverse repo rate are the key instruments of monetary policy of India that are used to control money supply in the economy.

Definition

i) Repo Rate

The term 'Repo' stands for 'Repurchase agreement'. Repo is form of short-term, interest-bearing and collateral-backed borrowing. Interest rate for such borrowings is termed as repo rate. Repo is basically a short-term money market instrument which

is used to raise capital for the shorter-term. In Indian Banking terms, repo rate is the rate at which Reserve Bank of India lends money to all the commercial banks in the country in the event of scarcity of funds. In other words, it is the rate at which Commercial Banks sell their securities and bonds to Reserve Bank of India with an agreement to repurchase the securities and bonds from Reserve Bank of India on a future date at a pre-determined price. The repurchase agreement is signed by both parties involved in the transaction. Current repo rate is 4.00%.

ii) Reverse Repo Rate

Reverse repo is an opposite contract to the Repo Rate. Reverse Repo rate is the rate at which Reserve Bank of India borrows funds from all the other commercial banks in the country. In other words, it is the rate at which commercial banks in India park their excess money with Reserve Bank of India for a short-term period. Current reverse repo rate is calculated at 3.35%.

Q33. Explain the importance of Repo rate and Reverse Repo rate.

Ans :

- Repo and reverse repo are the monetary measures used by the Reserve Bank of India to deal with the deficiency of funds and liquidity in the market. It is one of the vital money control mechanisms used by the central bank of the country.
- Bank lending and investment rates are decided based on the repo rate and reverse repo rate.
- Repo and reverse repo are the most effective and efficient tools used by the Reserve Bank of India to achieve price stability and to boost economic development.
- Repo rate and reverse repo rate are among the most crucial monetary policy instruments available to the RBI.
- There is considerable rise in borrowing by commercial banks through repo route which makes it an important element of India's monetary policy framework.

- The constant nature of the balance between Repo and Reverse-Repo makes it more powerful in the Indian banking system.

Q34. What are the different types of Repos?

Ans :

At present, there are two types of repos in operation in India. They are as follows,

1. RBI Repos

The RBI conducts repo and reverse repo operations with Primary Dealers and banks as a part of its OMOs to provide liquidity support. It has been injecting liquidity into the system every day through repos. The repo auctions are restricted to Primary Dealers and Banks only and is conducted on all working days except Saturdays.

They also offer refinance or reverse repo facility at a fixed price to Primary Dealers. The RBI also conducts repo auctions for optimizing returns on short-term surplus liquid funds, balancing the short-term liquidity fluctuations in the money market and providing banks with an outlet to manage short-term liquidity. The fixed rate repos of the RBI signal money market rates, impart stability to short-term interest rates and bring orderly conditions in the forex market.

2. Inter-Bank Repos

In the year 1922, repos were misused by brokers and banks leading to securities scam and they were banned for this reason. In 1995, the ban was lifted but repos use was restricted to eligible participant and instruments. After liberalization, repo deals were allowed in all central government date securities, T-bills of all maturities and state government securities. Primary Dealers and banks must be routed through Speculative Grade Liquidity (SGL) accounts of the RBI to be able to undertake repo deals. Repos can also develop secondary markets in private debt securities, corporate bonds, FIs bonds and PSU bonds.

The non-bank participants holding Speculative Grade Liquidity accounts with RBI are allowed to lend money to other

eligible participants (reverse repo) only. Inter bank rep market has emerged as an important component of the money market due to setting up of cleaning corporation and eliminating of non-bank entities from notice/call money market.

Q35. What are the advantages of Repos ?

Ans :

The following are some of the important advantages that Repos can provide to the financial and debt markets of a country.

- An active repo market leads to increase in the turnover of the money market.
- It improves liquidity and depth of the money market.
- It enables smooth adjustment of short term liquidity among varied categories of market participants.
- Repo is a tool for funding transactions. It provides a cheaper and most efficient way of improving liquidity in the secondary markets.
- Repos are a source of inexpensive finance for institutions.
- Reserve Bank of India can use repos as a tool of open market operations for injecting or withdrawing liquidity from the market.
- It can be used as indirect instruments of monetary control in the financial market.

3.5.4 Marginal Standing Facility (MSF)

Q36. Explain briefly about Marginal Standing Facility (MSF).

(OR)

What do you understand by Marginal Standing Facility (MSF)?

Ans :

(Imp.)

Introduction

The RBI had introduced the marginal standing facility (MSF) in its Monetary Policy (2011-12).

- MSF came into effect on from May 9, 2011.
- Banks used the facility for the first time in June 2011 and borrowed Rs.1 billion via the MSF.

Definition

Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely.

Banks borrow from the central bank by pledging government securities at a rate higher than the repo rate under liquidity adjustment facility or LAF in short. The MSF rate is pegged 100 basis points or a percentage point above the repo rate. Under MSF, banks can borrow funds up to one percentage of their net demand and time liabilities (NDTL).

- Banks can borrow through MSF on all working days except Saturdays, between 3:30pm and 4:30pm in Mumbai where RBI has its headquarters.
- The minimum amount which can be accessed through MSF is Rs. 1 crore and in multiples of Rs. 1 crore.
- The application for the facility can be submitted electronically also by the eligible scheduled commercial banks.
- The current marginal standing facility rate is 4.65%.

Features

1. Eligibility

All Scheduled Commercial Banks having Current Account and SGL Account with Reserve Bank, will be eligible to participate in the MSF Scheme.

2. Timing

The Facility will be available on all working days in Mumbai, excluding Saturdays.

3. Rate of Interest

The rate of interest on amount availed under this facility will be 100 basis points (originally set) above the LAF repo rate, or as decided by the Reserve Bank from time to time (reduced by the RBI later).

4. Discretion to Reserve Bank

The Reserve Bank will reserve the right to accept or reject partially or fully, the request for funds under this facility.

5. Mechanics of operations

The requests will be submitted electronically in the Negotiated Dealing System (NDS). Eligible members facing genuine system problem on any specific day, may submit physical requests in sealed cover in the box provided in the Mumbai Office.

6. Minimum request size

Requests will be received for a minimum amount of Rs. one crore and in multiples of Rs. one crore thereafter.

7. Eligible Securities

MSF will be undertaken in all SLR-eligible transferable Government of India (GoI) dated Securities/ Treasury Bills and State Development Loans (SDL).

Q37. What are the differences between LAF and MSF?

(OR)

Compare and contrast LAF and MSF?

Ans :

LAF	MSF
1. LAF stands for Liquidity adjustment facility 2. Minimum bidding amount is 5 cr. 3. All clients of RBI are eligible to bid. 4. Bank cannot sell Government security to RBI that is part of bank's SLR quota. 5. Bank can borrow any amount of money as long as it has the securities to sell.	1. MSF stands for Marginal standing facility 2. Minimum bidding amount is 1 cr. 3. Only scheduled commercial banks can bid. 4. Bank can sell the Government security from its SLR quota to RBI. 5. Bank can maximum borrow upto 2% of its NDTL.

3.6 MONETARY POLICY COMMITTEE (MPC)

Q38. Explain briefly about monetary policy committee.

(OR)

What do you understand by monetary policy committee?

Ans :

(Imp.)

The Monetary Policy Committee (MPC) is a committee of the Central Bank in India (Reserve Bank of India), headed by its Governor, which is entrusted with the task of fixing the benchmark policy interest rate (repo rate) to contain inflation within the specified target level.

Monetary Policy Committee is defined in section 2(iii)(cci) of the Reserve Bank of India Act, 1934 and is constituted under subsection (1) of section 45ZB of the same Act.

The MPC replaces the current system where the RBI governor, with the aid and advice of his internal team and a technical advisory committee, has complete control over monetary policy decisions. A Committee-based approach will add lot of value and transparency to monetary policy decisions.

Evolution

MPC was set up consequent to the agreement reached between Government and RBI to task RBI with the responsibility for price stability and inflation targeting. The Reserve Bank of India and Government of India signed the Monetary Policy Framework Agreement on 20 February 2015.

Subsequently, the government, while unveiling the Union Budget for 2016-17 in the Parliament, proposed to amend the Reserve Bank of India (RBI) Act, 1934 for giving a statutory backing to the aforementioned Monetary Policy Framework Agreement and for setting up a Monetary Policy Committee (MPC). *Vide* this amendment, it was written into the preamble of the RBI Act that the primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of growth, and to meet the challenge of an increasingly complex economy, RBI would operate a Monetary Policy Framework. Thus the amendment provides a statutory basis for a Monetary Policy Framework (MPF) and the MPC. This amendment to RBI Act was carried out through the Finance Bill, 2016 presented along with the Union Budget documents. A new Chapter (Chapter IIIF, section 45Z) was introduced in the RBI Act, through this Finance Bill, 2016, detailing the operation of MPC. The provisions in the Bill become effective once it is passed and notified as an Act of Parliament.

Government decided to bring the provisions of amended RBI Act regarding constitution of MPC into force on 27 June, 2016 so that statutory basis of MPC is made effective. Rules governing the procedure for Selection of Members of Monetary Policy Committee and Terms and Conditions of their Appointment and factors constituting failure to meet inflation target under the MPC Framework were also notified on 27 June, 2016.

The history of suggestions for setting up a MPC is not new and traces back to 2002 when the Y. V. Reddy Committee recommended for a MPC to decide policy actions. Subsequently, suggestions were made to set up a MPC in 2006 by the Tarapore Committee, in 2007 by the Percy Mistry Committee, in 2009 by the Raghuram Rajan Committee and then in 2013, both in the report of the Financial Sector Legislative Reforms Commission (FSLRC) and the Dr. Urjit R. Patel (URP) Committee. According to the URP Committee, "Heightened public interest and scrutiny of monetary policy decisions and outcomes has propelled a worldwide movement towards a committee based approach to decision making with a view to bringing in greater transparency and accountability in India."

3.6.1 Structure

Q39. Explain the structure of monetary policy committee.

(OR)

Discuss the structure of monetary policy committee.

Ans :

The structure of MPC is showed in the following figure,

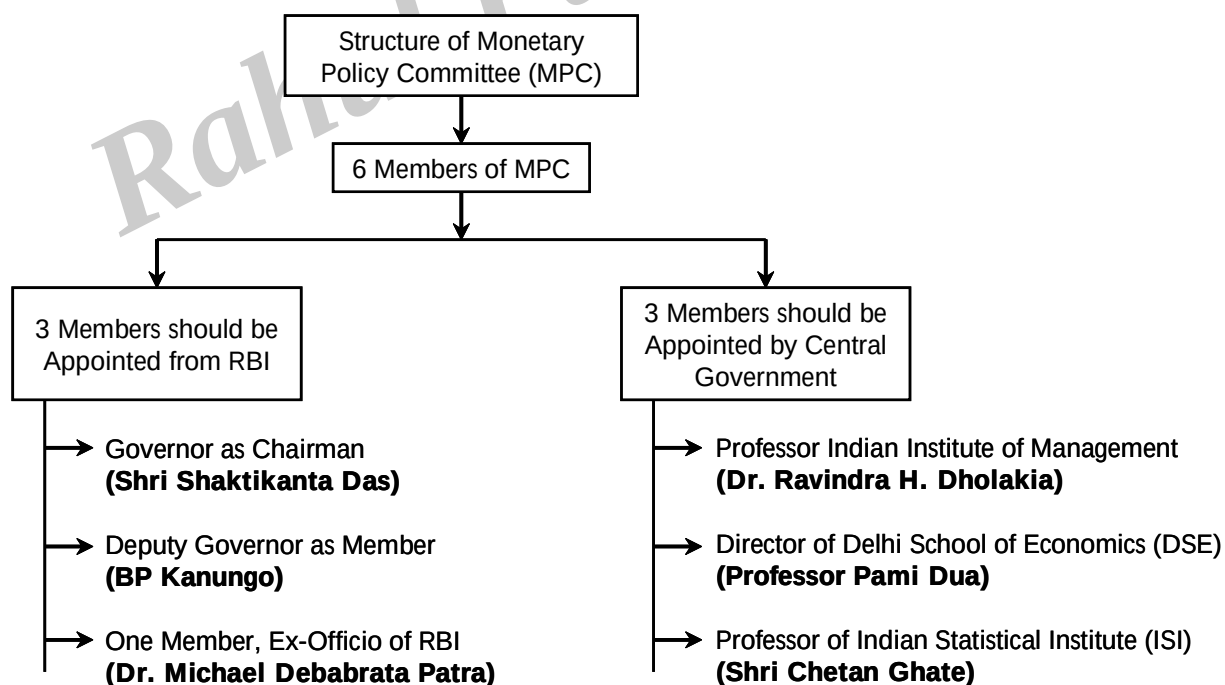


Fig.: Structure of MPC

According to the provisions of RBI Act, the MPC should consist of six members and out of six, three should be appointed from RBI and other three should be appointed by central government. On October, 2019, the central government constituted MPC with the help of powers given by RBI Act, 1934 under section 45ZB through a Gazette notification. The following composition of members listed out in such notification,

1. **Shri Shaktikanta Das** - the governor of the RBI as chairman.
2. **BP Kanungo** - the deputy governor of the RBI as incharge.
3. **Dr. Michael Debabrata Patra** - one officer of the RBI dominated by central board as its member.
4. **Dr. Ravindra H. Dholakia** - Professor of Indian Institute of Management (IIM).
5. **Pami Dua** - Director of Delhi School of Economics (DSE) as member.
6. **Shri Chetan Ghate** - (Professor of Indian Statistical Institute (ISI) as member.

The members of MPC who are appointed by the central government they have to hold office for a period of four years.

The Ex-Officio members of the committee hold the office for a term of four years or until the next order, whichever happens earlier.

Meetings of MPC

The first meeting of the MPC was conducted on 4th, October 2016 after the amendment made by the government on RBI Act, 1934. In the meeting, full-fledged implementation of new inflation targeting monetary policy framework. The members of MPC have to meet atleast four times in a year. The outcome of MPC meetings should be to administer the inflation targeting monetary policy regime through determining the policy rate or repo rate to contain inflation. The 'repo rate' is the policy instrument of a monetary policy which helps to understand the inflation target set by RBI. Currently, the rate set by RBI is 4%.

On 4th June 2016, the eleventh meeting of MPC was conducted at RBI (Mumbai). This meeting was successfully completed between 4th to 6th June and all its members attended the meeting without delay.

Minutes of Meeting

According to section 45ZL of amended RBI Act, 1934, the RBI is required to publish the minutes of meeting (information about decisions) after fourteenth day from the date of meeting.

The minutes of meeting should includes the following details,

1. The resolution of the meeting.
2. The vote given by each members based on the resolution adopted in the meeting.
3. The statement of every member on the adopted resolution.

3.6.2 Functions

Q40. Explain the functions of monetary policy committee.

(OR)

Discuss the functions of monetary policy committee.

(OR)

Elaborate the functions of MPC.

(OR)

Mention the functions of monetary policy committee.

(OR)

What are the functions of monetary policy committee.

(OR)

Brief on the functions of monetary policy committee.

Ans :

1. Under the Monetary Policy Framework Agreement, the RBI will be responsible for containing inflation targets at 4% (with a standard deviation of 2%) in the medium-term (For more details see here).

2. Under section 45ZA(1) of the RBI Act, 1934, the Central Government determines the inflation target in terms of the Consumer Price Index, once in every five years in consultation with the RBI. This target would be notified in the Official Gazette.
3. Further, RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.
4. Each Member of the Monetary Policy Committee has to write a statement specifying the reasons for voting in favour of, or against the proposed resolution, and the same alongwith the resolution adopted by the MPC is published as minutes of the meeting by RBI after 14 days of the said meeting.
5. In addition, subsequent to the MPC meeting, RBI has to publish a document explaining the steps to be taken by it to implement the decisions of the Monetary Policy Committee, including any changes thereto.

Rahul Publications

Short Question and Answers

1. Write briefly on prohibitory functions of RBI.

Ans :

- (i) It cannot provide any direct financial assistance to any industry, trade or business.
- (ii) RBI cannot purchase its own share.
- (iii) It cannot purchase shares of any commercial and industrial undertaking.
- (iv) RBI cannot purchase any immovable property.
- (v) It cannot give loans on the security of shares and property.

2. What is Repurchase agreement ?

Ans :

The term 'Repo' stands for 'Repurchase agreement'. Repo is form of short-term, interest-bearing and collateral-backed borrowing. Interest rate for such borrowings is termed as repo rate. Repo is basically a short-term money market instrument which is used to raise capital for the shorter-term. In Indian Banking terms, repo rate is the rate at which Reserve Bank of India lends money to all the commercial banks in the country in the event of scarcity of funds. In other words, it is the rate at which Commercial Banks sell their securities and bonds to Reserve Bank of India with an agreement to repurchase the securities and bonds from Reserve Bank of India on a future date at a pre-determined price. The repurchase agreement is signed by both parties involved in the transaction. Current repo rate is 4.00%.

3. Define Money market.

Ans :

Meaning

Money market is a market for short-term loans or financial assets. It is a market for the lending and borrowing of short term funds. As the name implies, it does not actually deal in cash or money.

But it actually deals with near substitutes for money or near money like trade bills, promissory notes and Government papers drawn for a short period not exceeding one year. These short term instruments can be converted into cash readily without any loss and at low transaction cost.

Money market is the centre for dealing mainly in short-term money assets. It meets the short-term requirements of borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus funds at the disposal of financial institutions and individuals are borrowed by individuals, institutions and also the Government.

Definitions

- (i) **According to Geottery Crowther**, "The money market is the collective name given to the various firms and institutions that deal in the various grades of near money".
- (ii) **According to RBI**, Defines the money market as, "a market for short term financial assets that are close substitutes for money, facilitates the exchange of money for new financial claims in the primary market as also for financial claims, already issued, in the secondary market".

4. Objectives of money market

Ans :

The following are the important objectives of a money market:

- (i) To provide a parking place to employ short-term surplus funds.
- (ii) To provide room for overcoming short-term deficits.
- (iii) To enable the Central Bank to influence and regulate liquidity in the economy through its intervention in this market.
- (iv) To provide a reasonable access to user of short-term funds to meet their requirements quickly, adequately and at reasonable costs.

5. Define Commercial Paper.*Ans :***Introduction**

During the 1980s a wave of financial liberalisation and innovation in financial instruments swept across the world. A basic feature of the many innovations is the trend towards securitisation, i.e., raising money direct from the investors in the form of negotiable securities as a substitute for bank credit.

The companies found it cheaper to borrow directly from public by way of short term paper. The cost of fund is cheaper for the companies as it involved lower information and transaction cost. This also suits the interest of many investors as it provides them with a wide spectrum of financial instruments to choose from and in placing their funds at reasonably high rates of return. Commercial paper is a new instrument used for financing working capital requirements of corporate enterprises.

Meaning

A commercial paper is an unsecured promissory note issued with a fixed maturity by a company approved by RBI, negotiable by endorsement and delivery, issued in bearer form and issued at such discount on the face value as may be determined by the issuing company.

6. What are Certificate of Deposits?*Ans :***Meaning**

Certificate of Deposits are short term deposit instruments issued by banks and financial institutions to raise large sums of money.

CDs are issued in the form of Usance Promissory Notes. They are negotiable and are in marketable form bearing specific face value and maturity. The CDs are transferable from one party to another. Due to their negotiable nature, they are also known as Negotiable Certificate of Deposit. The issuers of Certificate of Deposits are commercial banks, financial institutions etc. CDs are available for subscription by individuals, corporations, trusts, Associations and NRIs.

Features

- (i) Document of title to time deposit.
- (ii) Unsecured negotiable pronotes.
- (iii) Freely transferable by endorsement and delivery.
- (iv) Issued at discount to face value.
- (v) Repayable on a fixed date without grace days.
- (vi) Subject to stamp duty like the usance promissory notes.

7. What do you mean by Treasury Bills Market ?*Ans :***Meaning**

Treasury bill is a short term government securities usually of the duration of 91 days sold by the central bank on behalf of the government. There is no fixed rate of interest payable on the treasury bills. These are sold by the central bank on the basis of competitive bidding. Treasury bills are highly secured and liquid because of guarantee of repayment assured by the RBI who is always willing to purchase or discount them.

Classification

- (i) 91-Day Treasury Bills Market
- (ii) 182-Day Treasury Bills Markets
- (iii) 364-Day Treasury Bills Market
- (iv) 14-Day Treasury Bills Market

8. Features of call money market*Ans :*

- The call market enables the banks and institutions to even out their day to day deficits and surpluses of money.
- Commercial banks, co-operative Banks and primary dealers are allowed to borrow and lend in this market for adjusting their cash reserve requirements.
- Specified All Indian Financial Institutions, Mutual Funds and certain specified entities are allowed to access call/ Notice money only as lenders.

- It is a complete inter-bank market hence non-bank entities are not allowed access to this market.
- Interest rates in the call and notice money markets are market determined.
- The borrowers and the lenders are required to have current accounts with Reserve Bank of India.
- It serves as an outlet for deploying funds on short-term basis to the lenders having steady inflow of funds.

9. What is Reserve Bank of India ?

Ans :

Reserve Bank of India (RBI) is the central bank of India. It came in to reality after many difficulties. Imperial Bank of India founded in 1921 was considered as the leader of Indian banks. Any way RBI came in to reality by the passing of Reserve Bank of India Act in 1934 and started its functions from 1935.

At the beginning of the RBI, it was owned by private individuals with government. Finally in 1948 the central government become the whole owner of RBI.

Today, economic system should be favor, then only they can shine before other nations. So, it is very essential for a central bank to deal with the financial resources of the country. RBI is the one of the strongest central bank performing many functions.

10. "RBI ACTS AS LENDER OF LAST RESORT" - Explain.

Ans :

The commercial banks have to maintain as a part of statutory requirements certain percentage of their deposits with RBI which is called cash reserve ratio.

By increasing or decreasing this percentage of cash reserve ratio, RBI allows adequate funds for lending purpose by commercial banks. When all the commercial banks are depositing with Reserve Bank of India in the form of cash reserve ratio, a sizable amount of fund is available with RBI. This fund will be extended by RBI to any commercial bank which is facing crisis.

11. Liquidity adjustment facility

Ans :

Liquidity Adjustment Facility (LAF) is one of the most important instrument of monetary policy. It is introduced by RBI in June 5, 2000. It operates through Repo and reverse Repo auctions of securities. As a lender, RBI provides various general and sector-specific refinance facilities to banks such as,

- Export-Credit Refinance (ECR)
- Collateralized Lending Facility (CLF)

The Narasimham (Committee II (NC-II) (1998) suggested that the RBI support to the market should be through LAF for an effective flow of interest rates in the interbank call market where it can establish its Repo and reverse Repo rates. In accordance with these recommendations in April 1999, the Interim Adjustment Liquidity Facility (ILAF) was introduced, which was followed by the implementation of a full fledged LAF in June 2000.

12. Explain briefly about Marginal Standing Facility (MSF).

Ans :

Introduction

The RBI had introduced the marginal standing facility (MSF) in its Monetary Policy (2011-12).

- MSF came into effect on from May 9, 2011.
- Banks used the facility for the first time in June 2011 and borrowed Rs.1 billion via the MSF.

Definition

Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely.

Banks borrow from the central bank by pledging government securities at a rate higher than the repo rate under liquidity adjustment facility or LAF in short. The MSF rate is pegged 100 basis points or a percentage point above the repo rate.

Under MSF, banks can borrow funds up to one percentage of their net demand and time liabilities (NDTL).

- Banks can borrow through MSF on all working days except Saturdays, between 3:30pm and 4:30pm in Mumbai where RBI has its headquarters.
- The minimum amount which can be accessed through MSF is Rs. 1 crore and in multiples of Rs. 1 crore.
- The application for the facility can be submitted electronically also by the eligible scheduled commercial banks.
- The current marginal standing facility rate is 4.65%.

13. Monetary policy committee

Ans :

The Monetary Policy Committee (MPC) is a committee of the Central Bank in India (Reserve Bank of India), headed by its Governor, which is entrusted with the task of fixing the benchmark policy interest rate (repo rate) to contain inflation within the specified target level.

Monetary Policy Committee is defined in section 2(iii)(cci) of the Reserve Bank of India Act, 1934 and is constituted under subsection (1) of section 45ZB of the same Act.

The MPC replaces the current system where the RBI governor, with the aid and advice of his internal team and a technical advisory committee, has complete control over monetary policy decisions. A Committee-based approach will add lot of value and transparency to monetary policy decisions.

Evolution

MPC was set up consequent to the agreement reached between Government and RBI to task RBI with the responsibility for price stability and inflation targeting. The Reserve Bank of India and Government of India signed the Monetary Policy Framework Agreement on 20 February 2015.

Subsequently, the government, while unveiling the Union Budget for 2016-17 in the

Parliament, proposed to amend the Reserve Bank of India (RBI) Act, 1934 for giving a statutory backing to the aforementioned Monetary Policy Framework Agreement and for setting up a Monetary Policy Committee (MPC). Vide this amendment, it was written into the preamble of the RBI Act that the primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of growth, and to meet the challenge of an increasingly complex economy, RBI would operate a Monetary Policy Framework. Thus the amendment provides a statutory basis for a Monetary Policy Framework (MPF) and the MPC.

14. Functions of MPC

Ans :

- (i) Under the Monetary Policy Framework Agreement, the RBI will be responsible for containing inflation targets at 4% (with a standard deviation of 2%) in the medium-term (For more details see here).
- (ii) Under section 45ZA(1) of the RBI Act, 1934, the Central Government determines the inflation target in terms of the Consumer Price Index, once in every five years in consultation with the RBI. This target would be notified in the Official Gazette.
- (iii) Further, RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.
- (iv) Each Member of the Monetary Policy Committee has to write a statement specifying the reasons for voting in favour of, or against the proposed resolution, and the same alongwith the resolution adopted by the MPC is published as minutes of the meeting by RBI after 14 days of the said meeting.
- (v) In addition, subsequent to the MPC meeting, RBI has to publish a document explaining the steps to be taken by it to implement the decisions of the Monetary Policy Committee, including any changes thereto.

15. Explain various promotional functions of RBI.

Ans :

Various promotional functions performed by the Reserve Bank of India are given below :

- (i) **Promotion of Banking Habit:** The Reserve Bank of India helps in mobilizing the savings of the people for investment.
- (ii) **Providing Refinance for Exports:** The Reserve Bank of India is providing refinance for export promotion. The Export Credit and Guarantee Corporation (ECGC) and Export Import Bank were established initially by the Reserve Bank of India to finance the foreign trade of India.
- (iii) **Providing Credit to Agriculture:** The Reserve Bank of India makes institutional arrangements for rural or agricultural finance.
- (iv) **Providing Credit to Small Scale Industrial Unit:** Commercial banks lend loans to smallscale industrial units as per the directives issued by the Reserve Bank of India time to time. The Reserve Bank of India encourages commercial banks to render guarantee services also to small-scale industrial sector.
- (v) **Providing Indirect finance to Co-operative Sector:** The RBI has directed NABARD to give loans to State Cooperative Banks, which in turn lend loans to cooperative sector.
- (vi) **Exercising Control over Monetary and Banking system of the Country:** The Reserve Bank of India is vested with enormous and extensive powers regarding supervision and control over commercial banks, cooperative banks and also non-banking institutions receiving deposits. The Banking Regulation Act prescribes extensive requirements as minimum regarding the paid-up capital, reserves, cash reserves and liquid assets.
- (vii) **Making Industrial arrangement for Industrial Finance:** The Reserve Bank of India makes institutional arrangement for industrial finance.

Choose the Correct Answer

1. Which of the following statements is not true with regard to money market? [b]
(a) It involves low market risk.
(b) It is situated at specific locations.
(c) Deals in unsecured and short-term debt instruments.
(d) The instruments traded are highly liquid.
2. Which of the following statements is not true with regard to Treasury bills? [c]
(a) Are issued in the form of a promissory note.
(b) They are highly liquid and have assured yield
(c) They carry high risk of default.
(d) They are available for a minimum amount of RS. 25,000 and in multiples thereof.
3. Which of the following statements is not true with regard to Commercial paper? [a]
(a) Is a long-term unsecured promissory note with a fixed maturity period.
(b) It usually has a maturity period of 15 days to one year.
(c) It is sold at a discount and redeemed at par.
(d) Companies use this instrument for bridge financing.
4. The allocated function is performed by _____. [d]
(a) Financial market (b) Capital market
(c) Money market (d) All of the above
5. It is a market for short-term funds which deals in monetary assets whose period of maturity is up to one year. [d]
(a) Primary market (b) Secondary market
(c) Capital market (d) Money market
6. It is an instrument of short-term borrowing by the Government of India maturing in less than one year. [b]
(a) Commercial bill (b) Treasury bill
(c) Call money (d) None of the above
7. Who issues a treasury bill? [c]
(a) Any nationalized bank (b) Any private sector bank
(c) Reserve Bank of India (d) All of the above
8. It is used as an alternative to bank borrowing for large and creditworthy companies. [b]
(a) Commercial bill (b) Commercial papers
(c) Call money (d) None of the above

9. It is a method by which banks borrow from each other to be able to maintain the cash reserve ratio. [c]
(a) Commercial bill (b) Commercial papers
(c) Call money (d) None of the above
10. A rise in call money rates makes other sources of finance such as commercial paper and certificates of deposit _____. [b]
(a) Expensive in comparison with banks who raise funds from these sources.
(b) Cheaper in comparison with banks who raise funds from these sources.
(c) Creates no effect on other sources.
(d) None of the above
11. It is a short-term, negotiable, self-liquidating instrument which is used to finance the credit sales of firms. [a]
(a) Commercial bill (b) Commercial papers
(c) Call money (d) None of the above
12. They can be issued to individuals, corporations and companies during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high. [d]
(a) Commercial papers (b) Call money
(c) Commercial bill (d) Certificate of deposit
13. The market for short-term loans is known as: [c]
(a) Call money market (b) Treasury bill market
(c) Money market (d) Acceptance market
14. Bills drawn and accepted payable after three months are called: [b]
(a) Indigenous bills (b) Usance bills
(c) Clean bills (d) Supply bills
15. The market which helps commercial banks to maintain their SLR requirements is: [a]
(a) Call loan market (b) Discount market
(c) Acceptance market (d) Commercial bill market
16. The certificate which evidences an unsecured corporate debt of short-term maturity is: [d]
(a) Short-term loan certificate (b) Certificate of deposit
(c) Inter-bank participation certificate (d) Commercial paper
17. The major player in the Indian money market is: [c]
(a) Co-operative banks (b) Indigenous banks
(c) Commercial banks (d) Reserve Bank of India

Fill in the blanks

1. _____ market is the centre for dealing mainly in short-term money assets.
2. NBFC stands for _____.
3. An individual or private firm receiving deposits and dealing in _____.
4. _____ constitutes one of the components of the organized money market of our country.
5. A _____ is a type of certificate given by the bank to its depositors for a particular time period.
6. Reserve Bank of India acts as a banker to the government by maintaining the accounts of _____ and _____.
7. GIC stands for _____.
8. _____ are issued by the Reserve Bank of India on behalf of the Central Government for raising money.
9. A _____ is an unsecured promissory note issued with a fixed maturity by a company approved by RBI,
10. _____ are short term deposit instruments issued by banks and financial institutions to raise large sums of money.
11. The Reserve Bank of India helps in mobilizing the savings of the people for _____.
12. _____ are the credit instruments which helps business organizations and banking organizations.
13. Demand bills are also known as _____.
14. _____ market deals with the trading of excess funds.
15. _____ is the central bank of India.
16. RBI acts as _____ of last resort.
17. ECGC stands for _____.
18. _____ is the most important constituent of the money market.
19. LAF stands for _____.
20. LAF is introduced by RBI in _____.
21. The term 'Repo' stands for _____.
22. Reverse repo is an opposite contract to the _____.
23. _____ repo are the monetary measures used by the Reserve Bank of India.
24. MSF stands for _____.
25. MPC stands for _____.

ANSWERS

1. Money
2. Non-Banking Financial Companies
3. Hundies
4. Money lenders
5. Certificate of deposit
6. Central government, State government
7. General Insurance Corporation
8. Treasury bills
9. Commercial paper
10. Certificate of Deposits
11. Investment
12. Commercial bills
13. Sight bills
14. Call money
15. Reserve Bank of India
16. Lender
17. Export Credit and Guarantee Corporation
18. RBI
19. Liquidity Adjustment Facility
20. 5th June, 2020
21. Repurchase agreement
22. Repo Rate
23. Repo and reverse
24. Marginal Standing Facility
25. Monetary Policy Committee

UNIT V

EQUITY MARKET:

Meaning - Development of Equity Culture in India - Primary Market: IPO and FPO - Methods of IPO - Role of Merchant Bankers in Fixing the Price - Red Herring Prospectus - Sweat Equity - ESOP - Rights Issue - Secondary Market: Meaning and Functions of Stock Exchanges - Evolution and Growth of Stock Exchanges - Stock Exchanges in India - Recent Developments in Indian Stock Exchanges - Stock Market Indices - SEBI: Objectives and Functions.

5.1 EQUITY MARKET

5.1.1 Meaning

Q1. What do you understand by Equity market ?

(OR)

Explain briefly about Equity Market.

Ans :

(Imp.)

Meaning

An equity market is a market in which shares are issued and traded, either through exchanges or over-the-counter markets. Also known as the stock market, it is one of the most vital areas of a market economy because it gives companies access to capital and investors a slice of ownership in a company with the potential to realize gains based on its future performance.

There are five different ways by which a company can raise its equity capital in the primary market. They are,

- (i) Public issue
- (ii) Rights issue
- (iii) Preferential allotment
- (iv) Global investment banking and
- (v) Private placement

(i) Public Issue

Public issue is the sale of securities to the public at large and is governed and controlled by the provisions of the Companies Act 1956.

In U.S, public issues of stocks as well as bonds are managed by Investment bankers

who acts as underwriters. Investment bankers acts as intermediaries between issuers and investors. For instance, issuer sell securities to the investment bankers who further resell them to the investors. Thus, investment bankers underwrite the new issues by purchasing the securities from the issuer and assuming the risk of reselling the securities to the investors.

(ii) Rights Issue

Rights issue is an official invitation given by the company to its shareholders regarding the subscription for the purchase of further shares issued by a company. A 'right' represents an option or a choice that has to be made by a shareholder for the purchase of securities at a predetermined price. A limited company after obtaining the approval from its articles of association can issue new shares (either equity or preference).

(iii) Preferential Allotment

Preferential Allotment means an issue of an equity by a listed company to the selected investors at a price which may or may not be in accordance with the prevailing market price especially in the Indian Capital Market.

(iv) Global Investment Banking

Initially, selling new securities was restricted only in the domestic markets but presently the scenario has been changed due to globalization. Globalization helps the companies to raise new capital from different countries across the globe. A new concept has been introduced as "global equity offering" in the investment banking.

(v) Private Placements

Recently, many corporations have started introducing the “private placement” where in the new securities issues such as debt securities are being directly sold to the financial institution like Life Insurance Companies. As registration is necessary for these private placements, this results in time and money saving.

5.2 DEVELOPMENT OF EQUITY CULTURE IN INDIA
Q2. Explain the development of equity culture in India.
(OR)
What are the major developments of equity culture in India.

Ans :

The major developments of equity culture merely equity market is to accomplish the fiscal goals, regorms of the Indian stock market.

In February 1997, SEBI approved the Trade Guarantee Fund (TGF) by the BSE which assures the guarantee settlement of bonafide transactions of BSE members. TGF has a corpus (budget) of ` 172.5 crore and that has been operational from 12 May 1997. BSE, inorder to meet the financial requirements of stock brokers it decided to establish “BSE Bank”. Then evolved the HDFC and ICICI banks to facilitate money transactions between Stock Exchanges (SEs) for the sake of inter-market settlements in the ISESC. These banks receive money on daily basis and facilitate them during pay-in session.

The establishment of Stock Lending Scheme (SLS) has been approved by the authorities where it enables the seller of securities to borrow then for some specified period to deliver them to the buyer during the settlement on outstanding commitments. The borrowers are termed as the brokers, speculators, market makers and jobers. The lenders are the institutional investors. The depository and custodial services are created to provide trading of securities.

FII's are enabled to invest in the Indian capital market since September, 1992. By the end of 1997, around 439 FII's are registered with SEBI with a gross purchase and gross sales as shown below,

Year	Gross Purchase (`) in Crores	Gross Sales (`) in Crores
1994	9,267	67
1995	6,666	2,476
1996	15,739	2,812

FII's played a vital role in buying and selling of share prices in India where volatility of share prices has a rapid growth because of the participation of FII's in trading of securities. Almost all stock exchanges had introduced screen-based trading and about 16 stock exchanges have established clearing houses/ corporations by the end of 1997. There is a reduce in the rates of corporate tax and capital gains tax. According to the budget of 1997-98, the former for public and private limited companies is 35% and for NRI's and FII's it is 10%. The dividend tax and dividend income of the shareholders is abolished. The SEBI introduced a “market-based pricing” (or) “free pricing system in the recent times. RBI permitted the NRIs and OCBs to buy shares and debentures with 30% investment in equities of the Indian companies. They are engaged in all activities except in the sectors of agriculture and plantations.

In the recent times, new instruments such as stock invest and many hybrid claims have been introduced. The minimum percentages of public issues that are offered to public are reduced from 60% to 25%. The minimum number of shares to be applied has raised from 100 to 500.

Financial institutions and mutual funds are enabled to apply for firm allotments in the public issues. The entire intermediaries, agencies, organizations related to the functioning of the capital market have been brought under the SEBI. Presidential norms are established, processes for public issues, securities transfer etc., have been simplified. The government SEs have been reconstituted.

Companies are abolished from issuing Non-Voting Shares (NVS) upto 25% of their share capital. They are enabled to buy-back their own shares by using funds from their free reserves, securities premium account and the proceeds of prior issue made for the purpose of buy-back from 1997-98.

5.3 PRIMARY MARKET

Q3. Define primary market. Explain the function of primary market.

(OR)

What is a primary market? Discuss its functions.

(OR)

Write note on New issue market.

(OR)

Explain the functions of New issue market.

(OR)

What are the functions of primary market?

Ans : (Oct.-20, June-19(MGU), Imp.)

Meaning

The Primary Market, also known as a New Issue Market, is where new securities are issued – it is part of the capital market. Corporations, national and local governments, and other public sector

institutions can get financing through the sale of new stock or bond issues through the primary market.

Put simply, the primary market creates new securities and offers them for sale to the public.

All companies require capital for their operations. This capital (money) can be in the form of equity or debt. Equity is the stock capital (share capital) of a company. Debt consists of all the loans taken by the business.

In order to raise capital in the form of equity, a company can sell its shares to members of the public. When shares are sold directly to the public, this is done via the primary market route.

Example

XYZ Inc. sells shares to Investor A in the primary market. Investor A sells XYZ shares to Investor B in the secondary market.

Functions

The main functions of primary market are described below:

1. Organization of New Issues

The organization of new issues requires investigation of viability and prospects of new projects. An important element of the organization of new shares is the knowledge about adequacy and structure of financial arrangements.

The structure of financial arrangements involves requirements and availability of promoter's equity, equity from public, debt-equity ratio short term funds, liquidity ratio, and foreign exchange requirement. All this requires a careful study of the new issue by competent and well trained staff.

2. Underwriting of New Issues

Another step involved in floating a new issue is its underwriting. The term underwriting means guaranteeing purchase of a specified amount of new issue at a fixed price. The purchase may be for sale to the public, for only one's portfolio or for both the purposes.

If the underwriter fails to sell the guaranteed amount of shares to public, it will have to purchase the unsold shares by itself.

The underwriter is paid a commission for underwriting the new issue. Mostly underwriting of a new issue is undertaken by a group of financial institutions.

3. Distribution of New Issue

Distribution of new issues means the sale of the stock to the public. There are three main ways of selling the new issue to the public.

- (a) **Issue of a Prospectus to the Public:** The issue is sold to the public by issuing of prospectus. Prospectus is an invitation to the public to purchase the issue. The issue of a public prospectus is done through advertisement. It gives details about the company, issue and the underwriters.

- (i) **It Provides Liquidity:** The main function of the secondary market is to provide liquidity to securities. Liquidity of an asset means its easy convertibility into cash at short notice and with minimum loss of capital value.

The liquidity is provided through a continuous market for securities, that is, a market where securities can be bought and sold at any time during business hours at small transaction cost.

- (ii) The function of providing liquidity to old stocks is important

- For attracting new finance
- for encouraging prospective investors to invest in securities.
- They know that any time they want to get out of them into cash they can go to the market and sell them off.

- (b) **Encouragement to New Investment:** The new investment is also influenced by the secondary market. It acts as an important indicator of the investment climate in the economy. When stock prices of existing securities are rising and the volume of trading activity in the secondary market goes up, new issues also tend to increase as the primary market is better preferred. This is also a good time for companies to come forward with new issues.

Q4. Explain the features of primary market. (OR)

**Discuss the features of primary market.
(OR)**

Explain the features of new issue market.

Ans : (Oct.-20, Imp.)

Main features of the primary market are as follow:

1. It is related with New Issues

The first important feature of the primary market is that it is related with the new issues. Whenever a company issues new shares (or) debentures, it is known as Initial Public Offer (IPO).

2. It has No Particular Place

Primary market is not the name of any particular place but the activity of bringing in new issues is called the primary market.

3. It has Various Methods of Floating Capital

Following are the methods of raising capital in the primary market:

- (i) **Public Issue:** Under this method, the company issues a prospectus and invites the general public to purchase shares or debentures.

- (ii) **Offer for Sale:** Under this method, firstly the new securities are offered to an intermediary (generally firms of stock brokers) at a fixed price. They further resell the same to the general public. The advantage of doing this is that the issuing company feels free from the tedious work of making a public issue.

- (iii) **Private Placement:** Under this method, the company sells securities to the institutional investors or brokers instead of selling them to the general public. They, in turn, sell these securities to the selected clients at a higher price. This method is preferred as it is a cheaper method of raising funds as compared to a public issue.

(iv) Right Issue: This method is used by those companies who have already issued their shares. When an existing company issues new shares, first of all it invites its existing shareholders. This issue is called the right issue. In this case, the shareholder has the right either to accept the offer for himself or assign a part or all of his right in favour of another person.

(v) Electronic Initial Public Issue (e-IPOs): Under this method, companies issue their securities through the electronic medium (i.e. internet). The company issuing securities through this medium enters into a contract with a Stock Exchange.

SEBI registered broker have to be appointed for the objective of accepting applications. This broker regularly sends information about it to the company.

The company issuing security also appoints a Registrar, who helps in making the issue a success by establishing contact with the stock exchange.

Q5. List out the products of primary market.
(OR)

Explain briefly about various instruments of primary market.

Ans : (Oct.-20)

The primary market deals with the issue of new instruments by the corporate sector such as,

1. Equity Shares

Equity shares represent ownership position in a company. Equity holders are owners of the company and elect the board of directors and enjoy voting right. Equity shareholders control the operations of the firm. Equity shareholders have a claim on remaining assets which are leftover after meeting the claims of creditors and preference shareholder in event of liquidation. Equity share capital is also called as risk capital, because if the company is not performing well, the holders of the equity shares are sufferers and if the company is doing well they will reap the benefits.

2. Preference Shares

Preference shares are those which enjoy some extra benefits when compare to other types of shares. The preference shareholders are given due preference while giving dividends. Upon liquidation of the company, the preference shareholders are given preference. Preference shareholders are not participated in the affairs of management because they do not have voting rights. But the management give preference to all preference shareholders while giving benefits.

3. Debentures

Debenture is a document which either creates a debt or acknowledges it and any document which fulfills either of these conditions is a debenture. The debenture is issued by the company and is in the form of a certificate of indebtedness. It usually specifies the date of redemption. It also provides for the repayment of principal and interest at specified date of the given dates. It generally creates a charge in the undertaking or undertakings of the company.

Q6. Explain briefly about Participants of Primary Market.

(OR)

Who are the major intermediaries in the process of issue of new securities? Explain.

Ans :

The participants of primary market are as follows,

1. Merchant Banker

Merchant Banking is understood differently in different countries.

Though there is no universal definition for merchant banking functions and services offered by a merchant banker.

As per the Securities and Exchange Board of India (SEBI), 1992 defines, the notification of the ministry of finance defines a merchant bankers person who is engaged in the business of issues management either by making arrangement regarding selling,

buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management.

Merchant banking as an institution that covers a broad range of activities like management of customer services, corporate governance, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

2. Registrar to the Issue

A registrar collects investors and applications, keeps record of applications, application money and money paid to the securities seller, assists companies in determining the allotment basis, finalizing the allotment of securities and displacing documents in respect of issue of capital.

For a merchant banker to act as registrar to an issue, he must obtain a certificate of registration from the SEBI. For registration, SEBI divides registrars or share transfer agents in two categories.

- (i) Consists of persons acting as Registrar and Share Transfer agent.
- (ii) Consists of person acting either Registrar or Share Transfer.

3. Bankers to the Issue

Bankers to an issue perform the activities like acceptance of applications and the application money from the investors for issues of capital and refund of applications money.

4. Brokers

Brokers are the middlemen between purchaser and seller of securities. They bring buyers and sellers together for making deals. Brokers have good knowledge in estimating changes in prices which is beneficial for their clients in earning profitable gains. Brokers receive commission from both the parties for rendering their services.

Q7. Explain the advantages and disadvantages of primary market.

(OR)

State the the advantages and disadvantages of primary market.

Ans :

(Oct.-20)

Advantages

(i) Avenue for investment

A primary market provides good avenues for investments in financial assets which are more productive than physical assets. Most of the investors, particularly the household sector prefers this avenue since it is convenient and more profitable.

(ii) Mobilization of savings

A well developed primary market offers adequate incentives in the form of interest or dividend that may allure investors from all walks of the society to invest savings in the primary market.

(iii) Channelizing savings for productive use

The primary market helps to mobilise the small and scattered savings and augment the availability of investible funds. These funds are utilised for productive purposes and thus, the wastage in unproductive uses is avoided.

(iv) Source of large supply of funds

The rapid development of any country requires the growth of large scale industries which need huge capital. The huge amount of funds required for these industries can not be provided by few persons. But huge money can be raised in a primary market by floating new shares in the market.

(v) Rapid industrial growth

The primary market facilitates increase in production and productivity in the economy by means of establishing many new companies and thereby promoting rapid industrial growth in a country.

(vi) Source for expansions and technological upgradation

The primary market also serves as an important source for raising money for expansion of industries as well as for their technological upgradation.

Disadvantages**(i) Possibility for deceiving investors**

There is ample scope for attracting investors by giving mis-leading informations. The issuing companies are often tempted to present a rosy picture about the prospective projects. They make exaggerated claims about their prospects as well as over-subscription. As a result, innocent investors are affected.

(ii) No fixed norms for project appraisal

There is no adequate institutional arrangement for the appraisal of the projects to be undertaken by the new companies. Again, there are no fixed norms for getting the appraisals approved by designated institutions. Hence, poor investors have no scope to ascertain the actual profitability of a project.

(iii) Lack of Post Issue Seriousness

Moreover, there is no seriousness among most of the investors to check the performance of the company after the issue. Once the issue is subscribed, their duty is over.

(iv) Ineffective Role of Merchant Bankers

The merchant bankers do not pay adequate attention to the technical, managerial and feasibility aspects while appraising the project proposals. In fact they do not seem to play a development role as a result of which the small investors are duped by the companies.

(v) Delay in the Allotment Process

There is inordinate delay in receiving allotment letters, share certificates, refund orders etc. If shares are not allotted, the investor suffers loss of interest. There is delay in effecting transfer of shares. All these factors tend to affect the small investors who hesitate to approach a primary market for investing their funds.

(vi) Poor Mobilisation of Savings

The new issue market is not able to mobilise adequate savings from the public. It is estimated that only 5% to 10% of financial savings of the household sector go to the primary market.

(vii) Hesitancy to Invest on Shares

Generally, there is a tendency on the part of the investors to prefer fixed income bearing securities like preference shares and debentures. They hesitate to invest in equity shares since they do not fetch any fixed income. This risk aversion factor stands in the way of development of a healthy primary market.

5.3.1 Initial Public Offering (IPO)**Q8. Define the term Initial Public Offering (IPO).****(OR)****What is Initial Public Offering (IPO)?****Ans : (Imp.)**

Initial Public Offering, shortly known as IPO is the first public offering of equity shares of a company going to be listed on the stock exchange and publicly traded. It is the main source of acquiring money from the general public to finance its projects and the company allots shares to the investors in return. It is the turning point in the lifecycle of the company that transforms from a small closely held company, which seek to expand their business or large privately owned firms to a publicly listed one.

- (i) firstly when the fresh issue of shares takes place, resulting in injection of fresh capital to the company.
- (ii) Secondly, when existing shares are offered for sale, where in no infusion of capital takes place because the amount received as proceeds from the issue of shares go to shareholders who offer their shares for sale.

Certain eligibility conditions are required to be fulfilled by the company so as to make an IPO. Guidelines specified by the Securities and Exchange Board of India (SEBI) and Company Act need to be complied by the promoters of the enterprise.

5.3.1.1 Methods of IPO**Q9. Discuss the various methods involved in IPO.****(OR)****State the various techniques involved in IPO.**

Ans : (June-19(MGU), Imp.)

1. Fixed Price Offering

Under fixed price, the company going public determines a fixed price at which its shares are offered to investors. The investors know the share price before the company goes public. Demand from the markets is only known once the issue is closed.

2. Book Building Offering

Under book building, the company going public offers a 20% price band on shares to investors. Investors then bid on the shares before the final price is settled once the bidding has closed. Investors must specify the number of shares they want to buy and how much they are willing to pay. Unlike fixed price, there is no fixed price per share. The lowest share price is known as the floor price, while the highest share price is known as the cap price. The final share price is determined using investor bids.

Types of Book Building Process

Three types of options have been provided by SEBI to the issuer companies under book building. These options are as follows:

(a) 75% Book Building, 25% Fixed Price Offer:

In this type of offer, 75% of the issue is offered to institutional investors who participated in the bidding process. Balance 25% is offered to the public through prospectus and shall be reserved for allocation to individual investors who had not participated in the bidding process. The price for 25% offer is the price as determined through book building. First, the book building portion remains open for 3 to 7 days and on discovery of issue price after the completion of book building process, the fixed price portion opens for subscription.

(b) 90% Book Building, 10% Fixed Price Offer:

Here issuer company offers 90% of the issue through book building and the balance 10% through fixed price offer at a price discovered through book building. This option was available to the issuers during 1999-2000 and 2000-01 and later on discontinued by SEBI.

(c) 100% Book Building Offer: In this type of offer, the whole issue is offered through book building route. Issue opens and closes on the same dates for all categories of investors. Different categories of bidders bid at the point of time. This type of issue takes minimum number of days for the completion of the process of issue and allotment of shares. Generally, the issue is listed on a Recognized Stock Exchange after 3 weeks from the closure of the issue (2 weeks for completion of allotment + 1 week for completion of listing formalities).

Q10. Explain the SEBI guide lines for IPOs.

Ans :

The SEBI has been issuing guidelines from time to time with regard to IPOs so as to protect the interest of investors and also to promote a healthy capital market in the country.

Some of the important guidelines pertaining to IPO's are :

1. All allotments have to be made within 30 days of the closure of the ' public issue and 42 days in the case of a rights issue.
2. The set offer to the general public has to be at least 25% of the total issue size for listing on a stock exchange. For listing an IPO on the NSE :
 - (a) The paid up capital should be Rs. 20 crores.
 - (b) The issuing company should have a track record of profitability.
 - (c) The project should be appraised by a financial institution or a commercial bank or category I merchant banker.
3. In case an issue exceeds more than Rs. 100 crores, the issue is allowed to place the whole issue through book-building.
4. A minimum of 50% of the net offer to the public has to be reserved for investors applying for less than 1000 shares.
5. All listing formalities for a public issue have to be completed within 70 days from the date of closure of the subscription list.

6. There should be at least 5 investors for every Rs. 1 lakh of equity offered.
7. The PAN or GIR number should be compulsory quoted in the application where the monetary value of investment is Rs. 50,000 or above.
8. The subscription list for public issues shall be kept open for at least 3 working days and not more than 10 working days.

5.3.2 Follow-on Public Offering (FPO)

Q11. What is Follow-on Public Offering.

(OR)

Define the term Follow-on Public Offering.

Ans :

FPO, an acronym for Follow-on Public Offering, as the name suggests it is the public issue of shares to investors at large, by a publicly listed company. The process is after an IPO; wherein the company goes for a further issue of shares to the general public with a view to diversifying their equity base. The shares are offered for sale by the company through an offer document called prospectus. There is two type of Follow-on Public Offering:

- (i) Dilutive offering
- (ii) Non-Dilutive offering.

Q12. What are the difference between IPO and FPO.

(OR)

Distinguish between IPO and FPO.

Ans :

Basis for Comparison	IPO	FPO
1. Meaning	IPO refers to an offer of securities made to the public for subscription by the company for the first time.	FPO refers to an offer of securities for subscription to the public by a publicity-traded enterprise.
2. Issuer	Unlisted company.	Listed company.
3. Raising Capital	Through the first time from public.	Through a subsequent public contribution.
4. Risk	High Risk involved.	Comparatively low risk involved.
5. Objective	The main objective is raising capital through public investment.	The main objective is subsequent public investment.
6. Predictability	Less predictable.	More predictable.
7. Profit	The profits are Higher than FPO.	The profits are Lower than IPO.
8. Types	The IPO is divided into 2 types (i) Equity shares, (ii) preferred shares.	The FPO is divided into 2 types (i) Dilutive offering, (ii) non-dilutive offering.

Q13. Explain the different means of raising money for a business.

Ans :

A business can raise funds from various sources. Each of the source has unique characteristics, which must be properly understood so that the best available source of raising funds can be identified. There is not a single best source of funds for all organizations. Depending on the situation, purpose, cost and associated risk, a choice may be made about the source to be used. For example, if a business wants to raise funds for meeting fixed capital requirements, long term funds may be required which can be raised in the form of owned funds or borrowed funds. Similarly, if the purpose is to meet the day-to-day requirements of business, the short term sources may be tapped

1. Retained Earnings

A company generally does not distribute all its earnings amongst the shareholders as dividends. A portion of the net earnings may be retained in the business for use in the future. This is known as retained earnings. It is a source of internal financing or self financing or 'ploughing back of profits'. The profit available for ploughing back in an organization depends on many factors like net profits, dividend policy and age of the organization.

2. Trade Credit

Trade credit is the credit extended by one trader to another for the purchase of goods and services. Trade credit facilitates the purchase of supplies without immediate payment. Such credit appears in the records of the buyer of goods as 'sundry creditors' or 'accounts payable'. Trade credit is commonly used by business organizations as a source of short-term financing. It is granted to those customers who have reasonable amount of financial standing and goodwill.

The volume and period of credit extended depends on factors such as reputation of record of payment and degree of competition in the market. Terms of trade credit may vary from one industry to another

and from one person to another. A firm may also offer different credit terms to different customers. the purchasing firm, financial position of the seller, volume of purchases, past.

3. Factoring

Factoring is a financial service under which the 'factor' renders various services which includes:

- (a) Discounting of bills (with or without recourse) and collection of the client's debts. Under this, the receivables on account of sale of goods or services are sold to the factor at a certain discount. The factor becomes responsible for all credit control and debt collection from the buyer and provides protection against any bad debt losses to the firm. There are two methods of factoring — recourse and non-recourse. Under recourse factoring, the client is not protected against the risk of bad debts. On the other hand, the factor assumes the entire credit risk under non-recourse factoring i.e., full amount of invoice is paid to the client in the event of the debt becoming bad.
- (b) Providing information about credit worthiness of prospective client's etc., Factors hold large amounts of information about the trading histories of the firms. This can be valuable to those who are using factoring services and can thereby avoid doing business with customers having poor payment record. Factors may also offer relevant consultancy services in the areas of finance, marketing, etc.

4. Lease Financing

A lease is a contractual agreement whereby one party i.e., the owner of an asset grants the other party the right to use the asset in return for a periodic payment. In other words it is a renting of an asset for some specified period. The owner of the assets is called the 'lessor' while the party that uses the assets is known as the 'lessee'

The lessee pays a fixed periodic amount called lease rental to the lessor for the use of the asset. The terms and conditions regulating the lease arrangements are given in the lease contract. At the end of the lease period, the asset goes back to the lessor. Lease finance provides an important means of modernization and diversification to the firm. Such type of financing is more prevalent in the acquisition of such assets as computers and electronic equipment which become obsolete quicker because of the fast changing technological developments. While making the leasing decision, the cost of leasing an asset must be compared with the cost of owning the same.

5. Public Deposits

The deposits that are raised by organizations directly from the public are known as public deposits. Rates of interest offered on public deposits are usually higher than that offered on bank deposits. Any person who is interested in depositing money in an organization can do so by filling up a prescribed form. The organization in return issues a deposit receipt as acknowledgment of the debt. Public deposits can take care of both medium and short-term financial requirements of a business

6. Commercial Paper (CP)

Commercial Paper emerged as a source of short term finance in our country in the early nineties. Commercial paper is an unsecured promissory note issued by a firm to raise funds for a short period, varying from 90 days to 364 days. It is issued by one firm to other business firms, insurance companies, pension funds and banks. The amount raised by CP is generally very large. As the debt is totally unsecured, the firms having good credit rating can issue the CP. Its regulation comes under the purview of the Reserve Bank of India.

7. Issue of Shares

The capital obtained by issue of shares is known as share capital. The capital of a

company is divided into small units called shares. Each share has its nominal value. For example, a company can issue 1,00,000 shares of Rs. 10 each for a total value of Rs. 10,00,000. The person holding the share is known as shareholder. There are two types of shares normally issued by a company. These are equity shares and preference shares. The money raised by issue of equity shares is called equity share capital, while the money raised by issue of preference shares is called preference share capital

(a) Equity Shares: Equity shares is the most important source of raising long term capital by a company. Equity shares represent the ownership of a company and thus the capital raised by issue of such shares is known as ownership capital or owner's funds. Equity share capital is a prerequisite to the creation of a company. Equity shareholders do not get a fixed dividend but are paid on the basis of earnings by the company.

They are referred to as 'residual owners' since they receive what is left after all other claims on the company's income and assets have been settled. They enjoy the reward as well as bear the risk of ownership. Their liability, however, is limited to the extent of capital contributed by them in the company. Further, through their right to vote, these shareholders have a right to participate in the management of the company

(b) Preference Shares: The capital raised by issue of preference shares is called preference share capital. The preference shareholders enjoy a preferential position over equity shareholders in two ways:

- (i) Receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders and

- (ii) Receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation. In other words, as compared to the equity shareholders, the preference shareholders have a preferential claim over dividend and repayment of capital. Preference shares resemble debentures as they bear fixed rate of return.

Also as the dividend is payable only at the discretion of the directors and only out of profit after tax, to that extent, these resemble equity shares. Thus, preference shares have some characteristics of both equity shares and debentures.

5.4 ROLE OF MERCHANT BANKERS IN FIXING THE PRICE

Q14. Explain the role of merchant bankers in fixing the price.

Ans : (Imp.)

The role of merchant banker in fixing the prices involves the following methods,

1. Fixed Price Issue Method

Fixed price issue is regarded as where the issuer decides the issue price at the commencement and indicates it in the offer document. The companies are facilitated to price their equity shares. Meanwhile, the price determined in the offer document/letter of offer is to be justified by the company. It might be the face value of the instrument, discounted price (or) premium price.

Following are the conditions for the allotment of securities to various categories of investors in a fixed price issue,

- (i) Minimum percentage for the net offer of securities to retail individual investors is 50%.
- (ii) To evoke,

- (a) Other investors, involving corporate bodies/institutions.
- (b) Individual applicants other than retail individual investors.
- (iii) Shares that are set aside as unsubscribed are to be assigned to other categories where there exists more subscriptions.
- (iv) Minimum period for issues to remain open is 3 days and maximum period is of 10 days.

2. Book Building Process

In 1998, SEBI introduced the practice of issuing shares through the process of book building. It is considered as an important reform of the Indian market. The main aim of the book building is to depict demand and trace the price for the issue of securities i.e., it is a process of demand and price discovery of securities. It facilitates an opportunity to the market to know the price for the securities offered on the basis of bids received with periodical intervals with a limit of 30 minutes.

The book building process consists of two types. They are,

- (a) 75% Book Building Process :** The 75% book building process states that the rest of 25% of net issue is allotted to the public at the same price which is mentioned in the book building process.
- (b) 100% Book Building Process :** In 2001, Bharti Televentures has undertaken the first 100% book issue. The entire price issue is determined through the process of book building.

3. French Auction Method

In french auction method, company can fetch a substantially high value for shares compared to the book building through the floor price is standard. It is generally offered to institutional buyers.'

5.5 RED HERRING PROSPECTUS

Q15. What is prospectus. Explain the objectives of prospectus.

Ans : (Imp.)

Definition

According to Sec. 2(36) of the Companies Act describes a prospectus as "any document issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public (or) inviting offers from the public for the subscription (or) purchase of any share in, or debentures of a body corporate."

Objectives

1. To bring to the notice of the public that a new company has been formed.
2. To preserve authentic record of the terms and allotment on which the public have been invited to buy its shares or debentures.
3. To secure that the directors of the company accept responsibility for the statements in the prospectus.

Q16. Explain the contents of prospectus.

Ans :

The contents of the prospectus have been specified in Schedule II of the Companies Act. The important contents in the prospectus include the following.

1. Name and address of the company
2. Objects of the company
3. Full particulars of the signatories to the Memorandum and number of shares taken by them.
4. The names, addresses and occupations of the directors, managing directors or managers etc.
5. The number and classes of shares.
6. The minimum subscription.
7. The qualification shares of a director and the remuneration of the directors.

8. The amount payable on application, on allotment and on calls.
9. The names of the underwriters.
10. The estimated amount of preliminary expenses.
11. The names and addresses of the auditors of the company.
12. Particulars about reserves and surpluses.
13. Voting rights of the different classes of shares.
14. Reports of the auditors regarding profits and losses of the company.
15. A similar report by the Chartered Accountant regarding the Profits and Losses and Assets and Liabilities of the Company.

Q17. Explain briefly about red herring prospectus.

Ans : (Imp.)

A red herring is a preliminary prospectus filed by a company with the Securities and Exchange Commission (SEC), usually in connection with the company's initial public offering. A red herring prospectus contains most of the information pertaining to the company's operations and prospects but does not include key details of the security issue, such as its price and the number of shares offered.

A red herring prospectus, as a first or preliminary prospectus, is a document submitted by a company (issuer) as part of a public offering of securities (either stocks or bonds). Most frequently associated with an initial public offering (IPO), this document, like the previously submitted Form S-1 registration statement, must be filed with the Securities and Exchange Commission (SEC).

A red herring prospectus is issued to potential investors, but does not have complete particulars on the price of the securities offered and quantum of securities to be issued. The front page of the prospectus displays a bold red disclaimer stating that information in the prospectus is not complete and may be changed, and that the securities may not be sold until the registration statement, filed with the market regulator, is effective.

Potential investors may not place buy orders for the security, based solely on the information contained within the preliminary prospectus. Those investors may, however, express an "indication of interest" in the offering, provided that they have received a copy of the red herring at least 48 hours prior to the public sale. After the registration statement becomes effective, and the stock is offered to the public, indications of interest may be converted to purchase orders, at the buyer's discretion. The final prospectus must then be promptly delivered to the buyer.

"Red herring prospectus" means a prospectus that does not have complete particulars on the price of the securities offered and quantum of securities offered.

The red herring statement contains:

1. Purpose of the issue
2. Disclosure of any option agreement
3. Underwriter's commissions and discounts
4. Promotion expenses
5. Net proceeds to the issuing company (issuer)
6. Balance sheet
7. Earnings statements for last 3 years, if available
8. Names and address of all officers, directors, underwriters and stockholders owning 10% or more of the current outstanding stock
9. Copy of the underwriting agreement
10. Legal opinion on the issue
11. Copies of the articles of incorporation of the issuer.

5.6 SWEAT EQUITY

Q18. Explain briefly about sweat equity.

Ans : (Imp.)

Meaning

The term sweat equity is defined as the equity shares issued by a company to employees or directors at a discount other than cash or making available intellectual property rights by value additions, by whatever name called. These shares

are issued to an employee or a director as a token of appreciation for their best contribution to the company.

The name itself determines that it is rewarded for the hardwork of employees. Issuing of such shares to employees as a reward ensures more loyalty and effective contribution of the employees.

According to sec. 97 of the Companies Act, 1956 following are the conditions that allows the companies to issue sweat equity shares to the employees or directors,

- i) An Indian subsidiary company can issue sweat equity shares to Indian employees even if the subsidiary company is incorporated abroad.
- ii) The sweat equity shares are to be issued under a special resolution passed by the company in the general meeting.
- iii) These shares are liable to issue only one year after the commencement of business.
- iv) The resolution should display the details of number of shares, current market price, consideration, class of directors or employees who are liable for sweat equity shares.
- v) The sweat equity shares that are listed under a recognized stock exchange are to be issued according to the regulations of Securities Exchange Board of India (SEBI).
- vi) The provisions, limitations and restrictions related to equity shares are also applicable to sweat equity shares.

5.7 EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

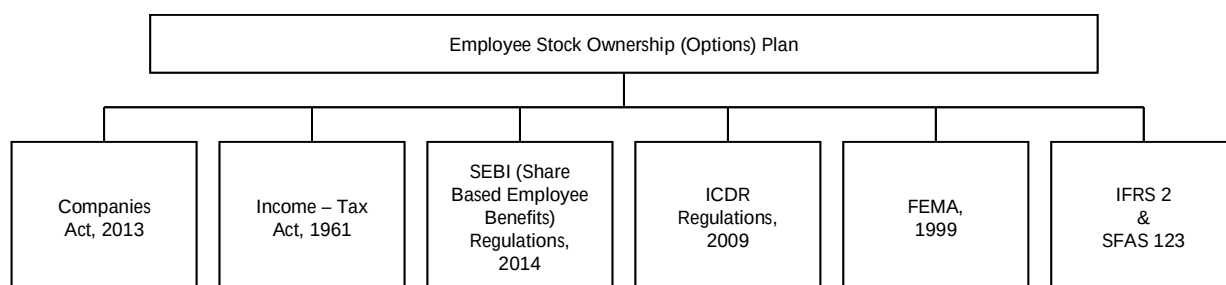
Q19. Explain briefly about ESOP.

Ans : (Imp.)

The Employee Stock Ownership (Options) Scheme (Plans) has seven decades long history.

- During the 1950s, an unconventional form of ownership was developed by Louis O. Kelso, a political economist and corporate lawyer, who is chiefly remembered as the Father of the Employee Stock Ownership Concept.

- ESOP is a generic term representing a basket of incentives or investments meant for employees of a corporate entity. In strict Company Law parlance, it is an option given to the whole-time directors, officers or employees the benefit or right to subscribe to its securities at a future date but at a pre-determined rate.
- It is an innovative way to motivate, reward, remunerate and to retain the employees. In this way, a set of employees will be granted the ownership of the entity.



- Human resource is one of the most useful resources to run any enterprise. Since a few last decades, the companies are using unique but untraditional methods of remunerating its employees in the form of ESOS, ESPS and Sweat Equity, etc.
- In India, when it comes to regulatory aspect on ESOP, a number of Statutes are required to be studied and keep in one's mind such as the Company Law, the Income-tax Law, Securities Laws, Foreign Exchanges Regulations, and also to some extent of International Financial Reporting Standards and Statement of Financial Accounting Standards.
- Earlier, only ESOS and ESPS were under the SEBI or Stock market regulator. Now, same have been expanded to others such as SAR, Restricted Stock award.

Q20. Explain the merits and demerits of ESOP.

Ans :

Merits

Some of the merits of ESOP are,

- It is useful for upcoming companies to retain cash for employing it in profitable areas.
- It is offered as a package of perks and incentives for its employees.
- It gives a chance to an employee for buying a certain number of shares in a firm for a specified number of years.
- The issuing price also called as grant price is a price prevailing in the market. The advantage is that employee can use the option whenever they want but within a limited period of time.
- The most important benefit to the employee is that, they can buy the shares when prices are going up or down, on a grant price and sell the same at a profit to others or retain it to get a better price.
- ESOP gives an option to have ownership in the firm, they offer service, which also makes them more close to the business of their company.
- Employees can avail financial benefits from successful business.
- They can make more money and profit than their normal salaries.
- It act as a means for creating a saving plan.
- It provides long-term benefits and some tax benefits.

Demerits

Some of the demerits of ESOP are,

- (i) Diversification type of firms suffer with problems, as many employees lost their savings of retirement by investing in a company's stock option, this was noticed in companies like Euron and World Com.
- (ii) A study in Washington of ESOP firms revealed that retirement assets were three times more and the diversified part of employee retirement plan was equal to the total retirement assets of non-ESOP firms.
- (iii) The employee ownership plan proved to be complex, there is about 17% of total 401 thousand assets which are invested in a company's stock.

Q21. What are the differences between sweat equity and ESOP?

Ans :

Sweat Equity	ESOP
1. Sweat equity Shares are issued as consideration for creation or transfer of IPR. 2. These shares can be issued at discounted price or free for know-how and services to the company against non-cash consideration. 3. These shares have compulsory lock-in period of 3 years. 4. The company shall not issue sweat equity shares for more than 15% of the existing paid-up equity share capital in a year or shares of the issue value of 5 crore, whichever is higher.	1. ESOP are given in the nature of incentive and retention plan. 2. The issue price is normally less than the market value of the shares against cash consideration. 3. The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option. 4. There is no such restriction in case of ESOP.

Q22. Explain the major tax benefits of ESOP's.

Ans :

ESOPs have a number of significant tax benefits, the most important of which are:

1. **Contributions of stock are tax-deductible:** It means companies can get a current cash flow advantage by issuing new shares or treasury shares to the ESOP, albeit this means existing owners will be diluted.
2. **Cash contributions are deductible:** A company can contribute cash on a discretionary basis year-to-year and take a tax deduction for it, whether the contribution is used to buy shares from current owners or to build up a cash reserve in the ESOP for future use.
3. **Contributions used to repay a loan the ESOP takes out to buy company shares are tax-deductible :** The ESOP can borrow money to buy existing shares, new shares, or treasury shares. Regardless of the use, the contributions are deductible, meaning ESOP financing is done in pretax dollars.

4. **Dividends are tax-deductible :** Reasonable dividends used to repay an ESOP loan, passed through to employees, or reinvested by employees in company stock are tax-deductible.
5. **Employees pay no tax on the contributions to the ESOP, only the distribution of their accounts, and then at potentially favorable rates:** The employees can roll over their distributions in an IRA or other retirement plan or pay current tax on the distribution, with any gains accumulated over time taxed as capital gains. The income tax portion of the distributions, however, is subject to a 10% penalty if made before normal retirement age.

5.8 RIGHTS ISSUE

Q23. What is Rights issue? Explain in detail the SEBI guidelines for right issues.

Ans : (Imp.)

Meaning

A rights issue of shares is basically a way through which a listed company in a stock exchange raises additional fund. It may seem similar to the Follow-on Public Offer (FPO), but there is a catch here. Here the new shares being issued are not offered to the public, instead, it is offered to the existing shareholders of the company. The shareholders have the right to subscribe the shares in proportion to their existing holdings, in a pre-defined time period.

For example, 1:2 rights issues signify that the existing shareholders of the company can purchase one extra share for every two shares already held in the Demat account. Here, a very important point to be noted that the new shares are issued at a discounted price than the current or prevailing rate in the market.

SEBI Guidelines

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

1. Composite Issue

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

2. Appointment of Merchant Banker

Appointment of Merchant Banker is not mandatory, if the size of rights issue by a listed company does not exceed Rs. 50 lakh. For issues of listed companies exceeding Rs. 50 lakhs, the issue is to be managed by an authorised merchant banker.

3. Minimum Subscription

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

4. Preferential Allotment

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

5. Underwriting

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

6. Rights of FCD/PCD Holders

The proposed rights issue should not dilute the value or rights of fully or partly convertible

debenture holders. If the conversion of FCDs/PCDs is due within a period of 12 months from the date of rights issue, reservation of shares out of rights issue is to be made for them in proportion to the convertible part of FCDs/PCDs.

7. **Over Subscription not to be Retained**

The quantum rights issue should not exceed as specified in the letter of offer. The companies are not allowed to retain oversubscription under any circumstances through rights issue.

8. **Promoter's Contribution**

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

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

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

9. **Vetting of Letter of Offer by SEBI**

The letter of offer pertaining to rights issue has to be vetted by SEBI and the concerned lead manager has to obtain SEBI clearance for the draft letter of offer before approaching stock exchange for fixing the record date for the proposed issue. A copy of letter of offer is forwarded to SEBI for information if the rights issue is less than Rs. 50 lakhs. The responsibility of vetting the rights issue is passed on to Merchant Bankers in 1995. Rights issue not accompanied by public issue, if made three months prior to or three months after the public issue will not have to be vetted by SEBI.

10. **Disclosure in the Letter of Offer**

The letter of offer like the prospectus should conform to the disclosure prescribed in Form

2A under Section 56(3) of the Companies Act, 1956. Full justification and parameters used for issue price should clearly be mentioned in the letter of offer.

11. **Advertisement in Newspaper**

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

12. **Compliance Report**

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

13. **Applicability of SEBI Guidelines**

The above guidelines with regard to rights issue apply only to rights issue made by existing listed companies.

14. **Revised Disclosure Norms for Listed Companies**

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

- (i) Listed companies going in for a rights issue can now fix and disclose the issue price any time prior to fixing the record date in consultation with the designated stock exchange.
- (ii) In the case of fixed price route, for public issues of such companies, the price can be fixed before filing of the prospectus with the Registrar of companies.

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

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

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

Q24. Explain the advantages and disadvantages of right issues.

Ans :

Advantages

- The shares are offered to the shareholders at the discounted price to encourage them to purchase the rights issue.
- The company saves a significant amount of money, such as underwriting fees, advertisement cost and so on.
- The control of the company remains in the hands of the existing shareholders. This is because the shares are only issued to those shareholders who on the date of rights issue are the holders of the shares.
- There is an equitable distribution of the shares and the same proportion of the voting rights.

Disadvantages

- The company may not be able to raise more funds and fail to achieve their target. This may happen if the existing shareholders of the company are not too keen to invest more.
- The value of each share may get diluted if there are an increased number of shares issued.
- If a well-established company is going for the rights issue of the shares, then it goes on to

create a negative market sentiment. It is assumed that the company is struggling to run its business operations smoothly.

Q25. Explain the different types of right issues.

(OR)

Elaborate the various types of right issues.

Ans :

There are two main types of rights issue of shares, which are as follows:

1. Renounceable Rights Issue

Here, an existing shareholder of the company has the right to transfer his/her right to subscribe rights issue of shares to anyone who may not be even shareholder of the company.

2. Non-Renounceable Rights Issue

The existing shareholders do not have the right to transfer his/her right to subscribe rights issue of shares to anyone. Here, the shareholder only has two options available, either to skip or purchase the shares.

Q26. Explain the Procedure for Rights Issue of Shares

Ans :

There is a proper process that is followed by the company for the rights issue of shares, which is mentioned below:

- A board meeting is called for the purpose of the rights issue of shares.
- After the approval of the board of directors of the company, an offer letter for the rights issue of shares, which also includes the right for renunciation option, is sent to the existing shareholders of the company.
- It must be noted that the letter must reach the shareholders around three days before the date of the rights issue.
- The company must receive the letters of rejection or acceptance from the shareholders.

- A board meeting is called again to approve the allotment of the shares to the shareholders who have shown keen interest to subscribe to the rights issue of shares.
- A share certificate is issued to the shareholders.

5.9 SECONDARY MARKET

5.9.1 Meaning

Q27. What do you understand by secondary market. Explain the instruments of secondary market.

(OR)

What is meant by secondary market? Describe the various instruments of secondary market.

Ans : (June-19, Imp.)

Meaning

Secondary market refers to a market where securities are traded after being initially offered to public in the primary market and/or listed on the stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets.

For the general investor, the secondary market provides an efficient platform for trading of his securities. For the management of the company, Secondary equity market serves as a monitoring and control conduit – by facilitating value-enhancing control activities, enabling implementation of incentive- based management contracts, and aggregating information (via price discovery) that guides management decisions.

Instruments

1. Equity

The ownership interest in a company of holders of its common and preferred stock. The various kinds of equity shares are:

2. Equity Shares

An equity share commonly referred to as ordinary share also represents the form of fractional ownership in which a shareholder,

as a fractional owner, undertakes the maximum entrepreneurial risk associated with a business venture. The holders of such shares are members of the company and have voting rights.

3. Right Issues/Rights Shares

The issue of new securities to existing shareholders at a ratio to those already held.

4. Bonus Shares

Shares issued by the companies to their shareholders free of cost by capitalization of accumulated reserves from the profits earned in the earlier years.

5. Preferred Stock/Preference shares

Owners of these kinds of shares are entitled to a fixed dividend (or) dividend calculated at a fixed rate to be paid regularly before dividend can be paid in respect of equity share. They also enjoy priority over the equity shareholders in payment of surplus. But in the event of liquidation, their claim rank below the claims of the company's creditors, bond holders/debenture holders.

A type of preference shares on which dividend accumulates if remains unpaid. All arrears of preference dividend have to be paid out before paying dividend on equity shares.

6. Cumulative convertible Preference Shares

A type of preference shares where the dividend payable on the same accumulates, if not paid. After a specified date, these shares will be converted into equity capital of the company.

7. Participating Preference Shares

The right of certain preference shareholders to participate in profits after a specified fixed dividend contracted for is paid. Participation right is linked with the quantum of dividend paid on the equity shares over and above a particular specified level.

8. Security Receipts

Security receipt means a receipt or other security, issued by a securitization company or reconstruction company to any qualified institutional buyer pursuant to a scheme, evidencing the purchase or acquisition by the holder thereof, of an undivided right, title or interest in the financial asset involved in securitization.

9. Government securities (G-Secs)

These are sovereign (credit risk-free) coupon bearing instruments which are issued by the Reserve Bank of India on behalf of Government of India, in lieu of the Central Government's market borrowing programme. These securities have a fixed coupon that is paid on specific dates on half-yearly basis. These securities are available in wide range of maturity dates, from short dated (less than one year) to long dated (up to twenty years).

10. Debentures

Bonds issued by a company bearing a fixed rate of interest usually payable half yearly on specific dates and principal amount repayable on particular date on redemption of the debentures. Debentures are normally secured/charged against the asset of the company in favour of debenture holder.

11. Bond

A negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bond holder periodic interest payments over the life of the loan.

Q28. Explain the features of secondary market.

Ans :

The following are the features of secondary market are :

1. Buyback of Shares

It is a system for any organisation to invest by buying shares from other investors in the market. This system is regulated by SEBI and Company Act. The provisions regulating buyback are contained under the companies Act 1956 which were amended in 1999.

The shares may be bought back by any company under the prescribed rule and regulations depending one or more of the following reasons :

- (i) To increase promoters holdings,
- (ii) To increase earning per share,
- (iii) Rationalise the capital structure by writing off capital not represented by available assets,
- (iv) To support share value, and
- (v) To pay surplus cash not required by business.

2. Corporate Action

The corporate actions is an action or event initiated by a company which has direct impact on the shareholders of the company. In such circumstances the share holders may respond to the company's decision. Corporate action may include declaration of dividend, issue of bonus shares, splitting shares into smaller denominations etc., such actions impact the market price of the shares.

3. Index

It is an indication of market trend, showing specified portfolio of share price's movements. It is a basket of securities and the average price movement of the basket securities indicates the index movement.

4. Sensex

Sensex is an index based on shares traded on the Bombay Stock Exchange. The Sensex and the NIFTY are barometers of the Indian market.

Q29. Explain the participants of Secondary Market.

Ans :

1. Stock Exchange**According to Securities Contract Regulation Act, 1956**

A stock exchange is defined as “an association organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities”.

2. Depositories

Depository is an organization which keeps investors securities in an electronic form by changing physical securities into electronic form with the help of dematerialization process. The investor needs to open a depository account called as demat a/c with any of the depository participants in order to use the services offered by the depository.

Depository mainly aims at removing paper ownership and reducing the paperwork in the process of trading and transfer of securities. The depository performs its functions with the help of network of depository participants (DPs) who communicates with the clearing members and investors. The various functions performed by depository are, keeping custody of investor's securities facilitating the surrender and withdrawal of securities, crediting accounts i.e., disusing dividend, rights issue and performs many other value added services like IPOs national savings certificates, Stock Lending and Borrowing (SLB).

In India, registration of depositories is compulsory with SEBI and it is regulated by the provision of the depositories Act, 1996.

3. Registrar to an Issue and Share Transfer Agent

The company or its registrar and transfer agent (R&T) contains complete information about the physical share holding along with the suitable/linked data to deal with transfer of

related operations. The depository participant sends the share certificates which are given for dematerialization to the company or its R&T agent in order to accomplish the dematerialization process.

4. Clearing Corporation

The Depository Trust and Clearing Corporation (DTCC) with the help of its subsidiaries offers clearance, settlement and information services for equities, corporate and municipal bonds, money-market instrument, government and mortgage backed securities and over-the-counter derivatives. DTCC has insurance transactions, relating funds and carries with their distribution networks.

Q30. Explain the various functions of Secondary Market.

Ans :

1. Offers Organized Market for Securities

The main function of a stock exchange is to provide a liquid and consistent market for securities. It is a ready market for securities wherein the buyers and seller of securities can meet and carries out the securities transaction.

2. Offers Liquidity to Securities

Stock exchanges offer liquidity facility to securities as the securities can be changed into cash anytime as per the wish of investors by simply selling them at the market prices. This helps in encouraging the investors to invest in capital market.

3. Offers Safety to Funds

Stock exchanges assures the protection of invested funds as they need to operate by following the rules and regulations and the bye laws. Implementation of set of rules helps in avoiding the over-trading, illegitimate speculation, insider trading and so on which further encourages the confidence levels of the investors.

4. Indicates trends in Business Cycle

The stock exchanges are easily affected by economics, political and social changes of the

national economy as well as the international markets. The index of share prices highlights the boom or depression conditions that exist in the company, in the industry and the economy as a whole.

5. **Facilitates the Marketing of New Issues**

The companies which list their shares on the stock exchange have greater acceptability in the market as stock exchanges offer a ready market for listed securities. The underwriting cost of such issues is less even the public responses are high and positive to new issues.

6. **Enables Collateral Lending by the Banks**

Usually the banks give acceptance approval as collateral securities to those securities which are listed and quoted on the stock exchange. The daily quotations help the bankers in identifying the real value of the shares and stocks which in turn enables them in ascertaining the loan amount that can be finalised for the security of such securities.

7. **Evaluates Securities**

The stock exchanges help in ascertaining the real value of the securities with the help of free play of demand and supply forces. The bargained market price by the stock exchange for securities are recorded and disclosed to the public. This would further facilitate the brokers and investors to make a comparison and assess the securities and to make a decision about their portfolio.

8. **Protects the Interest of Investors**

The stock exchange carries out its operation by following particular rules and bye-laws which are enforced by the law. These laws control the activities of the members. The strict implementation of rules, regulations and bye-laws by the stock exchange authorities protects the interest of the investors.

9. **Monitors Company Management**

It is necessary for a company to meet few conditions prior to the process of getting recognized on the stock exchange. Even after recognition, the company is consistently governed and regulated according to given

rules and regulations of the stock exchanges. This controls the activities and functions of the companies.

10. **Generates and Guides the Capital**

Stock exchanges act as the agents for capital formation. They usually give chance to the investors for investing in profitable investments by providing various kinds of shares and securities. Thus, savings are utilized and perfectly guided in productive way by the stock exchanges.

11. **Offers Opportunities for Speculation**

The stock exchanges offer opportunity to speculators for making profits by speculation. The stock exchange members who forecast about the market enter into contract, if their predictions and expectations are correct then they will enjoy huge profits.

5.10 STOCK EXCHANGE

5.10.1 Meaning

Q31. Define Stock Exchange.

(OR)

What is Stock Exchange.

Ans :

(Oct.-20)

Meaning

Stock Exchange (also called Stock Market or Share Market) is one important constituent of capital market. Stock Exchange is an organized market for the purchase and sale of industrial and financial security. It is convenient place where trading in securities is conducted in systematic manner i.e. as per certain rules and regulations.

It performs various functions and offers useful services to investors and borrowing companies. It is an investment intermediary and facilitates economic and industrial development of a country.

Definitions

(i) According to Securities Contract Regulation Act, 1956, A stock exchange is defined as "an association organization or body of individuals, whether incorporated

(or) not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities".

(ii) **According to Husband and Dockerary,** "Stock exchanges are privately organized markets which are used to facilitate trading in securities."

(iii) **The Indian Securities Contracts (Regulation) Act of 1956, defines Stock Exchange as,** "An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

Q32. What are the features of stock exchange?

Ans :

The features of stock exchange are:

1. Market for securities

Stock exchange is a market, where securities of corporate bodies, government and semi-government bodies are bought and sold.

2. Deals in second hand securities

It deals with shares, debentures bonds and such securities already issued by the companies. In short it deals with existing or second hand securities and hence it is called secondary market.

3. Regulates trade in securities

Stock exchange does not buy or sell any securities on its own account. It merely provides the necessary infrastructure and facilities for trade in securities to its members and brokers who trade in securities. It regulates the trade activities so as to ensure free and fair trade

4. Allows dealings only in listed securities

In fact, stock exchanges maintain an official list of securities that could be purchased and sold on its floor. Securities which do not figure in the official list of stock exchange are called unlisted securities. Such unlisted securities cannot be traded in the stock exchange.

5. Transactions effected only through members

All the transactions in securities at the stock exchange are effected only through its authorised brokers and members. Outsiders or direct investors are not allowed to enter in the trading circles of the stock exchange. Investors have to buy or sell the securities at the stock exchange through the authorised brokers only.

6. Association of persons

A stock exchange is an association of persons or body of individuals which may be registered or unregistered.

7. Recognition from Central Government

Stock exchange is an organised market. It requires recognition from the Central Government.

8. Working as per rules

Buying and selling transactions in securities at the stock exchange are governed by the rules and regulations of stock exchange as well as SEBI Guidelines. No deviation from the rules and guidelines is allowed in any case.

9. Specific location

Stock exchange is a particular market place where authorised brokers come together daily (i.e. on working days) on the floor of market called trading circles and conduct trading activities. The prices of different securities traded are shown on electronic boards. After the working hours market is closed. All the working of stock exchanges is conducted and controlled through computers and electronic system.

10. Financial Barometers

Stock exchanges are the financial barometers and development indicators of national economy of the country. Industrial growth and stability is reflected in the index of stock exchange.

5.10.2 Functions

Q33. Explain the various functions of stock exchange.

(OR)

Elaborate the various services of stock exchange.

(OR)

Describe the functions of stock exchange.

Ans : (July-21, June-19, Imp.)

i) Liquidity and Marketability of Securities

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

ii) Safety of Funds

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

iii) Supply of Long Term Funds

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

iv) Flow of Capital to Profitable Ventures

The profitability and popularity of companies are reflected in stock prices. The prices quoted

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

v) Motivation for Improved Performance

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

vi) Promotion of Investment

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

vii) Reflection of Business Cycle

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

viii) Marketing of New Issues

If the new issues are listed, they are readily acceptable to the public, since, listing presupposes their evaluation by concerned stock exchange authorities. Costs of underwriting such issues would be less. Public

response to such new issues would be relatively high. Thus, a stock market helps in the marketing of new issues also.

ix) **Miscellaneous Services**

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

5.10.3 Evolution and Growth of Stock Exchanges

Q34. Explain the evolution and growth of stock exchange in India.

Ans :

At present, 23 stock exchanges are operating in India, which includes the Over The Counter Exchange of India (OTCEI) and the National Stock Exchange (NSE).

In 1875, the Bombay Stock Exchange (BSE), which was introduced as "the native share and stock brokers association" was the only non-profit making association. It is the oldest stock exchange operating in Asia. The Tokyo stock exchange started its functioning in 1878 and the Bombay stock exchange started functioning as a public limited company from 8th August 2005.

India have nearly 10,000 listed companies and occupies a unique position for having the highest number of listed companies in the world.

After the implementation of securities contracts Act. 1956, the stock exchanges which were identified by the government can carry out its operations in India. According to the government policy, only one stock exchange should operate at one place.

Executive committee/council of management /governing body manages the stock exchange.

The government has the authority to appoint executive committee/council of management/ governing body, its rules and regulations should be followed as per the criteria stated by the government. The government has the right to withdraw the permission given to the stock exchange in public interest or in the interest of trade.

The government has the authority to take the place of a governing body, after giving a chance to the governing body to deal with the matter, which may arise any time. The government also has the authority to appoint any other person for performing the functions of the governing body and suspending the stock exchange business under specific conditions for the duration of not more than seven days, in public interest or interest of trade. The duration of suspension can be exceeded as per the situation on timely bases only after giving the chance to the governing body to deal with such matter.

When dealers and brokers trades outside the region of recognized stock exchange then they have to receive license from the government.

Participants

The members and authorized clerks are allowed to participate and manage the buying and selling of securities at stock exchange. The brokers and intermediaries helps the buyers and sellers in their dealings.

1. **Members**

Previously, only an individual was used to be the member of stock exchange. But at present, the companies are also entitled to become its members. Multiple membership is also allowed in stock exchange.

2. **Authorized Clerks**

Members are allowed to appoint a specified number of personnel as 'authorized clerks' who helps them in making transactions at stock exchange. The number of clerks differs from one exchange to another. The authorized clerks can operate as the agents of the members and can buy or sell the securities from their employers side but not from their own side.

3. Remisers

Remisers refers to the sub-brokers who are appointed by a member for protecting the business. They are not allowed to enter the business grounds for exchange dealings. The main aim of remisers is to protect the business from the outsiders. They play a significant role in protecting the business as the share brokers are not allowed to make advertisements.

4. Taravaniwalas and Brokers

Two types of members are present at Indian stock exchange which are as follows, Taravaniwala is a dealer in securities who performs the same job as the 'jobber' performs at London Stock Exchange. Broker acts as an 'Agent' of buyer (or) seller of securities. Jobbers are concerned with only brokers and not with the public.

On the other hand, broker is an intermediary between the jobber and the actual buyer/seller. It is found that taravaniwalas play double role i.e., 'dealer-cum-broker' in India.

5. Clearing House

Clearing house refers to an agency which makes arrangements for the delivery of securities and its payment by the respective parties. It integrates all the bargains done by each member of the stock exchange for determining the resulted position and determining the final buyers and sellers of securities to keep in touch with each other. Thus, clearing house simplifies and expedites the work.

Growth of Stock Exchange

In the year 1887 the first organized stock exchange was set up in India at Bombay. The securities contracts (regulation) Act 1956 gave recognition to merely seven stock exchanges i.e., Mumbai, Ahmedabad, Kolkata, Madras, Delhi, Hyderabad and Indore. The number of stock exchanges increased to 23 by the end of March 2008.

The stock market grew after the elimination of monitoring of capital issue and emergence of SEBI. The two important areas of Indian capital market i.e., primary and secondary market experienced tremendous growth in the post-liberalization period.

The growth of stock exchange in India has observed through various sources of stock market which are discussed as below,

(a) Industrial Securities Market

In spite of many irregularities and scams, industrial securities market have witnessed a drastic growth in the post-liberalization period. The development of industrial securities market was because of the following factors,

- (i) Enhancement in the status of balance of payments.
- (ii) Absolutely high level of foreign exchange reserves.
- (iii) Supportive financial results of companies.
- (iv) Increased levels of the investments by the Foreign Institution Investor (FII).

(b) Bombay Stock Exchange (BSE)

BSE acts as the barometer of the Indian economy. It occupies the 1st place in the whole world with respect to number of listed companies and 5th place in world in transaction numbers. An investor has a wide choice to select from more than 4700 listed companies which are categorized as A, B, S, T and Z groups for easy references.

(c) National Stock Exchange (NSE)

The national stock exchange (NSE) was established in November 1992 and it commenced its operations from 30th June 1994. It facilitates in the trading of equity investments, warrants, debentures, preference shares and so on. The first fully automated screen based trading system was basically developed by NSE which enables the trading members to carry out trade from the offices.

(d) Over-the-Counter Exchange of India (OTCEI)

The establishment of OTCEI took place in August 1989 and began its functioning in October 1992. OTCEI has spread its operations city-wise as well as scrip-wise. The number of listed companies on OTCEI in the year 2007 was 102 which was initially 6 in the year 1992-93.

5.10.4 Stock Exchanges in India**Q35. What are the major stock exchanges in India ?**

Ans : (Oct.-20, Imp.)

According to the securities contracts (Regulation) Act, 1956 "stock exchange means any body of individuals whether incorporated or not constituted for the purpose of assisting, regulating or controlling the business of buying, selling (or) dealing in securities".

There are three major stock exchanges present in India as follows,

1. BSE
2. NSE
3. OTCEI.

1. Bombay Stock Exchange (BSE)

Bombay Stock Exchange is an ancient stock exchange in India. It is regarded as the most important part of the economy which reveals the economic conditions. Basically BSE was operating in Mumbai alone but with the help of Bombay Online Trading System (BOLT), its operations spread over to 275 cities by March 2000. The number of trade workstations was also increased to 3803. There was an increase in its daily turnover from ` 11 crores during 1979-1980 to ` 4587 crores in the year 2000-2001.

Features

The following are the important features of BSE,

(a) Size and Operation

Presently BSE is regarded as the world's number one exchange with respect to the number of listed companies and

stands at fifth position in terms of transaction numbers. The investors have wider choice i.e., they can select from more than 4887 listed companies which are categorized into A, B, S, T and Z groups for easy references.

(b) SENSEX

The BSE index, SENSEX is the first stock market index in India which possesses an iconic image and is used globally. SENSEX is an index of 30 stocks including 12 major sectors. It is prepared by following 'free-float' technique and is easily affected by the market conditions.

(c) Other Indices

Beside SENSEX, BSE also provides 21 other indices comprising of 12 sectorial indices. An index cooperation agreement was made between BSE and Deutsche Borse with this agreement, SENSEX and other BSE indices are made accessible to investors located in Europe and America.

(d) SENSEX Tracker

The universal leader in ETFs the Barclays Global Investors (BGI) had introduced the 'ishares A (R) BSE SENSEX India Tracker with help of ishares A (R) brand for tracking the SENSEX.

(e) Exchange Traded Fund (ETF)

"Spice" is the first Exchange Traded Fund (ETF) on SENSEX which is listed on BSE. It introduces a trading tool for investors which can be utilized for making investment, trading, hedging and arbitrage. Small investors can have a long-term view of the market through 'SPICE'.

2. National Stock Exchange (NSE)

The National Stock Exchange of India was incorporated in November 1992 with an equity capital of Rs. 25 crores and promoted by IDBI, ICICI, LIC, GIC and its subsidiaries, State Bank of India and SBI Capital Markets Limited.

Objectives

The NSE has the following objectives:

- (i) To Establish nation wide trading facility for equities, debts and hybrids.
- (ii) To facilitate equal access to investors across the country.
- (iii) To provide fairness, efficiency and transparency to the securities trading.
- (iv) To enable shorter settlement cycles.
- (v) To meet international securities market standard.

Features

- (i) The NSE employs a fully automated screen based trading system. Investors can trade from 400 cities on a real time basis.
- (ii) It has two segments

➤ **Capital Market:** The capital market segment covers equities, convertible debentures and retail trade in debt instruments like non-convertible debentures. Securities of medium and large companies with nationwide investor base, including securities traded on other stock exchanges are traded in NSE through trading members.

➤ **Wholesale debt market:** The wholesale debt market segment is a market for high value transactions in government securities, public sector bonds, commercial papers and other debt instruments.

On the wholesale market segment, there are two types of entities viz.,

➤ **Trading members:** Trading members are recognized members of the exchange selected on the basis of selection criteria laid down under the provisions of SEBI and the securities contract (Regulation) Act, 1956. They can trade on their own or on behalf of their clients.

➤ **Participants:** Participants are the organisations directly responsible for the settlement of trades.

- (iii) The NSE market is a fully automated screen based environment. There is no trading floor as is prevalent in the traditional stock exchanges.
- (iv) The market operates with all participants stationed at their offices and making use of their computer terminals, to receive market information, to enter orders and to execute trade. Through 1777 satellite dishes there are 3000 computer terminals connected to NSE.
- (v) The trading members in the capital market segment are connected to the central computer in Bombay through a satellite link-up using VSATs (Very Small Aperture Terminals). The trading members in the whole sale debt market segment are linked, through dedicated high speed lines, to the central computer at Mumbai.
- (vi) Members are required to deliver securities and cash by the thirteenth and fourteenth day, respectively. The fifteenth day is the pay-out day.
- (vii) The automated trade matching system secures the best price available in the market to the investor. The trading member can transact a high volume of business efficiently.

3. Over-the-counter Exchange of India (OTCEI)

The OTCEI was basically established for small investors and small size firms. It has certain advantages such as quick settlements, clarity and the ability to reach all the regions of the country. It was designed on the basis of the National Association of Securities Dealer Automated Quotation system (NASDAQ) in United States of America wherein the off- exchange trading was done in over the counter market. In India, OTCEI started its operations in 1992. It was the first to launch screen based automated trading system. It was supported by various financial institutions such as ICICI, UTI, IDBI, IFCI, GIC, LIC and SBI

Features

- (i) It is a national ringless and computerised exchange.
- (ii) As opposed to the traditional ring in the stock exchange, the trading will be 'screen based'. Transactions would take place through satellite communication telephone lines.
- (iii) Trading on the OTCEI takes place through a net work of computers of OTC dealers located at different places within the same city and even across cities. These computers allow dealers to quote, query and transact through a central OTC computer, using the telecommunication links.
- (iv) Small and medium sized companies with a paid up capital between Rs. 30 lakhs and Rs.10 crores may be enlisted on the OTCEI. The maximum limit has now been raised to Rs. 25 crores.
- (v) OTCEI deals in equity shares, preference shares, bonds, debentures and warrants.
- (vi) A company which is listed on any other recognised stock exchange in India is not permitted simultaneously for listing on OTCEI.
- (vii) The minimum offer should be 40% of the issued capital or Rs. 20 lakh worth of shares in face value, whichever is higher.

5.10.5 Recent Developments in Indian Stock Exchanges**Q36. Explain the Recent Developments in Indian Stock Exchange.**

Ans :

1. Corporate Securities Market

With the objectives of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package to develop the securities market was introduced.

- The issuers complying with the eligibility criteria were allowed freedom to issue the securities at market determined rates. The secondary market overcame the geographical barriers by moving to screen-based trading.
- Trades enjoyed counter-party guarantee. The trading cycle shortened to a day and trades are settled within 2 working days, while all deferral products were banned. Physical security certificates almost disappeared. A variety of derivative products were permitted.

2. SEBI Act, 1992

It created a regulator (SEBI), empowered it adequately and assigned it with the responsibility for

- Protecting the interests of investors in securities
- Promoting the development of the securities market
- Regulating the securities market
- Enactment of SEBI Act is the first attempt towards integrated regulation of the securities market

3. Creation of Market Regulator

Securities and Exchange Board of India (SEBI), the securities market regulator in India, was established under SEBI Act 1992, with the main objective and responsibility for

- Protecting the interests of investors in securities
- Promoting the development of the securities market
- Regulating the securities market

4. Screen-based Trading

Prior to setting up of NSE, the trading on stock exchanges in India was based on an open outcry system. The system was inefficient and time consuming because of its inability to provide immediate matching or recording of trades. In order to provide efficiency, liquidity and transparency, NSE

introduced a nation-wide online fully automated screen-based trading system (SBTS) on the CM segment on November 3, 1994.

5. Reduction of Trading Cycle

Earlier, the trading cycle for stocks, based on type of securities, used to vary between 14 days to 30 days and the settlement involved another fortnight.

The Exchanges, however, continued to have different weekly trading cycles, which enabled shifting of positions from one Exchange to another. It was made mandatory for all Exchanges to follow a uniform weekly trading cycle in respect of scrips not under rolling settlement. In December 2001, all scrips were moved to rolling settlement and the settlement period was reduced progressively from T+5 to T+3 days

From April 2003 onwards, T+2 days settlement cycle is being followed

6. Equity Derivatives Trading

In order to assist market participants in managing risks better through hedging, speculation and arbitrage, SC(R) A was amended in 1995 to lift the ban on options in securities. Trading in derivatives, however, took off in 2000 with index futures after suitable legal and regulatory framework was put in place. The market presently offers index futures, index options, single stock futures and single stock options.

7. Risk Management

Market integrity is the essence of any financial market. To pre-empt market failures and protect investors, the regulator/exchanges have developed a comprehensive risk management system, which is constantly monitored and upgraded. It encompasses capital adequacy of members, adequate margin requirements, limits on exposure and turnover, indemnity insurance, online position monitoring and automatic disablement, etc. They also administer an efficient market surveillance system to curb excessive volatility, detect and prevent price manipulations.

8. Short Selling

Short selling is defined as selling a stock which the seller does not own at the time of trade.

- Pursuant to the recommendations of the Secondary Market Advisory Committee (SMAC) of SEBI and the decision of the SEBI Board, it was decided to permit all classes of investors to short sell.
- It increases liquidity in the market, and makes price discovery more efficient. Besides, it curbs manipulation of stocks as informed investors are able to go short on stocks they feel are higher than fair value. This facility was available to non-institutional investors. Vide a circular in February 2008; SEBI permitted all classes of investors, viz., retail and institutional investors to short sell. It, however, does not permit naked short sales and accordingly, requires participants to mandatorily honor their obligation of delivering the securities at the time of settlement

9. Cross Margining

Many trading members undertake transactions on both the cash and derivative segments of an Exchange. They keep separate deposits with the exchange for taking positions in two different segments.

- In order to improve the efficiency of the use of the margin capital by market participants and as in initial step towards cross margining across cash and derivatives markets SEBI allowed Cross Margining benefit in May 2008
- For Cross margining the stock positions of the institutions in capital market segment after confirmation by the custodian on T+1 day shall be compared with the stock futures position of the same institution in derivative segment based on the CP code of the institution at the end of the day. The position shall be considered for cross margining only if the position in the capital market segment off set the position in the derivative segment

10. Market Infrastructure

As part of the ongoing efforts to build debt market infrastructure, two new systems, the Negotiated Dealing System (NDS) and the Clearing Corporation of India Limited (CCIL) commenced operations on February 15, 2002.

- NDS facilitates screen based negotiated dealing for secondary market transactions in government securities and money market instruments, online reporting of transactions in the instruments available on the NDS and dissemination of trade information to the market. Government Securities (including T-bills), call money, notice/term money, repos in eligible securities, Commercial Papers and Certificate of Deposits are available for negotiated dealing through NDS among the members
- CCIL facilitates settlement of transactions in government securities (both outright and repo) on Delivery versus Payment (DVP-II) basis which provides for settlement of securities on gross basis and settlement of funds on net basis simultaneously. It acts as a central counterparty for clearing and settlement of government securities transactions done on NDS

11. Research in Securities Market

In order to deepen the understanding and knowledge about Indian capital market, and to assist in policymaking, SEBI has been promoting high quality research in capital market. It has set up an in-house research department, which brings out working papers on a regular basis.

In collaboration with NCAER, SEBI brought out a 'Survey of Indian Investors', which estimates investor population in India and their investment preferences. SEBI has also tied up with reputed national and international academic and research institutions for conducting research studies/projects on various issues related to the capital market.

The objective of this initiative is to foster research, which can support and facilitate -

- (a) stock exchanges to better design market micro-structure
- (b) participants to frame their strategies in the market place
- (c) regulators to frame regulations
- (d) policy makers to formulate policies
- (e) expand the horizon of knowledge. The Initiative has received tremendous response

12. Testing and Certification

A Testing and Certification Mechanism that has become extremely popular and is sought after by the candidates as well as employers is unique on-line testing and certification programme called National Stock Exchange's Certification in Financial Markets (NCFM). It is an online fully automated nation-wide testing certification system where the entire process from generation of question paper, testing, assessing, scores reporting and certifying is fully automated - there is absolutely no scope for human intervention.

- It allows tremendous flexibility in terms of testing centers, dates and timing and provides easy accessibility and convenience to candidates as he can be tested at any time and from any location - It tests practical knowledge and skills, that are required to operate in financial markets, in a very secure and unbiased manner, and certifies personnel who have a proper understanding of the market and business and skills to service different constituents of the market

13. Demutualization

Historically, stock exchanges were owned, controlled and managed by the brokers. In case of disputes, integrity of the stock exchange suffered. NSE, however, was set up with a pure demutualised governance structure, having ownership, management and trading with three different sets of people. Currently, all the stock exchanges in India have a demutualised set up.

14. Dematerialization

The old settlement system was inefficient due to the time lag for settlement and the physical movement of paper-based securities

- To obviate these problems, the Depositories Act, 1996 was passed to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed and accuracy
- There are two depositories in India, viz., NSDL and CDSL. They have been set up to provide instantaneous electronic transfer of securities

15. Clearing Corporation

The anonymous electronic order book ushered in by the NSE did not permit members to assess credit risk of the counterparty and thus necessitated some innovation in this area.

- To address this concern, NSE had set up the first clearing corporation, viz. National Securities Clearing Corporation Ltd. (NSCCL), which commenced its operations in April 1996

16. Investor Protection

In order to protect the interest of the investors and promote awareness, the Central Government (Ministry of Corporate Affairs) established the Investor Education and Protection Fund (IEPF) in October 2001. With the similar objectives, the Exchanges and SEBI also maintain investor protection funds to take care of investor claims. SEBI and the stock exchanges have also set up investor grievance/service cells for redress of investor grievance. All these agencies and investor associations also organise investor education and awareness programmes.

17. Globalization

Indian companies have been permitted to raise resources overseas through issue of ADRs, GDRs, FCCBs and ECBs. Further, FIIs have been permitted to invest in all types of securities, including government securities and

tap the domestic market. The investments by FIIs enjoy full capital account convertibility. They can invest in a company under portfolio investment route upto 24% of the paid up capital of the company.

The Indian stock exchanges have been permitted to set up trading terminals abroad. The trading platform of Indian exchanges is now accessible through the Internet from anywhere in the world. RBI permitted two-way fungibility for ADRs/GDRs, which means that the investors (foreign institutional or domestic) who hold ADRs/GDRs can cancel them with the depository and sell the underlying shares in the market.

18. Direct Market Access

In April 2008, SEBI allowed the direct market access (DMA) facility to the institutional investors. DMA allows brokers to offer their respective clients, direct access to the

Exchange trading system through the broker's infrastructure without manual intervention by the broker.

19. Launch of Securities Lending and Borrowing Scheme

In April 2008, the Securities Lending and Borrowing mechanism was allowed. It allows market participants to take short positions effectively with less cost.

20. Launch of Currency Futures

On August 29, 2008, NSE launched trading in currency future contracts in the USD-INR pair for the first time in India. Trading in other currency pairs like Euro - INR, Pound Sterling - INR and Japanese Yen was further made available for trading in March 2010.

21. Launch of Interest Rate Futures

On August 31, 2009, futures on interest rate were launched on the National Stock Exchange.

22. ASBA

Application Supported by Blocked Amount (ASBA) is a major primary market reform. It enables investors to apply for IPOs/FPOs and

rights issues without making a payment. Instead, the amount is blocked in investors' own account and only an amount proportionate to the shares allotted goes out when allotment is finalized.

23. Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009

In August 2009, the SEBI issued Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009, replacing the Disclosure and Investor Protection (DIP) Guidelines 2000. ICDR Regulations 2009 would govern all disclosure norms regarding issue of securities.

5.11 STOCK MARKET INDICES

Q37. Explain briefly about stock market indices.

Ans :

(Imp.)

A stock market index is one which indicates the pattern of movements of the prices of a group of securities which are considered to be the representative sample of the entire stock market. The stock market index is an invaluable guide to study the trend of growth patterns in the economy, to analyse as well as forecast business cycle and also to correlate stock market indices to various economic activities.

The stock market index is a convenient and effective product due to the following reasons :

- (i) It acts as a barometer for market behaviour.
- (ii) It is used to benchmark portfolio performance.
- (iii) It helps to allocate scarce resources to the best performed companies reflected through best performed scrips.
- (iv) It is used as a forecasting tool to predict the future movement of stock indices and also the business cycles.
- (v) It is used in derivative instruments like index futures and index options.
- (vi) It can be used for passive fund management as in the case of index funds.

Q38. Explain different types of stock indices.

(OR)

Describe the stock indices of BSE and NSE.

Ans :

(i) Sensex

The stock index which is very popular in BSE is Sensex. It is otherwise called BSE Sensitive Index. The base year for this index is April, 79. It was launched on 2nd January, 1986. The BSE sensex is a value-weighted index composed of originally 30 companies representing various sectors on the exchange. At present, all scrips are selected from specified groups only. This index is available on line and it is updated continuously.

(ii) BSE National Index

This index is made up of 100 scrips with 1982-84 as the base year. The special feature of this index is that it includes prices of scrips in other major stock exchanges of Delhi, Calcutta, Ahmedabad and Madras. In such a case, the average price of the scrip is taken for the compilation of the index.

(iii) BSE 200

It was introduced in May, 1994 with 1989-90 as the base year. This index consists of equity shares of 200 companies selected on the basis of market capitalisation, volume of turnover and strength of the companies fundamentals. It comprises of scrips of both specified and non-specified groups.

(iv) Dollex

It is nothing but BSE-200 expressed in Dollar values so that it may be useful to foreign investors. In Dollex, the BSE-200 is modified by dividing the current rupee market value by rupee – Dollar Conversion Rate.

(v) BSE-500

It was introduced in 1999 with the base year 1999 itself. It is treated to be a standard index covering all sections of the economy as well as the major part of capitalisation.

INDICES OF NSE

The common and popular name of the NSE index is CNX index. All NSC indices are prepared by the India Index Services and Products Ltd. (IISL) which is a joint venture of NSE, CRISIL and Standard and Poor. The CNX stands for the following :

C	stands for	CRISIL
N	stands for	NSE
X	stands for	Index

Addition of the letters S and P with any index indicates that it is supported by standard and poor also.

Major CNX Indices**(i) S & P CNX Nifty**

It is a popular index of NSE. It was introduced in April, 96 with 96 as the base year. It comprises of a well-diversified 50 stock index accounting for 23 sectors of the economy. Of the total traded value of all stocks on the NSE, the total value of Nifty stocks is about 70% and Nifty stocks represent about 59% of the total market capitalisation.

(ii) S & P CNX Diety

It is nothing but S&P CNX Nifty expressed in dollars and hence, it is basically a dollar dominated index. This is mainly intended for foreign investors. It is computed at on-line Rupee Dollar exchange rate.

(iii) CNX Nifty Junior

This index was launched in December, 1996 and S&P CNX Nifty and CNX Nifty Junior together account for 100 most liquid stocks in India. The two indices are synchronised so that they will always operate as disjoint sets in the sense that a stock will never appear in both indices at the same time.

(iv) S & P CNX 500 Equity Index

It comprises of 500 stocks covering 79 industries. It is purely a market capitalisation weighted index. It covers 97% of the total turnover in BSE and 73% of the total market capitalisation.

(v) CNX Midcap 200 Index

As the very name implies, it is the index for the stocks of mid-cap companies, Covering industries having market capitalisation between Rs. 150 crores and Rs. 1000 crores.

(vi) CNX Segment Indices

This index reflects the stock market performance of the various segments of the Indian corporate sector like multinationals, PSUs etc.

(vii) NSE Government Security Index

This index is meant for all Government of India Bonds issued after April 1992 but redeemable after 1997. The base date of the index is 1st January, 1997. This index is calculated on daily basis with the help of market capitalisation. New issues are added to the index while the old ones could be removed as soon as they are redeemed.

Q39. "The Indian stock market is suffering from many limitations". What are they?

Ans :

(i) Absence of Genuine Investors

As it is, speculative activities outplay the genuine trading activities. Very negligible fraction of transactions represent purchases or sales by genuine investors. Most of the transactions are carry-forward transactions with a speculative motive of deriving benefit from short-term price fluctuations. Speculators are only interested in taking a bet on the stock and profiting from its price swings.

Hence the market is not subject to free interplay of demand and supply for securities. It is reported that approximately Rs.3,000 crore is traded between the Bombay Stock Exchange and the National Stock Exchange every day. Investors buying and selling existing holdings contribute a very small portion of this. Almost 85 per cent is contributed by speculators.

(ii) Presence of Price-Rigging

There is a tendency among companies issuing securities to artificially push up the prices before the issue of securities. This is generally done by buying and selling securities by a few group of persons among themselves and thereby pushing the prices up. There is a strong bull movement in the market.

(iii) Prevalence of Insider Trading

Insider trading has been accepted as a routine practice in India. Insiders are those who have access to unpublished price-sensitive information by virtue of their position in the company and who use such information in their best advantage. Since it is an undesirable activity, the SEBI has introduced many regulations to curb insider trading. All of them remain in paper only and it is said that controlling insider trading is similar to controlling black money.

(iv) Lack of Transparency

Though many regulations have been introduced to inject transparency to the operations of stock market, they are not successful. Many brokers are violating the regulations with a view to cheating the innocent investing community. While the day's opening, high, low and closing prices are reported, no information is available to investors regarding the volume of transactions carried out at the highest and lowest prices. The time taken to execute a transaction is also not reported.

(v) Problem of Odd Lots

Generally, the listed securities are included under Group A or Group B categories. The other tradable securities which are not listed are called 'odd lots' and they come under the category of Group C. This group also contains permitted securities which are listed on other exchanges and not on the particular stock exchange concerned.

Investors in India have to face the problem of odd lots. Generally, as per the existing practice, all sales of odd lots are subject to discounts varying upto 15% and all purchases are subject to a premium of 15% or

even more. It means that the investor is a tremendous loser. It discourages investments on odd lots and thereby limiting the trading activities of odd lots.

(vi) Dominance of Financial Institutions

Few financial institutions like the UTI, LIC and GIC dominate the Indian stock market scene. Hence, the Indian stock market is significantly influenced by the actions of these few institutions. It actually reduces the level of competition in the stock market which is not a healthy trend for the growth of any stock market.

(vii) Lack of Professionalism

On the one hand, one can find highly competent and professional brokers playing an active and positive role in the market. On the other hand, many brokers are found to be lacking in high professional standards. Brokers with inadequate financial support and little skill or experience enter into big contracts. Therefore, defaults become quite common. Intraday trading is also quite common.

(viii) Unhealthy Competition of Merchant Bankers

At present there are about 900 merchant bankers rendering their services in the capital market. The increase in the number of merchant bankers has led to unhealthy competition and dilution of the quality of issue. Merchant bankers tend to show a definite bias towards the issuing company instead of protecting the interest of investors. They help the unscrupulous promoters to raise funds for dubious projects at unjustifiable premium. The ultimate sufferers are the investors.

5.12 SECURITIES EXCHANGE BOARD OF INDIA (SEBI)

Q40. Define SEBI ? Explain the purpose and role of SEBI.

Ans : **(Imp.)**

Securities Exchange Board of India (SEBI) was set up in April 12, 1988 to regulate the functions

of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions.

It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for Establishment of SEBI

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI).

Purpose and Role of SEBI

SEBI was set up with the main purpose of keeping a check on malpractices and protect the interest of investors. It was set up to meet the needs of three groups.

1. **Issuers** : For issuers it provides a market place in which they can raise finance fairly and easily.
2. **Investors** : For investors it provides protection and supply of accurate and correct information.
3. **Intermediaries** : For intermediaries it provides a competitive professional market.

Q41. Explain the composition of SEBI.

Ans :

The Board of Securities & Exchange Board of India (SEBI) is comprised of 9 members, excluding the Chairman. It is managed by its members, in the following manner:

- A Chairman is nominated by the Union Government.
- 2 members of SEBI, are officers from the Union Ministry of Finance.

- 1 member of SEBI, is from the Reserve Bank of India.
- There are 3 whole-time members, who are nominated by the Government of India.
- There are 2 Part-time members, who are also nominated by the Government of India.

5.12.1 Objectives

Q42. Explain the Objectives of SEBI.

(OR)

Describe the Objectives of SEBI.

Ans : (Imp.)

The SEBI was set up to achieve the following objectives:

- (i) **Regulation of Stock Exchanges:** The first objective of SEBI is to regulate stock exchanges so that efficient services may be provided to all the parties operating there.
- (ii) **Protection to the Investors:** The capital market is meaningless in the absence of the investors. Therefore, it is important to protect the interests of the investors. The protection of the interests of the investors means protecting them from the wrong information given by the companies in their prospectus, reducing the risk of delivery and payment, etc. Hence, the foremost objective of the SEBI is to provide security to the investors.
- (iii) **Checking the Insider Trading:** Insider trading means the buying and selling of securities by those persons (Directors, Promoters, etc.) who have some secret information about the company and who wish to take advantage of this secret information. This hurts the interests of the general investors. It was very essential to check this tendency. Many steps have been taken to check inside trading through the medium of the SEBI.
- (iv) **Control over Brokers:** It is important to keep an eye on the activities of the brokers and other middlemen in order to control the capital market. To have a control over them, it was necessary to establish the SEBI.

Q43. Explain the powers of SEBI.**Ans :** (June-19(MGU))

SEBI has been vested with the following powers.

1. Power to call periodical returns from recognised stock exchanges.
2. Power to call any information or explanation from recognized stock exchanges or their members.
3. Power to direct enquiries to be made in relation to affairs of stock exchanges or their members.
4. Power to grant approval to bye-laws of recognized stock exchanges.
5. Power to make or amend bye-laws of recognized stock exchanges.
6. Power to compel listing of securities by public companies.
7. Power to control and regulate stock exchanges.
8. Power to grant registration to market intermediaries.
9. Power to levy fees or other charges for carrying out the purpose of regulation.
10. Power to declare applicability of Section 17 of the Securities Contract (Regulation) Act is any state or area to grant licences to dealers in securities.

5.12.2 Functions**Q44. Explain the functions of SEBI.****(OR)****Describe the functions of SEBI.****(OR)****Elaborate the protective and development functions of SEBI.****(OR)****What are the regulatory functions of SEBI?****(OR)****Give a detailed note on functions of SEBI.****Ans :** (June-19(MGU), Imp.)

The SEBI performs functions to meet its objectives. To meet three objectives SEBI has three important functions. These are :

1. Protective functions
2. Developmental functions
3. Regulatory functions.

1. Protective Functions of SEBI

These functions are performed by SEBI to protect the interest of investor and provide safety of investment.

As protective functions SEBI performs following functions:

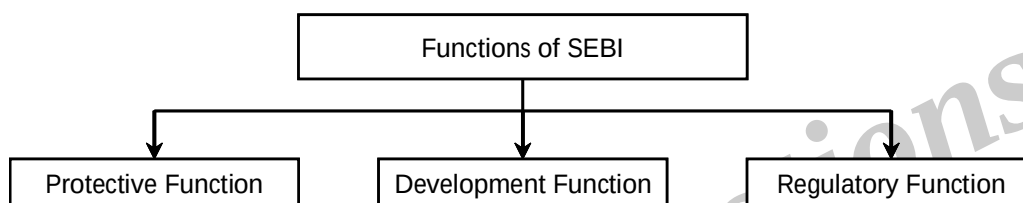
(i) It Checks Price Rigging: Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

(ii) It Prohibits Insider trading: Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities.

This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue.

This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

- (iii) **SEBI prohibits fraudulent and Unfair Trade Practices:** SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.
- (iv) **SEBI** undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.
- (v) **SEBI** promotes fair practices and code of conduct in security market by taking following steps:
- SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.
 - SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.
 - SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.



2. Developmental Functions

There are various developmental functions of SEBI. Some of them are as follows:

- **Promoting fair trade:** It has made underwriting optional in order to achieve the goal of promotion of fair trade.
- **Research:** SEBI also makes a publication of the data and information which is necessary for various participants of the market in order to conduct effective research.
- **Training of brokers:** Intermediaries of the securities market are trained to promote the efficiency of the market.

3. Regulatory Functions

These are various regulatory functions of SEBI, some of them are as follows :

- **Notifications of various Rules and Regulations:** SEBI is empowered to issue various rules and regulations to make the functioning of all the intermediaries existing in the securities market smooth.
- **Levying of Fees:** If any of the players of the market contravenes any order or direction passed by it, SEBI has the power to levy penalties, fees and other charges for the same.
- **Registration of Agents and Brokers:** For the purpose of making a safe market place for trading into the securities, it is mandatory for all the transfer agents, brokers, merchant banks, sub-brokers and so on to register themselves.
- **Prohibition of unfair trade practices:** SEBI has been entrusted with the primary duty of protecting the interests of investors. Hence, it prevents various fraudulent and unfair trade practices prevalent in the market to cheat the investors.
- **Regulator of Investment Schemes:** It has made the registration of mutual funds and collective investment schemes mandatory in order to regulate them.

- **Exercising and Performing Powers:** SEBI has been delegated various powers under the Securities Contracts (Regulation) Act 1956 by the Government of India. SEBI exercises and performs all such powers.
- **Enquiries and Inspection:** SEBI conducts various inspections and undertakes audits and enquiries of stock exchanges of India.

Q45. Explain the role of SEBI in Indian Capital Market ?

Ans :

SEBI is regulator to control Indian capital market. Since its establishment in 1992, it is doing hard work for protecting the interests of Indian investors. SEBI gets education from past cheating with naive investors of India. Now, SEBI is more strict with those who commit frauds in capital market.

The role of security exchange board of India (SEBI) in regulating Indian capital market is very important because government of India can only open or take decision to open new stock exchange in India after getting advice from SEBI.

If SEBI thinks that it will be against its rules and regulations, SEBI can ban on any stock exchange to trade in shares and stocks.

Now, we explain role of SEBI in regulating Indian Capital Market more deeply with following points :

1. Power to make rules for controlling stock exchange

SEBI has power to make new rules for controlling stock exchange in India. For example, SEBI fixed the time of trading 9 AM and 5 PM in stock market.

2. To provide license to dealers and brokers

SEBI has power to provide license to dealers and brokers of capital market. If SEBI sees that any financial product is of capital nature, then SEBI can also control to that product and its dealers. One of main example is ULIPs case. SEBI said, "It is just like mutual

funds and all banks and financial and insurance companies who want to issue it, must take permission from SEBI."

3. To Stop fraud in Capital Market

SEBI has many powers for stopping fraud in capital market.

It can ban on the trading of those brokers who are involved in fraudulent and unfair trade practices relating to stock market.

It can impose the penalties on capital market intermediaries if they involve in insider trading.

4. To Control the Merge, Acquisition and Takeover the companies

Many big companies in India want to create monopoly in capital market. So, these companies buy all other companies (or) deal of merging. SEBI sees whether this merge (or) acquisition is for development of business (or) to harm capital market.

5. To audit the performance of stock market

SEBI uses his powers to audit the performance of different Indian stock exchange for bringing transparency in the working of stock exchanges.

6. To make new rules on carry - forward transactions

Share trading transactions carry forward can not exceed 25% of broker's total transactions.

90 day limit for carry forward.

7. To create relationship with ICAI

ICAI is the authority for making new auditors of companies. SEBI creates good relationship with ICAI for bringing more transparency in the auditing work of company accounts because audited financial statements are mirror to see the real face of company and after this investors can decide to invest or not to invest. Moreover, investors of India can easily trust on audited financial reports. After Satyam Scam, SEBI is investigating with ICAI, whether CAs are doing their duty by ethical way or not.

8. Introduction of derivative contracts on Volatility Index

For reducing the risk of investors, SEBI has now been decided to permit Stock Exchanges to introduce derivative contracts on Volatility Index, subject to the condition that;

- (a) The underlying Volatility Index has a track record of at least one year.
- (b) The Exchange has in place the appropriate risk management framework for such derivative contracts.
- (c) Before introduction of such contracts, the Stock Exchanges shall submit the following:
 - (i) Contract specifications
 - (ii) Position and Exercise Limits
 - (iii) Margins
 - (iv) The economic purpose it is intended to serve
 - (v) Likely contribution to market development
 - (vi) The safeguards and the risk protection mechanism adopted by the exchange to ensure market integrity, protection of investors and smooth and orderly trading.
 - (vii) The infrastructure of the exchange and the surveillance system to effectively monitor trading in such contracts, and
 - (viii) Details of settlement procedures & systems
 - (ix) Details of back testing of the margin calculation for a period of one year considering a call and a put option on the underlying with a delta of 0.25 & -0.25 respectively and actual value of the underlying.

9. To Require report of Portfolio Management Activities

SEBI has also power to require report of portfolio management to check the capital

market performance. Recently, SEBI sent the letter to all Registered Portfolio Managers of India for demanding

10. To educate the investors

Time to time, SEBI arranges scheduled workshops to educate the investors. On 22 may 2010 SEBI imposed workshop. If you are investor, you can get education through SEBI leaders by getting update information .

Q46. Discuss the rules and regulations of SEBI.

Ans :

SEBI has adopted a number of regulations and revolutionary steps to re-establish the credit of capital market, which includes the following :

1. Share Price and Premium Determination

According to the latest directions of SEBI, Indian companies are now free to determine their share prices and premium on those shares. But determined price and premium amount will be equally applicable to all without any discrimination.

2. Control on Share Brokers

Under the new rules, every broker and sub-broker has to obtain registration with SEBI and any stock exchange in India.

3. Control on Utilizing 'Application Amount' having no Interest by Companies Releasing Public Issues

At the instance of SEBI, Commercial banks introduced Stock Investment Scheme under which investor has to submit stock-invests, purchased from banks, with their shares application. If the investor is allotted shares/debentures, the required amount is transferred in concerned company's account by the bank issuing 'stock invest'.

In other case (if share/debenture is not allotted), investor gets a pre-determined interest rate on invested capital. This step of SEBI ensured interest earning to the investor until he got share/debenture allotment. It also ensures the refund of invested amount to the investor in case shares are not allotted.

4. Underwriters

The minimum asset limit has been fixed to be Rs. 20 lakh to work as underwriter. Besides, SEBI has warned underwriters that their registration can be cancelled if any irregularity is found in the purchase of unsubscribed part of the share issue.

5. SEBI's Control on Mutual Fund

SEBI (Mutual funds) Regulation 1993, help to take over direct control of all mutual funds of government and private sector (excluding UTI). Under this new rule, the company floating a mutual fund should possess net assets of Rs. 5 crore which should consist of at least 40% contribution from promoter's side.

6. Control over Foreign Institutional Investors

SEBI has made it compulsory for every foreign institutional investor to get registered with SEBI for participating in Indian Capital Market. SEBI has issued directions in this regard.

7. Insider Trading

Companies and their employees usually adopt malpractice in Indian Capital Market to variate share prices. To check this type of insider trading, SEBI introduced SEBI (insider Trading) Regulations, 1992, which will ensure honesty in the capital market and will develop a feeling of faith among investors to promote investments in capital market in the long-run.

(iii) Dutch auction

(iv) Repurchase of odd lots

(v) Reverse rights issue

(vi) Employee stock option

2. The companies are not permitted to buyback through negotiated deals, spot transactions and private placement.

3. Promoters have been debarred from participating if the company options to buyback shares through stock exchange route.

4. Companies buying through stock exchanges must disclose purchase details daily.

5. The companies will have to specify the maximum price payable in the resolution seeking shareholders' approval.

6. The buyback should be done only in cash and an escrow account will have to be maintained by the merchant bankers.

7. No company is allowed to withdraw the buyback offer once it is announced.

Merchant bankers be associated in every offer for buyback where in they would be required to give a due diligence certificate.

The Registrar of shares (or) transfer agents will have to certify that the company has adhered to all regulations.

Q47. How does SEBI protect the interest of investors? Explain.

Ans :

The SEBI has been made as a regulatory authority of the licence to buyback shares by the Ordinance. The regulations of SEBI contains the following:

1. The companies are permitted to buyback the shares through six moves:
 - (i) Tender offers
 - (ii) Open offers

Short Question and Answers

1. Equity market

Ans :

Meaning

An equity market is a market in which shares are issued and traded, either through exchanges or over-the-counter markets. Also known as the stock market, it is one of the most vital areas of a market economy because it gives companies access to capital and investors a slice of ownership in a company with the potential to realize gains based on its future performance.

There are five different ways by which a company can raise its equity capital in the primary market. They are,

- i) Public issue
- ii) Rights issue
- iii) Preferential allotment
- iv) Global investment banking and
- v) Private placement

2. Define primary market

Ans :

Meaning

The Primary Market, also known as a New Issue Market, is where new securities are issued – it is part of the capital market. Corporations, national and local governments, and other public sector institutions can get financing through the sale of new stock or bond issues through the primary market.

Put simply, the primary market creates new securities and offers them for sale to the public.

All companies require capital for their operations. This capital (money) can be in the form of equity or debt. Equity is the stock capital (share capital) of a company. Debt consists of all the loans taken by the business.

In order to raise capital in the form of equity, a company can sell its shares to members of the public. When shares are sold directly to the public, this is done via the primary market route.

Example

XYZ Inc. sells shares to Investor A in the primary market. Investor A sells XYZ shares to Investor B in the secondary market.

3. Merchant Banker

Ans :

Merchant Banking is understood differently in different countries.

Though there is no universal definition for merchant banking functions and services offered by a merchant banker.

As per the Securities and Exchange Board of India (SEBI), 1992 defines, the notification of the ministry of finance defines a merchant bankers person who is engaged in the business of issues management either by making arrangement regarding selling, buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management.

Merchant banking as an institution that covers a broad range of activities like management of customer services, corporate governance, portfolio management, credit syndication, acceptance credit, counselling, insurance etc.

4. Initial Public Offering (IPO)

Ans :

Initial Public Offering, shortly known as IPO is the first public offering of equity shares of a company going to be listed on the stock exchange and publicly traded. It is the main source of acquiring money from the general public to finance its projects and the company allots shares to the investors in return. It is the turning point in the lifecycle of the company that transforms from a small closely held company, which seek to expand their business or large privately owned firms to a publicly listed one.

- (i) firstly when the fresh issue of shares takes place, resulting in injection of fresh capital to the company.

- (ii) Secondly, when existing shares are offered for sale, where in no infusion of capital takes place because the amount received as proceeds from the issue of shares go to shareholders who offer their shares for sale.

Certain eligibility conditions are required to be fulfilled by the company so as to make an IPO. Guidelines specified by the Securities and Exchange Board of India (SEBI) and Company Act need to be complied by the promoters of the enterprise.

5. What is Follow-on Public Offering?

Ans :

FPO, an acronym for Follow-on Public Offering, as the name suggests it is the public issue of shares to investors at large, by a publicly listed company. The process is after an IPO; wherein the company goes for a further issue of shares to the general public with a view to diversifying their equity base. The shares are offered for sale by the company through an offer document called prospectus. There is two type of Follow-on Public Offering:

- (i) Dilutive offering
- (ii) Non-Dilutive offering.

6. What is prospectus?

Ans :

Definition

According to Sec. 2(36) of the Companies Act describes a prospectus as "any document issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public (or) inviting offers from the public for the subscription (or) purchase of any share in, or debentures of a body corporate."

Objectives

- (i) To bring to the notice of the public that a new company has been formed.
- (ii) To preserve authentic record of the terms and allotment on which the public have been invited to buy its shares or debentures.
- (iii) To secure that the directors of the company accept responsibility for the statements in the prospectus.

7. Red herring prospectus

Ans :

A red herring is a preliminary prospectus filed by a company with the Securities and Exchange Commission (SEC), usually in connection with the company's initial public offering. A red herring prospectus contains most of the information pertaining to the company's operations and prospects but does not include key details of the security issue, such as its price and the number of shares offered.

A red herring prospectus, as a first or preliminary prospectus, is a document submitted by a company (issuer) as part of a public offering of securities (either stocks or bonds). Most frequently associated with an initial public offering (IPO), this document, like the previously submitted Form S-1 registration statement, must be filed with the Securities and Exchange Commission (SEC).

A red herring prospectus is issued to potential investors, but does not have complete particulars on the price of the securities offered and quantum of securities to be issued. The front page of the prospectus displays a bold red disclaimer stating that information in the prospectus is not complete and may be changed, and that the securities may not be sold until the registration statement, filed with the market regulator, is effective.

8. Sweat Equity

Ans :

Meaning

The term sweat equity is defined as the equity shares issued by a company to employees or directors at a discount other than cash or making available intellectual property rights by value additions, by whatever name called. These shares are issued to an employee or a director as a token of appreciation for their best contribution to the company.

The name itself determines that it is rewarded for the hardwork of employees. Issuing of such shares to employees as a reward ensures more loyalty and effective contribution of the employees.

9. Employee Stock Ownership Plan**Ans :**

The Employee Stock Ownership (Options) Scheme (Plans) has seven decades long history.

- During the 1950s, an unconventional form of ownership was developed by Louis O. Kelso, a political economist and corporate lawyer, who is chiefly remembered as the Father of the Employee Stock Ownership Concept.
- ESOP is a generic term representing a basket of incentives or investments meant for employees of a corporate entity. In strict Company Law parlance, it is an option given to the whole-time directors, officers or employees the benefit or right to subscribe to its securities at a future date but at a pre-determined rate.
- It is an innovative way to motivate, reward, remunerate and to retain the employees. In this way, a set of employees will be granted the ownership of the entity.

10. What is Rights issue?**Ans :**

A rights issue of shares is basically a way through which a listed company in a stock exchange raises additional fund. It may seem similar to the Follow-on Public Offer (FPO), but there is a catch here. Here the new shares being issued are not offered to the public, instead, it is offered to the existing shareholders of the company. The shareholders have the right to subscribe the shares in proportion to their existing holdings, in a pre-defined time period.

For example, 1:2 rights issues signify that the existing shareholders of the company can purchase one extra share for every two shares already held in the Demat account. Here, a very important point to be noted that the new shares are issued at a discounted price than the current or prevailing rate in the market.

11. Define Stock Exchange**Ans :****Meaning**

Stock Exchange (also called Stock Market or Share Market) is one important constituent of capital market. Stock Exchange is an organized market for the purchase and sale of industrial and financial security. It is convenient place where trading in securities is conducted in systematic manner i.e. as per certain rules and regulations.

It performs various functions and offers useful services to investors and borrowing companies. It is an investment intermediary and facilitates economic and industrial development of a country.

Definitions

- (i) **According to Securities Contract Regulation Act, 1956**, A stock exchange is defined as "an association organization or body of individuals, whether incorporated (or) not, established for the purpose of assisting, regulating and controlling of business in buying, selling and dealing in securities".
- (ii) **According to Husband and Dockerary**, "Stock exchanges are privately organized markets which are used to facilitate trading in securities."
- (iii) **The Indian Securities Contracts (Regulation) Act of 1956, defines Stock Exchange as**, "An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

12. Bombay Stock Exchange**Ans :**

Bombay Stock Exchange is an ancient stock exchange in India. It is regarded as the most important part of the economy which reveals the economic conditions. Basically BSE was operating in Mumbai alone but with the help of Bombay Online Trading System (BOLT), its operations spread

over to 275 cities by March 2000. The number of trade workstation was also increased to 3803. There was an increase in its daily turnover from ` 11 crores during 1979-1980 to ` 4587 crores in the year 2000-2001.

Features

The following are the important features of BSE,

a) Size and Operation

Presently BSE is regarded as the world's number one exchange with respect to the number of listed companies and stands at fifth position in terms of transaction numbers. The investors have wider choice i.e., they can select from more than 4887 listed companies which are categorized into A, B, S, T and Z groups for easy references.

b) SENSEX

The BSE index, SENSEX is the first stock market index in India which possesses an iconic image and is used globally. SENSEX is an index of 30 stocks including 12 major sectors. It is prepared by following 'free-float' technique and is easily affected by the market conditions.

c) Other Indices

Beside SENSEX, BSE also provides 21 other indices comprising of 12 sectorial indices. An index cooperation agreement was made between BSE and Deutsche Borse with this agreement, SENSEX and other BSE indices are made accessible to investors located in Europe and America.

13. National Stock Exchange

Ans :

The National Stock Exchange of India was incorporated in November 1992 with an equity capital of Rs. 25 crores and promoted by IDBI, ICICI, LIC, GIC and its subsidiaries, State Bank of India and SBI Capital Markets Limited.

Objectives

The NSE has the following objectives:

- (i) To Establish nation wide trading facility for equities, debts and hybrids.
- (ii) To facilitate equal access to investors across the country.
- (iii) To provide fairness, efficiency and transparency to the securities trading.
- (iv) To enable shorter settlement cycles.
- (v) To meet international securities market standard.

14. Define SEBI.

Ans :

Securities Exchange Board of India (SEBI) was set up in April 12, 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions.

It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for Establishment of SEBI

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI).

15. Protective Functions of SEBI

Ans :

These functions are performed by SEBI to protect the interest of investor and provide safety of investment.

As protective functions SEBI performs following functions:

- (i) **It Checks Price Rigging:** Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.
- (ii) **It Prohibits Insider trading:** Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.
- (iii) **SEBI prohibits fraudulent and Unfair Trade Practices:** SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.
- (iv) **SEBI** undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

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Choose the Correct Answer

1. Who controls the capital market in India? [a]
(a) SEBI (b) RBI
(c) IRDA (d) NABARD
2. Which of the following reasons is not responsible for the ups and downs in the Sensex? [d]
(a) Rain (b) Monetary policy
(c) Political instability (d) None of the following
3. How many companies are included in the SENSEX of India? [a]
(a) 30 (b) 50
(c) 111 (d) 25
4. Which of the following is not a credit rating agency? [c]
(a) CRISIL (b) ICRA
(c) NIKKEI (d) CARE
5. How many companies are included in the SENSEX? [c]
(a) 50 (b) 111
(c) 30 (d) None
6. Which of the following is responsible for the fluctuations in the Sensex? [d]
(a) Political instability (b) Monetary policy
(c) Rain (d) All of the above
7. When was Nifty established? [a]
(a) 1996 (b) 1952
(c) 1965 (d) None of these
8. The first computerised online stock exchange in India was _____. [a]
(a) NSE (b) OTCEI
(c) BSE (d) MCX
9. In primary markets, the property of shares which made it easy to sell newly issued security is considered as _____. [a]
(a) Increased liquidity (b) Decreased liquidity
(c) Money flow (d) Large funds
10. The money market where debt and stocks are traded and maturity period is more than a year is classified as _____. [b]
(a) Shorter term markets (b) Capital markets
(c) Counter markets (d) Long-term markets

11. The markets in which transactions are done through computers and telephone without any specific location are classified as _____. [c]
(a) Past counter market (b) Future counter market
(c) Over the counter markets (d) Capital counter market
12. The Securities and Exchange Board of India was not entrusted with the function of _____. [d]
(a) Investor protection
(b) Ensuring fair practices by companies
(c) Promotion of efficient services by brokers
(d) Improving the earning of equity holders
13. To regulate scam in Indian capital market, which of the following body has regulatory power: _____ [a]
(a) SEBI (b) RBI
(c) SBI (d) None of these
14. Which trading individuals has SEBI decided to grant a unified license to operate in commodity derivative and equity markets? [d]
(a) Clearing Members (b) Brokers
(c) NBFCs (d) Only (a) and (b)
15. SEBI has allowed celebs to endorse which products? [b]
(a) Stocks and shares (b) Mutual funds
(c) Dividends (d) Insurance
16. SEBI has relaxed investment rules for which funds? [a]
(a) Angel Funds (b) Mutual Funds
(c) Debt Funds (d) None of the above
17. When was SEBI constituted? [a]
(a) April, 1988 (b) March, 1982
(c) July, 1992 (d) Dec. 1974
18. Which of the following statement is NOT correct about the SEBI? [a]
(a) At present it is a non statutory body
(b) At present it is a statutory body
(c) It got statutory powers by an ordinance in 1992
(d) SEBI is managed by 6 members
19. Which of the following is not function of SEBI? [d]
(a) Protecting the interests of investors
(b) Registration of share brokers
(c) Change in the cash Reserve Ratio
(d) Allow Foreign Institutional Investors (FII) to invest in the securities market.

20. Stock markets in which already issued stocks are resold and re-bought are classified as _____. [d]
(a) red herring stock market (b) preemptive stock market
(c) silence stock market (d) secondary stock markets
21. Orders that are transacted at best available price are classified as _____. [c]
(a) post order (b) transacted order
(c) market order (d) available order
22. Which of the following index is not matched correctly ? [b]
(a) SET: Thailand (b) JCI: Japan
(c) NASDAQ: America (d) TSEC: Taiwan
23. Which of the following is responsible for the fluctuations in the Sensex? [d]
(a) Rain (b) Monetary policy
(c) Political instability (d) All of the above
24. Which of the following words does not belong to the stock exchange ? [d]
(a) NAV (b) NSE
(c) IPO (d) KPO
25. What is called "Blue Chip" ? [b]
(a) Companies which are run by large corporate houses
(b) A company, whose share always provides profit
(c) A multinational company
(d) A company which is listed on a foreign stock exchange
26. The place where stocks in the equity market are traded in the _____. [a]
(a) stock exchange (b) trade exchange
(c) OTC (d) None
27. The _____ is the part of the capital market the deals with the issuance of new securities and then sold to investor directly by the issuer. [a]
(a) primary market (b) secondary market
(c) stock market (d) debt market

Fill in the blanks

1. An _____ market is a market in which shares are issued and traded, either through exchanges or over-the-counter markets.
2. _____ means an issue of an equity by a listed company to the selected investors at a price.
3. The Primary Market, also known as a _____.
4. _____ shares represent ownership position in a company.
5. _____ shares are those which enjoy some extra benefits when compare to other types of shares.
6. _____ are the middlemen between purchaser and seller of securities.
7. IPO stands for _____.
8. Under _____ price, the company going public determines a fixed price at which its shares are offered to investors.
9. FPO stands for _____.
10. In _____ auction method, company can fetch a substantially high value for shares.
11. A _____, as a first or preliminary prospectus, is a document submitted by a company (issuer) as part of a public offering of securities.
12. _____ is defined as the equity shares issued by a company to employees or directors at a discount other than cash.
13. ESOP stands for _____.
14. Stock exchange is also known as _____.
15. OTCEI stands for _____.
16. _____ is a dealer in securities who performs the same job
17. _____ are concerned with only brokers and not with the public.
18. _____ house refers to an agency which makes arrangements for the delivery of securities and its payment by the respective parties.
19. _____ refers to the sub-brokers who are appointed by a member for protecting the business.
20. The national stock exchange (NSE) was established in _____.
21. The establishment of OTCEI took place in _____.
22. SEBI stands for _____.
23. _____ was set up with the main purpose of keeping a check on malpractices and protect the interest of investors.

ANSWERS

1. Equity
2. Preferential Allotment
3. New Issue Market
4. Equity
5. Preference
6. Brokers
7. Initial Public Offering.
8. Fixed
9. Follow-on Public Offering.
10. French
11. Red herring prospectus
12. Sweat equity
13. Employee Stock Ownership Plan
14. Share Market
15. Over The Counter Exchange of India.
16. Taravaniwala
17. Jobbers
18. Clearing
19. Remisers
20. November, 1992
21. August, 1989
22. Securities Exchange Board of India
23. SEBI

FACULTY OF COMMERCE
B.Com. II Year III-Semester(CBCS) Examination
(Common Paper for general and / Honours Courses)
July - 2021

FINANCIAL INSTITUTIONS AND MARKETS

Time : 2 Hours]

[Max. Marks : 80

PART - A - (4 × 5 = 20 Marks)

Note : Answer the following any **Four** Question.

ANSWERS

1. Components of financial system.
2. What is social cost-Benefit Analysis?

(Unit-I, Q.No.3)

Ans :

The social cost benefit analysis is a tool for evaluating the value of money, particularly of public investments in many economies. It aids in decision making with respect to the various aspects of a project and the design programmes of closely interrelated project. Social cost benefit analysis has become important among economists and consultants in recent years.

3. Electronic Banking.

Ans :

Electronic banking uses an electronic medium to help users get access to their funds. It eliminates the need for the bank's customers to visit the bank to do financial transactions. With more and more customers now using the internet for a host of their day-to-day activities, this digital medium of banking makes banking more accessible and convenient for users.

4. What are Government securities? (Unit-IV, SQA-1)
5. Merchant Banking (Unit-II, SQA-6)
6. Commercial papers (Unit-III, SQA-5)
7. Repo and Reverse Repo (Unit-III, Q.No.32)
8. Primary Market Vs Secondary Market

Ans :

Primary Market Vs Secondary Market

S.No.	Nature	Primary Market	Secondary Market
1.	Meaning	Offers security for the first time.	Offers trading of already issued securities.
2.	Another name	New issue market (NIM).	Aftermarket or share market.
3.	Type of product	Mainly include IPO and FPO	Shares, warrants, derivatives and more.
4.	Purchase type	Direct Purchases from Co.	Trading between Investors.
5.	Frequency of selling	Once	As many as possible
6.	Parties involved	Company and the investors.	investors buy and sell among themselves.

7.	Beneficiary	Company	Investor
8.	How to identify investment?	Investors primarily rely on prospectus and word-of-mouth publicity.	Several tools such as price to earnings (P/E), price to book (P/B), price to sales (P/S) and more.
9.	Intermediary	Underwriters	Brokers.
10.	Purpose	To raise capital for expansion and Investors.	Trading and thereby availing Liquidity to diversification, etc.
11.	Price	The company sells the shares to the investors at a fixed price.	Demand Supply discovers the price.
12.	Presence	No organization set up.	Geographical setup and organizational presence.
13.	Rules and Regulations	The company issuing securities goes through a lot of regulation and due diligence.	Investors and brokers follow the rules set by the exchange and the governing agencies.

PART - B - (4 × 15 = 60 Marks)

Note : Answer the following any **Four** Question.

9. What are the characteristics of financial system? Explain. (Unit-I, Q.No.1)
10. "Commercial Banks of Special among the intermediaries for the development of the economy". Justify (Unit-II, Q.No.1)
11. What is venture capital? Explain the Features and objectives of Venture capital. (Unit-II, Q.No.12,13)
12. Discuss the recent developments in Commercial Banks. (Unit-II, Q.No.7)
13. Define money Market? Explain the functions of money market. (Unit-III, Q.No.1,3)
14. Explain about liquidity adjustment facility of RBI (Unit-III, Q.No.30)
15. What are the Functions of Indian Debt Market? Explain (Unit-IV, Q.No.8)
16. Explain about securities Trading Corporation of India (STCI) (Unit-IV, Q.No.17)
17. Define Capital Market? Explain its features and Importance.

Ans :

The capital market is a market which deals in long-term loans. It supplies industry with fixed and working capital and finances medium-term and long-term borrowings of the central, state and local governments. The capital market deals in ordinary stock are shares and debentures of corporations, and bonds and securities of governments.

Features

1. Serves as a link between Savers and Investment Opportunities:

The capital market serves as a crucial link between the saving and investment process as it transfers money from savers to entrepreneurial borrowers.

2. Long term Investment:

It helps the investors to invest their hard-earned money in long-term investments.

3. Helps in Capital formation:

The capital market offers opportunities for those investors who have a surplus amount of money and want to park their money in some type of investment and also take the benefit of the power of compounding.

4. Helps Intermediaries:

While transferring shares and money from one investor to another, it takes help from intermediaries like brokers, banks, etc. thus helping them in conducting their business.

5. Rules and Regulations:

The capital markets operate under the regulation and rules of the Government thus making it a safe place to trade.

Importance

The capital market plays an important role in mobilizing saving and channel them into productive investments for the development of commerce and industry. As such, the capital market helps in capital formation and economic growth of the country. We discuss below the importance of capital market.

1. Link between savers and investors

The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called "Surplus units" and the investors/borrowers are known as "deficit units". The capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus units lend their surplus funds to deficit units.

2. Basis for industrialization

Capital market generates long term funds, which are essential for the establishment of industries. Thus, capital market acts as a basis for industrialization.

3. Accelerating the pace of growth

Easy and smooth availability of funds for medium and long period encourages the entrepreneurs to take profitable ventures/businesses in the field of trade, industry, commerce and even agriculture. It results in the all round economic growth and accelerates the pace of economic development.

4. Generating liquidity

Liquidity means convertibility into cash. Shares of the public companies are transferable i.e., in case of financial requirements these shares can be sold in the stock market and the cash can be obtained. This is how capital market generates liquidity.

18. What are the functions of stock exchange ? Explain.

(Unit-V, Q.No.33)

FACULTY OF COMMERCE
B.Com. III Year VI-Semester(CBCS) Examination
(Only for General and Tax Procedure Courses)
September / October - 2020
FINANCIAL INSTITUTIONS AND MARKETS

Time : 2 Hours]

[Max. Marks : 80

PART - A - (4 × 5 = 20 Marks)

Note : Answer the following any **Four** Question.

ANSWERS

1. Explain main functions of a Financial Market.

Ans :

1. Price Determination

The financial market performs the function of price discovery of the different financial instruments which are traded between the buyers and the sellers on the financial market. The prices at which the financial instruments trade in the financial market are determined by the market forces i.e., demand and supply in the market.

So the financial market provides the vehicle by which the prices are set for both financial assets which are issued newly and for the existing stock of the financial assets.

2. Funds Mobilization

Along with the determination of the prices at which the financial instruments trade in the financial market, the required return out of the funds invested by the investor is also determined by participants in the financial market. The motivation for persons seeking the funds is dependent on the required rate of return which is demanded by the investors.

Because of this function of the financial market only, it is signalled that how funds which available from the lenders or the investors of the funds will get allocated among the persons who are in need of the funds or raise the funds through the means of issuing financial instruments in the financial market. So, the financial market helps in the mobilization of the savings of the investors.

3. Liquidity

The liquidity function of the financial market provides an opportunity for the investors to sell their financial instruments at its fair value prevailing in the market at any time during the working hours of the market.

In case there is no liquidity function of the financial market, then the investor forcefully have to hold the financial securities or the financial instrument until the conditions arise in the market to sell those assets or the issuer of the security is obligated contractually to pay for the same i.e., at the time of maturity in debt instrument or at the time of the liquidation of the company in case of the equity instrument is until the company is either voluntarily or involuntarily liquidated.

Thus, in the financial market investors can sell their securities readily and convert them into cash thereby providing the liquidity.

2. Money Market Vs Capital Market.

Ans :

S.No.	Nature	Money Market	Capital Market
1.	Participants	Individual investors as well as institutional investors like financial institutions, banks, corporate houses and foreign investors participate in the capital market transactions.	The participants are RBI, Commercial Banks financial institutions, mutual funds and corporate houses. Individual investors do not participate in money-market.
2.	Instrument traded	The instruments of capital market include equity shares, preference shares, bonds, debentures, etc.	Some of the main instruments used in money-market are commercial paper, treasury bills, trade bills, certificate of deposit, etc.
3.	Duration of securities traded	The capital market deals in medium and long-term securities which are for more than one year.	Money-market deals in short-term securities having a maximum tenure of one year.
4.	Expected return	Higher returns on investment.	There is always a trade off between risk and return. Low risk involved leads to lesser returns.
5.	Safety	Capital market is more risky.	The instruments of money-markets are safe, less risky due to short duration and soundness of issuers.

3. Characteristics of Commercial Banks. (Unit-II, Q.No.1)
4. Merchant Banking. (Unit-II, SQA-6)
5. Venture Capital. (Unit-II, SQA-8)
6. Operating Lease Vs Financial Lease. (Unit-III, Q.No.28)
7. Red herring. (Unit-IV, SQA-7)
8. What are the advantages of Debt Market? (Unit-V, Q.No.5)

PART - B - (4 × 15 = 60 Marks)

Note : Answer the following any **Four** Question.

9. "Financial Markets and Financial Institutions play an important role in Financial System. Do you agree? (Unit-I, Q.No.2)
10. Discuss the various types Financial Markets. How the two markets are inter related. (Unit-I, Q.No.8)
11. What do you understand by the term 'Venture Capital'? Write a detailed note on objectives and importance of Venture Capital. (Unit-II, Q.No.12,13)
12. What is Leasing plain various kinds of Leasing, advantages and disadvantages of Leasing (Unit-II, Q.No.25,27,31)

13. Write Short Note on:
- i) Commercial Paper (Unit-III, Q.No.12)
 - ii) Certificate of Deposits (Unit-III, Q.No.14)
 - iii) Treasury Bills (Unit-III, Q.No.19)
 - iv) Repo (Unit-III, Q.No.32)
14. Write detail note on functions of Reserve Bank of India. (Unit-III, Q.No.26)
15. What is Government Securities Market? Explain the features and the trading mechanism of Government Securities Market. (Unit-IV, Q.No.12,13)
16. What is Debt Market? Explain the features, advantages and disadvantages of Debt Market. (Unit-IV, Q.No.1,2,3,5)
17. What is Primary Market and explain the main features, functions, advantages and disadvantages of Primary Market? (Unit-V, Q.No.3,4,7)
18. Define Stock Exchange. What is Over the Counter Exchange of India (OTCEI), its main features and advantages? (Unit-V, Q.No.31,35)

FACULTIES OF COMMERCE

B.Com. III Year VI-Semester (CBCS) (Instant) Examination

(Only for General / Tax Procedure Courses)

September / October - 2019

FINANCIAL INSTITUTION AND MARKETS

Time : 3 Hours]

[Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

[Short Answer Type]

Note: Answer any **Five** of the following questions not exceeding 20 lines each.**ANSWERS**

- | | |
|--|----------------------|
| 1. Write about Indian Financial System focusing on financial services. | (Unit-I, SQA-1) |
| 2. Write a short note on role of financial system in country's economic development. | (Unit-I, SQA-2) |
| 3. What are the basic principles of Lending? | (Unit-II, SQA-1) |
| 4. What is Portfolio management? | (Unit-II, SQA-2) |
| 5. What are ADRs and GDRs? | (Unit-I, SQA-3) |
| 6. Write briefly on prohibitory functions of RBI. | (Unit-III, SQA-1) |
| 7. What is a Debt Market? Explain the risks and features. | (Unit-IV, SQA-2,3,4) |
| 8. What are Bonds? What is Bond Rating? | (Unit-IV, SQA-5,6) |

PART - B (5 × 12 = 60 Marks)

[Essay Answer Type]

Note: Answer all the questions in not exceeding four pages each.

9. (a) Discuss the components of Indian Financial system. Explain in detail about the Non-Banking Institutions. (Unit-I, Q.No.3, Unit-II, Q.No.35)
- OR
- (b) What are the Innovative Financial Instruments devised for raising new funds? Explain. (Unit-I, Q.No.6)
10. (a) Discuss the features of venture capital. Explain the various stages of financing through it. (Unit-II, Q.No.12,17)

OR

- (b) What are the merits of leasing for a Lessee and Lessor? (Unit-II, Q.No.31)

11. (a) Write about the credit control measures adopted by RBI. (Unit-III, Q.No.29)
- OR
- (b) What do you understand by monetary policy committee? Discuss its structure and functions. (Unit-III, Q.No.38,39)
12. (a) Explain the classification of Indian Debt Market in detail. (Unit-IV, Q.No.8)
- OR
- (b) What is a Debt Instrument? Explain its types. (Unit-IV, Q.No.12,15,16)
13. (a) What is a primary market? Discuss its features and functions. (Unit-V, Q.No.3)
- OR
- (b) Who are the major intermediaries in the process of issue of new securities? Explain. (Unit-V, Q.No.6)

FACULTY OF COMMERCE
B.Com. III Year VI-Semester(CBCS) Examination
May / June - 2019
FINANCIAL INSTITUTIONS AND MARKETS

Time : 3 Hours]

[Max. Marks : 80

PART - A - (5 × 4 = 20 Marks)**[Short Answer Type]****Note :** Answer all the questions.**ANSWERS**

1. Write about Indian Financial System, focusing on organized sector. (Unit-I, Q.No.2)
2. Write a short note on Financial Markets and its types. (Unit-I, Q.No.8)
3. Bring out the characteristic features of a Commercial Bank. (Unit-II, Q.No.1)
4. "Bank act as agents of the Customers". Explain

Ans :

A banker acts as an agent of his customer and performs a number of agency functions for the convenience of his customers. For example, he buys or sells securities on behalf of his customer, collects cheques on his behalf and makes payment of various dues of his customers, e.g., insurance premium, etc. The range of such agency functions has become much wider and the banks are now rendering large number of agency services of diverse nature. For example, some banks have established Tax Services Departments to take up the tax problems of their customers.

5. Define Money Market. What are its functions. (Unit-III, Q.No.1,3)
6. What is Repurchase Agreement? (Unit-III, SQA-2)
7. What is a Government Securities Market? What are its features? (Unit-IV, SQA-1)
8. What is Prospectus? (Unit-V, SQA-6)

PART - B - (5 × 12 = 60 Marks)**[Essay Answer Type]****Note :** Answer all the questions.

9. (a) Elucidate the importance of Financial instruments and Financial Services in India Financial System. (Unit-I, Q.No.3,9)

OR

- (b) Give your views on developments in Indian Financial System since Independence.

(Unit-I, Q.No.18)

10. (a) What is a Lease Agreement? Explain the various kinds of leases.

(Unit-II, Q.No.25,27)

OR

- (b) Write about Non-Banking Financial Company. Discuss its types.

(Unit-II, Q.No.35)

11. (a) Explain the various sectors of a Money Market in detail.

Ans :

1. Unorganized money-market

The unorganized money market is an old and ancient market, mainly it made of indigenous bankers and money lenders, etc.

2. Call money or notice money

Call money, notice money, and term money markets are sub-markets of the Indian money market. These markets provide funds for very short-term. Lending and borrowing from the call money market for 1 day.

Whereas lending and borrowing of funds from notice money market are for 2 to 14 days. And when there are borrowing and lending of funds for the tenor of more than 14 days, it refers to "Term Money".

3. Treasury bills

The Bill market is a sub-market of this market in India. There are two types of the bill in the money market. They are treasury bills and commercial bill. The treasury bills are also known as T-Bills, T-bills are issued by the Central bank on behalf of Government, whereas Commercial Bills are issued by Financial Institutions.

Treasury bills do not yield any interest, but it is issued at discount and repaid at par at the time of maturity. In T-bills there is no risk of default; it is a safe investment instrument.

4. Commercial bills

Commercial bill is a money market instrument which is similar to the bill of exchange; it is issued by a Commercial organization to raise money for short-term needs. In India, the participants of the commercial bill market are banks and financial institutions.

5. Certificate of deposits

Certificate of Deposits also known as CDs. It is a negotiable money market instrument. It is like a promissory note. Rates, terms, and amounts vary from institution to institution. CDs are not supposed to trade publicly neither it is traded on any exchange

6. Organized money-market

The organized money market is that part which comes under the regulatory ambit of RBI & SEBI. Governments (Central and State), Discount and Finance House of India (DFHI), Mutual Funds, Corporate, Commercial or Cooperative Banks, Public Sector Undertakings, Insurance Companies, and Financial Institutions and Non-Banking Financial Companies (NBFCs) are the key players of the organized Indian money market.

OR

(b) Give a detailed note on functions of Reserve Bank of India. (Unit-III, Q.No.26)

12 (a) Express your views of Future Retail Debt Market in India. (Unit-IV, Q.No.1)

OR

(b) What are Debt instruments? Discuss its types. (Unit-IV, Q.No.12,15,16,17)

13. (a) What do you understand by Secondary Market? Explain the functions of stock exchanges. (Unit-V, Q.No.27,33)

OR

(b) Explain the different means of raising money for a business.

Ans :

1. Angel Investing

Angel investors are the influencers who want to invest in a business, which they feel, has the potential to be profitable in the future. However, before approaching an angel investor, you must ensure that you have equipped yourself with a strong business plan. These investors are also forming investor groups to make their research on small businesses more resourceful.

2. Working Capital Loan

These loans are availed by small businesses to meet the short-term needs of liquid cash. When there is a dearth of cash required for daily operations, a working capital loan can be hugely resourceful.

Business funding is granted for half to one year and interest rates range from anywhere between 12%-16% depending on the assessment of credit risk of a business.

3. Term Loan

Term loans are long-term loans applied by a business when investors like a pitch of a business that approached them; they would be willing to finance that idea for credit to meet the capital expenditures of a business and are offered the amount in full. Small business financing has a fixed duration with a lower rate of interest and depends on a business's credit profile. Generally, these are secured by collateral but lenders can also offer them unsecured. They can be anywhere between 15 to 20 years with a fixed or variable rate of interest.

MAHATMA GANDHI UNIVERSITY
FACULTY OF COMMERCE AND BUSINESS MANAGEMENT
B.Com. III Year VI-Semester(CBCS) Examination
(Only General Courses)
May / June - 2019
FINANCIAL INSTITUTIONS AND MARKETS

Time : 3 Hours]

[Max. Marks : 80

PART - A - (5 × 4 = 20 Marks)
[Short Answer Type]

Note : Answer all the questions.

ANSWERS

1. What is a Financial System? (Unit-I, SQA-2)
2. Internet Banking. (July-21, 3rd Answer)
3. What is a bill of exchange?

Ans :

According to the Negotiable Instruments Act 1881, a bill of exchange is defined as “an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument”.

4. Certificate of deposit. (Unit-III, SQA-6)
5. What is Rights Issue? (Unit-V, SQA-10)

PART - B - (5 × 12 = 60 Marks)
[Essay Answer Type]

Note : Answer all the questions.

6. (a) Explain in detail about the functions of Financial System. (Unit-I, Q.No.12)
OR
(b) Explain the role of financial system in economic development of the country. (Unit-I, Q.No.16)
7. (a) Define a Commercial Bank. Explain briefly about the functions of commercial bank. (Unit-II, Q.No.1,4)
OR
(b) Discuss in detail about the nature and functions of merchant Banker. (Unit-II, Q.No.8,10)

8. (a) Write a note on the functions of Reserve Bank of India. (Unit-III, Q.No.26)

OR

- (b) What is Money Market? What are its constituents? (Unit-III, Q.No.1,2)

9. (a) What do you understand by the Debt Market? Discuss its main features. (Unit-IV, Q.No.1,2)

OR

- (b) What is Government Securities Market? Explain its various features. (Unit-IV, Q.No.12)

10. (a) What do you understand by primary Market? Discuss the methods of IPO. (Unit-V, Q.No.3,9)

OR

- (b) Discuss the power and functions of SEBI. (Unit-V, Q.No.43,44)

FACULTIES OF COMMERCE

B.Com. III – Semester (CBCS) Examination

Model Paper - I

FINANCIAL INSTITUTIONS AND MARKETS

(Common paper for General / Honours / Tax Procedures Courses)

Time : 3 Hours]

[Max. Marks : 80

PART - A (5 × 4 = 20 Marks)

[Short Answer Type]

Note: Answer any five of the following questions not exceeding 20 lines each.

ANSWERS

1. Write a short note on role of financial system in country's economic development. (Unit-I, SQA-2)
2. What is Portfolio Management? (Unit-II, SQA-2)
3. What are the differences between Financial Lease and Operating Lease? (Unit-II, SQA-14)
4. What is Repurchase agreement ? (Unit-III, SQA-2)
5. "RBI ACTS AS LENDER OF LAST RESORT" - Explain. (Unit-III, SQA-10)
6. Discuss briefly about Securities Trading Corporation of India. (Unit-IV, SQA-11)
7. Define SEBI. (Unit-V, SQA-14)
8. Employee Stock Ownership Plan (Unit-V, SQA-9)

PART - B (5 × 12 = 60 Marks)

[Essay Answer Type]

Note: Answer all the questions in not exceeding four pages each.

9. (a) Discuss the structure of Indian Financial System. (Unit-I, Q.No. 2)
OR
(b) Give your views on developments in Indian financial system since independence. (Unit-I, Q.No. 18)
10. (a) (i) Define private equity. Explain the various reasons opting private equity. (Unit-II, Q.No. 20)
(ii) Define venture capital. Explain the features of venture capital. (Unit-II, Q.No. 12)
OR
(b) Define Leasing. Explain the advantages and disadvantages of Leasing. (Unit-II, Q.No. 25, 31)
11. (a) What is Money Market? Explain the functions of money market in India. (Unit-III, Q.No. 1, 3)
OR
(b) Brief on the functions of monetary policy committee. (Unit-III, Q.No. 40)

12. (a) Define Government securities. Explain the features of government securities. **(Unit-IV, Q.No. 12)**
- OR
- (b) (i) Explain the classifications of bonds. **(Unit-IV, Q.No. 25)**
(ii) Define Bond ratings. Explain the importance of bond ratings. **(Unit-IV, Q.No. 26)**
13. (a) Define primary market. Explain the function of primary market. **(Unit-V, Q.No. 3)**
- OR
- (b) Give a detailed note on functions of SEBI. **(Unit-V, Q.No. 44)**

FACULTIES OF COMMERCE**B.Com. III – Semester (CBCS) Examination****Model Paper - II****FINANCIAL INSTITUTIONS AND MARKETS****(Common paper for General / Honours / Tax Procedures Courses)****Time : 3 Hours]****[Max. Marks : 80****PART - A (5 × 4 = 20 Marks)****[Short Answer Type]****Note: Answer any five of the following questions not exceeding 20 lines each.****ANSWERS**

- | | |
|--|--------------------|
| 1. What are ADR's and GDR's? | (Unit-I, SQA-3) |
| 2. What are the basic principles of lending? | (Unit-II, SQA-1) |
| 3. Define Merchant banking. | (Unit-II, SQA-6) |
| 4. Monetary policy committee | (Unit-III, SQA-13) |
| 5. Explain briefly about Marginal Standing Facility (MSF). | (Unit-III, SQA-12) |
| 6. Describe the risk associated with debt market. | (Unit-IV, SQA-4) |
| 7. Red herring prospectus | (Unit-V, SQA-7) |
| 8. Define primary market | (Unit-V, SQA-2) |

PART - B (5 × 12 = 60 Marks)**[Essay Answer Type]****Note: Answer all the questions in not exceeding four pages each.**

- | | |
|---|--------------------------|
| 9. (a) Explain the various components of Indian financial system. | (Unit-I, Q.No. 3) |
| OR | |
| (b) Describe the various functions of financial system. | (Unit-I, Q.No. 12) |
| 10. (a) Define Non-banking Finance Companies Explain the classification of Non-banking Finance Companies. | (Unit-II, Q.No. 35) |
| OR | |
| (b) Describe the functions of merchant banker. | (Unit-II, Q.No. 10) |
| 11. (a) What is RBI? Elaborate the various functions of Reserve Bank of India. | (Unit-III, Q.No. 24, 26) |
| OR | |
| (b) Explain briefly about various Money market instruments. | (Unit-III, Q.No. 11) |

12. (a) (i) Explain the advantages of government securities. **(Unit-IV, Q.No. 14)**
(ii) Define Primary Dealer. Explain briefly about objectives of Primary Dealers in Government Securities. **(Unit-IV, Q.No. 20)**

OR

- (b) (i) What do you understand by Money Market and Debt Market in India. **(Unit-IV, Q.No. 6)**
(ii) Distinguish between Money Market and Debt Market. **(Unit-IV, Q.No. 7)**
13. (a) Define Stock Exchange. Explain the various functions of stock exchange. **(Unit-V, Q.No. 31, 33)**

OR

- (b) What is SEBI? Describe the objectives of SEBI. **(Unit-V, Q.No. 40, 42)**

FACULTIES OF COMMERCE**B.Com. III – Semester (CBCS) Examination****Model Paper - III****FINANCIAL INSTITUTIONS AND MARKETS****(Common paper for General / Honours / Tax Procedures Courses)****Time : 3 Hours]****[Max. Marks : 80****PART - A (5 × 4 = 20 Marks)****[Short Answer Type]****Note: Answer any five of the following questions not exceeding 20 lines each.****ANSWERS**

- | | |
|--|--------------------|
| 1. Write about Indian Financial system focusing on financial services. | (Unit-I, SQA-1) |
| 2. "Banker acts as an agent to the customer" | (Unit-II, SQA-4) |
| 3. Merits of leasing for a lessee and lessor. | (Unit-II, SQA-15) |
| 4. Explain various promotional functions of RBI. | (Unit-III, SQA-15) |
| 5. Define Money market. | (Unit-III, SQA-3) |
| 6. What is government securities markets? Discuss its features. | (Unit-IV, SQA-1) |
| 7. Initial Public Offering (IPO) | (Unit-V, SQA-4) |
| 8. Protective Functions of SEBI | (Unit-V, SQA-15) |

PART - B (5 × 12 = 60 Marks)**[Essay Answer Type]****Note: Answer all the questions in not exceeding four pages each.**

- | | |
|--|--------------------------|
| 9. (a) Describe the working of flow of funds matrix. | (Unit-I, Q.No. 13) |
| OR | |
| (b) Discuss the deficiencies of Indian financial system. | (Unit-I, Q.No. 19) |
| 10. (a) Define Commercial Banks. Bringout the characteristics features of a commercial banks. | (Unit-II, Q.No. 1) |
| OR | |
| (b) Explain the different types of leasing. | (Unit-II, Q.No. 27) |
| 11. (a) Explain the structure of Indian money market. | (Unit-III, Q.No. 8) |
| OR | |
| (b) What do you mean by Treasury Bills Market ? Discuss the advantages and disadvantages of Treasury Bills Market. | (Unit-III, Q.No. 19, 20) |

12. (a) Classify the various types of debt instruments. **(Unit-IV, Q.No. 8)**

OR

- (b) What is bond? Explain the objectives and features of bond. **(Unit-IV, Q.No. 22, 23)**

13. (a) "The Indian stock market is suffering from many limitations".
What are they? **(Unit-V, Q.No. 39)**

OR

- (b) Define the following terms :

(i) ESOP **(Unit-V, Q.No. 19)**

(ii) Sweat Equity **(Unit-V, Q.No. 18)**

(iii) Right Issue **(Unit-V, Q.No. 23)**