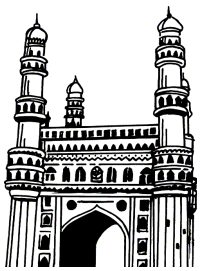
Rahul's ✔
Topper's Voice

R19
New Syllabus



JNTU (H)
MBA

II Year III Semester

Latest 2021 Edition

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

- ☞ **Study Manual**
- ☞ **Short Question & Answers**
- ☞ **FAQ's and Important Questions**
- ☞ **Internal Assessment**
- ☞ **Solved Previous Question Papers**
- ☞ **Solved Model Papers**

Price
₹. 179-00

- by -

WELL EXPERIENCED LECTURER

***Rahul Publications*®**
Hyderabad. Ph : 66550071, 9391018098

All disputes are subjects to Hyderabad Jurisdiction only

JNTU(H) MBA

II Year III Semester

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

Inspite of many efforts taken to present this book without errors, some errors might have crept in. Therefore we do not take any legal responsibility for such errors and omissions. However, if they are brought to our notice, they will be corrected in the next edition.

© *No part of this publications should be reporduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording and/or otherwise without the prior written permission of the publisher*

Price `. 179-00

Sole Distributors :

☎ : **66550071, Cell : 9391018098**

VASU BOOK CENTRE

Shop No. 3, Beside Gokul Chat, Koti, Hyderabad.

Maternity Hospital Opp. Lane, Narayan Naik Complex, Koti, Hyderabad.

Near Andhra Bank, Subway, Sultan Bazar, Koti, Hyderabad -195.

CONTENTS

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

STUDY MANUAL

FAQ's and Important Questions	**V - IX**
Unit - I	**1 - 52**
Unit - II	**53 - 125**
Unit - III	**126 - 172**
Unit - IV	**173 - 218**
Unit - V	**219 - 256**
Internal Assessment	**257 - 259**

SOLVED PREVIOUS QUESTION PAPERS

October / November - 2020	**260 - 260**
April / May - 2019	**261 - 262**
December - 2019	**263 - 264**
December - 2018	**265 - 266**

SOLVED MODEL PAPERS

Model Paper - I	**267 - 267**
Model Paper - II	**268 - 268**
Model Paper - III	**269 - 269**

SYLLABUS

UNIT – I

Introduction: The structure of Indian financial system; Equilibrium in financial markets; Indicators of Financial Development, Structure of Financial Institutions, Financial system and economic development; Financial Sector reforms after 1991 – Recent Developments of Indian Financial System.

Regulatory and Promotional Institutions: Function and Role of RBI, Monetary Policy and techniques of monetary control of RBI, Major Changes in Monetary Policy. The role and functions of SEBI. An update on the performance on Non-statutory Financial organization like IFCI, IRBI, IDFC, NABARD, SIDBI, and SFCs.

UNIT – II

Banking and Non Banking Institutions: Commercial banks – Growth and structure of commercial Banks- competition, interest rates, spreads, and NPAs. Bank capital – adequacy norms and capital market support. Banking Innovations- e-banking- Risk Management in Banking. Co-operative banksFeatures, Structure and Growth, Government initiatives to strengthen the co-operative banks.

Non-banking financial Institutions: Structure and functioning of Unit Trust of India and Mutual Funds. Growth of Indian Mutual funds and its Regulation. The Role of AMFI. Insurance Companies – Structure and Investment Pattern of Public and Private Sector insurance companies, Competition, innovation, Role of IRDA, Challenges of Insurance Sector in India.

UNIT – III

Financial and Securities Markets: Structure and functions of Call Money Market, Government Securities Market – T-bills market, Commercial Bills market, Commercial paper and certificate of deposits- Securities markets – Organization and structure, Listing trading and settlement. SEBI and Regulation of Primary and Secondary Markets. Role and functions of Clearing Corporation of India Ltd.

UNIT – IV

Asset /Fund Based Financial Services : Lease Finance- Conceptual and Regulatory Framework, Classification and Financial leasing, Hire Purchase and Consumer Credit, Factoring and Forfeiting, Housing finance, Venture capital financing.

UNIT – V

Fee-based / Advisory Services: Investment Banking – Introduction, Functions and activities of Merchant bankers, Lead Managers, underwriting, bankers to an issue, debenture trustees, portfolio managers. Challenges faced by investment bankers. Stock broking, Custodial Services, Depository system, Credit rating – Role of agencies, Process, regulations. CIBIL

Contents

UNIT - I

Topic		Page No.
1.1	Financial System	1
	1.1.1 Introduction	1
	1.1.2 The Structure of Indian Financial System	2
1.2	Equilibrium in Financial Markets	6
1.3	Indicators of Financial Development	7
1.4	Structure of Financial Institutions	9
1.5	Financial System and Economic Development	10
1.6	Financial Sectors Reforms after 1991	13
	1.6.1 Recent Developments in Indian Financial System	18
1.7	Regulatory and Promotional Institutions	19
	1.7.1 Reserve Bank of India	19
	1.7.2 Functions of RBI	20
	1.7.3 Roles of RBI	21
1.8	Monetary Policy	23
	1.8.1 Techniques of Monetary Control of RBI	26
	1.8.2 Major Changes in Monetary Policy	33
1.9	Securities Exchange Board of India (SEBI)	33
	1.9.1 Role of SEBI	33
	1.9.2 Functions of SEBI	34
1.10	An Update on the Performance on Non-Statutory Financial Organization	37
	1.10.1 Industrial Finance Corporation of India (IFCI)	40
	1.10.2 Industrial Reconstruction Bank of India (IRBI)	44
	1.10.3 Infrastructure Development Finance Company (IDFC)	45
	1.10.4 National Bank for Agriculture and Rural Development (NABARD)	45
	1.10.5 Small Industries Development Bank of India (SIDBI)	46
	1.10.6 State Finance Corporation (SFCs)	47
➢	Short Question & Answers	49 - 52

Topic **Page No.**

UNIT - II

2.1 Banking Structure in India 53
2.2 Commercial Banks 56
2.2.1 Organizational Structure of Commercial Banks 59
2.2.2 Growth of commercial bank 61
2.3 Competition in Banking Sector 67
2.4 Interest Rate 68
2.5 Spreads 70
2.6 Non-Performing Assets 70
2.7 Bank Capital 75
2.7.1 Adequacy Norms and capital market support 75
2.8 Banking Innovations 77
2.8.1 E-banking 79
2.8.2 Risk Management in E-banking 81
2.9 Cooperative Banks 86
2.9.1 Features of Co-operative Banks 86
2.9.2 Structure of Co-operative Banks 89
2.9.3 Growth of Co-operative Banks 90
2.9.4 Govt. Initiatives to Strengthen the Co-operative Banks 91
2.10 Non-banking Financial Institutions (NBFI) 93
2.11 Unit Trust of India 95
2.11.1 Structure of UTI 96
2.11.2 Functioning of UTI 97
2.12 Mutual Funds 98
2.12.1 Structure of Mutual Funds 99
2.12.2 Growth of mutual funds 100
2.12.3 Regulation of Mutual Funds 102
2.13 Role of AMFI 105
2.14 Insurance Companies 106
2.14.1 Structure and Investment Pattern of Public Sector and Private Sector 110
2.15 Competition and Innovation in Insurance Industry 115

Topic		Page No.
2.16	Insurance Regulatory and Development Authority (IRDA)	118
2.17	Challenges of Insurance Sector in India	120
➢	Short Question & Answers	121 - 125
	UNIT - III	
3.1	Financial Markets	126
3.2	Call Money Market	128
	3.2.1 Structure and Functions of Call Money Market	128
3.3	Treasury Bills Market	131
3.4	Commercial Bills Markets	134
3.5	Commercial Paper	137
3.6	Certificate of Deposits	140
3.7	Government Securities	143
3.8	Security Market	150
	3.8.1 Organization and Structure	150
	3.8.2 Listing, Trading and Settlement	154
3.9	Security Exchange Board of India (SEBI)	161
	3.9.1 SEBI Role in Primary Market	164
	3.9.2 SEBI Role in the Secondary Market	165
3.10	Clearing Corporation of India Limited	167
➢	Short Question & Answers	169 - 172
	UNIT - IV	
4.1	Asset / Fund Based Financial Services	173
4.2	Lease Finance	173
	4.2.1 Classification and Financial Leasing	175
	4.2.2 Conceptual and Regulatory Frame-work of Leasing	181
4.3	Hire Purchase	184
4.4	Consumer Credit	189
4.5	Factoring	193
4.6	Forfeiting	198
4.7	Housing Finance	202

Topic **Page No.**

4.8 Venture Capital Financing 207

➢ Short Question & Answers ..... 215 - 218

UNIT - V

5.1 Fee-based Advisory Services 219

5.2 Investment Banking 220

5.2.1 Introduction 220

5.2.2 Functions of Merchant Bankers 221

5.3 Activities of Merchant Bankers 226

5.3.1 Lead Managers 226

5.3.2 Underwriting 228

5.3.3 Bankers to an Issue 228

5.3.4 Debenture Trustees 229

5.3.5 Portfolio Managers 232

5.4 Challenges Faced by Investment Bankers 233

5.5 Stock Broking 234

5.6 Custodial Services 237

5.7 Depository System 239

5.8 Credit Rating 240

5.8.1 Role of Credit Rating Agencies 244

5.8.2 Credit Rating Process 248

5.8.3 Regulations of Credit Ratings 249

5.8.4 Credit Information Bureau India Limited (CIBIL) 252

➢ Short Question & Answers ..... 254 - 256

Frequently Asked & Important Questions

UNIT - I

1. Define financial system. Discuss the functions of financial system.

Ans : **(Aug.-17, Imp.)**

Refer Unit-I, Q.No. 1.

---

2. Discuss the structures of Indian Financial System.

Ans : **(Jan.-18, Feb.-12, Aug.-12, Imp.)**

Refer Unit-I, Q.No. 2.

---

3. What is meant by equilibrium in financial markets?

Ans : **(May-19, Imp.)**

Refer Unit-I, Q.No. 5.

---

4. Discuss the indicators of financial development.

Ans : **(June-18, Feb.-15, Imp.)**

Refer Unit-I, Q.No. 6.

---

5. Explain the financial sectors reforms after 1991.

Ans : **(May-19, June-18, Imp.)**

Refer Unit-I, Q.No. 11.

---

6. Discuss the role of RBI in banking sector ?

Ans : **(May-19, June-18, Imp.)**

Refer Unit-I, Q.No. 16.

---

7. Define Monetary policy. Explain the objectives of Monetary policy.

Ans : **(May-19, Dec.-18, Imp)**

Refer Unit-I, Q.No. 18.

---

8. Discuss the various techniques of monetary control of RBI.

Ans : **(Oct.-20, May-19, Dec.-18, Imp.)**

Refer Unit-I, Q.No. 21.

---

9. Define SEBI. Explain the objectives and role of SEBI.

Ans : **(Dec.-19, Feb.-17, Imp.)**

Refer Unit-I, Q.No. 28.

10. Discuss briefly about IFCI.

Ans : **(Dec.-19)**

Refer Unit-I, Q.No. 35.

11. Explain the functions of NABARD.

Ans : **(Feb.-15, Feb.-13)**

Refer Unit-I, Q.No. 41.

UNIT - II

1. Define Bank. Explain the structure of Banking in India.

Ans : **(Feb.-17, Aug.-15, Aug.-12, Imp.)**

Refer Unit-II, Q.No. 1.

2. Explain the organizational structure of commercial banks.

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

Refer Unit-II, Q.No. 4.

3. Discuss briefly about capital adequacy.

Ans : **(Feb.-16, Imp.)**

Refer Unit-II, Q.No. 22.

4. Discuss the Recent innovations in banking sector.

Ans : **(May-19, Dec.-19, Aug.-15, Imp.)**

Refer Unit-II, Q.No. 24.

5. Explain the functioning of UTI.

Ans : **(Feb.-16, Sep.-16, Imp.)**

Refer Unit-II, Q.No. 42.

6. Explain the facilities of mutual funds available to investor.

Ans : **(Dec.-18)**

Refer Unit-II, Q.No. 48.

7. What is AMFI ? Explain the Role of AMFI.

Ans : **(May.-19)**

Refer Unit-II, Q.No. 49.

8. Explain the Role of IRDA.

Ans : **(Oct.-20, May-19)**

Refer Unit-II, Q.No. 62.

9. Discuss the various challenges faced by the Insurance sector.

Ans : **(May-19, Imp.)**

Refer Unit-II, Q.No. 64

UNIT - III

1. Define Call money market. Explain structure and Functions of a Call Money Market.

Ans : **(Oct.-20, May-19, Jan-18, Aug.-17, Feb.-15)**

Refer Unit-III, Q.No. 4.

2. Define Treasury bill market? Explain the features of treasury bill market?

Ans : **(Oct.-20, Dec.-19, May-19)**

Refer Unit-III, Q.No. 6.

3. What are the types of treasury bill market.

Ans : **(Dec.-19)**

Refer Unit-III, Q.No. 7.

4. What is commercial papers? What are its features?

Ans : **(Dec.-19, Aug.-16, Aug.-16)**

Refer Unit-III, Q.No. 14.

5. What are certificate of deposits? Explain the features of certificate of deposits?

Ans : **(May-19, Dec.-19, Dec.-18)**

Refer Unit-III, Q.No. 18.

6. Explain the Listing, Trading and Settlement procedure in stock market.

Ans : **(Ferb.-17, Feb.-15)**

Refer Unit-III, Q.No. 30.

7. Elaborate the protective and develop-ment functions of SEBI.

Ans : **(Imp.)**

Refer Unit-III, Q.No. 43.

8. Explain how SEBI regulates primary markets in India.

Ans : **(May-19, Dec.-18, Sep.-16, Aug.-15)**

Refer Unit-III, Q.No. 44.

9. Elucidate the SEBI guidelines for regulation of secondary markets in India.

Ans : **(May-19, Dec.-18, Sep.-16, Aug.-15)**

Refer Unit-III, Q.No. 45

UNIT - IV

1. What is lease finance? Explain the characteristics of leasing.

Ans : **(May-19, Dec.-19, Aug.-19, Aug.-17, Imp.)**

Refer Unit-IV, Q.No. 2.

2. Explain the classification of leasing.

Ans : **(Oct.-20, Dec.-19, May-19, June-18, Imp.)**

Refer Unit-IV, Q.No. 4.

3. Differences between Financial Lease and Operating Lease.

Ans : **(Dec.-19)**

Refer Unit-IV, Q.No. 5.

4. What do you mean by Hire Purchase? Explain the features of Hire Purchase.

Ans : **(May-19, Dec.-18, Imp.)**

Refer Unit-IV, Q.No. 12.

5. Differentiate between Hire Purchase and Lease Financing.

Ans : **(May-19, Dec.-18, Feb.-12)**

Refer Unit-IV, Q.No. 15.

6. Explain the classification of consumer credit.

Ans : **(Sep.-16, Imp.)**

Refer Unit-IV, Q.No. 17.

7. Compare and contrast Factoring and Forfeiting.

Ans : **(May-19, Feb.-16, Imp.)**

Refer Unit-IV, Q.No. 33.

8. What is Venture Capital Financing? Explain the characteristics of Venture Capital Financing.

Ans : **(Oct.-20, Dec.-18, Aug.-17, Imp.)**

Refer Unit-IV, Q.No. 40.

9. Discuss the strategic role of Venture Capital financing in the development of a country.

Ans : **(Dec.-18, Imp.)**

Refer Unit-IV, Q.No. 44

UNIT - V

1. Define merchant banking. Explain the evolution of merchant banking.

Ans : **(May-19, Imp.)**

Refer Unit-V, Q.No. 2.

2. Explain the functions of merchant bankers.

Ans : **(Imp.)**

Refer Unit-V, Q.No. 3.

3. Who is a Debenture Trustee ? Explain briefly the responsibilities and obligations of a Debenture Trustee.

Ans : **(Imp.)**

Refer Unit-V, Q.No. 9.

4. Explain the challenges faced by the Investment Bankers.

Ans : **(May-19, Imp.)**

Refer Unit-V, Q.No. 12.

5. Define credit rating ? Explain the nature of credit rating.

Ans : **(Oct.-20, June-18, Imp.)**

Refer Unit-V, Q.No. 19.

6. Briefly describe the top three Indian credit rating agencies.

Ans : **(Dec.-19, May-19, Imp.)**

Refer Unit-V, Q.No. 24.

7. Outline the steps involved in credit rating process.

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

Refer Unit-V, Q.No. 26.

8. What is CIBIL? Who are its members? What are the objectives of CIBIL?

Refer Unit-V, Q.No. 28.

UNIT I

Introduction: The structure of Indian financial system; Equilibrium in financial markets; Indicators of Financial Development, Structure of Financial Institutions, Financial system and economic development; Financial Sector reforms after 1991 – Recent Developments of Indian Financial System.

Regulatory and Promotional Institutions: Function and Role of RBI, Monetary Policy and techniques of monetary control of RBI, Major Changes in Monetary Policy. The role and functions of SEBI. An update on the performance on Non-statutory Financial organization like IFCI, IRBI, IDFC, NABARD, SIDBI, and SFCs.

1.1 FINANCIAL SYSTEM

1.1.1 Introduction

Q1. Define financial system. Discuss the functions of financial system.

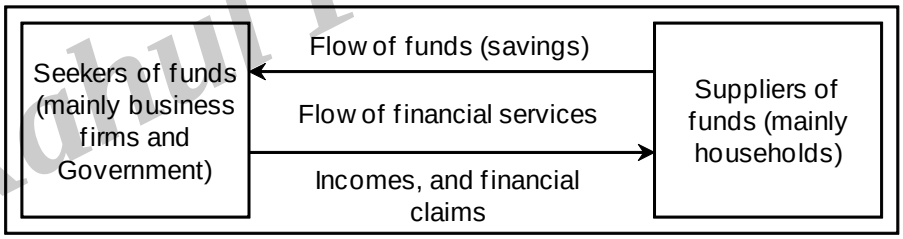
(OR)

What do you understand by financial system? Explain the functions of financial system.

Ans : **(Aug.-17, Imp.)**

Financial System of any country consists of financial markets, financial intermediation and financial instruments or financial products.

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.



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.

Functions

The functions of financial system are given below :

1. Pooling of Funds

In a financial system, the Savings of people are transferred from households to business organizations. With these production increases and better goods are manufactured, which increases the standard of living of people.

2. Capital Formation

Business require finance. These are made available through banks, households and different financial institutions. They mobilize savings which leads to Capital Formation.

Rahul Publications

3. Facilitates Payment

The financial system offers convenient modes of payment for goods and services. New methods of payments like credit cards, debit cards, cheques, etc. facilitates quick and easy transactions.

4. Provides Liquidity

In financial system, liquidity means the ability to convert into cash. The financial market provides the investors the opportunity to liquidate their investments, which are in instruments like shares, debentures, bonds, etc. Price is determined on the daily basis according to the operations of the market force of demand and supply.

5. Short and Long Term Needs

The financial market takes into account the various needs of different individuals and organizations. This facilitates optimum use of finances for productive purposes.

6. Risk Function

The financial markets provide protection against life, health and income risks. Risk Management is an essential component of a growing economy.

7. Better Decisions

Financial Markets provide information about the market and various financial assets. This helps the investors to compare different investment options and choose the best one. It helps in decision making in choosing portfolio allocations of their wealth.

8. Finances Government Needs

Government needs huge amount of money for the development of defense infrastructure. It also requires finance for social welfare activities, public health, education, etc. This is supplied to them by financial markets.

9. Economic Development

India is a mixed economy. The Government intervenes in the financial system to influence macroeconomic variables like interest rate or inflation. Thus, credits can be made available to corporate at a cheaper rate. This leads to economic development of the nation.

Rahul Publications

1.1.2 The Structure of Indian Financial System

Q2. Discuss the structures of Indian Financial System.

(OR)

Explain the structure of financial system.

(OR)

Explain the financial system in India.

Ans : **(Jan.-18, Feb.-12, Aug.-12, 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 financial system
2. Unorganized financial system.

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

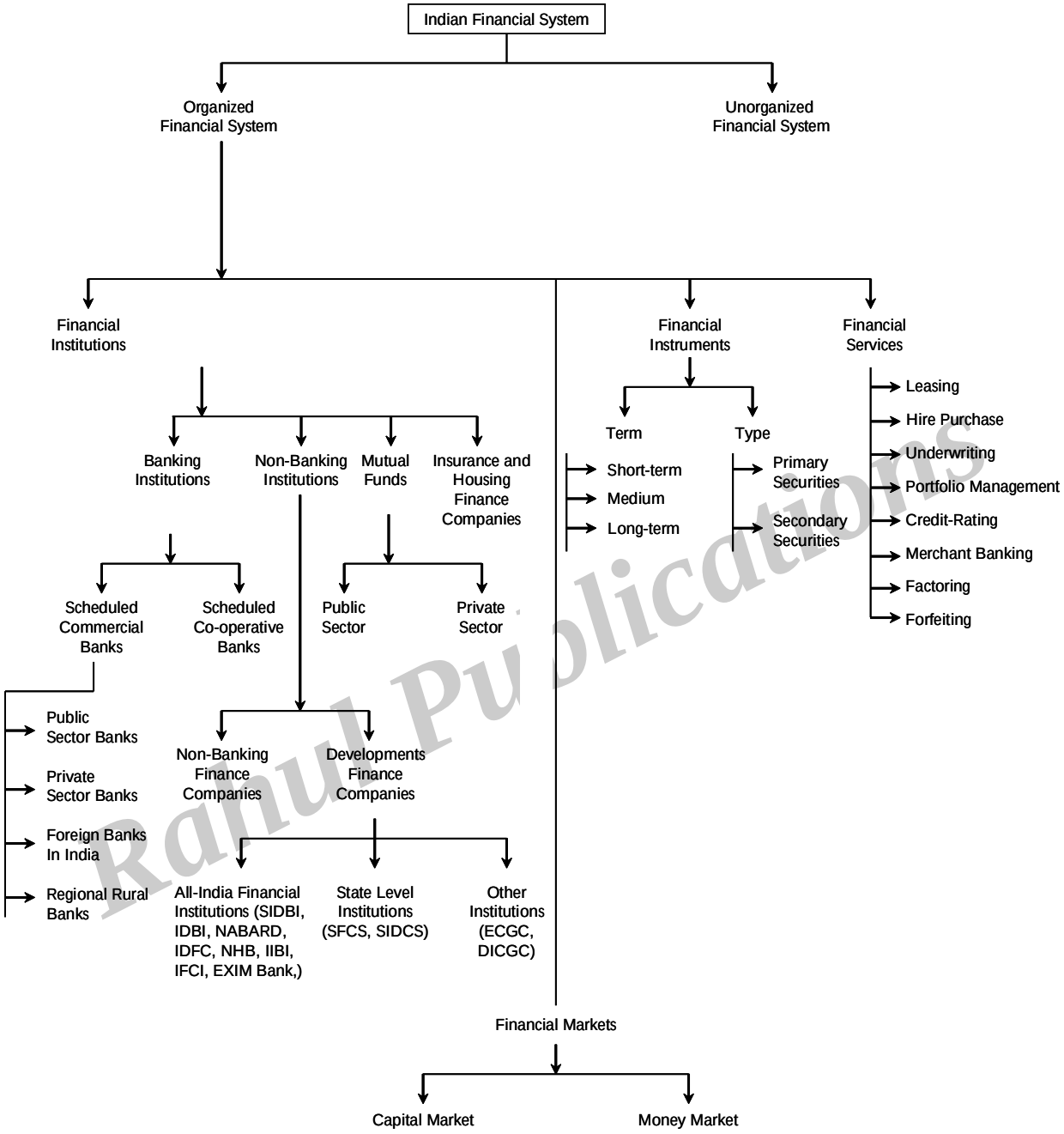


Fig.: Structure of the Indian Financial System

1. Organized Financial System

The organized 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,

Rahul Publications

(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:

(a) Primary (or) direct securities.

(b) Secondary (or) indirect securities.

(a) Primary Securities

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

Example: Shares and debentures issued directly to the public.

(b) 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:

(a) Short-term securities

(b) Medium-term securities

(c) Long-term securities.

(a) Short-term securities

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

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

(b) 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.

Rahul Publications

(c) 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 mobilized 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 mobilize the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

2. Unorganized 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.

Q3. Explain the characteristics features of financial system.

Ans : **(Dec.-18)**

The following are the characteristics features of financial system are :

(i) 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.

(ii) 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.

(iii) 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.

Rahul Publications

Q4. What are the objectives of financial system?

Ans :

The following are the objectives of financial system are :

i) Facilitate Payment

The financial system facilitates payment through banks and any other financial institution. Anything we buy or sale requires the transection of money. That is done by the financial system

ii) It Link Between Saver and Investor

The financial system provides a place where saver and investor meets. Saver saves money and investors invest it in different types of stocks to get profit on it.

iii) Helps in Capital Formation

For capital formation, there should be a good financial system that provides the finance timely and in an appropriate amount.

iv) To Ensure Safety on Investment

The financial system has different institutions for the proper supervision of the financial market that controls the market. So, the safety of the investment can be done.

v) Helps in the Growth of the Economy

Proper mobilization of funds and proper control in the financial market helps the business to grow and motivate investors to invest. That helps in the growth of the economy.

1.2 Equilibrium in Financial Markets

Q5. What is meant by equilibrium in financial markets?

(OR)

What do you mean by equilibrium in financial markets?

Ans : **(May-19, Imp.)**

The equilibrium in financial markets is usually determined by assuming that there would be perfect competition, and by using the well-known tool of supply and demand.

Financial markets are said to be perfect when,

a) A large number of savers and investor operate in markets

b) There are no taxes

c) The participants in markets have homogeneous expectations

d) The financial assets are infinitely divisible

e) All operators in the market are well-informed and information is freely available to all of them

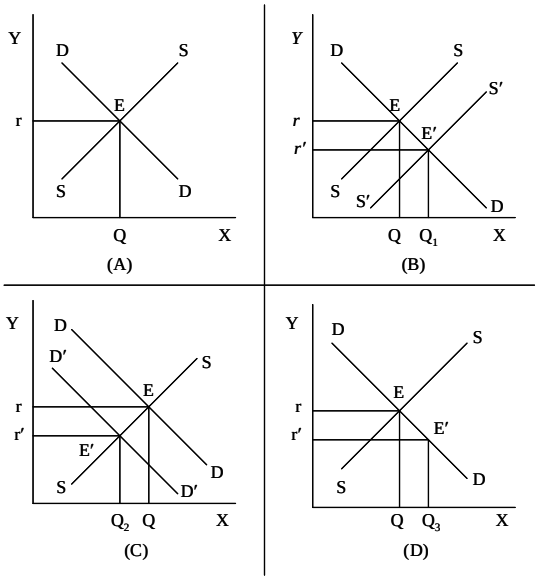
f) The savers and investors are rational

Under these ideal conditions, the financial markets attain the equilibrium position when the supply and demand are equal to each other. The supply curve and demand curve intersect with each other. Here the supply and demand for loanable funds which determine the equilibrium rate of interest.

Equilibrium in financial markets is established when the expected demand for funds for short-term and long-term investments matches with the planned supply of funds generated out of saving and credit creation. The equality of total desired borrowing with the total desired lending is necessary for establishing equilibrium rate of interest.

The figure SS curve shows the aggregate supply of funds and DD curve shows the aggregate demand for funds. Their intersection point E, reflects the equilibrium position at which Q amount of funds will be supplied and demanded at the equilibrium rate of interest, r. It is to be noted that the supply curve slopes upward from left to right, which means that as the rate of interest increases/decreases, more/less funds would be made available in the financial system. The demand curve slopes downward from left to right, which means that as the rate of interest increases, the demand for finance would decline.

Rahul Publications



Figure

The shifts in either the supply curve or the demand curve or both would result in changes in the market equilibrium. The figures b and c show the effect of the shift in the supply curve and demand curve respectively. In figure b when the supply curve shifts to the right i.e., when the supply of funds increases, other things being the same the equilibrium rate of interest declines from r to r^1.

Determinants of Supply and Demand for Funds

The determinants of supply and demand for funds has been dealt within theoretical and empirical studies that mention a variety of factors and emphasis them differently. One of the major determinants of supply of funds is the aggregate savings by the household sector, business sector and the government sector, in a given economy. The saving of the economic unit is equal to the difference between its disposable income and the consumption expenditure in a given year. A variety of factors have a bearing on the volume of savings in the economy.

Supply and Demands

The level of current and expected income, cyclical changes in income, age wise variations in income, distribution of income in the economy, degree of certainty of income, wealth, inflation, desire to provide for old age, family members, contingencies, thrift, rate of interest and availability of savings media with preferred investment characteristics, are the relevant factors in this respect. Another major determinant of supply of funds is the development of banks and other financial institutions which, in turn, determine the credit multiplier.

The demand for funds depends upon,

1. Investment in fixed and circulating (working) capital.
2. Demand for consumer durables and
3. Investment in housing.

The total investment demand, in turn, is determined by,

1. The current level of capital stock.
2. Capacity utilization.
3. The desired capital stock, which is influenced by business expectations (prospects) regarding future demand for goods (sales), prices, government policies and profitability.
4. Availability of internal funds.
5. Cost of funds and
6. Technological changes.

The demand for consumer durables depends upon,

1. Changes in tastes and preferences.
2. Fashion.
3. Demonstration effect and
4. Cost of funds.

1.3 INDICATORS OF FINANCIAL DEVELOPMENT

Q6. Discuss the indicators of financial development.

Ans : **(June-18, Feb.-15, Imp.)**

Financial development plays a vital role in promoting industrialization and growth. Financial development has 'caused' economic growth in India since 1996. The key factor for effective financial system is with strong financial system and institution frame work at globally and domestic as well as home country.

Rahul Publications

Financial developments are subject to high degree of risk of varying future. Financial development in the development of world economy. With the emergence of e-finance makes the world to provide a high rate of growth. With emergence of this its own difference from the risk generally associated with financial system.

Financial development involves improvements in,

1) Producing information about possible investments and allocating capital.
2) Monitoring firms and exerting corporate governance.
3) Trading, diversification and management of risk.
4) Mobilisation and pooling of savings.
5) Easing the exchange of goods and services.

These financial functions influence savings and investment decisions and technological innovations and hence economic growth.

Indicators

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.

Rahul Publications

1.4 STRUCTURE OF FINANCIAL INSTITUTIONS

Q7. Explain about the structure of financial institutions.

Ans :

Financial Institutions are intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner.

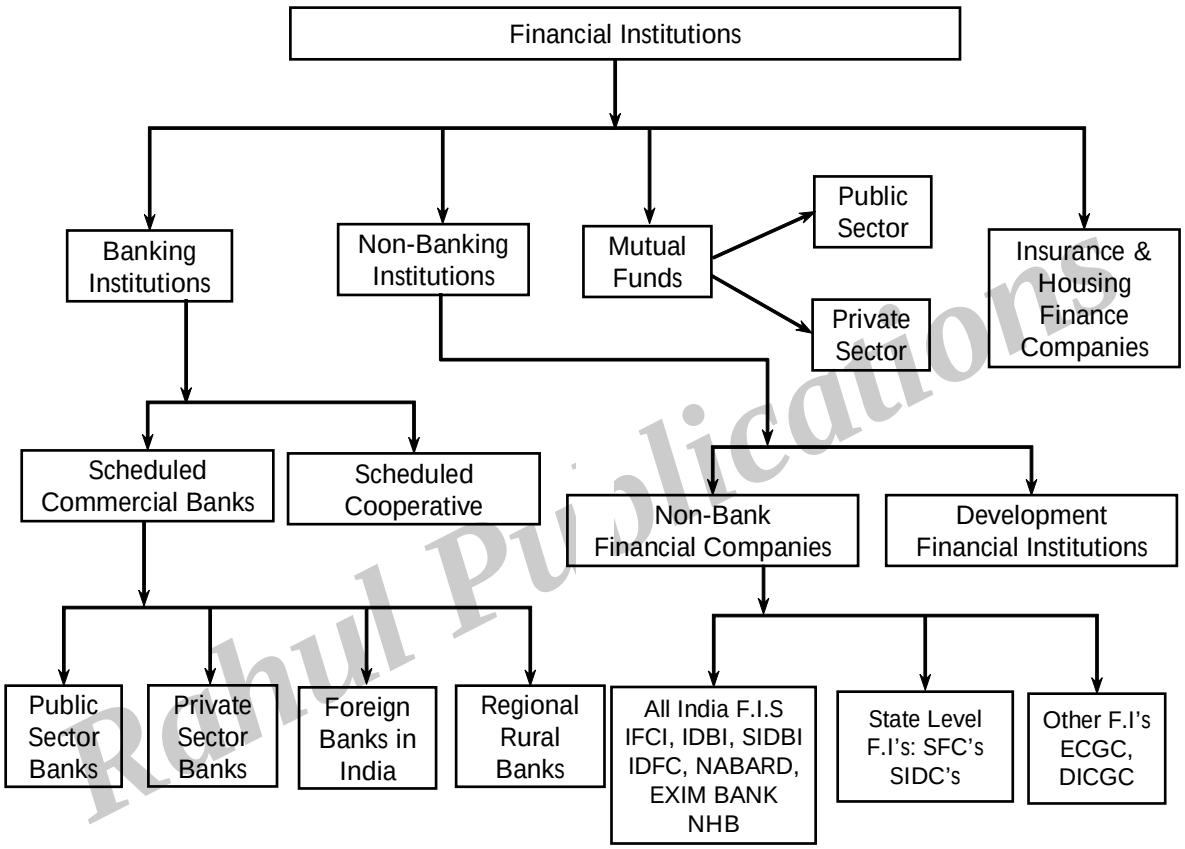


Fig.: Structure of Financial Institutions

Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are creators and purveyors of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the Developmental Financial Institutions (DFIs), and Non-Banking Financial Companies (NBFCs) as well as Housing Finance Companies (HFCs) are the major institutional purveyors of credit.

The Development Financial Institutions (DFIs) were established in India to resolve a typical market inadequacy problem, viz., the shortage of long-term resources and the perceived risk aversion of savers and creditors to part with funds of long gestation projects. In view of the inadequate provision of long term finance through banks and markets, many of these institutions were established by the government. The endorsement of planned industrialisation at the national level provided critical inducement for the establishment of DFIs at both the all-India and state levels.

Rahul Publications

Besides DFIs at both the all-India and state levels, there are also investment institutions and specialised financial institutions. These institutions provided financial assistance in the form of term loans, underwriting/direct subscription to shares/ debentures and guarantees.

(i) Banking Institutions

Mobilise the savings of the people. They provide a mechanism for the smooth exchange of goods and services. They extend credit while lending money. They not only supply credit but also create credit. There are two basic categories of banking institutions. They are Scheduled Commercial Banks, Scheduled Cooperative Banks. The banking system in India consists of scheduled commercial banks and scheduled cooperative banks, but it is the former which is dominant in terms of deposits, advances and investments. Commercial banks include foreign banks operating in India in addition to Indian banks in the public sector and the private sector, including regional rural banks. Since 1969, after nationalisation of 14 banks, commercial banks have made rapid strides in all the spheres of banking operations. Be it, the mobilisation of deposits, deployment of credit or geographical coverage they have accounted for most of the growth in the banking system.

(ii) Non-Banking Institutions

The Non-Banking Financial Institutions also mobilize financial resources directly or indirectly from the people. They lend the financial resources mobilized. They lend funds but do not create credit. Companies like LIC, GIC, UTI, Development Financial Institutions, Organisation of pension and Provident Funds etc. Fall in this category. The other non-banking financial institutions can be categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions (EXIM Bank etc.) investment institutions, state level institutions etc. Non-Banking Financial Companies (NBFCs) have emerged as an important part of the Indian Financial System. These companies have grown rapidly in the second half of the eighties and the first half of the nineties

(iii) Mutual Funds

Mutual funds provide households an option for portfolio diversification and relative risk-aversion through collection of funds from the households and make investments in the stock and debt markets

(iv) Insurance and Housing Finance Companies

Insurance is a contract in which a sum of money is paid by the assured in consideration of the insurer's incurring the risk of paying a large sum upon a given contingency.

The insurance companies that are available in India are,

(i) Life insurance companies

(ii) General insurance companies

(iii) Reinsurance companies

(iv) Captive insurance companies.

1.5 Financial System and Economic Development

Q8. Discuss the role of financial system of economic development.

(OR)

Explain the role of financial system in achieving economic development in India.

Ans : **(Dec.-18)**

- The importance of finance in development depends upon the desired nature of development. In the environment-friendly, appropriate technology based, decentralized Alternative Development Model, finance is. not a factor of crucial or critical importance. But even in a conventional model of modern industrialism, the perceptions in this regard vary a great deal.
- One view holds that finance is not important at all. The opposite view regards it to be very important.

Rahul Publications

Effects of Financial System on Saving and Investment

- The production function is the link between finance and economic development. It has been argued that men, materials, and money are crucial inputs in production activities.
- The human capital and physical capital can be bought and developed with money. In a sense, therefore, money, credit, and finance are the life-blood of the economic system.
- Given the real resources and suitable attitudes, a well-developed financial system can contribute significantly to the acceleration of economic development through three routes.
- First, technical progress is endogeneous; human and physical capital are its important sources; and the increase in them require higher saving and investment, which the financial system helps to achieve.
- Second, the financial system contributes to growth not only via technical progress but also in its own right.
- The economic development greatly depends on the rate of capital formation.
- The relationship between capital and output is strong, direct, and monotonic (the position which is sometimes referred to as "capital fundamentalism").
- Now, the capital formation depends on whether finance is made available in time, in adequate quantity, and on favorable terms all of which a good financial system could achieve.
- Third, it also enlarges the markets over space and time; it enhances the efficiency of the function of medium of exchange and thereby helps in economic development
- The importance of finance and financial system in economic development can be understood better we study various theories of the impact of financial, development on savings and investment.

Q9. Give a brief explanation about the various theories those discuss about the relationship between financial system and economic development.

Ans :

The following theories are relevant in this context:

i) Prior Voluntary Saving Theory,

ii) Credit Creation Theory,

iii) Forced Saving (or) Inflationary Financing Theory.

i) Prior Savings Theory

The Prior Savings Theory (PST) regards saving as a prerequisite or a determinant of investment, and it holds that all savings in the economy can find investment outlets. It stresses the need for appropriate monetary policy and fiscal policy for promoting and mobilizing savings voluntarily for investment and growth. It is believed that since investment is an alternative to consumption, any investment which is not financed by prior savings will generate inflation and not real income or development. This theory does not subscribe to the view that inflation is needed for growth; it is averse to inflation, it advocates control of inflation, and suggests a policy of reasonably high positive real interest rates to encourage savings by the public. PST believes in the neutrality of money in the growth process.

ii) Credit Creation Theory

According to Credit Creation Theory, the contribution of a financial system to growth goes beyond increasing prior-saving-based investment. There are two strands of thought in this regard According to the first one, emphasized by Kalecki and Schumpeter, the financial system plays a positive and catalytic role by providing finance or credit through creation of credit m anticipation of savings. This, to a certain extent, ensures the independence of investment from saving in a given period of time. The investment financed through created credit generates the appropriate level of income which, in turn leads to an amount of savings which are equal to the investment already undertaken The First Five Year Plan in India echoed this view when it stated that the judicious credit creation in production and availability of genuine savings has also a part to play in the process of economic development. It is assumed here that the investment out of created

Rahul Publications

credit results in a prompt income generation, otherwise, there will be sustained inflation rather than sustained growth.

iii) Theory of Forced Savings

The Theory of Forced Savings or Inflationary Financing stresses on increasing of investment not with prior savings, or not without prior savings, but with forced savings. This theory is credited mainly to Keynes and Tobin. According to them, investment is not determined by savings, it is savings which are determined by investment which can be increased autonomously through mon-etary expansion. The monetary expansion speed up development through four channels:

- First, if the resources are unemployed, it would increase aggregate demand, output, and savings.
- Second, if the resources are fully employed, it will generate inflation which will lower the real rate of return on financial investments or money, which will make real balances less attractive to hold, which will induce the wealth holders to invest more in physical capital. The resulting increase in capital intensity would increase output and savings. This is known as Tobin or Portfolio Shift Effect of monetary expansion.
- Third, inflation changes income distribution in favour of profit earners, which would lead to increase in savings. This is known as Income Distribution Effect. Fourth, inflation imposes tax on real money balances and thereby transfers resources to the Government for financing investment. This is known as Inflation Tax Effect.

Q10. Explain the Relationship between financial system and economic development.

Ans :

The financial intermediaries achieve economies of scale in the cost of transferring savings to the investors through pooling of default risk and reducing transactions costs. The economies of scale in borrowing and lending, and the access to superior technology are the sources of their advantage in respect of transactions cost. Financial institutions help development also by creating a more efficient payments, transfer and remittance mechanism. They help the public in effecting, facilitating transactions swiftly and safely on a continuous basis. They generate confidence among the buyers and sellers that the instruments used in making payments in respect of transactions will be accepted and honoured by all the participants in the system. Similarly, the financial institutions help to reduce one or more parts of information costs. These parts are:

(a) The search cost for searching investment opportunities;

(b) Verification cost incurred for assessing the viability of identified investment opportunities;

(c) Monitoring cost incurred for supervising investments making sure that funds supplied are used for the stated purpose; and

(d) Enforcement cost incurred to make borrowers to fulfil repayment obligations.

To put it differently, financial institutions promote development by offering the following "transformation services or functions."

(a) Liability-Asset Transformation: They issue claims (viz. deposits) to the customers that have characteristics different from those of their own assets, which, in turn, meet the requirements of a different set of their customers (viz. corporates).

(b) Size-Transformation: Financial institutions choose and manage portfolios whose risk and return they favourably alter by applying resources to acquire better information and to reduce transaction costs. As said above, they are able to do so through economies scale in lending and borrowing. They provide large volumes of finance by pooling small deposits or unit capital.

(c) Risk-Transformation: Financial inter-mediaries pool, distribute, reduce, manage risk better through greater diversification of the portfolio which is not possible for any single, particularly, small saver.

(d) Maturity Transformation: Financial institutions offer savers alternate forms of deposits according to their liquidity, risk, return preferences, and provide borrowers with loans of (long-term) maturities required by

Rahul Publications

them. The commercial banks borrow short and, on an average, lend long, and, in the process, they change the length of debt in such a way that reconciles the liquidity preference of the ultimate funds-providers and ultimate funds-users. In so doing, they stimulate the productive investment by persuading savers to switch from unproductive investment in tangible assets to productive investment in firms.

1.6 Financial Sectors Reforms after 1991

Q11. Explain the financial sectors reforms after 1991.

(OR)

Critically examine the financial sector reforms in India after 1991.

Ans : **(May-19, June-18, Imp.)**

The financial sector reforms in India were an integral part of the economic reforms introduced in 1991. The motivations for reforms in India were somewhat different from other countries. Since the nationalisation of banks in 1969, there had been a considerable expansion in banking facilities. The geographical and functional coverage of the Indian banking system was impressive. However, serious concerns had been expressed on the quality and efficiency of the services rendered and more particularly on the viability and profitability of the public sector banks. Profits after provisioning were at a level providing cause for serious concern. This was in a situation when the norms adopted for provisioning themselves were not very strict.

The various measures that were introduced since 1991, as part of banking sector reforms, can be classified into three broad categories,

- Modifying the policy framework.
- Improving the financial health through prescription of prudential norms and
- Institutional strengthening.

1. Policy Reforms

Commercial banking constitutes the largest segment of the Indian financial system after the nationalisation of major banks in two waves, starting in 1969, the Indian banking system became predominantly government owned by the early 1990s. Banking sector reform essentially consisted of a two-pronged approach. While nudging the Indian banking system to better health through the introduction of international best practices in prudential regulation and supervision early in the reform cycle, the idea was to increase competition in the system gradually. The implementation periods for such norms, were, however, chosen to suit the Indian situation. Special emphasis was placed on building up the risk management capabilities of the Indian banks. Unlike in other emerging market countries, many of which had the presence of government owned banks and financial institution, banking reform has not involved large scale privatisation of such banks.

The approach, instead, first involved and control with the government. With such widening of ownership most of these banks have been publicly listed, this was designed to introduce greater market discipline in bank management and greater transparency through enhanced disclosure norms. The phased introduction of new private sector banks and expansion in the number of foreign bank branches, provided for new competition. Meanwhile, increasingly tight capital adequacy, prudential and supervision norms were applied equally to all banks, regardless of ownership recapitalisation of banks from government resources to bring them to appropriate capitalisation standards. In the second phase, instead of privatisation, increase in capitalisation has been done through diversification of ownership to private investors up to a limit of 49 percent, there by keeping majority ownership.

i) Most of the interest rates in the economy deregulated, a beginning made to move towards market rates on government securities, the system of administered interest rates largely dismantled and the structure of interest rates greatly simplified.

ii) The preemption of banks resources through SLR in favour of the government was brought down and the rate of return on SLR securities is maintained "by and large at market rates. The SLR on incremental Net Domestic and Time Liabilities (NDTL) of banks reduced from 38.5 percent in 1991-92 to 25 percent now.

Rahul Publications

iii) The incremental CRR of 10 percent removed and the average CRR reduced from 15 percent in 1991-92 to 10 percent in 1995-96.

iv) Capital adequacy norms for banks, financial institutions and virtually all market intermediaries introduced. The Basel Committee framework for capital adequacy adopted.

v) Board of Financial Supervision (BFS) with an advisory council and an independent department of supervision established in RBI.

vi) Recovery of debts due to Banks and Financial Institutions Act, 1993 passed to set up special recovery tribunals to facilitate quicker recovery of loan arrears.

vii) In order to moderate or minimise the automatic moneterisation of the budget deficit, the agreement to impose a ceiling on the issue of adhoc Treasury Bills (TBs) and to phase them out in due course signed by the Government of India (GOI) and RBI in September 1994. Subsequently, the system of ad hoc treasury bills abolished and replaced by the system of ways and means advances effective April 1, 1997.

viii) The private sector allowed to set up banks, mutual funds, money market mutual funds, insurance companies etc., public sector banks permitted diversified ownership by law subject to 51 percent holding of government/RBI. SBI, IFCI and IRBI converted into public limited companies.

ix) Capital Issues (Control) Act, 1947 repealed and the office of Controller of Capital Issues abolished.

x) Securities and Exchange Board of India (SEBI) made a statutory body in February 1992 and armed with necessary authority and powers for regulation and reform of the capital market.

2. Interest Rate Deregulation and Financial Repression

Perhaps the single most important element of the financial sector reforms has been the deregulation of interest rates.

i) Interest rates were free on corporate bonds, most bank lending and bank deposits above one year maturity.

ii) Introduction of auctions coupled with reduced preemption led to more market determined interest rates for government securities.

iii) Administered interest rates are now confined mainly to short term bank deposits, priority sector lending and deposits of non banking financial companies.

For all practical purposes, financial repression is a thing of the past. Even on short term retail bank deposits which are still regulated, the ceiling rate is well above the historic average rate of inflation. Moreover, quite often the ceiling has not been a binding constraint in the sense that actual interest rates have often been below the regulatory ceiling.

Similarly, the prices of most other financial assets are also now determined by the more or less free play of market forces. Consequently, financial markets are increasingly able to perform the important function of allocating resources efficiently to the most productive sectors of the economy. This must count as one of the most enduring and decisive successes of the financial reforms.

3. Banking Reform

i) Prudential Measures

- Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities.

Rahul Publications

ii) Competition Enhancing Measures

- Granting of operation autonomy to public sector banks, reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49% of paid-up capital.
- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment, permission to banks to diversify product portfolio and business activities.

iii) Measures Enhancing Role of Market Forces

- Sharp reduction in preemption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exception and enhanced transparency and disclosure normal facilitate market discipline.
- Introduction of pure interbank call money market, auction-based repos-reserve repos for short-term liquidity management, facilitation of improved payments and settlement mechanism.

iv) Institutional and Legal Measures

- Setting up of Lok Adalats, debt recovery tribunals, asset recon-struction companies, settlement advisory committees, corporate debt restructuring mechanism etc., for quicker recovery/restructuring. Promulgation of Securitisation and Keconstruction of Financial Assets and Enforcement of Securities Interest (SAFFAESI) Act and its subsequent amendment to ensure creditor rights.
- Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Setting up Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Setting up of Clearing Corporation of India Limited (CCIL) to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments.

v) Supervisory Measures

- Establishment of the Board for Financial Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies.
- Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.
- Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
- Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

vi) Technology Related Measures

- Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement RTGS; system.

4) Government Security Market Reforms

i) Institutional Measures

- Administered Interest rates on government securities were replaced by an auction system for price discovery.
- Automatic monetisation of fiscal deficit through the issue of adhoc treasury bills was phased out.

Rahul Publications

- Primary Dealers (PD) were introduced as market makers in the government securities market.
- For ensuring transparency in the trading of government securities. Delivery versus Pay (DvP) settle-ment system was introduced.
- Repurchase agreements (repo) was introduced as a tool of short term liquidity adjustment. Subse-quently, the Liquidity Adjustment Facility (LAF) was introduced. LAF operates through repo and reverse auctions to set up a corridor for short-term interest rate. LAF has emerged as the tool for both liquidity management and also signalling device for interest rates in the overnight market.
- Market Stabilisation Scheme (MSS) has been introduced, which has expanded the instruments available to the reserve bank for managing the surplus liquidity in the system.

ii) Increase in Instruments in Government Securities Market

- 91-day treasury bill was introduced for managing liquidity and benchmarking. Zero Coupon Bonds, Floating Rate Bonds, Capital Indexed Bonds were issued and exchange traded interest rate futures were introduced. OTC interest rate derivatives like IRS/FRAs were introduced

iii) Enabling Measures

- Foreign Institutional Investors (FIIs) were allowed to invest in government securities subject tc certain limits.
- Introduction of automated screen-based trading in government securities through Negotiated Dealing System (NDS). Setting up of risk-free payments and settlement system in government securities through Clearing Corporation of India Limited (CCIL). Phased introduction of Real Time Gross Settlement System (RIGS).
- Introduction of trading of government securities on stock exchanges for promoting retailing in such securities, permitting non-banks to participate in repo market.

5. Reforms in Forex Market

i) Exchange Rate Regime

- Evolution of exchange rate regime from a single currency fixed exchange rate system to fixing the value of rupee against a basket of currencies and further to market-determined floating exchange rate regime.
- Adoption of convertibility of rupee for current account transactions with acceptance of Article VIII of the Articles of Agreement of the IMF. De facto full capital account convertibility for nonresidents and calibrated liberaliza-tion of transactions undertaken for capital account purposes in the case of residents.

ii) Institutional Framework

- Replacement of the earlier foreign Exchange Regulation Act (FERA), 1973 by the market friendly Foreign Exchange Management Act, 1999. Delegation of considerable powers by RBI to Authorised Dealers to release foreign exchange for a variety of purposes.

iii) Increase in Instruments in Forex Market

- Development of rupee-foreign currency swap market.
- Introduction of additional hedging instruments, such as, foreign currency-rupee options. Authorized dealers permitted to use innovative products like cross-currency options, interest rate and currency swaps, cap/collars and Forward Rate Agreements (FRAs) in the international forex market.

Rahul Publications

iv) Liberalization Measures

- Authorised dealers permitted to initiate trading positions, borrow and invest in overseas market subject to certain specifications and ratification by respective banks boards. Banks are also permitted to fix interest rates on non-resident deposits, subject to certain specification, use derivative products for asset-liability management and fix overnight open position limits and gap limits in the foreign exchange market, subject to ratification by RBI.
- Permission to various participants in the foreign exchange market, including exporters, Indian investing abroad, FIIs, to avail forward cover and enter into swap transactions without any limit subject to genuine underlying exposure.

6. Primary and Secondary Stock Market Reforms

i) A norm of five shareholders for every Rs. 1 lakh of fresh issues of capital and 10 shareholders for every Rs. 1 lakh of offer for sale prescribed as an initial and continuing listing requirement.

ii) The payment of any direct or indirect discounts or commissions to persons receiving firm allotment prohibited.

iii) Debt issues not accompanied by an equity component permitted to be sold entirely by the book-building process.

iv) Housing finance companies considered to be registered for issue purposes, provided they are eligible for refinance from the National Housing Bank.

v) Issuers allowed to list debt securities on stock exchanges without their equity being listed. Mutual funds permitted to underwrite public issues.

vi) The stock exchanges required to disclose, carry forward position scrip-wise and broker-wise at the beginning of carry forward session.

vii) A ceiling of Rs. 10 crores imposed on stock market members doing business of financing carry forward transactions.

viii) Depositories Act. 1996 passed to provide a legal framework for the establishment of depositories to record ownership details in book entry form and to facilitate dematerialization of securities.

ix) Stock lending scheme without attracting capital gains introduced. Under this scheme, short sellers can borrow securities through an intermediary before making such sales,

x) Stock exchanges asked to modify listing agreements in order to provide for the payment of interest by companies to investors from the 30th day of the closure of public issue.

xi) All stock exchanges required to institute the buy-in or auction process.

xii) Stock exchanges asked to collect 100 percent daily margins on the notional loss of a broker for every scrip, to restrict gross traded value to 33.33 times the broker's base minimum capital and to impose quarterly margins on the basis of concentration ratios.

xiii) The stock exchanges are being modernized, many of them have introduced electronic trading system, the Bombay Stock Exchange has started its on-line trading system, BOLT.

xiv) The Bombay Stock Exchange and other exchanges has screen-based trading system allowed to expand their trading terminals to locations where no stock exchange exists and to others subject to an understanding with the local stock exchange.

xv) Both short and long sales are required to be disclosed to the exchange at the end of each day and they are to be regulated through the imposition of margins.

xvi) There are many other stock market reforms which have been introduced during the past five to six years.

Rahul Publications

1.6.1 Recent Developments in Indian Financial System

Q12. Explain Recent changes in Indian financial system.

(OR)

Discuss the recent developments of Indian financial system.

Ans : **(Oct.-20)**

India has a financial system that is controlled by self-governing regulators in the sectors of banking, insurance, capital markets, opposition and various services sectors. In a number of sectors Government plays the role of regulator. Ministry of Finance, Government of India looks after financial sector in India. Finance Ministry every year presents annual economical on February 28 in the Parliament. The annual budget proposes changes in taxes, changes in government policy in almost all the sectors and budgetary and other allocations for all the Ministries of Government of India. Indian financial system was characterized by:

- Absence of organized capital market
- Dependence of industries and other users on internal sources
- Rare cases of public issues of capital for expansion and modernization
- Few financial institutions and players in the market
- Very strict conditions for loan assistance to companies

1. Withdrawal of legal tender status for Rs 500 and Rs 1000 notes

"To break the grip of corruption and black money, we have decided that the five hundred rupee and thousand rupee currency notes presently in use will no longer be legal tender from midnight tonight that is 8th November 2016…."With these words the Indian Prime Minister in one stroke announced the withdrawal of what constituted 86% of Indian currency in circulation at that point in time. The announcement initially came with a list of caveats for exchange and withdrawal that have since seen frequent additions/revisions by the day and accompanied by stories of unprecedented disruptions to the daily life of citizens and businesses in the aftermath of the ban.

2. Setting up of the monetary policy committee

October 4th , 2016 marked the first time that a committee, rather than one person, until then the RBI Governor, would decide the policy interest rates in the economy. Entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level, the Monetary Policy Committee was set-up with six members – three nominated from the Central Government and three from the Reserve Bank of India, with the RBI Governor getting the casting vote in case of a tie.

3. Passage of the goods and services tax bill

Aimed at doing away with a host of Central and State taxes and ushering in a one tax regime for the entire country, both the Houses of Parliament passed the Goods & Services Tax Bill in August 2016, with the President giving his assent in September. Including most of the Central and State taxes such as the Value Added Tax (VAT), excise duty, service tax, central sales tax, additional customs duty and special additional duty of customs, GST would lead to a uniform consumption-based tax structure across the land for almost all goods and services and the government has set a deadline of April 1, 2017 to roll this out. GST implementation would integrate the economy and provide for a common national market that enables businesses to leverage a simplified tax regime

4. Passage of the insolvency and bankruptcy code

In May 2016, both Houses of the Parliament passed the Insolvency and Bankruptcy Code that set in motion a national bankruptcy law to deal with insolvencies. The new law, which does away with at least 12 different rules, some of which are centuries old, is expected to usher in an effective bankruptcy resolution system that improves the ease of doing business in India. The Central Government in December notified the final regulations related to the insolvency resolution process under the Liquidation and Bankruptcy Code 2016, paving way for the operationalization of the 10-member Liquidation and Bankruptcy Board (IBBI).

Rahul Publications

5. Thrust towards digitization of government payments

In 2016 saw extensive measures to incentives greater implementation of digital payments with an all-round push by different Ministries and controllers. For instance, the Ministry of Electronics and Information Technology laid out Procedures for Acceptance of Electronic Payments and Receipts in November 2016 that covers a time bound process for the integration of digital payments and receipts connecting all Government divisions. It has set an ambitious deadline of 31 December 2016 by which 90% of outflows and receipts of all Government Divisions are to be made online

1.7 REGULATORY AND PROMOTIONAL INSTITUTIONS

Q13. Define the following terms :

a) Regulatory Institutions

b) Promotional Institutions

Ans :

(a) Regulatory Institutions

Regulatory institution is to ensure that firms provide the goods and service promised and that their behaviour, in general, confirm with established standard in the country and/or abroad.

(b) Promotional Institutions

Promotional institutions that are purposely established to create incentives and facilities that motive firm to engage in exporting,

1.7.1 Reserve Bank of India

Q14. What is RBI ? Explain the organiza-tional structure of RBI.

Ans :

Introduction

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.

Organizational Structure of RBI

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.

Rahul Publications

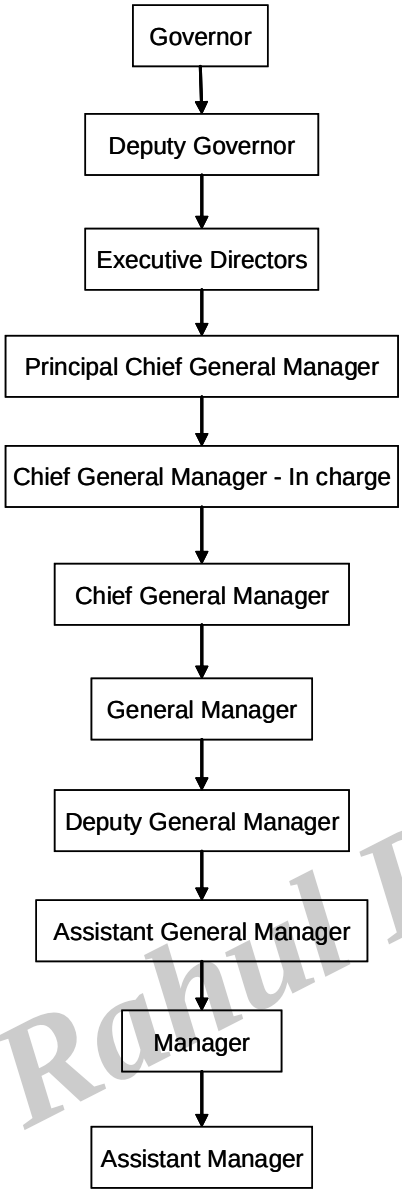


Fig.: Structure of RBI

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.

1.7.2 Functions of RBI

Q15. What are the functions of RBI ?

(OR)

Discuss the functions of RBI.

(OR)

Explain the regulatory functions of RBI.

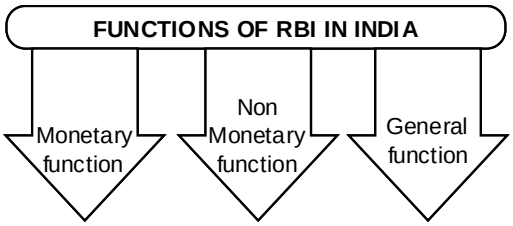
Ans : **(June-18, Aug,-15)**

RBI performs so many functions. For simplicity we can categorize them in to three major heads like

i) Monetary functions

ii) Non- monetary functions and

iii) Other or miscellaneous functions



i) Monetary Functions

RBI performs the following monetary functions

a) Monopoly of note issue : In India RBI enjoys the sole right to issue notes except coins. RBI has an department for money issue called "issue department". When RBI issue money in to the economy, RBI keeps its reserves in the form of gold, bullion etc.

b) Banker to government : RBI become the banker of government by doing activities like collecting of taxes, making

Rahul Publications

payments on behalf of central government, maintain debt of public union, provides loans to government with out securities (up to three months) etc.

c) **Bankers bank and lender of last resort :** RBI is the bankers bank, RBI can issue licenses to new banks and other permissions. All the banks in India should follows the rules and regulations given by RBI, including many policies related to reserve ratio, bank rate, repo and rivers repo rate etc. RBI act as a clearing houses also, it is done by RBI by collecting precautionary deposits from commercial banks.

d) **Credit controller :** It is a very important function performing by RBI. They can control the economy via adopting many policies with other banks like changing interest rates, SLR, CRR etc.

e) **Controller of foreign exchange operations :** Simply RBI is the authorized dealer in foreign exchange, gold coin, bullion etc. on behalf of government. So, RBI is the authorized agent to control foreign exchange operations of the country.

ii) Non-monetary Functions

RBI performs the following non- monetary functions. Mainly they can classified in to two, namely supervisory functions and promotional functions.

(a) Supervisory functions : RBI is the bankers bank and so, they supervising all Indian banks. RBI can supervise banks by using of RBI Act and further issuing of rules and regulations. Now, RBI setup a department called "department of supervision" to control the commercial banks.

(b) Promotional functions : Since RBI is the central bank of India , it has the responsibility to boost the Indian rural area and by achieve balanced society. RBI provides many promotional schemes to promote rural area's agriculture, small industries to create employment opportunity by establishing financial institutions, conducting surveys etc. Banks like NABARD, RRB etc are dedicated to rural area. So, RBI promoting villages of India.

Further, RBI promoting industrial fields by establishing financial institutions like UTI. Any way the motto behind RBI to promote rural area is nothing, to create a good atmosphere for industries and employment and by achieve balanced development of the country.

iii) Other or Miscellaneous Functions

Further RBI functioning many other things also. RBI collecting data related to Indian economy and publish them via media. RBI offering its own specialized institutions to youngsters who are enthusiastic in banking field. Many innovative fields of studies are introducing RBI. College of Agricultural Finance at Pune is one of them.

1.7.3 Roles of RBI

Q16. Discuss the role of RBI in banking sector ?

Ans : **(May-19, June-18, Imp.)**

The various roles played by RBI are as follows:

a) Note Issuing Authority : The RBI has the sole right or authority of issuing currency notes other than one rupee notes and coins, coins of smaller denominations. The issue of currency is one of its basic functions. The currency notes issued by the Bank are legal tender everywhere in India without any limit. All affairs of the Bank relating to note issue are conducted through its Issue Department. The Bank can issue notes against the security of gold coins and gold bullion, foreign securities, rupee coins, Government of India securities, and such bills of exchange and promissory notes as are eligible for purchase by the Bank. The RBI notes have a cent percent backing or cover in these approved assets.

Rahul Publications

b) Government Banker : The RBI is the banker to the Central and State Governments. It provides to the Governments all banking services such as acceptance of deposits, withdrawals of funds by cheques, making payments as well as receipts and collection of payments on behalf of the government, transfer of funds, and management of public debt. The Bank receives government deposits free of interest and is not entitled to any remuneration for the conduct of the ordinary banking business of the Government. The deficit or surplus in the Central Government account with the RBI is managed by the creation and cancellation of treasury bills.

c) Ways and Means Advances : As a banker to the government, the Bank can make ways and means advances to both the central and state governments. The maximum maturity period of these advances is three months. The ways and means advances to the state governments are subject to some limits. These advances are of the following types :

i) **Normal or clean advances:** Advances without any collateral security

ii) **Secured advances:** Those which are secured against the pledge of Central government securities and

iii) **Special advances:** Those granted by the Bank at its discretion

d) Overdrafts : The state governments have made heavy use of overdrafts from the RBI. An overdraft refers to drawls of credit by the state government from the RBI in excess of the credit limits granted by the RBI. At present, overdrafts up to and inclusive of the seventh day are charged at the Bank rate and from the eighth day onwards at 3 percent above the Bank rate. The issue, management and administration of the public debt are among the major functions of the RBI as the banker to the government. The bank charges a commission from the governments for rendering this service.

e) Banker's Bank : The RBI is called a banker's bank because it has a very special relationship with commercial and co-operative banks, and the major part of its business is with these banks. The Bank controls the volume of reserves of commercial banks and thereby determines the deposits creating ability of the banks. The banks hold a part or all of their reserves with the RBI. The RBI is the ultimate source of money and credit in India.

f) Supervising Authority : The RBI has the vast powers to supervise and control commercial and cooperative banks with a view to developing an adequate and sound banking system in the country. It has the following powers

i) To issue licenses for the establishment of new banks

ii) To issue licenses for the setting up of bank branches

iii) To prescribe minimum requirements regarding paid-up capital to inspect the working of banks in India as well as aboard in respect of their organisational set-up, branch expansion, mobilization of deposits, investments, and credit portfolio management

iv) To conduct adhoc investigation from time to time into complaints, irregularities, and frauds in respect of banks.

v) To approve or force amalgamations.

g) Exchange Control Authority : RBI maintains the stability of the external value of the rupee. It pursues this objective through its domestic policies and the regulation of the foreign exchange market. The major tasks of RBI in this regard are as follows :

i) To administer the foreign exchange control

ii) To choose the exchange rate system and fix or manage the exchange rate between the rupee and other currencies

iii) To manage exchange reserves

Rahul Publications

iv) To interact or negotiate with the monetary authorities of the Sterling Area, Asian Clearing Union, and other countries, and with international financial institutions such as the IMF, World Bank and Asian Development Bank.

h) Promoter of the Financial System : RBI has been rendering development or promotional services which have strengthened the country's banking and financial structure. This has helped in mobilizing savings and directing credit flows to desired channels, thereby helping to achieve the objective of economic development with social justice. It has helped in deepening and widening the financial system.

i) Industrial Finance : The role of RBI in diversifying the institutional structure for providing industrial finance has been equally important. All the special development institutions (SDIs) at the Central and State levels and many other financial institutions created by the Bank on its own or it advised and rendered help institutions setting up these institutions. **Ex:** UTI was originally an associate institution of the RBI.

j) Credit Delivery : The Bank has evolved and put into practices the consortium, co-operative and participatory approach to lending among banks and other financial institutions. By developing the practice of inter-institutional participation, of expertise pooling and of geographical presence, it has helped to upgrade credit delivery and service capability of the financial system. By issuing appropriate guidelines in 1977, regarding the transfer of loans accounts by borrowers, it has evolved a mutually acceptable system of lending so that the banking business grows in a healthy manner and without any cut-throat competition.

k) Formulating Prudential Norms : To preserve and enhance the stability of the banking and financial system is an important part of the promotional role of the RBI. The financial stability has now assumed relatively greater importance as one of the tasks of the RBI. RBI plays an important role in building up and maintaining confidence in the underlying stability of the IFS. RBI helps to create and maintain a stable, efficient and well-functioning financial system in India.

Q17. Describe the role of RBI for regulating NBFIs.

Ans : **(Jan.-18)**

According to the RBI (Amendment) Act, 1997, every NBFI which owns 1.25 lakhs of funds and above must be registered with RBI. Currently, RBI regulates all NBFIs except HFCs.

The following are the provisions by which RBI regulates NBFIs,

1. An NBFI must have funds of a minimum net worth of 25 lakhs, which must be achieved in 3 years. Flowever, this time limit can be extended to a period of more than 3 years at RBI's discretion.
2. They must create a reserve fund by transferring not less than 20% of their net deposits to the fund per year.
3. Deposits of 10% and 15% must be maintained in liquid assets.
4. The depositors of NBFIs also have the facility of nomination.
5. The RBI offers guidance to the NBFIs on various issues, such as disclosures, investments, credit, prudential norms etc.
6. A minimum capital adequacy norm of 8% must be achieved by March, 1996.

1.8 MONETARY POLICY

Q18. Define Monetary policy. Explain the objectives of Monetary policy.

Ans : **(May-19, Dec.-18, Imp)**

Meaning

Monetary policy refers to the measures which the central bank of the country takes in controlling the money and credit supply in the country with a view to achieving certain specific economic objectives.

Rahul Publications

Objectives

The objectives of monetary policy differ from country to country according to their economic conditions. In the less developing countries like India or Pakistan its objective may be the maintenance of monetary stability and help in the process of economic development. In the developed countries its objective may be to achieve full employment, without inflation. Following are the main objectives of the monetary policy.

1. Control of Inflation and Deflation

Inflation and deflation both are not suitable for the economy. If the price level is reasonable and there is an adjustment between the price and cost, rate of out put can increase. Monetary policy is used to coordinate the cost and price. So price stability is achieved through the monetary policy.

2. Exchange Stability

Monetary policy second objective is to achieve the stable foreign exchange rate. If the rate of exchange is stable it shows that economic condition of the country is stable.

3. Economic Development

Monetary policy plays very effective role in promoting economic growth by providing adequate credit to productive sectors.

4. Increase in the Rate of Employment

Monetary policy another objective is to achieve full employment but without inflation.

5. Equal Distribution of Credit

Monetary policy should also ensure that distribution of credit should be equitable and purposeful. The credit priority should be given to backward areas.

6. Improvement in Standard of Living

It is also the major objective of the monetary policy that it should improve the quality of life in the country.

Q19. Describe the functions of monetary policy.

Ans : **(May-19)**

(i) Monetary policy should try to maintain in the economy a most suitable interest rate structure.

(ii) Monetary policy can be of great use in these economies for effecting necessary adjustment between the demand for and supply of money. The demand for money is likely to go up on account of increased transactions and gradual disappearance of non-monetized sector combined with increased demand for money on account of precautionary and speculative motives. The use of money and credit for speculative purposes has to be controlled by the monetary authorities through suitable monetary policy and by the government through direct physical controls, failing which, inflation is likely to appear, which may stifle growth instead of helping it.

(iii) Monetary policy can, perhaps, be more useful in influencing the pattern of investment and production by controlling the provision of credit by banks. It can induce the banks to advance medium-term and long-term loans of productive nature at the same time prohibiting them to advance loans of unproductive and speculative nature.

(iv) Monetary policy can help in the expansion of financial institutions by granting subsidies and special facilities to new institutions and provision of training facilities for their staff. In most of the underdeveloped countries the credit system is restricted to providing credit for large estates, plantations and to foreign traders, and are not available to farmers, small traders and industries.

In such a situation an extension of commercial bank, co-operative bank and savings bank facilities can encourage development and mobilize savings for productive purposes. Therefore, it is said that the creation and mobilization of real savings-the most important condition for growth-is helped or hindered by monetary policy and by the development of financial institutions.

Rahul Publications

(v) Monetary policy can prove more effective through selective credit control. Poor economies are extremely inflation-sensitive on account of speculation in commodities that are in short supply, like wheat and rice. This speculation is done mostly by borrowed funds got from the banks. Monetary policy can be made use of to stop borrowing for speculative purposes and to divert them for productive purposes.

(vi) Monetary policy can also help growth. The sectoral impacts of such policy in a developing economy are worth noting. Monetary expansion can be used, at least in theory, to change the terms of trade against the agricultural sector, which tends to benefit from increased production in the secondary or tertiary sectors. If the prices of industrial goods can be raised through inflation without affecting the prices of food-stuffs and raw materials, it may prove useful for growth but in actual practice it may be difficult to follow.

(vii) Monetary policy in a developing economy should also be concerned with the balance of payments problem. When a country starts developing, its balance of payments may become adverse on account of various reasons. Under such circumstances, besides, exercising direct controls on foreign exchange, the monetary authority can help in turning the balance of payments favorable by using the traditional methods of control, like raising the bank rate, etc.

Q20. Explain the features of monetary policy.

Ans :

The main features of the monetary policy of the Reserve Bank of India are given below:

1. Active Policy

Before the advent of planning in India in 1951, the monetary policy of the Reserve Bank was a passive, cheap and easy policy. It means that Reserve Bank did not use the measures of monetary policy to regulate the economy.

For example from 1935 to 1951, the bank rate remained stable at 3%. But since 1951, the Reserve Bank has been following an active monetary policy. It has been using all the measures of credit control.

2. Overall Expansion

An important feature of Reserve Bank's monetary policy is that of overall expansion of money supply. In the words of S.L.N. Sinha 'The Reserve Bank's responsibility is not merely one of credit restriction.

In a growing economy there has to be continuous expansion of money supply and bank credit and the central bank has the duty to see that legitimate credit requirements are met'. In fact, the overall, trend of money supply has been one of the expansions along with an almost continuous rise in price level.

3. Seasonal Variations

The monetary policy is characterised by the changing behaviour of busy and slack seasons. These seasons are tied to the agricultural seasons. In the busy season there is an expansion of funds on account of the seasonal needs of financing production, and inventory building of agricultural commodities.

On the other hand, the slack season is characterised by the contraction of funds due to the return flow. It may be pointed out that aggregate contraction of funds during the slack season has tended to fall far short of expansion in the preceding busy season.

The main reason behind this changing pattern is the requirement of additional funds by the industrial sector. Thus, during busy season the Reserve Bank adopts an expansionary credit policy and tightens the liquidity pressures during the slack season.

4. Tight and Dear Monetary Policy

In order to restrain inflation the Reserve Bank has often adopted a tight and dear monetary policy. A tight monetary policy implies that the rate of growth of money supply is lowered. A dear money policy refers to

Rahul Publications

increase in bank rate. This increase in bank rate leads to an increase in the interest rates charged by the banks.

5. Investment and Saving Oriented

The monetary policy adopted by the Reserve Bank is both investment and saving oriented. To encourage investment, adequate funds were made available for productive purposes at reasonable rates of interest. The Reserve Bank has also kept the interest on deposits at a reasonable rate to attract savings.

6. Imbalance in Credit Allocation

The monetary policy is biased towards industrial sector. Agriculture does not get the required institutional finances. Consequently, it has to depend upon money lenders to a considerable extent for its credit needs.

The agricultural sector has to pay high rate of interest and even then does not get required amount of capital. A large part of funds flows to large industries. Even small scale industries suffer from the inadequacy of finances. Thus monetary policy has resulted in imbalances in credit allocation.

7. Wide Range of Methods of Credit Control

The Reserve Bank has used a wide range of instruments of credit control. It has adopted all the measures of quantitative and qualitative credit controls to meet the needs of a complex and varying economic situation.

Since the objective has been to achieve economic growth with stability, the policy of monetary management has gone beyond the traditional regulatory function. It has adopted a more positive role of channeling credit to desired sectors.

8. Guiding Factors

According to Shri. C. Rangarajan the following three factors have essentially guided the conduct of monetary policy:

(i) Monetary policy measures have generally been a response to fiscal policy.

(ii) While monetary policy has been primarily acting through availability of credit, the cost of credit has also been adjusted upwards sometimes very sharply to meet effectively the inflationary situations.

(iii) The areas of operation of monetary policy did not remain confined to those related to regulation of monetary authority in the allocation of credit to the non-Government sector because of an important element of national economic policy, specially after the nationalisation of banks.

1.8.1 Techniques of Monetary Control of RBI

Q21. Discuss the various techniques of monetary control of RBI.

(OR)

Describe the various techniques of monetary control of RBI.

(OR)

Explain the techniques of monetary control of RBI.

Ans : **(Oct.-20, May-19, Dec.-18, 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

Rahul Publications

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, l934 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.

Rahul Publications

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.

Q22. Discuss the Recent changes in RBI's monetary policy?

Ans :

Since 1991 RBI's monetary management has undergone some major changes.

1. Multiple Indicator Approach

Upto late 1990s, RBI used the 'Monetary targeting approach' to its monetary policy. Monetary targeting refers to a monetary policy strategy aimed at maintaining price stability by focusing on changes in growth of money supply. After 1991 reforms this approach became difficult to follow. So RBI adopted Multiple indicator Approach in which it looks at a variety of economic indicators and monitor their impact on inflation and economic growth.

2. Selective Methods Being Phased Out

With rapid progress in financial markets, the selective methods of credit control are being slowly phased out. Quantitative methods are becoming more important.

3. Reduction in Reserve Requirements

In post-reform period the CRR and SLR have been progressively lowered. This has been done as a part of financial sector reforms. As a result, more bank funds have been released for lending. This has led to the growth of economy.

4. Deregulation Of Administered Interest Rate System

Earlier lending rate of banks was determined by RBI. Since 1990s this system has changed and lending rates are determined by commercial banks on the basis of market forces.

5. Delinking Of Monetary Policy From Budget Deficit

In 1994 government phased out the use of adhoc treasury Bills. These bills were used by government to borrow from RBI to finance fiscal deficit. With phasing out of Bills, RBI would no longer lend to government to meet fiscal deficit.

6. Liquidity Adjustment Facility (LAF)

LAF allows banks to borrow money through repurchase agreement LAF was introduced by RBI during June, 2000, in phases. The funds under LAF are used by banks to meet day-to-day mismatches in liquidity.

7. Provision Of Micro Finance

By linking the banking system with Self Help Groups, RBI has introduced the scheme of micro finance for rural poor. Along with NABARD, RBI is promoting various other microfinance institutions.

Rahul Publications

8. External Sector

With globalisation large amount of foreign capital is attracted. To provide stability in financial markets, RBI uses sterilization and LAF to absorb the excess liquidity that comes in with huge inflow of foreign capital.

9. Expectation As A Channel Of Monetary Transmission

Traditionally, there were four key channels of monetary policy transmission:- Interest rate, credit availability, asset prices and exchange rate channels. Interest rate is the most dominant transmission channel as any change in monetary policy has immediate effect on it. In recent years fifth channel, Expectation has been added. Future expectations about asset prices, general price and Income levels influence the four traditional channels.

Q23. Explain the evaluation of monetary policy.

Ans :

The RBI aims at one time was controlled expansion. On one hand it was taking steps to expand bank credit. On other hand RBI uses quantitative and qualitative methods to control credit. These two contradictory objectives limited the success of monetary policy. The performance of monetary policy can be seen from its achievements and failures, let us discuss.

Positive Aspects of Monetary Policy

1. Short Term Liquidity Management

RBI has developed various methods to maintain stability in interest rate and exchange rate like LAF, OMO and MSS. RBI has also managed its sterlization operations very well.

2. Financial Stability

With the help of controls, regulation and supervision mechanism, RBI has been successful in maintaining financial stability. During the period of global crisis it has also been able to maintain macro economic stability.

3. Financial Inclusion

Along with NABARD, RBI has made a great impact in the growth of microfinance. RBI has supported Self Help Group Model and promoted other microfinance institutions.

4. Adaptability

In India monetary policy is flexible, as it changes with time. RBI has developed new methods of credit control and shifted from monetary targeting to multiple indicator approach.

5. Increase In Growth

To maintain the growth of economy RBI has used its instruments' effectively. At present India has the second highest rate of GDP growth after China. Thus monetary policy has played an important role.

6. Increase In Bank Deposits

The increase in bank deposits over the years indicates trust and confidence of people in banking sector. Effective supervision of RBI over banks and financial institutions is largely responsible for trust and confidence of public in banking sector.

Q24. Explain the tools of monetary policy.

Ans :

1. Monetary Base

Monetary Policy can be implemented by changing the size of the monetary base. This directly changes the total amount of money circulating in the economy. A central bank can use open market operations to change the monetary base. The central bank would buy/sell bonds in exchange for hard currency. When the central bank disburses/collects this hard currency payment, it alters the amount of currency in the economy, thus altering the monetary base.

2. Reserve Requirements

The monetary authority exerts regulatory control over banks. Monetary Policy can be implemented by changing the proportion of total assets that banks must hold in reserve with the central bank. Banks only maintain a

Rahul Publications

small portion of their assets as cash available for immediate withdrawal; the rest is invested in illiquid assets like mortgages and loans. By changing the proportion of total assets to be held as liquid cash, the Federal Reserve changes the availability of loanable funds. This acts as a change in the money supply.

3. Discount Window Lending

Many central banks or finance ministries have the authority to lend funds to financial institutions within their country. By calling in existing loans or extending new loans, the monetary authority can directly change the size of the money supply.

4. Interest Rates

The contraction of the monetary supply can be achieved indirectly by increasing the nominal interest rates. Monetary authorities in different nations have differing levels of control of economy-wide interest rates. In the United States, the Federal Reserve can set the discount rate, as well as achieve the desired Federal funds rate by open market operations. This rate has significant effect on other market interest rates, but there is no perfect relationship. In the United States open market operations are a relatively small part of the total volume in the bond market.

Q25. Explain limitations of monetary policy.

Ans :

1. Huge Budgetary Deficits

RBI makes every possible attempt to control inflation and to balance money supply in the market. However Central Government's huge budgetary deficits have made monetary policy ineffective. Huge budgetary deficits have resulted in excessive monetary growth.

2. Coverage of Only Commercial Banks

Instruments of monetary policy cover only commercial banks so inflationary pressures caused by banking finance can be controlled by RBI, but in India, inflation also results from deficit financing and scarcity of goods on which RBI may not have any control.

3. Problem of Management of Banks And Financial Institutions

The monetary policy can succeed to control inflation and to bring overall development only when the management of banks and Financial institutions are efficient and dedicated. Many officials of banks and financial institutions are corrupt and inefficient which leads to financial scams in this way overall economy is affected.

4. Unorganized Money Market

Presence of unorganised sector of money market is one of the main obstacle in effective working of the monetary policy. As RBI has no power over the unorganised sector of money market, its monetary policy becomes less effective.

5. Less Accountability

At present time, the goals of monetary policy in India, are not set out in specific terms and there is insufficient freedom in the use of instruments. In such a setting, accountability tends to be weak as there is lack of clarity in the responsibility of governments and RBI.

6. Black Money

There is a growing presence of black money in the economy. Black money falls beyond the purview of banking control of RBI. It means large proposition of total money Supply in a country remains outside the purview of RBI's monetary management.

7. Increase Volatility

The integration of domestic and foreign exchange markets could lead to increased volatility in the domestic market as the impact of exogenous factors could be transmitted to domestic market. The widening of foreign exchange market and development of rupee - foreign exchange swap would reduce risks and volatility.

8. Lack of Transparency

According to S. S. Tarapore, the monetary policy formulation, in its present form in India, cannot be continued indefinitely. For a more effective policy, it would be necessary to have greater transparency in the policy formulation and transmission process and the RBI would need to be clearly demarcated.

Rahul Publications

Q26. Explain the monetary policy in the 21st Century.

Ans :

One of the most obvious trends over the last two decades has been the gradual erosion of central bank power by market forces. Central banks are operating under tighter constraints as financial markets become more integrated and efficient, and as capital itself becomes more mobile and currencies more volatile. Now, more than ever, central banks need to ensure that they carry the markets with them if their policies are to have any chance of success.

1. Monetary Policy in Operation

Monetary policy sometimes works under conflicting goals, e.g. the desire to avoid inflation versus the desire to boost output and employment. It is necessary to establish what it can and can't do. For example, the central bank can fix the reserves or it can set the interest rates on any one class of debt instruments. It can also set the foreign exchange rate of its currency. But a central bank trading only in the securities market and making or taking payment by adjusting the supply of reserves can't directly set the volume of bank lending. It can only exert influence on these economic processes.

2. Use of Money as an 'Intermediate' Target

The central bank can decide on the amount of 'money supply' in a given year, but cannot directly set the amount of money in the financial system; besides, it can't directly control the volume of bank credit. It tries to use money as an intermediate target by conducting monetary policy.

3. E-money and Falling Demand for Central Bank Money

Central banks face a new threat. Long-run factors, technological ones in particular, reduce the effectiveness of monetary policy. These new developments threaten to reduce the demand for central bank money (the monetary base) to a level where the central bank's leverage over the monetary system-its ability to influence interest rates, exchange rates, and the money supply-effectively disappears. As electronic substitutes for cash become more widely available.

4. Implications of a Declining Demand for Base Money

The declining demand for base money causes major problems for central bankers. First, as base money becomes less significant, it will gradually lose its effectiveness as a channel through which the central bank can influence the broader monetary system.

Secondly, the decline in the demand for base money would make prices and interest rates more vulnerable to external shocks and, in particular, to changes in the technological and other factors that influence the demand for currency.

5. Globalisation and the Monetary Policy

With the deregulation of financial markets and globalisation, the process of monetary policy formulation has acquired a much greater market orientation than ever before. This has been accompanied by several institutional changes in the monetary-fiscal interface to ensure that central banks possess autonomy.

The process of globalisation and liberalisation has necessitated widening of the mandate of central banks. For their policies to be effective, monetary authorities are required to modify the way in which they conduct monetary policy. Central banks in emerging markets also face similar issues. A special challenge in their case has been the need to calibrate the changes in the operating procedures of monetary policy with the pace of transition from an administered regime of interest rates to a market based process.

6. Monetary Policy and Inflation

One of the most significant developments in the theory and practice of monetary policy in recent years has been inflation targeting. The rationale for inflation targeting emerges as the joint consequence of two tools of monetary policy. It can be either open market operations or the interest rate the bank

Rahul Publications

charges on advances. It is possible to express the policy chosen at any time in terms of the intended outcome of any single economic magnitude that monetary policy affects: inflation, output, employment or the economy's foreign balance. Maintaining price stability fosters greater output and employment in the long run. And in the short run, there is nothing monetary policy can do about either output or employment.

7. Central Bank Independence

Central bank independence relates to three areas viz. personnel matters; financial aspects; and conduct of policy. Personnel independence refers to the extent to which the government distances itself from appointment and dismissal procedures of top central bank officials and the governing board. Financial independence relates to the freedom of the central bank to decide the extent to which government expenditure is either directly or indirectly financed via central bank credits. Policy independence is related to the flexibility given to the central bank in the formulation and execution of monetary policy.

8. Central Bank (Reserve Bank) Autonomy Over the Years

The Reserve Bank of India (RBI) was set up in March 1934, with the stated objective of monetary stability and operations on currency and credit system in India.

Shortly after Independence, the RBI was nationalised. The early years, RBI was involved in promoting credit to agriculture and industry in pursuant to the overall objectives of the Five-Year Plans. An example of differences between the Government and RBI was the resignation of Governor Rama Rao in 1957.

During 1948 to 1969, the RBI matured into a full-fledged professionally managed central bank. The mid-fifties saw the beginning of serious erosion of autonomy in the monetary policy function due to the emergence of the system of ad hoc treasury bills and automatic monetisation of fiscal deficit.

The third phase started with the nationalisation of major banks in 1969. Government became the owner of a number of banks, but the supervision of these banks was conducted by the RBI. High fiscal deficits persisted, which posed serious problems for prudent monetary management.

The interest rates were administered and the Statutory Liquidity Ratio (SLR) requirements of the banking sector were periodically hiked. Recourse to the RBI credit was high, thus leading to high levels of monetisation. To neutralise the effect of monetisation on the price level, the RBI had to increase the Cash Reserve Ratio (CRR) requirements of the banking sector.

Monetary Policy in India

The conduct of monetary policy was guided by the objective of provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on the movements in the price level. Ensuring macroeconomic stability was a concurrent objective with intensified monitoring of price movements, in view of the hardening of international commodity prices, especially crude oil. Strong capital inflows posed a challenge for monetary management.

The Reserve Bank responded with a policy mix of prepayment of external debt and liberalisation of foreign exchange transactions to maintain monetary conditions in line with the overall objectives. The monetary management with additional instruments in the context of the large volume of capital inflows led to the institution of a Market Stabilisation Scheme (MSS). Interest rates on nonresident deposits were gradually aligned with those prevailing in the international markets in view of the rapid expansion in banks' external liabilities.

These measures were reinforced by refinements in the Liquidity Adjustment Facility (LAF) scheme to strengthen the operating procedure of monetary policy. The Reserve Bank undertook parallel initiatives to improve the credit delivery system, especially in respect of agriculture and small and medium enterprises (SMEs). Let us understand the meanings of some of the tools used by the RBI.

Rahul Publications

1. Bank Rate

The **bank rate** is the rate at which banks borrow from the RBI. (See Reserve Bank Monthly Bulletin or website to check the current Bank Rate.) It is also defined as the rate of which Reserve Bank gives loans to banks by discounting bills. Any revision in bank rate by the RBI is a signal to banks to revise deposit rates as well as Prime Lending Rate (PLR).

2. Repo Rate

The **repo rate** is the rate at which the RBI borrows from the banks. This is also the floor rate at which overnight deals are struck. Besides lowering the cost of the funds, a lower repo rate will see the emergence of a short-term yield curve, since yields on a 91-day Treasury bill and repo rate will be the same. (Refer Reserve Bank website for updated rate.)

3. CRR and SLR

CRR is the cash reserve ratio, which is the percentage of net funds that commercial banks have to park fortnightly with the RBI to do business. Lowering of CRR means that more money comes into circulation.

In addition to the CRR requirement banks are supposed to maintain a certain percent of net deposits in government securities and similar instruments specified. This is known as Statutory Liquidity Ratio (SLR) which is 25% at present.

1.8.2 Major Changes in Monetary Policy

Q27. Explain in detail about Major Changes in Monetary Policy.

Ans :

Monetary Policy Committee (MPC) of the Reserve Bank of India has provided the major changes in monetary policy in recent times. According to RBI, "The decision of the MPC is consistent with the 'neutral' stance of monetary policy in consonance with the objective of achieving the medium-term target for Consumer Price Index (CPI) inflation of 4% within a band of ± 2% while supporting growth". This was the first three day-bi-monthly policy meeting which raised and increases the repo rate by 25 basis points in January 2014.

(i) During the financial year 2018-19, the MPC decided to maintain the estimation of GDP growth at 7.4%.

(ii) For the period of April-September, RBI forecasted the retail inflation at 4.8 to 4.9%.

(iii) The members of the Monetary Policy Committee; (MPC) voted for hike upto 0.25%.

(iv) RBI Governor has stated that the year 2018-19 monsoon is going to be favourable for agricultural sector.

(v) The development of market currencies got depreciated towards US dollar, this situation further results in geopolitical risks, financial market volatility and trade protectionism and also the domestic growth.

(vi) The RBI stated that the volatility in the crude oil prices has included to the inflation.

1.9 Securities Exchange Board of India (SEBI)

1.9.1 Role of SEBI

Q28. Define SEBI. Explain the objectives and role of SEBI.

Ans : **(Dec.-19, Feb.-17, Imp.)**

Securities Exchange Board of India (SEBI) was set up in 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,

Rahul Publications

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).

Role

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.

Objectives

The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

1. To regulate the activities of stock exchange.
2. To protect the rights of investors and ensuring safety to their investment.
3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.
4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

1.9.2 Functions of SEBI

Q29. Explain the various functions of SEBI.

Ans : **(Dec.-19, Aug.-17, 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

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:

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

Rahul Publications

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

2. Developmental Functions

These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange. Under developmental categories following functions are performed by SEBI:

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting flexible and adoptable approach in following way:

(a) SEBI has permitted internet trading through registered stock brokers.

(b) SEBI has made underwriting optional to reduce the cost of issue.

(c) Even initial public offer of primary market is permitted through stock exchange.

3. Regulatory Functions

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

(v) SEBI regulates takeover of the companies.

(vi) SEBI conducts inquiries and audit of stock exchanges.

Q30. 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."

Rahul Publications

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 frame work 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 .

Rahul Publications

Q31. 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 atleast 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.

1.10 AN UPDATE ON THE PERFORMANCE ON NON-STATUTORY FINANCIAL ORGANIZATION

Q32. What do you mean by Non-bank Statutory Financial Organization. Explain the objectives of NBSFOs.

Ans : **(Aug.-12)**

Non-bank statutory financial organizations are the financial institutions that are statutorily established by government. They are not considered as banks and financial intermediaries as they do not involve in mobilization of savings. The government and RBI provide finance and other resources to NBOs. However, recently they have started mobilization of savings either directly or indirectly and allowed the private sector in their ownership group of NBSFOs. Mostly NBSFOs are meant for specialized purposes such as offering financial assistance to small scale units, rural development etc. Only some are generalized institutions.

Rahul Publications

NBSFOs are also called "developmental banks" or "term lending institutions" or "special development financial institutions" and they include more than 30 institutions.

Objectives

i) To serve as an agent of development in various sectors viz., industry, agriculture and international trade.

ii) To accelerate the growth of the economy.

iii) To allocate resources to high priority areas.

iv) To foster rapid industrialisation, particularly in the private sector, so as to provide employment opportunities as well as higher production.

v) To develop entrepreneurial skills.

vi) To promote the development of rural areas.

vii) To finance housing, small scale industries, infrastructure and social utilities.

In addition, they are assigned a special role in,

- Planning, promoting and developing industries to fill the gaps in industrial sector.
- Coordinating the working of institutions engaged in financing, promoting or developing industries, agriculture or trade.
- Rendering promotional services such as discovering project ideas, undertaking feasibility studies and providing technical, financial and managerial assistance for the implementation of projects.

Q33. Explain the role and functions of Non-Statutory Financial Organization in India.

Ans :

i) Industrial Financial Corporation of India (IFCI)

This is the first term-financing institution and was set up in July 1948 by the Government of India under the IFCI Act, 1948 with the objective of providing medium and long-term loans to large industrial concerns in the private sector. However, now the units from the co-operative, joint, and public sector also have been made eligible for its assistance. It provides direct rupee and foreign currency loans for setting up new industrial projects and for expansion, diversification, renovation, and modernisation of existing units. It also underwrites and directly subscribes to industrial securities, provides financial guarantees, merchant banking services, and lease finance.

ii) National Industrial Development Corporation (NIDC)

The NIDC was set up in October 1954 as a statutory corporation owned by the Government of India. Its functions are: (a) To formulate and execute projects for setting up new industries, (b) To provide consultancy services, (c) To finance the rehabilitation and modernisation of certain industries, such as, cotton and jute textiles, and machine tools.

iii) Industrial Credit and Investment Corporation of India (ICICI)

It was founded on January 5, 1955 as a public limited company with government support and under the sponsorship of the World Bank, and representatives of the Indian industry.

Features

The type of assistance and scope of activities of the ICICI were more or less similar to those of the IFCI. Its principal business was to provide medium and long-term project financing leasing and other types of financial and advisory services to private industry in India.

iv) Industrial Development Bank of India (IDBI)

The IDBI was set up as a wholly-owned subsidiary of the RBI on July 1, 1964 under an Act of Parliament, and by merging the Industrial Refinance Corporation (IRC) which, in turn, was set up by the government earlier in June 1958. In February 1976. the IDBI was delinked from the RBI and since then, it has become a separate and independent entity wholly owned by the government. It is now the central or apex institution in the field of industrial finance.

v) Export-Import Bank of India (EXIM Bank)

The EXIM Bank was set up in January 1982 as a statutory corporation wholly owned by the Central government. Its paid-up capital in 1988-

Rahul Publications

89 was Rs 220.5 crore. It grants direct loans in India and outside for the purpose of exports and imports, refinances loans of banks and other notified financial institutions for purposes of international trade, rediscounts usance export bills for banks, provides overseas investment finance for Indian companies towards their equity participa-tion in joint ventures abroad, and guarantees, along with banks, obligations on behalf of project exporters. It is also a co-ordinating agency in the field of international finance, and it undertakes development of merchant banking activities in relation to export-oriented industries. It thus pro-videos fund-based as well as non-fund-based assistance in the foreign trade sector. Specifically, its products and services include: (a) post-shipment term finance, (b) preshipment credit, (c) term loans for export-oriented units, (d) overseas investment finance, (e) finance for export marketing, (f) overseas buyer's credit lines of credit to foreign governments, (g) re-lending facility to banks abroad, (h) rediscounting of export bills, (i) refinance of export credit, (j) bulk import finance, and (k) research, analysis, advisory and information services.

vi) Industrial Reconstruction Bank of India (IRBI)

In April 1971, the IDBI had set up, at the instance of the GOI, the Industrial Reconstruction Corporation of India (IRCI), as a joint-stock company, to provide reconstruction and rehabilitation assistance. The IFCI, ICICI. LIC, and public sector banks also had contributed to its share capital. The IRCI was reconstituted and renamed as IRBI in 1985 in terms of the IRBI Act. It functions as a principal credit and reconstruction agency for industrial revival, modernisation, rehabilitation, expansion, reorganisation, diversification, and rationalisation. It is empowered to grant loans and advances; underwrite stocks, shares and bonds; and guarantee loans, performance, and deferred payments. It gives assistance for capital expenditure, addition of balancing equipment, correcting imbalances in working capital of sick, weak, closed units and those facing imminent closure.'

vii) Shipping Credit and Investment Corporation of India (SCICI)

The SCICI was incorporated as a public limited company in 1986 and its issued capital of Rs 50 crore has been contributed by ICICI (20%), IDBI, IFCI, LIC, UTI, GIC, SBI, and four other commercial banks. Its main objective is to act as a channel for providing development finance to oceanic shipping, deep sea fishing, oil exploration, ship repairing, and offshore, coastal, and intermediary water services. It has diversified into areas, such as food processing and transportation.

viii) Infrastructure Leasing and Financial Services Ltd. (IL and FS)

The IL and FS was set up in May 1988 jointly by the Central Bank of India (CBI), UTI, HDFC, International Finance Corporation, ORIX Corporation from Japan, Credit Commercial de France, and SBI. It functions as a subsidiary of CBI. The areas of its assistance are: (a) Financing of large infrastructure projects like highways, bridges, and power plants; (b) Equipments leasing for infra-structure development, pollution control, transportation, and communication; (c) Investment bank-ing services including promotion of mutual funds and extension of venture capital; (d) Participation as a member of stock exchanges with a focus on the development of secondary markets.

Q34. Explain the factors affecting for Growth of Non-Statutory Financial Organization.

Ans :

Many factors are responsible for the emergence and the growth of development banks the world over and in India, in particular. They are,

1. Fostering Industrial Growth

An important factor that was responsible for the growth of development banks was the requirement of institutional machinery for fostering industrial growth in the country, especially after the world war II. This caused the need for supplying the basic ingredients of development, capital, knowledge and entrepreneurship for the rapid industrial growth of the country.

2. Long-term Assistance

Another factor that caused the growth of development banks in India and the world over was the need for long-term assistance to business undertakings in the form of loans, underwriting and investment.

Rahul Publications

3. Balanced Development

The need for promoting balanced and viable development by assuming the promotional role of discovering project ideas, undertaking feasibility studies, providing technical, financial and managerial assistance for the implementation of projects etc., also enhanced the growth of development banks.

4. Promotional Services

The need for the provision of financial assistance and rendering of promotional services such as the development of infrastructure and social utilities etc., also prompted the development in the realm of development banking.

5. Infrastructure Building

A strong reason for the phenomenal growth of the development banks was the need for building up the infrastructure required for the accelerated industrial development and economic growth.

6. Economic Policies

The growth of development banks was also driven by the need for assisting in the process of implementation of economic policies formulated by the government.

7. Other Factors

In addition to the above-mentioned factors, the following factors also contributed to the growth of development banks,

i) Need for providing assistance for reconstruction, modernisation and development of war-shattered industries.

ii) Scientific and technological innovations leading to the need for venture capital funds.

1.10.1 Industrial Finance Corporation of India (IFCI)

Q35. Discuss briefly about IFCI.

Ans : **(Dec.-19)**

Government of India came forward to set up the Industrial Finance Corporation of India (IFCI) in July 1948 under a Special Act. The Industrial Development Bank of India, scheduled banks, insurance companies, investment trusts and co-operative banks are the shareholders of IFCI. The Government of India has guaranteed the repayment of capital and the payment of a minimum annual dividend.

Since July I, 1993, the corporation has been converted into a company and it has been given the status of a Ltd. Company with the name Industrial Finance Corporations of India Ltd. IFCI has got itself registered with Companies Act, 1956. Before July I, 1993, general public was not permitted to hold shares of IFCI, only Government of India, RBI, Scheduled Banks, Insurance Companies and Co-operative Societies were holding the shares of IFCI.

Management of IFCI

The corporation has 13 members Board of Directors, including Chairman. The Chairman is appointed by Government of India after consulting Industrial Development Bank of India. He works on a whole time basis and has tenure of 3 years. Out of the 12 directors, four are nominated by the IDBI, two by scheduled banks, two by co-operative banks and two by other financial institutions like insurance companies, investment trusts, etc.

IDBI normally nominates three outside persons as directors who are experts in the fields of industry, labour and economics, the fourth nominee is the Central Manager of IDBI. The Board meets once in a month. It frames policies by keeping in view the interests of industry, commerce and general public. The Board acts as per the instructions received from the government and IDBI. The Central Government reserves the power up to the Board and appoints a new one in its place.

Financial Resources of IFCI

The financial resources of the corporation consist of share capital bonds and debentures and borrowings.

a) Share Capital: The IFCI was set up with an authorized capital of Rs. 10 crores consisting of 20,000 shares of Rs. 5,000 each. This capital was later on increased at different times and by March, 2003 it was Rs. 1068 crores. The capital was subscribed by Central

Rahul Publications

Government, Reserve Bank of India, scheduled banks, Life Insurance Corporation, investment trusts, co-operative banks are other financial institutions.

In 1964, the share capital held by the central government and RBI was transferred to the Industrial Development Bank. The corporation thus became a subsidiary of IDBI. The central government had guaranteed the shares of the corporation both for repayment of the principal and for the payment of a dividend at 2.5 per cent on the original issue and 4 per cent on the additional issues. However, since July , 1993 IFCI has been converted into a limited company.

b) Bonds and Debentures : The corporation is authorized to issue bonds and debentures to supplement its resources but these should not exceed ten times of paid-up capital and reserve fund. The bonds and debentures stood at a figure of Rs. 57.69 crores 1971 and rose to Rs. 15366.5 crores as on 31st March 2003. The bonds and debentures are also guaranteed by the central government for both payment of interest at such rates as may be fixed at the time the bonds and debentures are issued.

c) Borrowings : The corporation is authorized to borrow from government IDBI and financial institutions. Its borrowings from IDBI and Govt. of India were Rs. 975.6 crore on March 31, 2003. Total assets of IFCI as on March 31, 2003 aggregated Rs. 22866 crore including investments of Rs. 3820.3 crore and loans and advances of Rs. 13212.8 crore.

Q36. Explain the functions of IFCI.

Ans : **(Dec.-19)**

IFCI is authorized to render financial assistance in one or more of the following forms :

1. Granting loans or advances to or subscribing to debentures of industrial concerns repayable within 25 years. Also it can convert part of such loans or debentures into equity share capital at its option.
2. Underwriting the issue of industrial securities i.e. shares, stock, bonds, or debentures to be disposed off within 7 years.
3. Subscribing directly to the shares and debentures of public limited companies.
4. Guaranteeing of deferred payments for the purchase of capital goods from abroad or within India.
5. Guaranteeing of loans raised by industrial concerns from scheduled banks or state co-operative banks.
6. Acting as an agent of the Central Government or the World Bank in respect of loans sanctioned to the industrial concerns.

Q37. Discuss the promotional activities of IFCI.

Ans :

The IFCI has been playing very important role as a financial institution in providing financial assistance to eligible industrial concerns. However, no less important to its promotional role whereby it has been creating industrial opportunities also. It has been taking up directly as well as indirectly; such steps and activities are regarded necessary for the acceleration of the process of industrialization in the country.

The promotional role of IFCI has been to fill the gaps, either in the institutional infrastructure for the promotion and growth of industries, or in the provision of the much needed guidance in project intensification, formulation, implementation and operation, etc. to the new tiny, small-scale or medium scale entrepreneurs or in the efforts at improving the productivity of human and material resources.

1. Development of Backward Areas

The main thrust of all financial institutions has been to removal of regional imbalances by promoting industrialization of backward areas. IFCI introduce a scheme of confessional finance for projects set up in backward areas. The backward-districts were divided into three categories depending upon the state of development there. All these categories were eligible for concessional finance. Nearly 50 per cent of total lending of IFCI has been to develop backward areas.

Rahul Publications

2. Promotional Schemes

IFCI has been operating six promotional schemes with the object of helping entrepreneurs to set up new units, broadening the entrepreneurial base, encouraging the adoption of new technology, tackling 'the problem of sickness and promoting opportunities for self development and self employment of unemployed persons etc. These schemes are as such:

a) **Subsidy for Adopting Indigenous Technology :** The projects which use indigenously developed technology are entitled to a concession in the form of subsidy covering interest payments due to IFCI during the first three years of operations, extendable to five years.

b) **Meeting Cost of Market Studies :** The entrepreneurs setting up medium sized industrial projects for the first time can avail 75 per cent of the cost of market survey/study subject to a ceiling of Rs. 15,000 provided it is handled by Technical Consultancy Organization. .

c) **Meeting Cost of Feasibility Studies:** IFCI provides subsidy for the fees paid for consultancy assignments relating to feasibility, project reports etc. The amount allowable is 80 per cent of the fees of Rs. 7,500 whichever is less. This limit is Rs. 8,500 or 100 per cent of the total fees whichever is less for handicapped or scheduled caste persons.

3. Promoting Small Scale and Ancillary Industries

For the identification of products suitable for ancillary or further processing in small scale sector and preparation of feasibility reports a subsidy of Rs. 0.1 million per annum for technical consultancy organization is allowed.

4. Revival of Sick Units

There is a subsidy to the extent of 80 per cent or Rs. 5,000 (whichever is less) for the fees charged by a technical consultancy organization for carrying out a diagnostic study or for the implementation of rehabilitation programme. This facility is allowed to tiny units or units in small scale sector.

5. Self-development and Self employment Scheme

An unemployed person in the age group of 21 to 35 years may be allowed a soft loan for providing margin money for getting a loan from a bank or a financial institution. The soft loan at interest free rate in first year and has confessional interest later on. The amount available under this scheme is 25% of margin money subject to Rs. 5000.

Financial institutions provide means and mechanism of transferring resources from those who have an excess of income over expenditure to those who can make productive use of the same. The commercial banks and investment institutions mobilize savings of people and channel them into productive uses.

Financial institutions provide all type of assistance required infrastructural facilities Institutions of economic persons who can take the development in the following ways.

a) **Providing Funds :** The under-developed countries have low levels of capital formation. Due to low incomes, people are not able to save sufficient funds which are needed for sensing up new units and also for expansion diversification and modernization of existing units. The persons who have the capability of starting a business but does not have requisite help approach to financial institutions for help.

These institutions help large number of persons for taking up some industrial activity. The addition of new industrial units and increasing the activities of existing units will certainly help in accelerating the pace of economic development. Financial institutions have large invertible funds which are used for productive purposes.

Rahul Publications

b) Infrastructural Facilities : Economic development of a country is linked to the availability of infrastructural facilities. There is a need for roads, water, sewage, communication facilities, electricity etc. Financial institutions prepare their investment policies by keeping national priorities in major and the institutions invest in those aim is which can help in increasing the development of the country.

c) Promotional Activities : An entrepreneur faces many problems while setting up a new unit. One has to undertake a feasibility report, prepare project report, complete registration formalities, seek approval from various agencies etc. All these things require time, money and energy. Some people are not able to undertake this exercise or some do not even take initiative. Financial institutions are the expense and manpower resources for undertaking the exercise of starting a new unit.

d) Development of Backward Areas : Some areas remain neglected because facilities needed for setting up new units are not available here. The entrepreneurs set up new units at those places which are already developed. It causes imbalance in economic development of some areas. In order to help the development of backward areas, financial institutions provide special assistance to entrepreneurs for setting up new units in these areas. IDBI, IFCI, ICICI give priority in giving assistance to units set up in backward areas and even charge lower interest rates on lending.

Such efforts certainly encourage entrepreneurs to set up new units in backward areas. The industrial units in these areas improve basic amenities and create employment opportunities. These measures will certainly help in increasing the economic development of backward areas.

6. Planned Development

Financial institutions help in planned development of the economy. Different institutions earmark their spheres of activities so that every business activity is helped. Some institutions like SIDBI, SFCI's especially help small scale sector while IFCI and SIDC's finance large scale sector or extend loans above a certain limit.

7. Accelerating Industrialization

Economic development of a country is linked to the level of industrialization there. The setting up of more industrial units will generate direct and indirect employment, make available goods and services in the country and help in increasing the standard of living. Financial institutions provide requisite financial, managerial, technical help for setting up new units. In some areas private entrepreneurs do not want to risk their funds or gestation period His long but the industries are needed for the development of the area.

Financial institutions provide sufficient funds for their development. Since 1947, financial institutions have played a key role in accelerating the pace of industrialization. The country has progressed in almost all areas of economic development.

8. Employment Generation

Financial institutions have helped both direct and indirect employment generation. They have employed many persons to man their offices. Besides office staff, institutions need the services of experts which help them in finalizing lending proposals.

These institutions help in creating employment by financing new and existing industrial units. They also help in creating employment opportunities in backward areas by encouraging the setting up of units in those areas, Thus financial institutions have helped in creating new and better job opportunities.

Rahul Publications

Q38. Explain the Economic contribution of IFCI.

Ans : **(Dec.-19)**

The economic contribution of IFCI can be measured from the following points,

1. Since its establishment, IFCI has spent ` 444 billion and it has sanctioned financial assistance of ` 462 billion to 5,707 concerns.
2. It has made investments of ` 2,526 billion in the infrastructure and industrial sectors.
3. The assistance of IFCI helped in creating production capacities of,
   - 8 port project, 1 bridge project and 66 telecoms projects.
   - 5,544 hospital beds.
   - 22,106 hotel rooms.
   - 14,953 mw of electricity.
   - 30.2 million tpa of steel and iron.
   - 59.3 million tpa of cement.
   - 18.5 million tpa of fertilizers.
   - 1.7 million tonnes tpa of paper and paper related products.
   - 7.2 million tpa of sugar production.
   - 6.5 million spindles in the textile industry.
   - 32.8 million tpa of petroleum refining.

1.10.2 Industrial Reconstruction Bank of India (IRBI)

Q39. What are the functions of IRBI ?

Ans :

The Industrial Reconstruction Bank of India (IRBI) was established in 1985 under the Industrial Reconstruction Bank of India Act. 1985, after reconstitution of the erstwhile Industrial Reconstruction Corporation of India. It is the principal credit and reconstruction agency for rehabilitation of sick and closed industrial units. It assists industrial concerns by granting loans and advances, underwriting of stocks, shares, bonds and debentures and guarantees for loans/deferred payments. The range of its services includes provision of infrastructural facilities, consultancy, managerial and merchant banking facilities and making available machine and other equipment on lease or hire-purchase basis.

To provide financial assistance as well as to revive and revitalize sick industrial units in public/ private sectors, an institution called the Industrial Reconstruction Corporation of India (IRCI) was set up in 1971 with a share capital of Rs. 10 crores.

In March 1985, it was converted into a statutory corporation called the Industrial Reconstruction Bank of India (IRBI), with an authorised capital of Rs. 200 crores and a paid-up capital of Rs. 50 crores.

Functions

The following functions were laid down for the IRBI:

i) To provide financial assistance to sick industrial units.

ii) To provide managerial and technical assistance to sick industrial units,

iii) To secure the assistance of other financial institutions and government agencies for the revival and revitalization of sick industrial units,

iv) To provide merchant banking services for amalgamation, merger, reconstruction, etc.,

v) To provide consultancy services to the banks in the matter of sick units, and

vi) To undertake leasing business.

In a similar fashion, the IRBI is to function as the principal credit and reconstruction agency for industrial revival and coordinate the activities of other institutions engaged in the revival of industries and also to assist and promote industrial development and rehabilitation of industrial concerns.

The IRBI is empowered to take over the management of assisted sick industrial units, lease them out or sell them as running concerns or to prepare schemes for reconstruction-by scaling down the liabilities with the approval of the Government of India.

During 1986-87, the IRBI sanctioned a total assistance of Rs. 148.9 crores and disbursed Rs. 946 crores by way of term loans to industrial units for essential capital expenditure relating to modernisation, diversification, renovation, expansion, etc.

During 1995-96, the sanctions of IRBI amounted to Rs. 897 crore. Its cumulative sanctions amounted to Rs. 3,521 crore and disbursement Rs. 2,404 crore.

Rahul Publications

1.10.3 Infrastructure Development Finance Company (IDFC)

Q40. Explain briefly about IDFC. List out the objectives of IDFC.

Ans : **(Oct.-20)**

The IDFC, a new financial institution, has been set for providing long-term finance for infrastructure 'development with an authorised share capital of Rs 5,000 crore to be contributed by the GOI, RBI, banks, and FIs. The GOI has already made a budgetary provision of Rs 500 crore during 1996-97 with a matching initial contribution by the RBI. The IDFC will act as a direct lender, as a refinancing institution, and as a provider of financial guarantees. It was incorporated on January 30, 1997 in Chennai as a specialised institution to facilitate the flow of private finance to commercially viable infrastructure projects in the areas such as telecom, power, roads, ports, railways, urban infrastructure, environment- friendly infrastructure, food and agriculture related infrastructure, urban water and sanitation, etc. The IDFC provides debt and equity support and advisory services. It helps promoters in raising resources from international markets by offering financial guarantees. Its initial paid-up capital is Rs 1000 crore. The government and RBI have provided Rs 650 crore as subordinated debt. Thus, the total capital of IDFC at present is Rs 1650 crore.

Objectives

- Delivering profitability, pursuing innovation, growing its asset base and promoting thought leadership
- Focus on four key sectors Transport, Energy, Telecommunication (Telecom) and IT, and Industrial and Commercial infrastructure
- Delivery of four main products Project Finance, Equity Finance, Structured Products and Advisory / Investment Banking services
- Exploration of four new frontiers Urban Services, Rural Infrastructure, Healthcare and Education.

1.10.4 National Bank for Agriculture and Rural Development (NABARD)

Q41. Explain the functions of NABARD.

Ans : **(Feb.-15, Feb.-13)**

In 1981, the Committee to Review Arrangement for Institutional Credit for Agriculture and Rural Development set up by the RBI, recommended the establishment of the NABARD.

Capital of NABARD

The authorized capital of NABARD is Rs. 500 crore. It can float bonds and debentures, can receive deposits from Central Government, commercial banks and local bodies. It can also borrow from foreign governments. The paid-up capital is contributed by the Central Government and the RBI in equal proportions. At the time of its establishment, loans and advances issued by the RBI and outstanding against State cooperative banks and Regional rural banks were transferred to NABARD. Besides, the RBI has also sanctioned a credit of Rs. 1200 crore to NABARD. For liberal financing NABARD receives funds from the World Bank and IDA.

Functions of NABARD

a) It functions as an apex institution i.e., it takes up all the functions performed by the RBI with regard to rural credit. It attends to all the matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas.

b) It serves as refinancing agency for the institutions providing production and investment credit of promoting various developmental activities in rural areas.

c) It gives medium-term credit to State cooperative banks for seasonal agricultural operations, marketing of crops, distribution of fertilizers and working capital requirements of cooperative sugar mills.

d) It provides short-term credit to State cooperative banks for seasonal agricultural operations, marketing of crops, distribution of fertilizers and working capital requirements of cooperative sugar mills.

Rahul Publications

e) It extends medium-term and long-term credit of investment schemes in agriculture of State cooperative banks, Land development banks, Regional Rural Banks and commercial banks.

f) It provides long-term loans to State Government to for subscribing to the share capital of cooperative institutions.

g) It undertakes monitoring and evaluation of projects refinanced by it.

h) It takes measures towards institution building for improving absorptive capacity of credit delivery system. These measures include monitoring, formulation of rehabilitation schemes, reconstruction of credit institutions and training of personnel etc.

Q42. Discuss the achievements of NABARD.

Ans :

NABARD is a single integrated organization which looks after the credit requirements of all types of agricultural and rural development activities. Its performance in extending various types of financial assistance is as follows :

a) Short-term Credit : It provides short-term credit facilities to state cooperative Banks for financing seasonal agricultural operations, marketing of crops, pisciculture activities, purchase and distribution of fertilizers, marketing activities etc.

b) Medium-term Credit : Medium term facilities are provided to StCBs and RRBs for converting short-term loans into medium-term loans.

c) Long-term Credit : Long term loans are granted to State Governments.

d) Assistance to Less Developed States : It has continued the policy of promoting agricultural investment in the less developed and under-banked states.

e) Assistance to Non-Farm Sector : It also provides financial help to non-form activities with a view to promote integrated rural development. Finance I provided for production and marketing activities of cooperative sugar mills, recognized cottage and small scale industries.

f) Rehabilitation Programme : It has started taking active part in organizing and strengthening the cooperative credit structure of the country. It has initiated a rehabilitation programme for financially and administratively weak Central and State Cooperative banks.

g) Assistance to Research and Development Projects : Every year, it provides financial assistance to a number of banks from its Research and Development Fund for setting up or strengthening their Technical, Monitoring and Evaluation cell.

h) Rural Infrastructure Development Fund: The Union Budget 1995-96 proposed creation of Rural Infrastructure fund in NABARD with a corpus of Rs. 2000 crore.

i) Kisan Credit Cards : It was introduced in 1998-99. They are issued to farmers by commercial banks, cooperative and RRBs. These cards enable the farmers to obtain credit. The limit of Rs. 5,000 was dispensed with. The loans disbursed under KCC scheme are insured by the General Insurance Corporation.

1.10.5 Small Industries Development Bank of India (SIDBI)

Q43. Discuss the objectives and functions of SIDBI ?

Ans :

Small Industries Development Bank of India (SIDBI) was established as wholly owned subsidiary of Industrial Development Bank of India (IDBI) under the Small Industries Development of India Act, 1989. It is the principal institution for promotion, financing and development of industries in the small scale sector. It also coordinates the function of institutions engaged in similar activities.

Objectives of SIDBI

a) Initiating steps for technological upgradation and modernization of existing units

b) Expanding the channels for marketing the products of the small scale sector

c) Promotion of employment-oriented industries, especially in semi urban areas to create more employment opportunities and thereby checking migration of population to urban areas

Rahul Publications

Functions of SIDBI

a) It refinances loans and advances provided by the existing lending institutions to the small scale units.

b) It discounts and rediscounts bills arising from sale of machinery to and manufactured by small scale industrial units.

c) It extends financial support to State Small Industries Corporation for providing scarce raw materials to and marketing to and marketing the products of the small scale units.

d) It provides services like factoring, leasing etc to small units.

e) It extends financial support to State Small Industries Corporations for providing scarce raw materials to and marketing the products of the small scale units.

f) It provides financial support to National Small Industries Corporation for providing, leasing, hire-purchase and marketing help to the small scale units

Capital of SIDBI

SIDBI started its operations from April 1990 with an initial authorized capital of Rs. 250 crore, which could be increased to Rs. 1000 crore. It also took over the outstanding portfolio of IDBI relating to small scale sector held under Small Industries Development Fund as on March 31, 1990 worth over Rs. 4000 crores.

1.10.6 State Finance Corporation (SFCs)

Q44. Explain the features of SFCs.

Ans :

The IFCI provides financial assistance to large public limited companies and cooperative societies and does not cover the small and medium-sized industries. In order to meet the varied financial needs of small and medium sized industries, the Government of India passed the State Finance Corporations Act in 1951 which empowers the State Governments to establish such Corporations in their states. The first State Finance Corporation was set up in Punjab in 1953.

Features of SFC's

a) The SFCs were set up with the objective of providing the financial assistance to the small as well as the medium industrial concerns. Though there has been a notable rise in the overall financial assistance, the performance in individual Corporations differed largely due to the attitudes and motivations of the local entrepreneurs in different states.

b) Prior to 1966, the SFCs showed preference for medium industries. But, now there has been a marked shift in their lending policies in favour of the small units.

c) Major beneficiaries of the financial assistance of the SFCs have been the food processing industries, services, chemicals, textiles, metal products, machinery.

d) A special feature of the lending operations of SFCs has been the provision of finance to industrial concern of backward areas.

e) The SFCs provide concessional assistance to the industrial units located in backward area in terms of soft loans at concessional rates, lower margins, reduced service charges etc.

f) In order to encourage self-employment, the SFCs have formulated schemes of assistance to technician-entrepreneurs.

Q45. List out the objectives of SFC's.

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

Objectives of SFC's

1. Provide financial assistance to small and medium industrial concerns.
2. Provide long and medium-term loan repayable ordinarily within a period not exceeding 20 years.
3. Grant financial assistance to any single industrial concern under corporate or co-operative sector with an aggregate upper limit of rupees Sixty lakhs.
4. To lay special emphasis on the development of backward areas and small scale industries.

Q46. What are the functions of SFC's ?

Ans :

a) The SFCs have been established to provide long-term finance to small-scale and + medium-sized industrial concerns organized as public or private companies, corporations, partnerships.

b) The SFCs extend loans and advances to the industrial concerns repayable within a period of 20 years.

Rahul Publications

c) The SFCs guarantees loans raised by the industrial concerns in the market or from scheduled or cooperative banks and repayable within 20 years.

d) The SFCs subscribes to the debentures of the industrial concerns repayable within a period of 20 years.

e) The SFCs guarantee loans raised by the industrial concerns from scheduled or cooperative banks and repayable within 20 years.

f) The SFCs underwrite the issue of stocks, shares, bonds and debentures by industrial concerns.

g) The SFCs guarantee the deferred payments for the purchase of plant, machinery etc. within the country.

h) The SFCs are prohibited from subscribing directly to the shares or stock of any company having limited liability, except for underwriting purposes and granting any loan or advance on the security of own shares.

Q47. Explain the financial Resources of the SFCs.

Ans :

The capital resources of the SFCs includes :

a) Share capital and reserves

b) Bonds and debentures

c) Borrowing from the RBI, State governments

d) Finance from IDBI

e) Deposits

The SFCs can also raise funds by issuing bonds and debentures. Bonds and debentures issued by the Corporation are guaranteed by the respective State governments and mostly subscribed by the commercial banks and other financial institutions.

Q48. Explain the Prospects and drawbacks of SFC's

Ans :

Prospects

1. Special Help to Women Entrepreneurs

Many state financial corporation like Delhi SFC have state new scheme for helping women who want to open their new business in India. This is good prospect of state financial corporation for development of women.

2. Highest Loan Provider for Small Scale Industry

It is also achievement of SFCs that these institutions have provided more than Rs. 6,300 crore to small scale industry in 2010.

3. Industrial Research

Since establishing SFCI in 1951, SFCs are working 59 years in India. So, these financial institutions have huge industrial information and these institutions are also busy for collecting industrial information. A new businessman can start their industrial research by contacting these institutions if he wants to open a new business.

Drawbacks of SFC's

a) The financial resources for the SFCs are inadequate. They face the difficulty of finding funds.

b) The SFCs have not been able to provide adequate financial assistance to meet the requirements of small and medium industries.

c) The SFCs charge very high interest rates on all loans other than the soft loans.

d) The SFCs also face the serious problem of increasing magnitude of over dues. The main reasons for over dues are delay in the implementation of projects and industrial sickness.

e) The SFCs lack self-sufficient organizational set up along with adequate specialized and trained staff for ensuring their efficient functioning.

f) There is also a shortage of technical personnel for judging the soundness of the proposed schemes of the borrowing units.

g) Many difficulties are faced by the SFCs while extending financial assistance to the small industrial units.

Rahul Publications

Short Question and Answers

1. What do you mean by equilibrium in financial markets?

Ans :

The equilibrium in financial markets is usually determined by assuming that there would be perfect competition, and by using the well-known tool of supply and demand.

Financial markets are said to be perfect when,

a) A large number of savers and investor operate in markets

b) There are no taxes

c) The participants in markets have homogeneous expectations

d) The financial assets are infinitely divisible

e) All operators in the market are well-informed and information is freely available to all of them

f) The savers and investors are rational

Under these ideal conditions, the financial markets attain the equilibrium position when the supply and demand are equal to each other. The supply curve and demand curve intersect with each other. Here the supply and demand for loanable funds which determine the equilibrium rate of interest.

Equilibrium in financial markets is established when the expected demand for funds for short-term and long-term investments matches with the planned supply of funds generated out of saving and credit creation. The equality of total desired borrowing with the total desired lending is necessary for establishing equilibrium rate of interest.

2. Cash Reserve Ratio

Ans:

The Cash Reserve Ratio (CRR) is an effective instrument of credit control. Under the RBI Act of, l934 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%.

3. Statutory Liquidity Ratio

Ans:

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%.

4. Explain the characteristics features of financial system.

Ans :

The following are the characteristics features of financial system are :

(i) 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.

Rahul Publications

(ii) 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.

(iii) 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.

5. Financial sectors Reforms.

Ans :

a) Policy Reforms

Commercial banking constitutes the largest segment of the Indian financial system after the nationalisation of major banks in two waves, starting in 1969, the Indian banking system became predominantly government owned by the early 1990s. Banking sector reform essentially consisted of a two-pronged approach. While nudging the Indian banking system to better health through the introduction of international best practices in prudential regulation and supervision early in the reform cycle, the idea was to increase competition in the system gradually. The implementation periods for such norms, were, however, chosen to suit the Indian situation. Special emphasis was placed on building up the risk management capabilities of the Indian banks. Unlike in other emerging market countries, many of which had the presence of government owned banks and financial institution, banking reform has not involved large scale privatisation of such banks.

b) Interest Rate Deregulation and Financial Repression

Perhaps the single most important element of the financial sector reforms has been the deregulation of interest rates.

i) Interest rates were free on corporate bonds, most bank lending and bank deposits above one year maturity.

ii) Introduction of auctions coupled with reduced preemption led to more market determined interest rates for government securities.

iii) Administered interest rates are now confined mainly to short term bank deposits, priority sector lending and deposits of non banking financial companies.

6. What are the objectives of financial system?

Ans :

The following are the objectives of financial system are :

i) Facilitate Payment

The financial system facilitates payment through banks and any other financial institution. Anything we buy or sale requires the transection of money. That is done by the financial system

ii) It Link Between Saver And Investor

The financial system provides a place where saver and investor meets. Saver saves money and investors invest it in different types of stocks to get profit on it.

iii) Helps In Capital Formation

For capital formation, there should be a good financial system that provides the finance timely and in an appropriate amount.

Rahul Publications

iv) To Ensure Safety On Investment

The financial system has different institutions for the proper supervision of the financial market that controls the market. So, the safety of the investment can be done.

v) Helps In The Growth of The Economy

Proper mobilization of funds and proper control in the financial market helps the business to grow and motivate investors to invest. That helps in the growth of the economy.

7. Role of RBI for regulating NBFIs.

Ans :

According to the RBI (Amendment) Act, 1997, every NBFI which owns 1.25 lakhs of funds and above must be registered with RBI. Currently, RBI regulates all NBFIs except HFCs.

The following are the provisions by which RBI regulates NBFIs,

1. An NBFI must have funds of a minimum net worth of 25 lakhs, which must be achieved in 3 years. Flowever, this time limit can be extended to a period of more than 3 years at RBI's discretion.
2. They must create a reserve fund by transferring not less than 20% of their net deposits to the fund per year.
3. Deposits of 10% and 15% must be maintained in liquid assets.

8. Define Monetary policy.

Ans :

Meaning

Monetary policy refers to the measures which the central bank of the country takes in controlling the money and credit supply in the country with a view to achieving certain specific economic objectives.

Objectives

The objectives of monetary policy differ from country to country according to their economic conditions. In the less developing countries like India or Pakistan its objective may be the maintenance of monetary stability and help in the process of economic development. In the developed countries its objective may be to achieve full employment, without inflation. Following are the main objectives of the monetary policy.

i) Control of Inflation and Deflation

Inflation and deflation both are not suitable for the economy. If the price level is reasonable and there is an adjustment between the price and cost, rate of out put can increase. Monetary policy is used to coordinate the cost and price. So price stability is achieved through the monetary policy.

ii) Exchange Stability

Monetary policy second objective is to achieve the stable foreign exchange rate. If the rate of exchange is stable it shows that economic condition of the country is stable.

9. Define SEBI.

Ans :

Securities Exchange Board of India (SEBI) was set up in 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).

Rahul Publications

Role

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.

i) Issuers : For issuers it provides a market place in which they can raise finance fairly and easily.

ii) Investors : For investors it provides protection and supply of accurate and correct information.

iii) Intermediaries : For intermediaries it provides a competitive professional market.

10. Non-bank Statutory Financial Organization.

Ans :

Non-bank statutory financial organizations are the financial institutions that are statutorily established by government. They are not considered as banks and financial intermediaries as they do not involve in mobilization of savings. The government and RBI provide finance and other resources to NBOs. However, recently they have started mobilization of savings either directly or indirectly and allowed the private sector in their ownership group of NBSFOs. Mostly NBSFOs are meant for specialized purposes such as offering financial assistance to small scale units, rural development etc. Only some are generalized institutions.

NBSFOs are also called "developmental banks" or "term lending institutions" or "special development financial institutions" and they include more than 30 institutions.

11. NABARD

Ans :

In 1981, the Committee to Review Arrangement for Institutional Credit for Agriculture and Rural Development set up by the RBI, recommended the establishment of the NABARD.

Capital of NABARD

The authorized capital of NABARD is Rs. 500 crore. It can float bonds and debentures, can receive deposits from Central Government, commercial banks and local bodies. It can also borrow from foreign governments. The paid-up capital is contributed by the Central Government and the RBI in equal proportions. At the time of its establishment, loans and advances issued by the RBI and outstanding against State cooperative banks and Regional rural banks were transferred to NABARD. Besides, the RBI has also sanctioned a credit of Rs. 1200 crore to NABARD. For liberal financing NABARD receives funds from the World Bank and IDA.

Functions of NABARD

a) It functions as an apex institution i.e., it takes up all the functions performed by the RBI with regard to rural credit. It attends to all the matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas.

b) It serves as refinancing agency for the institutions providing production and investment credit of promoting various developmental activities in rural areas.

Rahul Publications

UNIT II

Banking and Non Banking Institutions: Commercial banks – Growth and structure of commercial Banks- competition, interest rates, spreads, and NPAs. Bank capital – adequacy norms and capital market support. Banking Innovations- e-banking- Risk Management in Banking. Co-operative banksFeatures, Structure and Growth, Government initiatives to strengthen the co-operative banks.

Non-banking financial Institutions: Structure and functioning of Unit Trust of India and Mutual Funds. Growth of Indian Mutual funds and its Regulation. The Role of AMFI. Insurance Companies – Structure and Investment Pattern of Public and Private Sector insurance companies, Competition, innovation, Role of IRDA, Challenges of Insurance Sector in India.

2.1 BANKING STRUCTURE IN INDIA

Q1. Define Bank. Explain the structure of Banking in India.

(OR)

Draw a chart depicting the banking structure in India.

(OR)

Explain the banking structure in India.

Ans : **(Feb.-17, Aug.-15, Aug.-12, Imp.)**

Definition

(i) According to Walter Leaf "A bank is a person or corporation which holds itself out to receive from the public deposits payable on demand by cheque".

(ii) According to The Banking Companies Act, 1949. "A banking company is defined as one which transacts the business of banking which means accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand (or) otherwise and withdrawals by cheque, draft, order or otherwise".

The banking structure in India consists of commercial banks, financial institutions, non-banking financial companies and Co-operative credit institutions. Each component can be studied as follows :

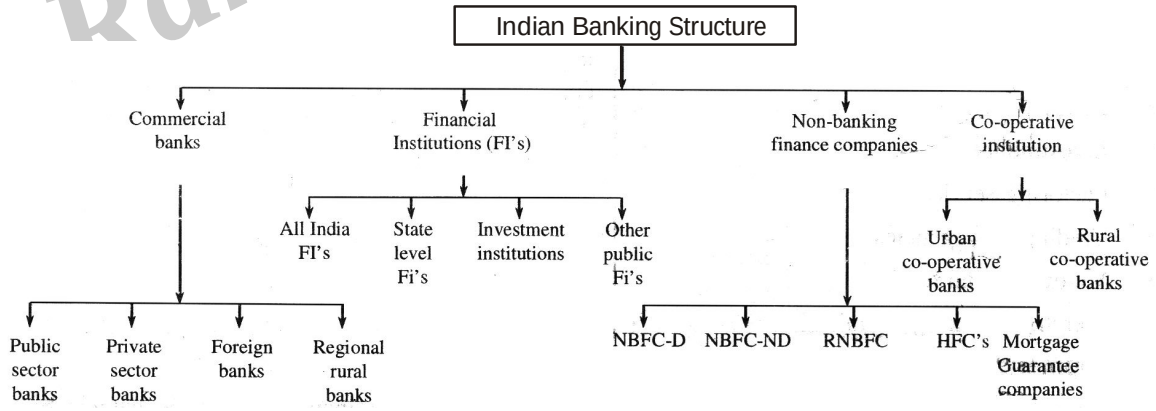


Fig.: An overview of Indian Banking Structure

1. Commercial Banks

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.

Rahul Publications

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 Grameena Vikas Bank, Arunachal Pradesh Rural Bank, Baroda Gujrat Bank, Himachal Gramin Bank etc.

2. Financial Institutions (FI's)

Financial institutions form the second component of the IF's. Financial institutions are business organizations which deal with financial resources. They are the industrial

Rahul Publications

sources of finance. It is a link between the savers and investors and helps in the credit allocation process financial institution's are necessary for the efficient functioning of the economy. By accepting the deposits from individuals and institutions, resources or funds are collected. Financial institutions then loan them to industry or trade. They take decisions regarding efficient use of scarce capital. They are involved in transactions of financial instruments. Financial include institution (FI's),

(a) All India Financial Institutions (FI's)

(b) State level financial institutions

(c) Investment institutions and

(d) Other public FI's.

All India FI's comprises Exim Bank, NABARD, NHB and SIDBI. EXIM Bank in also known as "Term-lending institution", whereas NABARD, NHB and SIDBI constitutes the refinancing institutions. EXIM Bank makes direct investments in projects. Based on the nature of investment refinancing has to be carried out. For example, NABARD provide refinancing facility to agriculture and other allied activities. NHB extends refinance to housing sector whereas, for Micro Small and Medium Enterprise (MSME), refinancing facility is provided by SIDBI.

State Financial Corporation (SFC's) and State Industrial and Development Corporations (SIDC's) are termed as state level "Financial institutions". Investment institutions comprises LIC and GIC. Under the companies Act, 1956, the government of India announced "Public financial institutions" which includes Industrial Finance Corporation of India (IFCI) and Tourism Finance Corporation of India (TFCI).

3. Non-banking Finance Companies (NBFC)

NBFC's are financial intermediaries whose main function is to accept deposits and deliver credit. They are responsible for channeling financial resources which may be source for capital formation. They aid the banking sector in meeting the financial requirements of the corporate sector. As compared to banks NBFC's are flexible, quick, efficient and customize services as per the requirements of the clients.

NBFC's provide services which may include.

- Hire purchase finance
- Equipment lease finance
- Loans
- Investments
- Factoring services
- Credit rating agencies
- Venture capital funds
- Merchant banking organization.

Non-banking Financial Companies (NBFC's) are classified as,

(a) Deposit taking (NBFC-D)

(b) Non deposit taking (NBFC-ND)

(c) Residuary (RNBFC)

(d) Mortgage guarantee companies

(e) Housing Financing Companies (HFC's).

Deposit taking NBFC's (NBFC-D) and non-deposit taking NBFCs (NBFCs-ND) constitute the major categories of NBFCs in India. Residuary NBFC (RNBC) is a type of NBFCs engaged into the accept once of deposits from public. In recent years the business model of RNBC has undergone a drastic change whereas, earlier, they used to retain maximum part of the NBFC deposits. Mortgage guarantee companies and housing finance companies (HFCs) are also special type of NBFC. Altogether there are NBFCs which are operating in India.

4. Co-operative Credit Institutions

Co-operative banking plays in important role in the frame of with reference of the economic growth of the country. Co-operative banks were the basic strength for the growth of the economies of Denmark. Israel, Ireland and many other countries. The planning commission stated that "Co-operatives are of great significance for the working of Five Year Plans."

Rahul Publications

Role of Co-operative Banks

i) **Low Rate of Interest :** Co-operative banks provide loans to the farmers and artisans at low rate of interest and thereby they are protected from the oppression of the Mahajans. Co-operative banks prevent unnecessary expenditure by providing loans only for the productive purposes.

ii) **Increase in Agricultural Production Farmers are granted loans by the Co-operative banks :** for purchasing good seeds, fertilizers and cattle. These banks facilitates in consolidating the land-holdings and eradicating the hindrances in irrigation and transport. Ultimately the agricultural production increases. The role played by co-operatives in Green Revolution such as Wheat revolution in Punjab and Haryana. Sugarcane revolution in Maharashtra and cotton revolution in Gujrat is commendable.

iii) **Rural Upliftment :** Farmer's income and their standard of living is being developed and improved due to Co-operative banking. According to the norms in India, Co-operative banks are required to spend 10% of their profits on rural development. Therefore, the role of co-operatives in the development of rural areas is quite significant.

vi) **Encouragement to Thrift :** Co-operative banking inspires to utilize the funds carefully. Even the small savings of the people are utilized in a more advantageous manner.

v) **Moral Advantages :** Co-operative banks foster moral values by encouraging brotherhood, mutual support and confidence and by discouraging unnecessary legal disputes, misuse of money, gambling and so on.

vi) **Social Advantage :** The members of the Co-operative banks exercise an effective control on their activities due to the unlimited liability of the bank. This results in social awareness. These banks are also involved in social work programmes such as construction of wells and drains, provision of drinking water, healthcare facilities and so on.

vii) **Educational Advantages Banking-training is provided to the members of the:** Co-operative banks and their organizational abilities are encouraged as well.

viii) **Help in Planning :** With the Co-operation of the people the five year plans in India have been successful. The people's co-operation was achieved because of co-operative banking. Thus, the importance of co-operative banking is great for the five- year plans in India.

2.2 COMMERCIAL BANKS

Q2. What are Commercial Banks? Explain the functions of commercial banks.

Ans : **(Sep.-16)**

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:

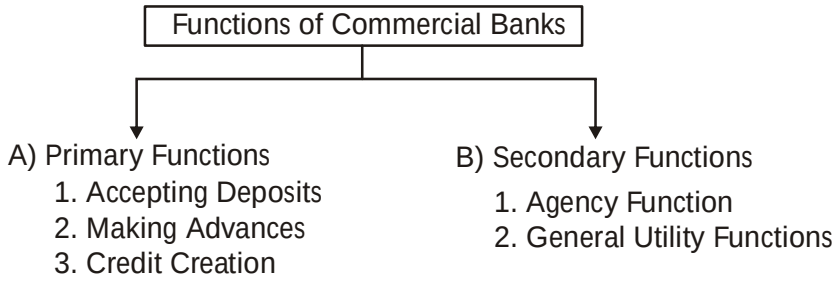
(i) **According to Prof. Sayers,** "A bank is an institution whose debts are widely accepted in settlement of other people's debts to each other." In this definition Sayers has emphasized the transactions from debts which are raised by a financial institution.

(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."

Rahul Publications

Functions

Commercial bank being the financial institution performs diverse types of functions. It satisfies the financial needs of the sectors such as agriculture, industry, trade, communication, etc. That means they play very significant role in a process of economic social needs. The functions performed by banks are changing according to change in time and recently they are becoming customer centric and widening their functions. Generally the functions of commercial banks are divided into two categories viz. primary functions and the secondary functions. The following chart simplifies the functions of banks.



A) Primary Functions of Commercial Banks

Commercial Banks performs various primary functions some of them are given below.

1. **Accepting Deposits:** Commercial bank accepts various types of deposits from public especially from its clients. It includes saving account deposits, recurring account deposits, fixed deposits, etc. These deposits are payable after a certain time period.

2. **Making Advances:** The commercial banks provide loans and advances of various forms. It includes an over draft facility, cash credit, bill discounting, etc. They also give demand and demand and term loans to all types of clients against proper security.

3. **Credit creation:** It is most significant function of the commercial banks. While sanctioning a loan to a customer, a bank does not provide cash to the borrower Instead it opens a deposit account from where the borrower can withdraw. In other words while sanctioning a loan a bank automatically creates deposits. This is known as a credit creation from commercial bank.

B) Secondary Functions of Commercial Banks

Along with the primary functions each commercial bank has to perform several secondary functions too. It includes many agency functions or general utility functions. The secondary functions of commercial banks can be divided into agency functions and utility functions.

1. **Agency Functions** : Various agency functions of commercial banks are

   - To collect and clear cheque, dividends and interest warrant.
   - To make payment of rent, insurance premium, etc.
   - To deal in foreign exchange transactions.
   - To purchase and sell securities.
   - To act as trusty, attorney, correspondent and executor.
   - To accept tax proceeds and tax returns.

Rahul Publications

2. **General Utility Functions** : The general utility functions of the commercial banks include
   - To provide safety locker facility to customers.
   - To provide money transfer facility.
   - To issue traveller's cheque.
   - To act as referees.
   - To accept various bills for payment e.g., phone bills, gas bills, water bills, etc.
   - To provide merchant banking facility.
   - To provide various cards such as credit cards, debit cards, Smart cards, etc.

Q3. Explain the limitations of Credit Creation by 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.

Rahul Publications

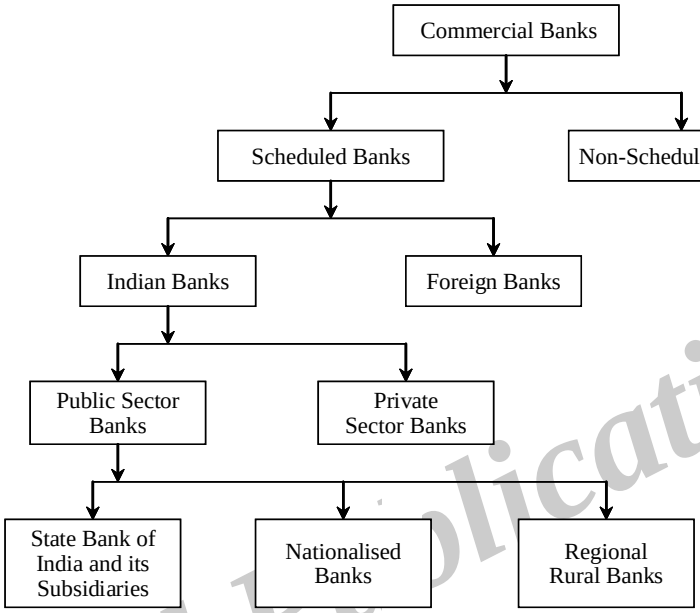
2.2.1 Organizational Structure of Commercial Banks

Q4. Explain the organizational structure of commercial banks.

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

The following figure represents the structure of commercial banks in the country.

Commercial banks can be divided into two main categories as mentioned below:



1. Schedule banks
2. Non – scheduled banks

1. Schedule Banks

A scheduled bank is so called because it has been included in the second Schedule of the Reserve Bank of India Act 1934. To be included in the schedule, a bank must satisfy the following three conditions:

(i) It must have a paid–up capital and reserves of an aggregate value of at least Rs. 5 laths;

(ii) It must satisfy the Reserve Bank that its affairs are not conducted in a manner detrimental to the interest of its depositors; and

The commercial banking system in India consisted of 297 scheduled banks (including foreign banks) and one non-scheduled bank at the end of December 2000. Of the scheduled banks, 223 are in public sector and these account for about 82% of the deposits of all scheduled banks.

2. Non - Scheduled Banks

Banks whose names do not figure in the second schedule of the Reserve Bank of India Act are non – scheduled banks. These banks are also subject to the statutory cash reserve requirements. But unlike scheduled banks, they are not required to keep them with the reserve bank of India. The categories of non – scheduled banks are on the way out. Their number was 16 in June 1969 which decreased to 1 only on June, 1997.

Rahul Publications

Q5. Explain the Suggestion for Improvement of Indian Commercial Banks.

Ans :

The following suggestion can be given to improve the operational efficiency of the Indian commercial banks:

1. Sympathetic Government Policy

For the successful operation of Indian Commercial Banks, the State Government and Central Government should extend active cooperation to these commercial banks. The government should adopt the liberal policy with these banks. In other words, there should be no discrimination practiced against these banks.

2. Curb on Foreign Exchange Banks

It is essential that a check should be imposed on the unfair practices adopted by the foreign exchange banks. They should be made to restrict their activities as far as possible to export- import trade only.

3. Elimination of Inter-Bank Competition

In fact, inter-bank competition is the main obstacle in the banking development of the country. They should reduce the inter-bank competition through mutual understanding and agreement.

4. Amalgamation of Banks

For the development of banking it is essential that the smaller and uneconomic units should be merged with the bigger schedule banks of the country. It will reinforce the banking structure of the country.

5. Cooperation between Scheduled and Non-Scheduled Banks

For the development of banking it is essential to establish cooperation between the scheduled and non-scheduled banks in the country.

6. Appointment of Competent and Efficient Staff

It is also essential to appoint efficient and competent staff to eliminate the present defects and drawbacks of the commercial banks. It is also required to improve their salaries and service conditions.

7. Incentive for New Branches

The commercial banks should be given special incentives by the RBI for opening new branches in smaller cities and rural areas.

8. Improvement in Banking Procedures

Commercial banks are required to impure their banking procedures. They should encourage the use of Indian languages in place of English and should also bring about necessary improvement in their method of account-keeping. The commercial banks should also be encouraged to strengthen their reserves as best as they can.

9. Computerization

The use of computers should be made to a great extent for the banking development of the country. Although some Indian banks have undertaken such a programme, beginning with mechanization of their internal operations and reconciliation of inter-branch transactions but the progress has been very slow and halting.

10. Restoration of the Authority of Reserve Bank

At present the Commercial banks are under double control of the Reserve Bank of India and the Union Ministry of Finance. This is not desirable. The Commercial banks should be under the exclusive control of Reserve Bank of India.

Rahul Publications

2.2.2 Growth of commercial bank

Q6. Discuss in detail about the growth of commercial banks in India.

Ans : **(Oct.-20)**

Banks are very essential components of the Indian Economy and IFS. The importance of banks has risen and fallen over a period of time. The growth of commercial banks in India can be understood clearly through the following,

1. Nationalization of Banks

Nationalization of banks began with nationalization of RBI on Ist January 1949. The SBI, which was formerly called Imperial Bank of India was nationalized in the year 1955. In 1959, eight major state-associated banks were converted to subsidiary banks of the SBI. Two subsidiary banks were merged to form one subsidiary bank in 1963, which reduced the number of associate banks to seven. 14 other major Indian scheduled bank were nationalized in July 1969 and by April 1980, 6 more were nationalized.

Public sector banks occupy a dominant position in the commercial banking in India. The SBI group of banks is the largest among them with control over more than a quarter of total bank deposits.

Two important tasks were assigned to the public sector banks for economic growth of the country. Mobilization of deposits was to be done through large programmes of branch expansion, especially in the unbanked semi-urban and rural areas and diversification of bank credit to enable financial aid to neglected section and sectors.

2. Regulation of Banks by the RBI

RBI plays a vital role in the control, regulation and development of banking in all aspects. The Banking Companies Act 1949 or the Banking Regulation Act has provided authority, extensive powers to RBI to control and supervise other banks. From licensing of banks to their liquidation, all these aspects were covered by RBI and most of the growth factors of the commercial banks of India is due to effective functioning of RBI.

3. Amalgamation and Liquidation of Banks

RBI issued a deliberate policy for the amalgamations and de-licensing and liquidations of small and ill-managed banks during the time of World War II. This resulted in fall in the number of commercial banks from 566 at the end of 1951 to 271 at the end of 1990. These small banks were replaced by large banks which reduced the failures by banks and lead to proper management of All India Policy.

4. Branch Expansion

Till 1954, there was a subsequent fall in the total number of banks in India due to amalgamation of smaller banks and closure of small and non-scheduled bank. In 1956-61 the banking office slowly increased from 4,000 to 5,012. From July 1962, RBI enabled a systematic programme of branch expansion by encouraging banks to open branches in rural, semi-urban and unbanked area. By December 1970 the number of banks were doubled from 5,000 to 11,000 approximately.

Due to the nationalization of 14 major banks in July 1969, a sense of urgency and major catalyst to branch expansion was enabled.

Q7. Explain the classification of public sector banks.

Ans :

Public sector banks dominate commercial banking in India. The Government of India entered commercial banking when it took over the Imperial

Rahul Publications

Bank of India in 1955 and converted it into the state bank of India on 1 July 1955. Now the State bank of India has seven subsidiary banks. Those banks are collectively known as the State Bank Group. It is notable that the State Bank of India at no stage was wholly owned by the Government of India.

In July 1969, the Government of India took an important step of nationalizing 14 large banks. In April 1980, six more banks were nationalized increasing the number of nationalized banks to 20.

In October 1975 another category was added to the public sector banks in the form of regional rural banks. These banks have been set up with the objective of providing credit and other facilities for agriculture and other productive activities in rural areas. These banks are public sector banks as 50% of their capital is provided by the Central Government, 15% by the State Government concerned and the balance 35% by sponsoring public sector commercial bank.

The public sector commercial banking scene is also undergoing change. The New Bank of India has been merged with the Punjab National Bank.

The government of India does not want to contribute more to the capital of commercial bank. Therefore, public sector bank will be raising capital by making public issues. In view of the recommendations in second report (1998) of Narasimham Committee, some mergers or closures may take place in future.

Classification of Pubic Sector Banks

Public sector banks are further classified into:

A) State Bank of India

B) Nationalized Banks

C) Regional Rural Banks

A) State Bank of India

The public sector commercial banking in India started with setting up of State Bank of India, in 1955, by taking over the Imperial Bank of India. In next 5 years the princely states banks were made associate banks of the State Bank of India. These banks taken together are known as State Bank of India Group or SBI Group. Thus, the Group consists of:

1. State Bank of India
2. State Bank of Hyderabad
3. State Bank of Patiala
4. State Bank of Travancore
5. State Bank of Bikaner & Jaipur
6. State Bank of Mysore
7. State Bank of Saurashtra
8. State Bank of Indore

The State Bank of India was the first one to make a public issue in 1993 – 94. At present the bank has authorized capital of Rs. 1000 crores and the issued subscribed and paid – up capital of the bank is more than Rs. 474 crores. After the public issue RBI's shareholding has come down to 68.93% from 92%. There is a proposal to bring it down to 33%.

B) Nationalized Banks

Another important step towards public sector banking was taken in July 1969, when 14 banks with a deposit base of Rs. 50 crores or more were nationalized. Again in 1980, six more private sector banks were nationalized bringing up the total number of banks nationalized to twenty. These banks were:

1. Bank of Baroda
2. Punjab National Bank
3. Bank of India
4. Canara Bank
5. Central Bank of India
6. Indian Bank
7. Indian Overseas Bank
8. Syndicate Bank
9. UCO Bank
10. Allahabad Bank
11. United Bank Of India
12. Oriental Bank of Commerce
13. Corporation Bank
14. Vijaya Bank
15. Dena Bank

Rahul Publications

16. Bank Of Maharashtra
17. Andhra Bank
18. Punjab &Sind Bank
19. New Bank of India

C) Regional Rural Banks

The Narasimham Committee on rural credit recommended the establishment of Regional Rural Banks (RRBs) on the ground that they would be much better, suited then the commercial banks or cooperative banks in meeting the needs of rural areas.

Accepting the recommendations of the Narasimham Committee, the government passed the Regional Rural Banks Act, 1976. The main objective of RRBs is to provide credit and other facilities particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs and develop agriculture, trade, commerce, industry are other productive activities in the rural areas.

The first five RRBs were set up on October 2, 1975, at Moradabad and Gorakhpur in Uttar Pradesh, Bhiwani in Haryana, Jaipur in Rajasthan and Malda in West Bengal. These banks were sponsored by the Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank c " India respectively. Each RRB has an authorized capital of Rs. 1 crore and issued and paid-up capital of Rs. 25 lakhs. The share capital of the RRBs is subscribed by the central government (50%), the state government concerned (15%) and the sponsoring commercial bank (35%).

The RRBs, though basically scheduled commercial banks, differ from the latter in certain respects,

i) The area of RRBs is limited to a specified region comprising one or more districts of a State.

ii) The RRBs are to grant loans and advances to small and marginal farmers, rural artisans and agricultural labourers and other of small means for productive purpose.

iii) The lending rates of RRBs would not be higher than the lending rates of cooperative societies in any particular State.

Q8. Explain the importance of public sector banks.

Ans :

Meaning

In India, the sectorial organization of business can be broadly divided into two groups-Private sector organization and public sector organization. Public sector plays an important role in the economic development of India. The role and importance of public sector can be briefly explained as follows:

1. **Employment :** Public sector provides employment to large number of people in the country. For instance, the Indian Railways provide employment to about 15.5 lakh people, perhaps the largest employer in the world.

2. **Rural Development :** Public sector units facilitate rural development. This is possible due to:
   (i) Infrastructure development, both economic and social infrastructure
   (ii) Locating Projects in rural areas like the Bokara Steel Plant, the Raurkela Steel Plant, etc.

3. **National Income :** Public sector units contribute to the national income of the country. The public sector has grown in size over the years both in terms of number of units as well as in production. It is estimated that the public sector's contribution to GDP is about 25%, and that of the private sector's 75%.

4. **Capital formation :** The public sector contributes to capital formation by mobilization of savings through public sector banks. The all India financial institutions like IDBI, ICICI, etc., play an important role in industrial investment and capital formation by providing medium terms and long-term funds to industry and service sector.

5. **Foreign Exchange Earnings :** The public sector enterprises have contributed to the export earnings of the country. The public

Rahul Publications

sector units export a number of products like engineering goods, chemicals, minerals, metals, etc. they also export services.

6. **Social Order :** The public sector units contribute to the social order b y providing employment to a large number of people in the country. The employment generation reduces the possibility of anti-social activities.

7. **Government Revenue :** PSUs bring revenue to the Government. The revenue is in the form of:
   (a) Direct Taxes
   (b) Indirect Taxes
   (c) Profits of PSUs

8. **Infrastructure Development :** Public sector units play an important role in the development of the infrastructure of the nations. The public sector has developed roadways, railways, airways, power, and so

Q9. Explain the importance of private sector banks.

Ans :

Private banking in India was practiced since the beginning of banking system in India. The first private bank in India to be set up in Private Sector Banks in India was Indus Island Bank. It is one of the fastest growing Bank Private Sector Banks in India. IDBI ranks the tenth largest development bank in the world as Private Banks in India and has promoted world class institutions in India.

The first Private Bank in India to receive an in principle approval from the Reserve Bank of India was Housing Development Finance Corporation Limited, to set up a bank in the private sector banks in India as part of the RBI's liberalization of the Indian Banking Industry. It was incorporated in August 1994 as HDFC Bank Limited with registered office in Mumbai and commenced operations as Scheduled Commercial Bank in January 1995.

ING Vysya, yet another Private Bank of India was incorporated in the year 1930. Bangalore has a pride of place for having the first branch inception in the year 1934. With successive years of patronage and constantly setting new standards in banking, ING Vysya Bank has many credits to its account.

List of Private Banks in India

The following are the various private sector banks in India :

1. The Vysya Bank Ltd.
2. The Federal Bank Ltd.
3. The Jammu & Kashmir Bank Ltd.
4. The South Indian Bank Ltd.
5. The United Western Bank Ltd.
6. The Karur Vysya Bank Ltd.
7. Karnataka Bank Ltd.
8. Bank of Madura Ltd.
9. The Catholic Syrian Bank Ltd.
10. Tamilnadu Mercantile Bank Ltd.
11. The Laxmi Vilas Bank Ltd.
12. The Sangli Bank Ltd.
13. The Dhan Lakshmi Bank Ltd.
14. The Nedungadi bank Ltd.
15. Lord Krishna Bank Ltd.
16. Bharat Overseas Bank Ltd.

Importance of Private Sector Banks in India

The private sector banks play a vital role in the Indian economy. They indirectly moti-vate the public sector banks by offering a healthy competition to them. The following are their importance:

(i) Offering high degree of Professional Management : The private sector banks help in introducing a high degree of professional management and marketing concept into banking. It helps the public sector banks as well to develop similar skill and technology.

(ii) Creates healthy competition : The private sector banks provide a healthy competition on general efficiency levels in the banking system.

(iii) Encourages Foreign Investment : The private sector banks especially the foreign banks have much influence on the foreign investment in the country.

Rahul Publications

(iv) Helps to access foreign capital markets : The foreign banks in the private sector help the Indian companies and the government agencies to meet out their financial requirements from international capital markets. This service becomes easier for them because of the presence of their head offices/other branches in important foreign centres. In this way they help a large extent in the promotion of trade and industry in the country.

(v) Helps to develop innovation and achieve expertise : The private sector banks are always trying to innovate new products avenues (new schemes, services, etc.) and make the industries to achieve expertise in their respective fields by offering quality service and guidance.

They introduce new technology in the banking service. Thus, they lead the other banks in various new fields. For example, introduction of computerised operations, credit card business, ATM service, etc.

Q10. Differences between Private Sector Banks and Public Sector Banks.

Ans :

S.No.	Private Sector Banks	S.No.	Public Sector Banks
1.	At least 51 per cent ownership vests with the Government PSUs include SBI, its subsidiaries and nationalized banks.	1.	Majority shareholding lies with the general public, include both old private sector banks like Bank of Rajasthan, South Indian Bank, Jammu & Kashmir Bank Ltd., as well as new private sector banks like HDFC, UTL ICICI, Kotak Mahindra.
2.	They have old set-up. therefore, capital assets are more.	2.	They have lower balance sheet size and are set-up with lower capital base.
3.	Branches are more including those in rural areas, therefore, penetration and geographical reach is far more.	3.	Branches are comparatively less including those in rural areas.
4.	Number of employees is much more, and they are organized in Trade- Unions.	4.	Less number of personnel and unions do not pose a problem.
5.	Fund income is more as concentration is more on loans and advances. Some have forayed into credit cards, mutual funds, etc.	5.	Fee income is more as they earn commission from loan syndication, equipment leasing, credit cards, mutual funds, Insurance, etc.
6.	They are less technology savvy.	6.	They use state-of-the-art technology which helps them to grow faster, with less investment.
7.	Though a number of changes have been made yet Government control is more.	7.	In the last 4-5 years, there has been further deregulation, and these banks have comparatively more freedom to operate.
8.	NPAs are much higher.	8.	NPAs are much lower.
9.	For public banks "Ltd." will not be used in the last of the name.	9.	For private banks "Ltd." will be used in the last of the name.

Rahul Publications

Q11. Explain the structure and comparative performance of commercial banks.

Ans :

The latest advancements in telecommunications and information technology have transformed the structure of the banking system. Most, of the Indian banks have established their branches overseas as a result of which their assets and liabilities has increased the volume and nature of risks.

Indian banks are permitted to set up Overseas Banking Units (OBUs) in Special Economic Zones (SEZs). OBUs operations are mainly concerned with the non-residents and is found to be independent of the domestic banking. They provide less taxs and levies and are exempted from CRR and SLR requirements. The Reserve Bank has specified some licensing conditions on OBUs which restricts them to deal with India rupee, they are allowed to deal in foreign currencies, they are even restricted to deal with the domestic money market. But, are found to be free from the control of interest rates.

1. Mobilization of Funds

Deposits and non-deposits constitute the resources for the banks to fulfill their requirements. Banks mobilise deposits from the household sector, corporate sector, financial institutions and so on NRI and foreign consulates and embassies deposits with government acts as the best method for mobilizing funds from one country to another. Deposits could be raised by considering the time and demand. Time deposits are bifurcated into short, medium and long-term deposits whereas, the demand deposits are classified into current and savings deposits. Due to tax benefits on long term deposits, higher interest rates on deposit schemes for senior citizens and sound deposit mobilization attempts by bank so as to overcome the problems of credit, banks are mobilising increased levels of time deposits.

Foreign deposits are mobilised by special deposit schemes formulated specifically for the non-residents which is usually nominated in foreign currency and local currency.

Non-deposit resources are raised through public issues, debt and equity, in the capital market. Even, the amount borrowed from the home country as well as from the foreign country also serves the purpose of non-depository resources. Bank raise long-term funds from foreign capital markets in the form of ADRs/GPRs.

Even the funds could be borrowed in the call/ notice money market, repo market, and CBLO market which are characterized by short maturing period. They usually borrows from RBI in the form of export credit refinance facility, financial institutions and the world sector.

Banks are also utilizing the External Commercial Borrowings (ECBs) and the inter-bank borrowings in India and foreign country with an intention of raising funds. They are permitted to use foreign currency borrowings for providing the Pre-shipment Credit in Foreign Currency, (PCFC)/ Export Bills Rediscounting (EBR) to exporters and utilize funds produced by the trading of swaps in the domestic foreign exchange markets for issuing loans.

2. Lending of Funds

Lending is the main process of a commercial bank. Banks are undertaking investment opportunities with a purpose of generating huge profits on their portfolio by assuming low levels of risk. Their portfolio includes four classes of assets, cash in hand and balances with the central bank, assets (both short term and long term assets) with the banking system, investments in government and other approved securities, including the loans and advances.

3. Lending to Agriculture

In addition to the long term finance, banks are granting short term credit facilities for performing the seasonal agricultural operations like crop cultivation and long term credit for establishing assets like purchase or replacement of tractors, installation of diesel pump, irrigation system, etc. Banks offer direct and indirect finance to the agricultural sector eventhough if such finance is associated with high levels of risks which may be due to several factors.

Rahul Publications

4. Lending to Priority Sector

A financial lending to the priority sector was established to guarantee that the bank provide credit finance to the important sectors of the economy. Such finance occurs in compliance with the national priorities. Agriculture, exports and small industries were recognized as priority sectors. The areas belonging to this sector are weaker sections of the population and are found to be employment intensive like that of agriculture and small enterprises. Priority sector norms were recommended by RBI without any ceilings in February 1972. Later, they gets updated in April 2007. The revised norms are applied to the agriculture, small enterprises, retail trade in essential commodities and consumer cooperative stores, micro credit, education loans and housing loans.

RBI has specified that public and private sector scheduled banks can lend about 40 percent of Adjusted Net Bank Credit (ANBC) or credit equal to the amount of Off- Balance sheet Exposures (OBE) to the priority sector based on their quantum.

5. Lending to Industry

Banks provide short term working capital and long term finance to fulfill both the short term and long term financial obligations of the industry large, small and medium and micro enterprises are lended by the banks.

6. Infrastructure Financing

Banks also provide funds to infrastructural projects by granting term loans, bonds and guarantees. New Banks are permitted to provide more than 40 percent of the bank's capital funds i.e., 50 percent to group borrower whereas, the rate of borrowing exceeds from 15 - 20% while providing financial assistance to a single borrower.

Banks are also lending funds to Special Purpose Vehicles (SPVs) belonging to private sectors enabling them to undertake the infrastructural projects.

7. Lending to Household Sector

Household sectors are financed by way of housing loans, Auto loans, advances to individuals against fixed deposits, credit card, educational loans and loans for the purchase of consumer durables. Retail loans constitute the basic drivers of credit growth.

8. Lending to the Sensitive Sectors

Scheduled commercial banks lend funds to the sensitive sectors like real estate, capital markets and commodities. The bank's exposure to capital market comprises loan against shares, direct investment in equity and mutual funds, and advances and guarantees to the brokers.

RBI has imposed, excessive limits on bank's exposure to individual and group borrowers in India so as to prevent focus on credit.

2.3 Competition in Banking Sector

Q12. Explain the competition in banking sector in Indian Economy.

Ans :

In bank competition, certain institutional and economic realities in India need to be kept in mind.

- First, as was shown earlier, there is a high degree of concentration of the banking business with a handful of banks. The market for banking services is an oligopolistic market.
- Second, the policy environment was characterized by close regulation and control' till 1991. For example, the interest rates on deposits as well as financial accommodation were controlled by the monetary authorities till very recently.
- Third, profitability was not the dominant criterion on the basis of which banks were expected to function. There were restrictions on the choice of assets by banks. Banks were expected to finance the government through the purchase of government securities and other accommodation; they were expected to finance priority sectors, sick units, and so on.
- It was a situation in which incentives for vigorous competitive pursuit of objectives were wanting. As was expected in the oligopolistic markets, the markets were shared through mutual understanding and mutually beneficial agreements. This policy was blessed by the authorities.
- Finally, Indian banks had a captive internal market which was insulated against all international competition. Against this

Rahul Publications

background, banks can be said to have competed among themselves and with Non-Bank Financial Institutions (NBFI), non-banking companies, small saving organizations, and so on. In this competition, they lost some ground in the recent past.

- The investors had found that UTI, non-banking companies and small saving organizations offered a rate of return much more attractive than the banks did. The investment in the former had been made all the more attractive by many tax concessions. Of late, the Indian banks have been facing sharp competition from foreign banks.
- The development of the market for Certificates of Deposits (CDs) and Commercial Papers (CPs) had increased the scope and prospects for competition among banks for deposits and loans. The corporate customers can be expected to shop around from bank to bank for the best terms on these instruments. The success in meeting this competition would mean higher cost of funds.

Techniques for Attracting Savings

The techniques of competition which banks have been using for attracting savings from NBFIs are :

1. Offering a competitive rate of return,
2. Introducing a variety of schemes to meet diverse investment needs and preferences of savers,
3. Offering them better services,
4. Offering depositors supplementary services such as transfer of money, travellers cheques, and so on.

Factors for Measurement of Competition

Indian Banking has seen many changes in the last decade like imposition of prudential standards, greater competition among banks, entry of new private banks, etc. This paradigm shift in the Indian banking sector can be seen in terms of two dimensions: One relates to operational aspect especially performance and risk-management system and the second dimension relates to structural and external environment or exogenous aspects.

The status of banking institution is measured by four factors. Each of the factors is given an equal weightage of 25%. Each parameter within a factor is ranked by giving equal weightage across all the banks.

These are as following :

1. Efficiency
2. Financial strength
3. Profitability
4. Size and scale

Efficiency, Financial strength, Profitability, and Size and scale are the composite of interest rates, spreads, and Non-Performing Assets/Advances (NPAs).

2.4 INTEREST RATE

Q13. Define Interest Rate. Explain the classification of interest rate.

Ans :

Interest is the amount which is paid by a borrower for using funds belonging to someone else. It is a transaction between surplus and deficit units. The surplus units lend money because they earn an attractive amount for parting with it. The waiting period involves a 'reward' which includes the lender to forego the use of money.

Again, a lender can part with money for some time limit as he would like it for his own requirements. Thus, in the borrowing and lending transaction, timing is an important consideration as it should be suitable to the borrower and the lender. Interest involves a rate at which funds are borrowed. This rate is need based and dependent on market position of demand and supply of funds. Therefore, an interest rate is to be paid to take a loan.

Definitions

(i) According to Alfred Marshall Interest in the price paid for abstinence of money

(ii) According to Neo – Keynesians Interest is defined interest as equilibrium between stock and flow variables of the real and monetary section. They developed the theory called the ISLM theory.

In the capital market of the country one of the most useful things is to be familiar with the kind of interest rates that operate in the environment. The investors have to cope with the different kinds

Rahul Publications

of interest rate called by different names. In order to be a successful investor he should be able to recognize the kinds of interest rates and by whom these rates are fixed.

Types

1. **Ceiling rate of interest :** It is also the maximum rate of interest fixed by any authority. In India the ceiling rate is usually fixed by the Government of India and the Reserve Bank of India. It depends on the face value of a financial instrument. It is fixed according to the face value of an instrument. It pervades a wide spectrum of the environment but usually does not include the market rate or yield rate. Therefore, the market rate and the yield rate are independent of ceiling rates and are not subject to their restrictions.
2. **Coupon rate of Interest :** It is the rate of interest paid on the face value of a bond is a debenture. A person who purchases a long – term bond from a company expects an interest in the form of coupon.

Q14. Discuss the various interest Rates prevailing in India.

Ans :

In India interest rate is dependent on the planned investment and technological improvements in the economy. It can be equated with the planned priorities of the country. It represents a high natural rate and low market rate. The adjustments in the planning of the economy have led to the movement of prices and interest rate in an upward direction.

1. **Rates in Govt. Funds :** On governments funds interest rates have been stable and low. The yields have also been stabilized. This is in consonance with the planning of the economy.
2. **Muranjan Paradox :** The interest rates show a rise mainly in the short term and call markets where the Hundi rates and Bazar rates are very high. Commercial organizations have found it difficult to cope up with the interest rates. It has been found that the short – term rates are higher than long – term rates of interest. This has been explain as the 'Muranjan Paradox'.
3. **Long – Term Low Interest Rates :** Because of the pressures of the financial institutions like Life Insurance Corporation of India and Unit Trust of India, the long – term rates have increased slowly in the private sector. But while rates of interests given by the private sectors on preference shares have been quite low, the yields on dividends have shown a rise. The yields on ordinary shares have also shown a fall between 1979 and 1984 and 1996. The yields of ordinary share on almost all industries have shown a fall.
4. **Interest on CDD :** Interests on fixed deposit in companies have shown remarkable steadiness and growth. A large number of convertible debentures have been issued but the rise of short – term rates have been faster than these long – term investments.
5. **Post Office Rates :** The interest rates on Post Office schemes and government securities have also shown better interest rates for investors with the benefit and they make a more attractive form of interest when compared to the commercial bank deposits.
6. **Rule of Government :** As government plays a great part in the lending and deposit rates, the interest rates in India cannot be said to be determined by the market forces. The Reserve Bank of India fixes the lending rates of commercial banks. The Controller of Capital Issues fixes the ceiling of debentures and preference shares interest rates. Government fixes the rates of its own long – term securities and Treasury bill and also the interest rates of financial institutions. The Co-operative Societies are regulated. They accept deposits at a higher – rate than their lending rates.

Q15. Explain the factors affecting of Interest.

Ans :

There are markets for investments which include the money market, bond market, as well as retail financial institutions like banks, which set interest rates.

Rahul Publications

Each specific debt takes into account the following factors in determining its interest rate,

1. **Opportunity Cost**
   This encompasses any other use to which the money could be put, including lending to others, investing elsewhere, holding cash (for safety, example) and simply spending the funds.
2. **Inflation**
   Since the lender is deferring his consumption, he will at a bare minimum, want to recover enough to pay the increased cost of good;; due to inflation. Because future inflation is unknown, there are three tactics,
   i) Charge X% interest 'plus inflation'. Many governments issue 'real-return' or 'inflation indexed' bonds.
   The principal amount and ,the interest payments are continually increased by the rate of inflations.
   ii) Decide on the 'expected' inflation rate. This still leaves both parties exposed to the risk of 'unexpected' inflation.
   iii) Allow the interest rate to be periodically changed. While a 'fixed interest rate remains the- same throughout the life of the debt, 'variable' or 'floating' rates can be reset. There are derivative products that allow for hedging and swaps between the two.
3. **Default :** There is always the risk, the borrower will become bankrupt, abscond or otherwise default on the loan. The risk premium attempts to measure the integrity of the borrower, the risk of his enterprise succeeding and the security of any collateral pledged. For example, loans to developing countries have higher risk premiums than those to the US government due to the difference in creditworthiness. An operating line of credit to a business will have a higher rate than a mortgage.
4. **Deferred Consumption :** Charging interest equal only to inflation will leave the lender with the same purchasing power, but he would prefer his own consumption now rather than later. There will be an interest premium of the delay. He may not want to consume, but instead would invest in another product. The possible return he could realise in competing investments will determine what interest up charges.
5. **Length of Time :** Shorter terms have less risk of default and inflation because the near future is easier to predict. Broadly speaking, if interest rates increase, then investment decreases due to the higher cost of borrowing (all else being equal).

2.5 SPREADS

Q16. Explain the concept of spreads.

Ans :

In order to profit from a spread transaction the trader attempts to determine whether the size of the difference between the prices of the two contracts will increase or decrease. A spread earns a profit if the correct direction of the price difference is forecasted and the appropriate spread transaction is set up in conjunction with the changing price structure of the future contracts.

Spreaders must forecast the relevant factors that cause changes in the spreads. Change in financial futures spread depends upon the behaviour of interest rate. A profitable spread creates a gain on one side of the spread that is larger than the loss on the other side of the spread. A pure speculator would make more money by taking only the profitable side of the market; however, a spread reduces the risk of a position in case the forecast is incorrect. In recognition of the reduced risks, margins on spread positions are much less than the margins on pure long or short positions, and hence the leverage for spreads is increased. Risk is reduced, since both sides of spread usually move in the same direction, even though their prices can change by different amounts.

2.6 NON-PERFORMING ASSETS

Q17. Define Non-Performing Assets. Explain the factors affecting Non-performing assets.

Ans : **(Dec.-18)**

Meaning

Non-performing assets, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest payments are not being made on time.

Rahul Publications

A loan is an asset for a bank as the interest payments and the repayment of the principal create a stream of cash flows. It is from the interest payments than a bank makes its profits.

Banks usually treat assets as non-performing if they are not serviced for some time. If payments are late for a short time a loan is classified as past due. Once a payment becomes really late (usually 90 days) the loan classified as non-performing.

A high level of non-performing assets compared to similar lenders may be a sign of problems, as may sudden increase. However this needs to be looked at in the context of the type of lending being done. Some banks lend to higher risk customers than others and therefore tend to have a higher proportion of non-performing debt, but will make up for this by charging borrowers higher interest rates, increasing spreads.

A mortgage lender will almost certainly have lower non-performing assets than a credit card specialist, but the latter will have higher spreads and may will make a bigger profit on the same assets, even if it eventually has to write off the non-performing loans.

Factors

The banking sector has been facing the serious problems of the rising NPAs. But the problem of NPAs is more in public sector banks when compared to private sector banks and foreign banks. The NPAs in PSB are growing due to external as well as internal factors.

(A) External Factors

1. **Ineffective recovery tribunal :** The Govt. has set of numbers of recovery tribunals, which works for recovery of loans and advances. Due to their negligence and ineffectiveness in their work the bank suffers the consequence of non-recover, their by reducing their profitability and liquidity.
2. **Wilful Defaults :** There are borrowers who are able to payback loans but are intentionally withdrawing it. These groups of people should be identified and proper measures should be taken in order to get back the money extended to them as advances and loans.
3. **Natural calamities :** This is the measure factor, which is creating alarming rise in NPAs of the PSBs. Every now and then India is hit by major natural calamities thus making the borrowers unable to pay back there loans. Thus the bank has to make large amount of provisions in order to compensate those loans, hence end up the fiscal with a reduced profit.

   Mainly ours farmers depends on rain fall for cropping. Due to irregularities of rain fall the farmers are not to achieve the production level thus they are not repaying the loans.
4. **Industrial sickness :** Improper project handling , ineffective management , lack of adequate resources , lack of advance technology , day to day changing govt. Policies give birth to industrial sickness. Hence the banks that finance those industries ultimately end up with a low recovery of their loans reducing their profit and liquidity.
5. **Lack of demand :** Entrepreneurs in India could not foresee their product demand and starts production which ultimately piles up their product thus making them unable to pay back the money they borrow to operate these activities. The banks recover the amount by selling of their assets, which covers a minimum label. Thus the banks record the non-recovered part as NPAs and has to make provision for it.
6. **Change on Govt. policies :** With every new govt. banking sector gets new policies for its operation. Thus it has to cope with the changing principles and policies for the regulation of the rising of NPAs.

Rahul Publications

The fallout of handloom sector is continuing as most of the weavers Co-operative societies have become default largely due to withdrawal of state patronage. The rehabilitation plan worked out by the Central govt to revive the handloom sector has not yet been implemented. So the over dues due to the handloom sectors are becoming NPAs.

B) Internal Factors

1. **Defective Lending process** : There are three cardinal principles of bank lending that have been followed by the commercial banks since long.
   i) Principles of safety
   ii) Principle of liquidity
   iii) Principles of profitability
2. **Inappropriate technology :** Due to inappropriate technology and management information system, market driven decisions on real time basis can not be taken. Proper MIS and financial accounting system is not implemented in the banks, which leads to poor credit collection, thus NPA. All the branches of the bank should be computerised.
3. **Improper swot analysis :** The improper strength, weakness, opportunity and threat analysis is another reason for rise in NPAs. While providing unsecured advances the banks depend more on the honesty, integrity, and financial soundness and credit worthiness of the borrower.
   - Banks should consider the borrowers own capital investment.
   - It should collect credit information of the borrowers from
     a) From bankers
     b) Enquiry from market/ segment of trade, industry, business.
     c) From external credit rating agencies.
   - Analyses the balance sheet True picture of business will be revealed on analysis of profit/loss a/c and balance sheet.
   - Purpose of the loan

     When bankers give loan, he should analy-ses the purpose of the loan. To ensure safety and liquidity, banks should grant loan for productive purpose only. Bank should analyses the profita-bility, viability, long term acceptability of the project while financing.
4. **Poor credit appraisal system :** Poor credit appraisal is another factor for the rise in NPAs. Due to poor credit appraisal the bank gives advances to those who are not able to repay it back. They should use good credit appraisal to decrease the NPAs.
5. **Managerial deficiencies :** The banker should always select the borrower very carefully and should take tangible assets as security to safe guard its interests. When accepting securities banks should consider the
   - Marketability
   - Acceptability
   - Safety
   - Transferability

   The banker should follow the principle of diversification of risk based on the famous maxim "do not keep all the eggs in one basket"; it means that the banker should not grant advances to a few big farms only or to concentrate them in few industries or in a few cities. If a new big

Rahul Publications

customer meets misfortune or certain traders or industries affected adversely, the overall position of the bank will not be affected.

6. **Absence of regular industrial visit:** The irregularities in spot visit also increases the NPAs. Absence of regularly visit of bank officials to the customer point decreases the collection of interest and principals on the loan. The NPAs due to wilful defaulters can be collected by regular visits.

7. **Re loaning process :** Non remittance of recoveries to higher financing agencies and re loaning of the same have already affected the smooth operation of the credit cycle. Due to re-loaning to the defaulters and CCBs and PACs, the NPAs of OSCB is increasing day by day.

Q18. Explain the various problems in Non-performing assets.

Ans :

1. Owners do not receive a market return on there capital .in the worst case, if the banks fails, owners loose their assets. In modern times this may affect a broad pool of shareholders.
2. Depositors do not receive a market return on saving. In the worst case if the bank fails, depositors loose their assets or uninsured balance.
3. Banks redistribute losses to other borrowers by charging higher interest rates, lower deposit rates and higher lending rates repress saving and financial market, which hamper economic growth.
4. Non performing loans epitomise bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital, and by extension, labour and natural resources.
5. Non performing asset may spill over the banking system and contract the money stock, which may lead to economic contraction. This spill over effect can channelize through liquidity or bank insolvency :
   a) When many borrowers fail to pay interest, banks may experience liquidity shortage. This can jam payment across the country,
   b) Illiquidity constraints bank in paying depositors
   c) Undercapitalised banks exceeds the banks capital base.

Q19. Explain the Strategic of NPA.

Ans :

There are two approaches to manage NPA. They are as follows :

A) Preventive Management

1. **Credit Assessment and Risk Management Mechanism :** A lasting solution to the problem of NPAs can be achieved only with proper credit assessment and risk management mechanism. The documentation of credit policy and credit audit immediately after the sanction is necessary to upgrade the quality of credit appraisal in banks.

   In a situation of liquidity overhang the enthusiasm of the banking system is to increase lending with compromise on asset quality, raising concern about adverse selection and potential danger of addition to the NPAs stock. It is necessary that the banking system is equipped with prudential norms to minimize if not completely avoid the problem of credit risk.

2. **Organizational Restructuring:** With regard to internal factors leading to NPAs the onus for containing the same rest with the bank themselves. These will necessities organizational restructuring improvement in the managerial efficiency, skill up gradation for proper assessment of credit worthiness and a change in the attitude of the banks towards legal action, which is traditionally viewed as a measure of the last resort.

Rahul Publications

3. **Reduce Dependence on Interest:** The Indian banks are largely depending upon lending and investments. The banks in the developed countries do not depend upon this income whereas 86 per cent of income of Indian banks is accounted from interest and the rest of the income is fee based.

   The banker can earn sufficient net margin by investing in safer securities though not at high rate of interest. It facilitates for limiting of high level of NPAs gradually. It is possible that average yield on loans and advances net default provisions and services costs do not exceed the average yield on safety securities because of the absence of risk and service cost.

4. **Potential and Borderline NPAs under Check:** The potential and borderline accounts require quick diagnosis and remedial measures so that they do not step into NPAs categories. The auditors of the banking companies must monitor all outstanding accounts in respect of accounts enjoying credit limits beyond cut-off points, so that new sub-standard assets can be kept under check.

B) Curative Management

The curative measures are designed to maximize recoveries so that banks funds locked up in NPAs are released for recycling. The Central Government and RBI have taken steps for arresting incidence of fresh NPAs and creating legal and regulatory environment to facilitate the recovery of existing NPAs of banks. They are :

1. **Debt Recovery Tribunals (DRT) :** In order to expedite speedy disposal of high value claims of banks, Debt Recovery Tribunals were setup. The Central Government has amended the recovery of debts due to banks and financial institutions Act in January 2000 for enhancing the effectiveness of DRTs.

   The provisions for placement of more than one recovery officer, power to attach dependents property before judgment, penal provision for disobedience of Tribunals order and appointment of receiver with powers of realization, management, protection and preservation of property are expected to provide necessary truth to the DRTs and speed up the recovery of NPAs in times to come.

2. **Lok Adalats :** The Lok Adalats institutions help banks to settle disputes involving accounts in doubtful and loss categories. These are proved to be an effective institution for settlement of dues in respect of smaller loans. The Lok Adalats and Debt Recovery Tribunals have been empowered to organize Lok Adalats to decide for NPAs of Rs. 10 lacs and above.

3. **Asset Reconstruction Company (ARC) :** The Narasimham Committee on financial system (1991) has recommended for setting up of Asset Reconstruction Funds (ARF). The following concerns were expressed by the committee.

   i) It was felt that centralized all India fund will severely handicap in its recovery efforts by lack of widespread geographical reach which individual bank posses, and

   ii) Given the large fiscal deficits, there will be a problem of financing the ARF.

   Subsequently, the Narasimham committee on banking sector reforms has recommended for transfer of sticky assets of banks to the ARC. Thereafter the Varma committee on restructuring weak public sector banks has also viewed the separation of NPAs and its transfer thereafter to the ARF is an important element in a comprehensive restructuring strategy for weak banks. This enables a one time clearing of balance sheet of banks by sticky loans.

4. **Corporate Debt Restructuring (CDR):** The corporate debt restructuring is one of the methods suggested for the reduction of NPAs. Its objective is to ensure a timely and transparent mechanism for restructure of corporate debts of viable corporate entities.

Q20. How can we reduce the NPAs of Banks & Financial Institutions?

Ans : **(Dec.-19)**

1. Lok Adalats (LAs) were set up by the government of India to settle NPAs and by December 2001, PSBs registered 1,09,558 cases of net worth ` 646 crores.

Rahul Publications

2. The government established 22 Debt Recovery Tribunals (DRTs) to recover bad debts. Over 41,243 cases of bad debts were registered with DRTs since their inception.
3. One-Time Settlement Scheme (OTSS) was initiated by banks in May 1999 and July 2000. This scheme helped banks in recovering around ` 668 crore and ` 2,600 crore by the end of September 2001.
4. In 2001, Credit Debt Restructuring Mechanism (CDRM) was initiated to restructure corporate debts of ` 20 crore and above in a transparent way with banks and financial institutions.

2.7 BANK CAPITAL

Q21. What do you mean by Bank Capital and Bank Capital Regulation.

Ans :

(i) Bank Capital

Bank Capital reflects the net worth of a bank. It consists of both assets and liabilities. Assets of a bank include cash, securities, interest generated from loans, letter of credit, interbank loans. Liabilities include loan loss reserves and debt.

(ii) Bank Capital Regulation

Banks are included under the most regulated global industries. The regulation in banking sector is mostly in terms of capital regulation. The reasons for the regulation of bank capital is to mitigate the risk due to systematic crisis and the inability of the primary creditors or dependents to monitor the performance of the banks. Banks get insolvent due to their inability in repayment of the debts to the creditors within the stipulated time. According to Modigti and Miller, the capital structure of a firm does not effect it's value if the market is perfect and furnished with complete information. There has been observed a significant effect of deviations of markets from the perfect on the capital structure of the firm. The factors include taxes, financial distress, transaction costs, agency costs and asymmetric information are considered as the imperfections in case of all firms whereas especially in bank the two factors included in addition to these factors are,

(i) Access of bank to safety net or deposit insurance

(ii) The deposits from the small and uninformed depositors act as sources of bank debts.

2.7.1 Adequacy Norms and capital market support

Q22. Discuss briefly about capital adequacy.

Ans : **(Feb.-16, Imp.)**

Capital Adequacy Ratio (CAR) is a ratio that regulators in the banking system use to watch bank's health, specifically bank's capital to its risk. Regulators in the banking system track a bank's CAR to ensure that it can absorb a reasonable amount of loss.

Regulators in most countries define and monitor CAR to protect depositors, thereby maintaining confidence in the banking system.

Capital adequacy ratio is the ratio which determines the capacity of a bank in terms of meeting the time liabilities and other risk such as credit risk, market risk, operational risk, and others. It is a measure of how much capital is used to support the banks' risk assets.

Capital Adequacy Ratio (CAR)

Capital adequacy ratio (CAR), also called Capital to Risk (Weighted) Assets Ratio (CRAR), is a ratio of a bank's capital to its risk. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory Capital requirements.

Formula of CAR

Capital adequacy ratios ("CAR") are a measure of the amount of a bank's core capital expressed as a percentage of its assets weighted credit exposures.

Capital adequacy ratio is defined as

$$CAR = \frac{\text{Tier 1 capital} + \text{Tier 2 capital}}{\text{Risk weighted assets}}$$

TIER 1 CAPITAL -A) Equity Capital, B) Disclosed Reserves

TIER 2 CAPITAL -A) Undisclosed Reserves, B) General Loss reserves, C) Subordinate Term

Rahul Publications

Debts where Risk can either be weighted assets (a) or the respective national regulator's minimum total capital requirement. If using risk weighted assets,

$$CAR = \frac{T_1 + T_2}{a \geq 10\%}$$

The percent threshold varies from bank to bank (10% in this case, a common requirement for regulators conforming to the Basel Accords) is set by the national banking regulator of different countries.

Two types of capital are measured: tier one capital (T_1 above), which can absorb losses without a bank being required to cease trading, and tier two capital (T_2 above), which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

Q23. What are the capital adequacy Norms being followed.

(OR)

What are the norms prescribed by the RBI capital adequacy of banks?

Ans : **(Feb.-16, Aug.-12)**

The World Trade Organization (WTO), of which India is a member nation, requires the countries like India to get their banking systems at par with the global standards in terms of financial health, safety and transparency, by implementing the Basel II Norms by 2009.

1. Basel Committee Norms

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide.

It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. The Committee's Secretariat is located at the Bank for International Settlements (BIS) in Basel, Switzerland.

2. Need For Such Norms

The first accord by the name .Basel Accord I. was established in 1988 and was implemented by 1992. It was the very first attempt to introduce the concept of minimum standards of capital adequacy. Then the second accord by the name Basel Accord II was established in 1999 with a final directive in 2003 for implementation by 2006 as Basel II Norms. Unfortunately, India could not fully implement this but, is now gearing up under the guidance from the Reserve Bank of India to implement it from 1 April, 2009.

3. Basel Norms

Basel I Norms : The Basel Committee on Banking Supervisions had published the first Basel Capital Accord (Popularly called as Base I framework) in July, 1988 prescribing minimum capital adequacy requirements in bank for maintaining the soundness and stability of the International Banking System and to diminish existing source of competitive inequality among international banks.

Basel II Norms : Basel II Norms have been introduced to overcome the drawbacks of Basel I Accord. For Indian Banks, its the need of the hour to buckle-up and practice banking business at par with global standards and make the banking system in India more reliable, transparent and safe. These Norms are necessary since India is and will witness increased capital flows from foreign countries and there is increasing cross-border economic & financial transactions.

Features of Basel II Norms

Basel II Norms are considered as the reformed & refined form of Basel I Accord. The Basel II Norms primarily stress on 3 factors, viz. Capital Adequacy, Supervisory Review and Market discipline. The Basel Committee calls these factors as the Three Pillars to manage risks.

Pillar I : Capital Adequacy Requirements

Under the Basel II Norms, banks should maintain a minimum capital adequacy requirement of 8% of risk assets. For India, the Reserve Bank of India has mandated maintaining of 9% minimum capital adequacy requirement. This requirement is popularly called as Capital Adequacy Ratio (CAR) or Capital to Risk Weighted Assets Ratio (CRAR).

Pillar II : Supervisory Review

Banks majorly encounter with 3 Risks, viz. Credit, Operational & Market Risks.

Rahul Publications

Basel II Norms under this Pillar wants to ensure that not only banks have adequate capital to support all the risks, but also to encourage them to develop and use better risk management techniques in monitoring and managing their risks. The process has four key principles :

(a) Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for monitoring their capital levels.

(b) Supervisors should review and evaluate bank's internal capital adequacy assessment and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios.

(c) Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

(d) Supervisors should seek to intervene at an early stage to prevent capital from falling below minimum level and should require rapid remedial action if capital is not mentioned or restored.

Pillar III : Market Discipline

Market discipline imposes banks to conduct their banking business in a safe, sound and effective manner. Mandatory disclosure requirements on capital, risk exposure (semiannually or more frequently, if appropriate) are required to be made so that market participants can assess a bank's capital adequacy. Qualitative disclosures such as risk management objectives and policies, definitions etc. may be also published.

Basel III Norms

Basel III is the third of the Basel Accords, which are recommendations on .banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel III, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

Advocates of Basel in believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse.

In practice, Basel III attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

The overall goals of Basel III Norms are :

i) To refine the definition of bank capital

ii) Quantify further classes of risk

iii) To further improve the sensitivity of the risk measures.

2.8 BANKING INNOVATIONS

Q24. Discuss the Recent innovations in banking sector.

(OR)

Explain the innovations in Indian banking system.

Ans : **(May-19, Dec.-19, Aug.-15, Imp.)**

Corporation bank has been updating their banking operations according to the technological advancements in the market across the 1000 branches since many years. The latest IT services offered by corporation bank include phone banking, any branch banking, ATM services, internet banking etc. Thus, it is successful in reducing the NPA's and in increasing the returns.

The various innovations in the field of banking are as follows :

1. Participation Certificates and Inter-Bank Participations

The RBI introduced Participation Certificates (PCs) in April 1970, with the objective of greater mobilisation of funds, reducing resource to the RBI, and diversifying the availability of financial instruments. The PC is an instrument whereby a bank sell to third

Rahul Publications

part a part or all of a loan made by the bank to a client. These certificates had become very popular in 1978 and 1979 after which the RBI advised banks to a achieve a significant and lasting reduction in their recourse to PCs.

2. Credit Cards

Commercial banks introduced a new facility called credit card, at the beginning of the 1980s. since them, it has rapidly expanded in terms of the number of banks offering it, the number of member-establishments and the number of members using it. The credit card is a convenient medium of exchange which enables its holder to buy goods and services from member-establishments without using money. The credit cards are issued to people having a certain minimum income. The card holder is required to pay neither an interest to the bank nor a higher price for goods purchased; he pays only a fee to the bank for the facility. The cost of arrangements met from the increased sales which result from the use of credit cards.

3. Consortium Approach

This approach to lending was introduced by the RBI in 1974. It required than one bank would finance a single borrower requiring large credit limit. It

i) Enabled banks to spread risk of lending
ii) Broke the monopoly of big banks to have large accounts
iii) Enable banks to share experience and expertise
iv) Introduced uniformity in approaches to lending
v) Enabled banks to pool their resources and
vi) Checked multiple financing of the same account.

Each consortium had a lead bank, which had the largest share in the loan, which processed the loan proposal, which called the meetings of the consortium for sanction of limits and review of accounts which obtained RBI permission for credit limits, and which conducted joint inspection of the borrower's activities.

4. New Technology Banking

The importance of sophisticated or high technology for improving customer service, productivity and operational efficiency of banks is well-recongised. As a part of their action plans, bank in India have introduced many new techniques and a considerable degree of mechanisation and computerization in their operations. Banks are now switching to Personal Computer (PCs) and LAN/WAN systems. They have introduced mechanized cheque clearance, using magnetic ink character recognitions technology. They are in the process of setting up exclusive data communication networks for banks known as BANKNET.

5. Stock invest

It is new financial instrument which was introduced by banks in 1992 to facilitate investment in industrial securities in the primary market. It helps to replace the present cumbersome process of refunding application money in case securities are not allotted. The stock invest in a kind of guaranteed cheque issued by a bank against the deposits maintained by the investor, in lieu of cash, personal cheque or draft. It ensures that the investor's share application money remains in the deposit account under lieu to the bank. Then, it is used, money is not withdrawn by the bankers to the issue till the time of allotment, while in case of a normal cheque, it is encashed by them within a week. It blocks the money in the bank account, fetching is issued against the account-holder til the time of allotment at the fixed deposit rate. The stock invest is issued against the special account to be opened with the bank, and it is as liquid as a savings bank account.

6. Local Area Banks

These were introduced in the Union Budget 1996-97 in order to develop commercial banks in India. These banks would be similar of unit banks and their creation would be consistent with the present philosophy of privatisation. They would meet the banking requirements of the local areas primarily in rural India, although they can be set up in the urban and metropolitan areas also. They would be in the private sectors.

Rahul Publications

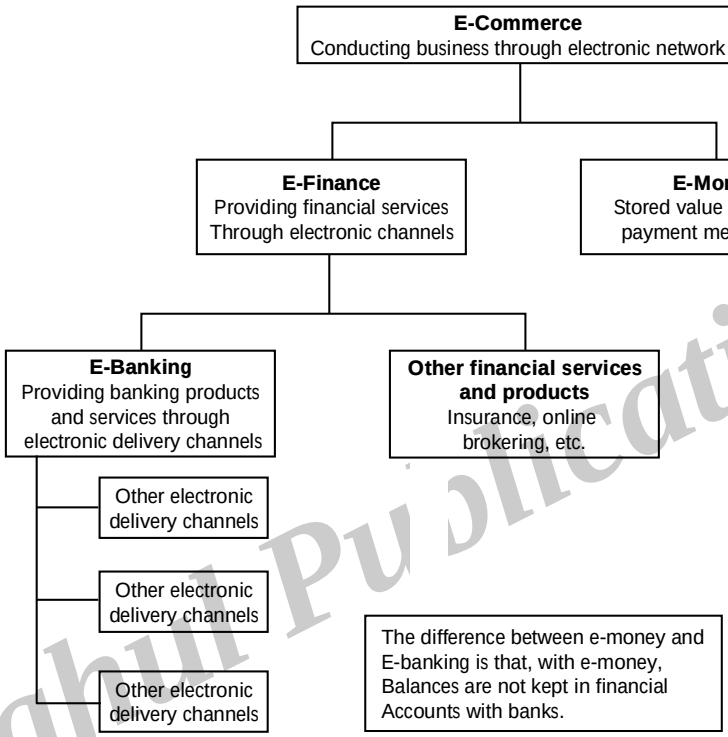
2.8.1 E-banking

Q25. What is E-banking. Explain various forms of E-banking.

Ans :

Definition

Electronic banking, also known as electronic funds transfer (EFT), is simply the use of electronic means to transfer funds directly from one account to another, rather than by cheque or cash.



Rahul Publications

1. Internet Banking

Internet banking system and method in which a personal computer is connected by a network service provider directly to a host computer system of a bank such that customer service requests can be processed automatically without need for intervention by customer service representatives. The system is capable of distinguishing between those customer service requests which are capable of automated fulfillment and those requests which require handling by a customer service representative. The system is integrated with the host computer system of the bank so that the remote banking customer can access other automated services of the bank. The method of the invention includes the steps of inputting a customer banking request from among a menu of banking requests at a remote personnel computer; transmitting the banking requests to a host computer over a network; receiving the request at the host computer; identifying the type of customer banking request received; automatic logging of the service request, comparing the received request to a stored table of request types, each of the request types having an attribute to indicate whether the request type is capable of being fulfilled by a customer service representative or by an automated system; and, depending upon the attribute, directing the request either to a queue for handling by a customer service representative or to a queue for processing by an automated system.

2. Automated Teller Machines (ATM)

An unattended electronic machine in a public place, connected to a data system and related equipment and activated by a bank customer to obtain cash withdrawals and other banking services. Also called automatic teller machine, cash machine; Also called money machine.

3. Tele Banking

Undertaking a host of banking related services including financial transactions from the convenience of customers chosen place anywhere across the GLOBE and any time of date and night has now been made possible by introducing on-line Telebanking services. By dialing the given Telebanking number through a landline or a mobile from anywhere, the customer can access his account and by following the user-friendly menu, entire banking can be done through Interactive Voice Response (IVR) system. With sufficient numbers of hunting lines made available, customer call will hardly fail. The system is bilingual and has following facilities offered

- Automatic balance voice out for the default account.
- Balance inquiry and transaction inquiry in all
- Inquiry of all term deposit account
- Statement of account by Fax, e-mail or ordinary mail.
- Cheque book request
- Stop payment which is on-line and instantaneous
- Transfer of funds with CBS which is automatic and instantaneous
- Utility Bill Payments
- Renewal of term deposit which is automatic and instantaneous
- Voice out of last five transactions.

4. Smart Card

A smart card usually contains an embedded 8-bit microprocessor (a kind of computer chip). The microprocessor is under a contact pad on one side of the card. Think of the microprocessor as replacing the usual magnetic stripe present on a credit card or debit card.

The microprocessor on the smart card is there for security. The host computer and card reader actually "talk" to the microprocessor. The microprocessor enforces access to the data on the card.

5. Debit card

Debit cards are also known as check cards. Debit cards look like credit cards or ATM (automated teller machine) cards, but operate like cash or a personal check. Debit cards are different from credit cards. While a credit card is a way to "pay later," a debit card is a way to "pay now." When you use a debit card, your money is quickly deducted from your checking or savings account.

Q26. Explain the benefits of E-Banking.

Ans :

(A) For Banks

i) Price

In the long run a bank can save on money by not paying for tellers or for managing branches. Plus, it's cheaper to make transactions over the Internet.

ii) Customer Base

The Internet allows banks to reach a whole new market- and a well off one too, because there are no geographic boundaries with the Internet. The Internet also provides a level playing field for small banks who want to add to their customer base.

iii) Efficiency

Banks can become more efficient than they already are by providing Internet access for their customers. The Internet provides the bank with an almost paper less system.

iv) Customer Service and Satisfaction

Banking on the Internet not only allow the customer to have a full range of services available to them but it also allows them some services not offered at any of the branches. The person does not have to go to a branch where that service may or may not be offer. A person can print of information, forms, and applications via the Internet and be able to search for information efficiently

Rahul Publications

instead of waiting in line and asking a teller. With more better and faster options a bank will surly be able to create better customer relations and satisfaction.

v) Image

A bank seems more state of the art to a customer if they offer Internet access. A person may not want to use Internet banking but having the service available gives a person the feeling that their bank is on the cutting image.

(B) For Customers

i) Bill Pay

Bill Pay is a service offered through Internet banking that allows the customer to set up bill payments to just about anyone. Customer can select the person or company whom he wants to make a payment and Bill Pay will withdraw the money from his account and send the payee a paper check or an electronic payment

ii) Other Important Facilities

E- banking gives customer the control over nearly every aspect of managing his bank accounts. Besides the Customers can, Buy and Sell Securities, Check Stock Market Information, Check Currency Rates, Check Balances, See which checks are cleared, Transfer Money, View Transaction History and avoid going to an actual bank. The best benefit is that Internet banking is free. At many banks the customer doesn't have to maintain a required minimum balance. The second big benefit is better interest rates for the customer.

2.8.2 Risk Management in E-banking

Q27. Explain briefly about various types of risk associated with banking.

Ans :

The Banking sector has a pivotal role in the development of an economy. It is the key driver of economic growth of the country and has a dynamic role to play in converting the idle capital resources for their optimum utilization so as to attain maximum productivity. In fact, the foundation of a sound economy depends on how sound the Banking sector is and vice versa.

In India, the banking sector is considerably strong at present but at the same time, banking is considered to be a very risky business. Financial institutions must take risk, but they must do so consciously. However, it should be borne in mind that banks are very fragile institutions which are built on customers' trust, brand reputation and above all dangerous leverage. In case something goes wrong, banks can collapse and failure of one bank is sufficient to send shock waves right through the economy. Therefore, bank management must take utmost care in identifying the type as well as the degree of its risk exposure and tackle those effectively.

Definition

Risk refers to 'a condition where there is a possibility of undesirable occurrence of a particular result which is known or best quantifiable and therefore insurable'. Risk may mean that there is a possibility of loss or damage which, may or may not happen.

Risks may be defined as uncertainties resulting in adverse outcome, adverse in relation to planned objective or expectations.

In the simplest words, risk may be defined as possibility of loss. It may be financial loss or loss to the reputation/ image.

Risk in Banking Business

In the post LPG period, the banking sector has witnessed tremendous competition not only from the domestic banks but from foreign banks alike. In fact, competition in the banking sector has emerged due to disintermediation and deregulation. The liberalised economic scenario of the country has opened various new avenues for increasing revenues of banks. In order to grab this opportunity, Indian commercial banks have launched several new and innovated products, introduced facilities like ATMs, Credit Cards, Mobile banking, Internet banking etc. Apart from the traditional banking products, it is seen that Mutual Funds, Insurance etc. are being designed/ upgraded and served to attract more customers to their fold.

In the backdrop of all these developments i.e., deregulation in the Indian economy and product/ technological innovation, risk exposure of

Rahul Publications

banks has also increased considerably. Thus, this has forced banks to focus their attention to risk management (Sharma, 2003). In fact, the importance of risk management of banks has been elevated by technological developments, the emergence of new financial instruments, deregulation and heightened capital market volatility (Mishra, 1997).

In short, the two most important developments that have made it imperative for Indian commercial banks to give emphasis on risk management are discussed below –

(a) Deregulation

The era of financial sector reforms which started in early 1990s has culminated in deregulation in a phased manner. Deregulation has given banks more autonomy in areas like lending, investment, interest rate structure etc. As a result of these developments, banks are required to manage their own business themselves and at the same time maintain liquidity and profitability. This has made it imperative for banks to pay more attention to risk management.

(b) Technological Innovation

Technological innovations have provided a platform to the banks for creating an environment for efficient customer services as also for designing new products. In fact, it is technological innovation that has helped banks to manage the assets and liabilities in a better way, providing various delivery channels, reducing processing time of transactions, reducing manual intervention in back office functions etc. However, all these developments have also increased the diversity and complexity of risks, which need to be managed professionally so that the opportunities provided by the technology are not negated.

Q28. Explain the classification of risk.

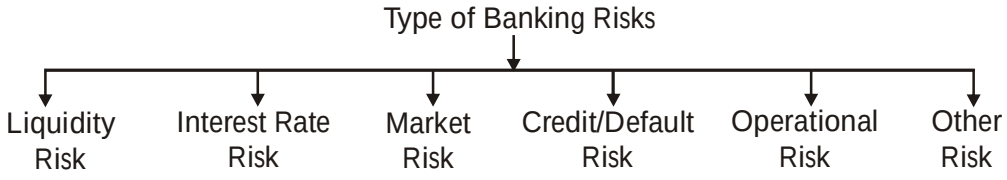
(OR)

How is Risk management done in banking.

Ans : **(May.-19)**

Risk may be defined as 'possibility of loss', which may be financial loss or loss to the image or reputation. Banks like any other commercial organisation also intend to take risk, which is inherent in any business. Higher the risk taken, higher the gain would be. But higher risks may also result into higher losses. However, banks are prudent enough to identify, measure and price risk, and maintain appropriate capital to take care of any eventuality. The major risks in banking business or 'banking risks', as commonly referred, are listed below:

1. Liquidity Risk
2. Interest Rate Risk
3. Market Risk
4. Credit or Default Risk
5. Operational Risk
6. Other Risks

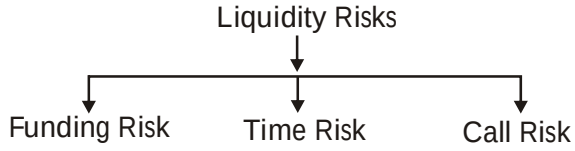


Rahul Publications

1. Liquidity Risk

The liquidity risk of banks arises from funding of long-term assets by short-term liabilities, thereby making the liabilities subject to rollover or refinancing risk. It can be also defined as the possibility that an institution may be unable to meet its maturing commitments or may do so only by borrowing funds at prohibitive costs or by disposing assets at rock bottom prices. The liquidity risk in banks manifest in different dimensions.

(a) Funding Risk: Funding Liquidity Risk is defined as the inability to obtain funds to meet cash flow obligations. For banks, funding liquidity risk is crucial. This arises from the need to replace net outflows due to unanticipated withdrawal/ non-renewal of deposits (wholesale and retail).



(b) Time Risk: Time risk arises from the need to compensate for non-receipt of expected inflows of funds i.e., performing assets turning into non-performing assets.

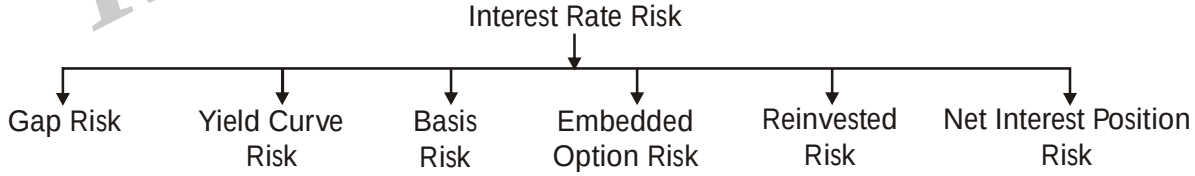
(c) Call Risk: Call risk arises due to crystallisation of contingent liabilities. It may also arise when a bank may not be able to undertake profitable business opportunities when it arises.

2. Interest Rate Risk

Interest Rate Risk arises when the Net Interest Margin or the Market Value of Equity (MVE) of an institution is affected due to changes in the interest rates. In other words, the risk of an adverse impact on Net Interest Income (NII) due to variations of interest rate may be called Interest Rate Risk. It is the exposure of a Bank's financial condition to adverse movements in interest rates.

IRR can be viewed in two ways – its impact is on the earnings of the bank or its impact on the economic value of the bank's assets, liabilities and Off-Balance Sheet (OBS) positions. Interest rate Risk can take different forms. The following are the types of Interest Rate Risk –

(a) Gap or Mismatch Risk: A gap or mismatch risk arises from holding assets and liabilities and Off-Balance Sheet items with different principal amounts, maturity dates or re-pricing dates, thereby creating exposure to unexpected changes in the level of market interest rates.



(b) Yield Curve Risk: Banks, in a floating interest scenario, may price their assets and liabilities based on different benchmarks, i.e., treasury bills' yields, fixed deposit rates, call market rates, MIBOR etc. In case the banks use two different instruments maturing at different time horizon for pricing their assets and liabilities then any non-parallel movements in the yield curves, which is rather frequent, would affect the NII. Thus, banks should evaluate the movement in yield curves and the impact of that on the portfolio values and income.

(c) Basis Risk: Basis Risk is the risk that arises when the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude. For example, in a rising interest rate scenario, asset interest rate may rise in different magnitude than the interest rate on corresponding liability, thereby creating variation in net interest income.

Rahul Publications

The degree of basis risk is fairly high in respect of banks that create composite assets out of composite liabilities. The loan book in India is funded out of a composite liability portfolio and is exposed to a considerable degree of basis risk. The basis risk is quite visible in volatile interest rate scenarios. When the variation in market interest rate causes the NII to expand, the banks have experienced favourable basis shifts and if the interest rate movement causes the NII to contract, the basis has moved against the banks.

(d) **Embedded Option Risk**: Significant changes in market interest rates create the source of risk to banks' profitability by encouraging prepayment of cash credit/demand loans, term loans and exercise of call/put options on bonds/ debentures and/ or premature withdrawal of term deposits before their stated maturities. The embedded option risk is experienced in volatile situations and is becoming a reality in India. The faster and higher the magnitude of changes in interest rate, the greater will be the embedded option risk to the banks' Net Interest Income. The result is the reduction of projected cash flow and the income for the bank.

(e) **Reinvested Risk**: Reinvestment risk is the risk arising out of uncertainty with regard to interest rate at which the future cash flows could be reinvested. Any mismatches in cash flows i.e., inflow and outflow would expose the banks to variation in Net Interest Income. This is because market interest received on loan and to be paid on deposits move in different directions.

(f) **Net Interest Position Risk**: Net Interest Position Risk arises when the market interest rates adjust downwards and where banks have more earning assets than paying liabilities. Such banks will experience a reduction in NII as the market interest rate declines and the NII increases when interest rate rises. Its impact is on the earnings of the bank or its impact is on the economic value of the banks' assets, liabilities and OBS positions.

3. Market Risk

The risk of adverse deviations of the mark-to-market value of the trading portfolio, due to market movements, during the period required to liquidate the transactions is termed as Market Risk. This risk results from adverse movements in the level or volatility of the market prices of interest rate instruments, equities, commodities, and currencies. It is also referred to as Price Risk.

(a) **Forex Risk**: Forex risk is the risk that a bank may suffer losses as a result of adverse exchange rate movements during a period in which it has an open position either spot or forward, or a combination of the two, in an individual foreign currency.

(b) **Market Liquidity Risk**: Market liquidity risk arises when a bank is unable to conclude a large transaction in a particular instrument near the current market price.

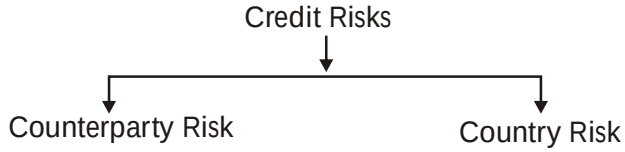
4. Default or Credit Risk

Credit risk is more simply defined as the potential of a bank borrower or counterparty to fail to meet its obligations in accordance with the agreed terms. In other words, credit risk can be defined as the risk that the interest or principal or both will not be paid as promised and is estimated by observing the proportion of assets that are below standard. Credit risk is borne by all lenders and will lead to serious problems, if excessive. For most banks, loans are the largest and most obvious source of credit risk. It is the most significant risk, more so in the Indian scenario where the NPA level of the banking system is significantly high

Rahul Publications

There are two variants of credit risk which are discussed below –

(a) Counterparty Risk: This is a variant of Credit risk and is related to non-performance of the trading partners due to counterparty's refusal and or inability to perform. The counterparty risk is generally viewed as a transient financial risk associated with trading rather than standard credit risk.



(b) Country Risk: This is also a type of credit risk where non-performance of a borrower or counterparty arises due to constraints or restrictions imposed by a country. Here, the reason of non-performance is external factors on which the borrower or the counterparty has no control.

5. Operational Risk

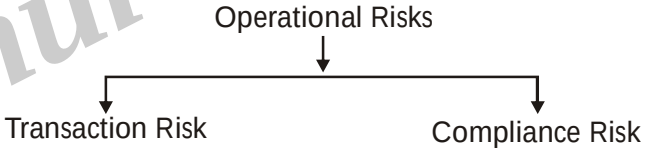
Basel Committee for Banking Supervision has defined operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events'. Thus, operational loss has mainly three exposure classes namely people, processes and systems.

Managing operational risk has become important for banks due to the following reasons:

1. Higher level of automation in rendering banking and financial services
2. Increase in global financial inter-linkages

Two of the most common operational risks are discussed below :

(a) Transaction Risk: Transaction risk is the risk arising from fraud, both internal and external, failed business processes and the inability to maintain business continuity and manage information.



(b) Compliance Risk: Compliance risk is the risk of legal or regulatory sanction, financial loss or reputation loss that a bank may suffer as a result of its failure to comply with any or all of the applicable laws, regulations, codes of conduct and standards of good practice. It is also called integrity risk since a bank's reputation is closely linked to its adherence to principles of integrity and fair dealing.

6. Other Risks

Apart from the above mentioned risks, following are the other risks confronted by Banks in course of their business operations:

(a) Strategic Risk: Strategic Risk is the risk arising from adverse business decisions, improper implementation of decisions or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organisation's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals and the quality of implementation.

(b) Reputation Risk: Reputation Risk is the risk arising from negative public opinion. This risk may expose the institution to litigation, financial loss or decline in customer base.

Rahul Publications

2.9 Cooperative Banks

Q29. Define Co-operative bank. Explain the components of co-operative banks.

Ans :

Meaning

Co-operative Banks in India are registered under the Co-operative Societies Act. The cooperative bank is also regulated by the RBI. They are governed by the Banking Regulations Act 1949 and Banking Laws (Co-operative Societies) Act, 1965. According to NAFCUB the total deposits & lendings of Co-operative Banks in India is much more than Old Private Sector Banks & also the New Private Sector Banks.

Co-operative banks role in rural financing continues to be important day by day, and their business in the urban areas also has increased phenomenally in recent years mainly due to the sharp increase in the number of primary co-operative banks.

Components

The co-operative banking structure in India is divided into following four components:

1. Primary Co-operative Credit Society

The primary co-operative credit society is an association of borrowers and non-borrowers residing in a particular locality. The funds of the society are derived from the share capital and deposits of members and loans from central co-operative banks. The borrowing powers of the members as well as of the society are fixed. The loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, etc.

2. Central Co-operative banks

The state co-operative bank is a federation of central co-operative bank and acts as a watchdog of the co-operative banking structure in the state. Its funds are obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India. The state cooperative banks lend money to central co-operative banks and primary societies and not directly to the farmers.

3. State co-operative banks

The state co-operative bank is a federation of central co-operative bank and acts as a watchdog of the co-operative banking structure in the state. Its funds are obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India. The state cooperative banks lend money to central co-operative banks and primary societies and not directly to the farmers.

4. Land development banks

The Land development banks are organized in 3 tiers namely; state, central, and primary level and they meet the long term credit requirements of the farmers for developmental purposes. The state land development banks oversee, the primary land development banks situated in the districts and tahsil areas in the state. They are governed both by the state government and Reserve Bank of India. Recently, the supervision of land development banks has been assumed by National Bank for Agriculture and Rural development (NABARD). The sources of funds for these banks are the debentures subscribed by both central and state government. These banks do not accept deposits from the general public.

2.9.1 Features of Co-operative Banks

Q30. Explain the features of Co-operative Banks.

Ans :

i) They are organised and managed on the principles of co-operation, self-help, and mutual help. They function with the rule of "one member, one vote".

ii) They function on "no profit, no loss" basis. For commercial banks also, profitability is no longer the main objective, but in their case this change has been brought about as a result

Rahul Publications

of social or public policy, while co-operative banks, by their very nature, do not pursue the goal of profit maximisation.

iii) Co-operative banks perform all the main banking functions of deposit mobilisation, supply of credit and provision of remittance facilities. However, it is said that the range of services offered is narrower and the degree of product differentiation in each main type of service is much less in the caseco-operativetive banks, compared to commercial banks. In other words, co-operative banks are characterised by functional specialisation. It should be added that this is true with much less force now, because many changes have taken place in the co-operative banking system since the Banking Commis-sion arrived at the above-mentioned conclusion.

For example, co-operative banks now provide housing loans also. The UCBs provide working capital loans and term loans as well. The State Co-operative Banks (SCBs), Central Co-operative Banks (CCBs) and Urban Co-operative Banks (UCBs) can normally extend housing loans up to Rs one lakh to an individual. The scheduled UCBs, however, can lend up to Rs three lakh for housing purposes. The UCBs can provide advances against shares and debentures also.

iv) Co-operative banks are perhaps the first government-sponsored, government-supported, and government-subsidised financial agency in India. They get financial and other help from the RBI, NABARD, Central government and state governments. They constitute the "most favoured" banking sector with no risk of nationalisation. For commercial banks, the RBI is a lender of last resort, but for co-operative banks, it is the lender of first resort which provides financial resources in the form of contribution to the initial capital (through state governments), working capital, and refinance. The promotional role of the RBI can be seen in respect of co-operative banks, and this role supersedes its regulatory role, in respect of these banks.

v) Co-operative banks belong to the money market as well as to the capital market. Primary agricultural credit societies provide short-term and medium-term loans. Land Development Banks (LDBs) provide long-term loans, UCBs meet working capital as well as fixed capital requirements, and SCBs and CCBs also provide both short-term and term loans. Similarly, they accept short-term and long-term deposits, and some of them mobilise resources through the issue of debentures.

vi) Co-operative banks are financial intermediaries only partially. The sources of their funds (resources) are: (a) Central and state governments, (b) the RBI and NABARD, (c) other co-operative institutions, (d) ownership funds, and (e) deposits or debenture issues. It is interesting to note that intra-sectoral flows of funds are much greater in co-operative banking than in commercial banking. Inter-bank deposits, borrowings, and credit form a significant part of assets and liabilities of co-operative banks. This means that intra-sectoral competition is absent and intra-sectoral integration is high for co-operative banks.

However, co-operative banks face stiff competition from commercial banks and other financial intermediaries. Till their nationalisation, commercial banks did not pose any competition to co-operative banks. In fact, till then, certain areas of operations were deliberately left to co-operative banks. But recently, the competition from LIC, UTI, and small-savings organisation has become quite tough, and co-operative banks are in a disadvantageous position in this area of inter-sectoral competition.

vii) Co-operative banks have a federal structure of three-tier linkages. Further, their operation is of mixed banking type. Primary credit societies are unit banks; many UCBs also are unit banks. But SCBs DCBs (CCBs), and SLDBs, PLDBs and many UCBs have a number of branches. Subject to this, it can

Rahul Publications

be said that each co-operative institution in each tier is a separate entity with definite jurisdiction and has an independent board of management.

viii) Some co-operative banks are scheduled banks, while others are non-scheduled banks. For in-stance, SCBs and some UCBs are scheduled banks but other co-operative banks are non-schedule: banks. At present, 28 SCBs and 11 UCBs with Demand and Time Liabilities over Rs 50 crore each are included in the Second Schedule of the RBI Act.

ix) Co-operative banks accept current, saving, and fixed or time deposits fr - individuals and institutions including banks. Some UCBs numbering about 40 in 1989 are allowed open and maintain NRI accounts in rupees but not in foreign currency. Deposits mobilised by them in i given area are used for financing activities in that locality.

Some co-operative banks, namely, Land Development Banks (LDBs), issue debentures to raise re-sources for their operations. These debentures are secured by mortgaging lands belonging to borrowe-s from LDBs and are often guaranteed by the state government. They are regarded as trustee securities an: are treated on par with government securities for making advances. There are three types of sub debentures: ordinary, rural, and special. These debentures are almost entirely subscribed by such instructional investors as banks, LIC, and the government.

Q31. Explain the importance of co-operative Banks.

Ans :

i) Low Rate of Interest : Co-operative banks provide loans to the farmers and artisans at low rate of interest and thereby they are protected from the oppression of the Mahajans. Co-operative banks prevent unnecessary expenditure by providing loans only for the productive purposes.

ii) Increase in Agricultural Production Farmers are granted loans by the co-operative banks : for purchasing good seeds, fertilizers and cattle. These banks facilitates in consolidating the land-holdings and eradicating the hindrances in irrigation and transport. Ultimately the agricultural production increases. The role played by co-operatives in Green Revolution such as Wheat revolution in Punjab and Haryana. Sugarcane revolution in Maharashtra and cotton revolution in Gujrat is commendable.

iii) Rural Upliftment : Farmer's income and their standard of living is being developed and improved due to co-operative banking. According to the norms in India, Co-operative banks are required to spend 10% of their profits on rural development. Therefore, the role of co-operatives in the development of rural areas is quite significant.

vi) Encouragement to Thrift : Co-operative banking inspires to utilize the funds carefully. Even the small savings of the people are utilized in a more advantageous manner.

v) Moral Advantages : Co-operative banks foster moral values by encouraging brotherhood, mutual support and confidence and by discouraging unnecessary legal disputes, misuse of money, gambling and so on.

vi) Social Advantage : The members of the co-operative banks exercise an effective control on their activities due to the unlimited liability of the bank. This results in social awareness. These banks are also involved in social work programmes such as construction of wells and drains, provision of drinking water, healthcare facilities and so on.

vii) Educational Advantages Banking-training is provided to the members of the: Co-operative banks and their organisational abilities are encouraged as well.

viii) Help in Planning : With the co-operation of the people the five year plans in India have been successful. The people's co-operation was achieved because of co-operative banking. Thus, the importance of co-operative banking is great for the five- year plans in India.

Rahul Publications

2.9.2 Structure of Co-operative Banks

Q32. Explain the structure of Co-operative Banks.

Ans :

The structure of Co-operative Bank is as follows :

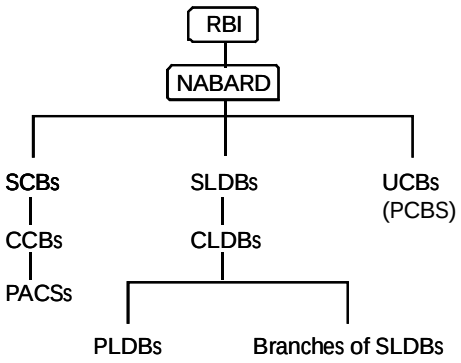


Fig.: Structure of Co-operative Banks

1. State Level

The state level comprises of State Co-operative Banks (SCBs) and State Land Development Banks (SLDBs).

2. District Level

The district level comprises of the Central Co-operative Banks (CCBs) or the District Central Co-operative Banks (DCCBs) and the Central Land Development Banks (CLDBs).

3. Village Level

- The village level comprises of the Primary Agricultural Credit Societies (PACSs), the Primary Land Development Bank (PLDBs) and branches of SLDBs.
- The lower tier comprises of shareholders and members of the immediate higher tier. There are the Urban Co-operative Banks (UCBs) or the Primary Co-operative Banks (PCBs), which are excluded from the federal structure.
- Eventhough the Co-operative Bank have a federal organizational structure, the integration of the system is done vertically based upon the functional responsibilities of its various components.
- The SCBs, CCBs and PACs comprise the medium term and short-term credit structure. Which is similar in all states.
- The land development banks i.e., SLDBs, CLDBs, PLDs and branches of SLDBs comprise the long term credit structure which is not same in all the states. The PLDBs are similar to Primary Co-operative Agriculture and Rural Development Banks (PCARDBs) and SLDBs are similar to State Co-operative Agricultural and Rural Development Bank (SCARDBs).
- In the federal structure, the state level co-operative banks are considered as the apex institutions whereas from point of view of supply of resources, supervision, promotion and control, NABARD, National Co-operative Bank of India (NCBI) and RBI are considered as apex institutions and SCBs and SLDBs are considered as institution with intermediate position in the structure.
- The working of CCBs is co-ordinated and regulated by the SCBs, which also act as caretaker of the surplus funds of CCBs and supplement them by getting loans from the RBI and by attracting deposits.
- The CCBs finance their members by mobilizing the resources in districts, they also help the channelizing of funds to primary credit societies from SCBs.
- The PACSs deal with credit activities and act as a base of the co-operative banking at the village level.
- The majority of states have federal set-up as long-term credit is not uniform. In these states, SLDBs are at state level and the affiliated primary land development bank are present in taluka and district levels. Other states have a unitary structure consisting of operational units as SLDBs branches just below SLDBs.

Rahul Publications

- The SLDBs get funds from issue of special development debentures and ordinary debentures. The PLDBs acquire funds mostly from the SLDBs and the land development banks cannot obtain deposits as they are not considered as banks in a true sense. They only provide long term loans.
- UCBs are generally restricted under their by-laws which enables them to run their business only in urban, sub-urban and metropolitan areas. They are corporate in nature and their services are mainly intended to small scale industrial units, professional and salaried classes, retail trader etc. A town or area can have more than one UCB.
- It has been opined by the Banking Commission that the term "urban co-operative banks" is not clearly and uniformly defined in every state. In states like Maharashtra, the term "bank" can only be used for those urban credit societies which perform banking business with a paid-up share capital of not less than ` 20,000.

  The RBI serves as the licensing authority of new branches of existing banks and new banks.

2.9.3 Growth of Co-operative Banks

Q33. Explain the growth of Co-operative Banks.

Ans :

The co-operative banking reforms since 1991 are highlighted in the following points.

1. The procedure of licensing of new UCBs was liberalised to a great extent specifically for income recognition, classification of assets and other prudential norms.
2. The National Co-operative Bank of India (NCBI) was registered on August 5, 1993 as a multistate co-operative society. It is developed by National Co-operative Union as the central institution for the co-operative banks. Its equity capital is ? 100 crore and it also includes foreign equity participation.
3. NABARD started a co-operative development fund in order to facilitate the enhancement of managerial systems and skills in the co-operative banks.
4. Lending or deposit rates of all co-operative banks have been either abolished or has been made less.
5. From April 1995, PCBs got permission to invest their excess fund in equity /bonds of all-India Financial Institutions and in PSU bonds, within the ceiling of 1,0 percent of their deposits.
6. From February 1996, PCBs were given permission to invest their excess funds in CDs given by scheduled commercial banks and other financial institutions approved by the RBI.
7. All scheduled PCBs were included under the provision of the Banking Ombudsman Scheme, 1995.
8. From April 1996, Scheduled PCBs were given permission to take equipment leasing and hire- purchase financing activities after fulfilling few prudential needs.
9. From November 1996, PCBs were permitted to invest their excess funds in the units of UTI upto 5 percent of their increasing deposits of the previous year, within the overall ceiling of 10 percent of their deposits for investment in the bonds of public sector companies and equity or bonds of all-India financial institutions.
10. Presently, the PCBs have been permitted to expand their area of functions/activities to the whole district of their registration comprising rural areas, and were allowed to expand direct finance for agricultural activities from December 1996.
11. From 1996-97, the prudential accounting norms were laid on to SCBs/CCBs, in two stages i.e, 1996-97 and 1997-98.

Rahul Publications

2.9.4 Govt. Initiatives to Strengthen the Co-operative Banks

Q34. Discuss the government Initiatives that Strengthens the Development of Co-operative Banks.

(OR)

Explain the motives initiated by the government in order to strength the Co-operative Banks India.

Ans : **(Dec.-18)**

The government and the RBI had introduced few strong measures to fortify strengthen the development of co-operative banks prior to the submission of the Khusro committee report. Few of the policy initiatives are explained as follows,

1. A scheme was being articulated by NABARD for the reorganisation of PACSs and this scheme was implemented in the states which gave its acceptance.
2. Few programmes were started for the development of chosen PACSs into completely multi-purpose co-operative societies in several states and Union Territories.
3. The 15-point programme for the enhancement of PACSs was carried out in 16 Pilot Project Districts which resulted in the significant enhancement of the chosen PACSs performance with respect to mobilisation of deposits, issuing of loans and collection of dues from the members.
4. Apart from these further some state governments such as Andhra Pradesh, Madhya Pradesh, West Bengal also instigated few development programmes in order to boost the fundamental functioning of the co-operative credit institutions.
5. 175 CCBs and 7SCBs of the country were being recognised as 'weak'banks lying on their financial status on 30 June 1987. These banks were made to undergo the rehabiliation programme, but this programme was unsuccessful and failed.
6. A 12-point Action Programme was articulated and disseminated by NABARD to all the state government in order to help the weak banks which were either not eligible or were about to become ineligible for refinance support.
7. A decision was taken in June 2004, of not issuing new licenses for establishing new banks or for setting up new branches until and unless an adequate framework for regulation and control was being practised for the present UCBs.
8. The Reserve Bank developed a vision document for UCBs in March 2005, which among others carried out discussions about the issues of the sector and emphasized the problems of double controlling system which limited the RBI's capability in coping up with the weaknesses of entities in the sector.
9. The Reserve Bank offered a proposal to the state governments for signing MOU, with respect to the vision document, in order to assure considerable connection of approach of the two agencies given under the regulation and supervision of UCBs. As a part and parcel of MOU the state level task force for Co-operative Urban Banks (TAFCUBs) inclusive of representatives of the reserve bank state government and federation/association of UCBs, was decided upon. The TAFCUB was given the task of recognizing the possible achievable and non-achievable UCBs in the state and furnish a re-established way for the former and a non-interruptive exit route for the latter set of banks. The exit route may comprise merger/ amalgamation with financially sound banks, conversion into societies or lastly via liquidation.
10. The suggestions of the task force, which were being appointed by the government of India in 2004 to come up with an action plan for retaining the structure of short-term rural co-operative credit had being accepted as a standard.
11. The government of India along with the state government has sanctioned a revival package for the STCCs, after discussing it with the state

Rahul Publications

government, in the year 2006, Jan. NABARD was being appointed to follow the revival package in all the states. In order to implement the revival package in any state, it needed the signatures of the MOU among the GOI, the participating state government and NABARD. A separate audit of all PACS. DCCBS and STCB in every participating state was being conducted in a special way to obtain accurate and unbiased calculation of losses as on March 31, 2004 and the losses are divided fairly, these losses might have taken place because of credit business, Public Distribution(PDs) business or other trading business. All the participating states would also propose an ordinance as per para 9 of the MOU to change the State Co-operative Societies Act to provide an effect to the institutional and legal reforms or would carry out the required legislation. Implementation of the package was started in thirteen states namely, A.P, Arunachal Pradesh, Bihar, Chattisgarh, Gujarat, Haryana, M.P, Maharashtra, Orissa, Rajasthan, Uttarkhand, U.P and West Bengal.

Q35. Write briefly about the Co-operative Banking Reforms Since 1991.

Ans :

1. The procedure of licensing of new UCBs has been liberalised to a great extent specified for income recognition, classification of assets and other prudential norms.
2. The National Co-operative Bank of India (NCBI) has been registered on August 5, 1993 as a multi state co-operative society. It is developed by National Co-operative Union as the central/main institution for the co-operative banks. Its equity capital is ` 100 crore and it also includes foreign equity participation.
3. NABARD has started a co-operative development fund in order to facilitate in the enhancement of managerial systems and skills in the co-operative banks.
4. Lending or deposit rates of all co-operative banks have been either abolished or has been made less.
5. From April 1995, PCBs were of well permission to invest their excess fund in equity/ bonds of all-India Financial Institutions and in PSU bonds, within the ceiling of 10 percent of their deposits.
6. From February 1996, PCBs were given permission to invest their excess funds in CDs given by scheduled commercial banks and other financial institutions approved by the RBI.
7. All scheduled PCBs were included under the provision of the Banking Ombudsman Scheme, 1995.
8. From April 1996, Scheduled PCBs were given permission to take equipment leasing and hire- purchase financing activities after fulfilling few prudential needs.
9. From November 1996, PCBs were permitted to invest their excess funds in the units of UTI upto 5 percent of their increasing deposits of the previous year, within the overall ceiling of 10 percent of their deposits for investment in the bonds of public sector companies and equity or bonds of all-India financial institutions.
10. Presently, the PCBs have been permitted to expand their area of functions/activities to the whole district of their registration comprising rural areas, and were allowed to expand direct finance for agricultural activities from December 1996.
11. From 1996-97, the prudential accounting norms were laid on to SCBs/CCBs, in two stages i.e, 1996-97 and 1997-98.

Rahul Publications

2.10 NON-BANKING FINANCIAL INSTITUTIONS (NBFI)

Q36. Discuss the various Non-banking Financial Institutions (NBFI).

Ans : **(Jan.-13, Imp.)**

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering.

Examples of these include insurance firms, pawn shops, cashiers check issuers, check cashing locations, currency exchanges, and micro loan organizations. Alan Greenspan has identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment [which] act as backup facilities should the primary form of intermediation fail."

Types

The NBFC's can be classified into the following eight categories,

1. **Hire-purchase Finance Company :** These companies are engaged in the business of hire-purchase financing or hire-purchase transactions.
2. **Investment Company :** This company is concerned with mobilising money from the people and channeling them in securities of companies. It also engages in trading such securities of earn profits.
3. **Leasing Company :** To is type of NBFC is concerned with undertaking leasing or financing of equipment leasing.
4. **Loan Company :** It renders financial support by way of loans or advances or otherwise for any activity other than its own.
5. **Mutual Benefit Financial Company :** This is a company notified under Section 620 A of the Companies Act.
6. **Housing Finance Company :** It is concerned with the financing of the acquisition or construction of houses or development of plots or land. These companies are supervised by the National Housing Bank.
7. **Miscellaneous Non-banking Company :** This type of company is engaged in the activities of managing, promoting, of new companies.
8. **Residuary Non-banking Company :** In this category, all finance companies are included which receive deposits, under any scheme or arrangement by whatever name called, in lump sum or in installments by way of contributions or subscriptions.

Q37. Explain the Objectives of NBFI.

Ans :

The following are the objectives of NBFI are :

1. **Promote Savings**

NBFIs encourage people to save more. They collect household and corporate savings. These offer lucrative saving schemes, provide higher rate of interest. These have developed savings habits in middle income group also, who were earlier inclined to spend rather than save.

2. **Helpful in Investment of Savings**

Economic development depends on the rate of capital formation and the capital formation depends on the investment of savings. Such savings can be invested in agriculture, industries, infrastructure etc. The NBFIs mobilize the savings and convert these savings in productive investments.

3. **Availability of Credit**

NBFIs meet the credit requirements for economic development. It provides credit to various sectors of economy. Thus, NBFIs promote economic development by providing credit facilities to various productive sectors of the economy.

4. **Helpful in Promoting Exports**

Export-import-bank (EXIM Bank) has been playing a very significant role in promoting exports and meeting the credit needs of

Rahul Publications

exporters. It provides export credit and help in export documentation. It also provides bank guarantee to exporters while importing capital goods and raw materials.

5. Helpful in Entrepreneurial Development

Entrepreneurs hesitate to invest in new ventures due to lack of funds. NBFIs provide easy loans to entrepreneurs to set up new business units and expand the existing units. NBFIs also help in public issue of shares and debentures of companies. These also act as underwriter i.e., give guarantee to the issuing company that in case the public does not subscribe the whole issue, then they will purchase these shares or debentures. NBFIs also help the entrepreneurs in preparing feasibility reports and survey reports for setting up new industrial projects.

6. Promote Agriculture Development

National Bank for Agriculture and Rural Development (NABARD) is the apex bank for agricultural and rural credit. It refinances agricultural credit. It has helped to reduce dependence of farmers on mahajans and sahukars and thus promoted agriculture development,

7. Promote Industrial Development

NBFIs provide credit to industrial sector. NBFIs also provide necessary foreign exchange to the industries for importing capital goods and raw material. So NBFIs promote industrial development.

8. Helpful in Pushing-up the Demand

People have low income and low standard of living in underdeveloped countries. Their demand for consumer goods is also low. NBFIs provide loans to these customers to enable them to buy consumer durables. As a result, demand for consumer durables goes up and so also their production. New industries spring up which leads to more income, output and employment. Standard of living of the people improves. In this way, NBFIs by providing consumer credit help to increase aggregate demand and supply and thereby accelerate rate of economic growth.

9. Promote Employment

NBFIs promote industrial development by providing loans to business units. Setting up of more industries promotes employment.

Thus, financial institutions play a crucial role in growth and development of nation by offering a well-organized credit market catering to financial needs of various sectors of the economy.

Q38. Explain about the structure of NBFI

Ans : **(Jan.-18)**

The Non-banking institutions are classified into,

1. Non-banking finance companies
2. Development finance companies.

1. Non-Banking Finance Companies

The non-banking finance companies includes. Development Finance Institutions (DFIs), Non-Banking Finance Companies (NBFCs), and Housing Finance Corporations (HFCs).

2. Development Finance Companies

The Development Finance Companies are further classified as,

(i) All-India Financial Institutions

All-India Financial Institutions includes Industrial Finance Corporation of India (IFC1), Industrial Development Bank of India (IDBI), Industrial Investment Bank of India (UBI), Small Industries Development Bank of India (SIDBI), Infrastructure Development Finance Company (IDFC), National Bank for Agriculture and Rural Development, EXIM Bank and National Housing Bank (NHB).

(ii) State Level Institutions

The State Level Institutions includes State Financial Corporation's (SFCs) and State Industrial Development Corporations (SIDCs).

(iii) Other Institutions

Other institutions includes Export Credit Guarantee Corporation of India (ECGC), Deposit Insurance and Credit Guarantee Corporation (DICGC) etc.

Rahul Publications

2.11 UNIT TRUST OF INDIA

Q39. Write a note on unit trust of India.

Ans :

The Unit Trust of India or UTI was established on 1st February, 1964 under the Unit Trust of India Act, 1963 by the government of India. Its establishment has been a landmark in the history of investment trusts in India. It completed 35 years on 30th June, 1999. The UTI started the sale of units to the public from the July, 1964.

Objective

The basic objective of the UTI is to offer both small and large investors the means of acquiring shares in the widening prosperity resulting from the steady, industrial growth of the country. There are two primary objectives of UTI, i.e., (i) to promote and pool the small savings from the lower and middle income people who cannot have direct access to the stock exchange, and (ii) to give them an opportunity to share the benefits and fruits of prosperity resulting from rapid industrialization in India.

Functions

The main functions of UTI are as follows :

- To encourage savings of lower and middle-class people.
- To sell units to investors in different parts of the country.
- To covert the small savings into industrial finance.
- To give them an opportunity to share the benefits and fruits of industrialization in the country.
- To provide liquidity to units.

Q40. Discuss the Operational Activities of UTI.

Ans :

The following are the salient features of the operational activities of the UTI :

1. Mobilization of Savings

Unit Trust of India right from its inception has been playing a useful role in mobilization of savings of the people. During the period 1965 - 93. The Trust made net sale of units under different schemes worth Rs. 38, 715.00 crores giving an annual average of Rs. 1, 251.00 crores .

2. Pattern of Investment

The most important aspect of the utilization of funds is the pattern of Investment of the Trust's Funds. The information available on the direction of the investible funds of the Trust in the different Investment outlets discloses that the Unit Trust has tried its best to build a balanced flexible investment portfolio composed of corporate securities, government securities and other investments, representing fixed deposits with companies, advanced deposits for shares and debentures, bridging finance, application money and money at call and short notice in order to ensure a reasonable return, consistent with the safety of capital and capital appreciation.

3. Assistance to Corporate Sector Undertaking

By serving as an effect conduit between saving and investment UTI has achieved spectacular success in rendering financial support to programs of rapid industrialization in the country. Because of the sizeable resources garnered by the Trust, it has been possible for it to pump substantial amount of assistance into the corporate sector undertakings.

4. Forms of Assistance

The Trust has granted financial assistance to the corporate sector by investment in privately placed debentures and loans, underwriting and direct subscription and by way of special deposits. It is to be noted that about 50% of assistance of the Trust was in the form of underwriting and direct subscription. About one third of the Trust's assistance was by way of privately placed debentures and loans.

5. Purpose wise Distribution of Assistance

Until recently, major portion of assistance was given to existing projects for their expansion and diversification programs. However in recent years UTI provided lion's share of its funds for other purposes (i.e. Working capital).

Rahul Publications

6. Sectorial Distribution of UTI's Assistance

UTI has invested bulk portion of its funds in private sector undertakings private sector enterprises received about 80 percent of the total assistance of the trust.

7. UTI's Assistance to Backward Areas

In consonance with the government policy of fostering industrial growth in relatively backward areas, UTI has been providing sizeable amount of assistance to enterprises located in these areas. UTI has provided assistance to backward areas through subscription to privately placed debentures.

8. State Wise Distribution of Assistance

The Unit Trust of India has provided assistance to industrial enterprises situated in different parts of the country in order to accomplish a geographical diffusion in its investment portfolio.

2.11.1 Structure of UTI

Q41. Discuss the structure of UTI.

Ans : **(Feb.-16, Sep.-16)**

1. UTI was introduced in 1963 as a Trust under the UTI Act, 1963. UTI was vested back with its authority from RBI and IDBI with which it was an associate institute. It offers beneficial and during investment opportunities by issuing units and shares under different schemes. The main sources of its funds are RBI, LIC, SBI and other banks, who contribute initial capital, borrowings from RBI / IDBI and other banks and unit capital which are invested in corporate securities. From April 1986, UTI was permitted to grant term loans, rediscount bills, undertake equipment leasing and hire-purchase financing, allow housing and construction finance, offer merchant banking activities and portfolio management services and develop the overseas or "off shore" funds.

   The UTI comprises 19 institutions in its group as follows. UTI Securities Exchange Ltd., UTI Bank, UTI Investors Services Ltd., three credit rating agencies (CRISIL, ICRA and CARE), DFHI, SHCIL, OTCEI and others.

   The important main financial instrument started by the UTI in the financial markets is unit. There are two types of popular units,

   (i) Ordinary and

   (ii) Capital.

   The face value of ordinary unit and capital unit are ` 10 and ` 100 respectively. The unit is marketable, highly liquid, transferable and risk free. Units are termed as "trustee securities", and banks accept them as a security for granting loans.

2. Three phases of MFI from 1964-1997.

   I) $\rightarrow$ 1964 - 86 $\rightarrow$ Industry was a monopoly with one participant i.e. UTI.

   II) $\rightarrow$ 1987 - 92 $\rightarrow$ Public sector banks and financial institutions started up their MFs.

   III) $\rightarrow$ 1992 - 97 $\rightarrow$ Entrance of private sector MFs and participation of foreigners were permitted.

3. The MFs raised from zero before 1964 and one in 1964 to 32 in 1997. The below table lists the names of 30 of these funds. The structure of MFI in India is composed of 11 public sector funds and 21 private sector funds. The UTI is termed as national institution by the special Act. Therefore, it is not considered as a private or public sector. Seventeen funds have foreign participation. All the MFs are registered with the SEBI, as UTI is under the regulation of SEBI from 1 July 1994. MFs have established a separate body. Many parties are planning to enter into the MFI. 28 sponsors have been approved by SEBI to establish new MFs by 31 March, 1996.

Rahul Publications

4. UTI holds a dominant position in the MFI. It is responsible for 34 percent of all the schemes, 83 percent of the organised resources.

5. The decreasing order of major funds as per the cumulative mobilisation of resources, UTI, SBIMF, CANBANK MF, LICMF, GICMF, Morgan Stanley MF, BOIMF, INDBank MF, PNBMF, Kothari MF, ICICIMF and many others.

6. The size of MFI has witnessed drastic growth in quick span of time. The total funds amounted to more than ` 81000 crore. The unit-holding accounts in 1963 increased from zero to 1.2 crore in 1991 and 6.2 crore in 1995. But, the share of MFs in the financial savings of the household sector was not upto the mark, it was 0.7 percent in 1970-71, 2.3 percent in 1985-86, 13.3 percent in 1991-92, 7.0 percent in 1992-93 and 0.2 percent in 1995-96.

7. The MF schemes raised from one in 1964 to 197 in 1997, from these schemes 67 were floated by the UTI, 90 by other public sector funds and 40 by private sector funds. 90 percent schemes are CEFs and 10 percent are OEFs. SEBI has permitted CEFs to repurchase their units after a short lock-in period and share of CEFs in the total business is not adequate with their numerical strength, in order to increase the size of OEFs.

8. The UTI's share of closed-ended income schemes has been constant approximately 20 percent of total assets and closed-ended growth schemes has increased from 8 to 22 percent during 1986-87 to 1995-96. The overseas funds comprise a very small part of UTI assets and shares. It has declined from 3 to 1 percent during the period 1994-95.

2.11.2 Functioning of UTI

Q42. Explain the functioning of UTI.

(OR)

Write a note on functioning of UTI.

Ans : **(Feb.-16, Sep.-16, Imp.)**

Functions of Unit Trust of India

The functions of Unit Trust of India can be categorized into two,

(a) Mobilization of Savings

The UTI mobilizes the savings of the investors by selling the units under various schemes. It has introduced 79 schemes till now, according to the needs and preferences of the different types of investors. US-64 is the first scheme of UTI launched in 1964, which constitutes the most significant scheme in the present day context. It is classified in two different kind of schemes,

(i) Open-ended schemes and

(ii) Closed-ended schemes.

After that it has issued many fixed income schemes and growth schemes such as monthly Income US, Growing Income, Growing monthly income, Defferred income, Growth schemes, Income-cum-growth schemes, Off shore funds, Venture capital financings and so on. Many schemes in addition to the US.

In 1995-96 UTI has introduced 7 new schemes. In 1998, June 30, there were 79 operational US schemes. Out of which 28 belongs to open-ended schemes while the remaining belongs to close-ended schemes. The UTI is always available to buy back units from the holders. The units benefits in a continuous professional management, safety, diversification of investment and liquidity.

Rahul Publications

Unit Trust of India mobilized the savings of about ` 176 crores in 1964-74 which has been increased to ` 81607 crores in the year 1999-2000. Due to the US 64 crisis in 1998, there were negative reserves that influenced the entire process of resource mobilization. After the division of UTI into UTI I and UTI II, US 64 scheme and monthly income schemes were grouped under UTI I and the remaining schemes were grouped into UTI II.

(b) Diversification of Activities of UTI

UTI has diversified its activities by creating the subsidiaries which are as follows,

i) The UTI Bank Ltd., 1994

ii) UTI investor services Ltd.

iii) UTI securities exchange Ltd., 1997

iv) UTI investment advisory services and

v) UTI institute of capital markets.

(c) Investment Resources

The UTI invests its funds in shares and securities. It helps in underwriting of shares and direct subscription to shares and debentures of the organisations. UTI also invests a proportionate amount of its total funds in all India financial institutions. By an amendment of UTI Act on April 23,1986, UTI provides term loans, rediscount bills, undertakes equipment leasing and hire purchase financing.

The important objective of investment strategy of UTI is to obtain increased return by reducing risk to low levels by diversifying portfolio of securities. Its investment has wide scope towards various industries and services. The success of UTI's investment strategy is based on the efficiency consistency of research and trend analysis and also the various forces operating in capital markets and corporate sectors.

2.12 MUTUAL FUNDS

Q43. Define mutual funds. Explain the classification of mutual funds.

Ans :

Meaning

Mutual Fund is a type of collective investment method by which many people pool their money in a fund and invest in various securities like stock, bonds or cash investments. Every mutual fund has a fund manager or investment advisor so it is also called as managed funds.

In world's top stock markets collective investments holds a major share because of its flexibility. Depends on the objective of the funds like long term growth and low risk factor or high income growth with high risk factor or low growth rate and stability of principal, fund manager invests in respective fields on behalf of shareholders. For individual investors it is very easy type of investment because someone else manages their funds, take care of accounts and invest money over many different available securities.

Types

- **Net Asset Value**

  This is per share amount of total fund's value. To calculate the NAV first add current market values of all assets and divide it by the number of shares. In stocks prices change in every second but NAV is calculated in a daily basis.

- **Open Ended Scheme**

  In open ended scheme any time during the scheme period an investor can enter or exit the scheme by buying or selling at its present Net Asset Value (NAV).

- **Close Ended Scheme**

  In this scheme a fixed number of shares are sold during its initial public offer (IPO) and later the buying and selling or shares are possible only in secondary market.

Rahul Publications

- **Equity Funds**

  Mutual funds invest in stock market are called equity funds or stock funds. Equity funds can again divided in to many categories.

- **Growth Funds**

  In this funds will be invested in companies with high growth potential for a long term capital appreciation. Growth funds are more volatile to market risks.

- **Income Funds**

  Invest in companies with high dividend payouts providing safety and regular income.

- **Blend Funds**

  It is a mixture of Growth and Income funds to provide long term capital appreciation and current income. By risk-wise it is in between growth funds and income funds

- **Small-Cap, Mid-Cap and Large-Cap Funds**

  In stock market companies are divided in to many groups according to their market capitalization like large-cap, mid-cap and small-cap companies. Market Capitalization is one way of measuring the size of the company and is decided by the number of shares in the market and value per share. Mutual funds are also categorized like this based on the share they hold.

- **Equity Linked Saving Schemes ELSS**

  This is equity linked saving schemes. It is a kind of diversified mutual fund in which fund manager invest in varies companies from varies industry so risk factor is low. Also in India there is a tax benefit in investing ELSS. These funds have a lock in period of three years but the return is better and plus you will get tax benefits.

- **Other Types of Mutual Funds**

  There are many other types of mutual funds like money market funds, Leveraged Funds, Index Funds, Hedge Funds, Sector Funds, Specialized Funds etc.

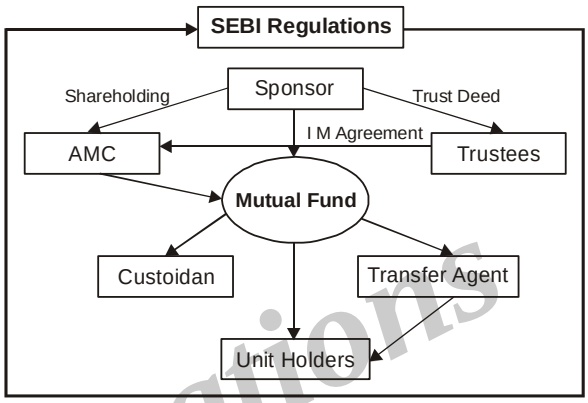
2.12.1 Structure of Mutual Funds

Q44. Explain the Structure of Mutual Funds.

(OR)

Describe the Structure of Mutual Fund operations in India.

Ans : **(Dec.-18, Imp.)**



The above diagram gives an idea on the structure of an Indian mutual fund.

1. Sponsor

Sponsor is basically a promoter of the fund. For example Bank of Baroda, Punjab National Bank, State Bank of India and Life Insurance Corporation of India (LIC) are the sponsors of UTI Mutual Funds. Housing Development Finance Corporation Limited (HDFC) and Standard Life Investments Limited are the sponsors of HDFC mutual funds. The fund sponsor raises money from public, who become fund shareholders. The pooled money is invested in the securities. Sponsor appoints trustees.

2. Trustees

Two third of the trustees are independent professionals who own the fund and supervises the activities of the AMC. It has the authority to sack AMC employees for non-adherence to the rules of the regulator. It safeguards the interests of the investors. They are legally appointed i.e. approved by SEBI.

Rahul Publications

3. AMC

Asset Management Company (AMC) is a set of financial professionals who manage the fund. It takes decisions on when and where to invest the money. It doesn't own the money. AMC is only a fee-for-service provider.

The above 3 tier structure of Indian mutual funds is very strong and virtually no chance for fraud.

4. Custodian

A Custodian keeps safe custody of the investments (related documents of securities invested). A custodian should be a registered entity with SEBI. If the promoter holds 50% voting rights in the custodian company it can't be appointed as custodian for the fund. This is to avoid influence of the promoter on the custodian. It may also provide fund accounting services and transfer agent services. JP Morgan Chase is one of the leading custodians.

5. Transfer Agents

Transfer Agent Company interfaces with the customers, issue a fund's units, help investors while redeeming units. Provides balance statements and fund performance fact sheets to the investors. CAMS is a leading Transfer Agent in India.

2.12.2 Growth of mutual funds

Q45. Discuss the Growth of Mutual Funds in India.

Ans : **(Dec.-19)**

The growth of mutual funds in India are categorized into four phases,

1. Phase - I (1964-87)
2. Phase - II (1987-92)
3. Phase - III (1992-97) and
4. Phase - IV (beyond 1997).

1. Phase-I (1964-87)

The concept of mutual funds emerged in with the establishment of UTI in 1963. The Unit Trust of India (UTI) was considered as the first mutual fund established under UTI Act, 1963, a special act of the parliament. It commenced its operations in 1964 with the objective of mobilizing saving and again reinvesting them with the help of corporate securities in order to achieve maximizing yield and capital appreciation. The launch of the unit scheme led to the emergence of phase-I.

The unit scheme is the first open ended scheme. UTI's investible funds progressed when its market value raised from ` 49 crore in 1965 to ` 219 crore in 1970-71 to ` 1,126 crore in 1980-81 and in June 1987 it raised to ` 5068 crore. This phase introduced innovative scheme which attracted investors. This phase launched five income oriented, open ended schemes and are sold across the globe. UTI introduced master share, the equity growth fund and India fund in 1986. Both of these funds emerged as a marketing success for UTI and India fund was listed on the London Stock Exchange (LSE).

2. Phase-II (1987-92)

The second phase started with the entry of mutual fund which is sponsored by nationalized banks and insurance companies. During the year 1987, the two funds launched in Indian Trust Act, 1882 are SBI mutual fund and Canbank mutual fund. In 1988, the UTI launched another fund called the India Growth Fund and this fund is listed on the New York Stock Exchange (NYSE). During the year 1990, the insurance companies, LIC and GIC and banks which are nationalized such as Indian Bank, Bank

Rahul Publications

of India and Punjab National Bank commenced its operations of wholly owned mutual fund subsidiaries.

The other banking product provided by the arms of sponsor banks during the second phase of mutual fund is 'assured return type of scheme'. RBI issued some guidelines which are applicable only to mutual funds in the year 1989. The government of India offered some guidelines in June 1990 and these guidelines are for all mutual funds operating in India. The guidelines focused on compulsory registration with the SBI and to maintain an arms length relationship between the sponsor and Assets Management Company (AMC). Entry of public sector funds in the mutual fund industry raised the growth of market value to ` 53,462 crore and number of investors to more than 23 million. The factor which is responsible for attractiveness of equity funds is tax benefits under equity linked savings scheme.

3. Phase-III (1992-97)

The history of mutual funds changed during the year 1993. The Securities and Exchange Board of India (SEBI) in January 1993 issued mutual fund regulations. The common regulatory framework of SEBI notified regulations for all mutual funds except UTI. The entry in the mutual fund industry was opened for private domestic and foreign players. The first private mutual fund was introduced with the merger of Kothari Group of Companies and Pioneer, a US Fund Company and together called as Kothari Pioneer Mutual Fund in 1993. They both established the first open ended fund in 1993. In May 1992 the UTI introduced a new scheme called master gain and proved a phenomenal market success during this phase.

Market value increased to ` 4700 crores and number of investors increased to 50 million. The phase-Ill suffered huge losses during the year 1995 and 1996 due to significant fall in NAV's of the equity funds, the service quality of mutual fund, lack of service infrastructure, ineffective performance of the public sector funds, failure of foreign funds like Morgan Stanley etc. Because of this significant downfall the investor had negative impact for investing in mutual funds. Mutual funds sales suffered heavy losses in the year 1995-96.

4. Phase-IV (beyond 197)

This phase had a significant increase in the flow of funds towards mutual funds. This phase had a positive impact on capital market, tax benefits and improvement in the quality of investor service. In the year 1999-2000, sales mobilization level increased significantly from 31,420 crore to ` 73,000 crore. In the year 2000-01, the trend changed when UTI gave a shock to the investing public by disclosing NAV related to the country's largest mutual fund scheme. Because of this disclosure. Pioneer ITI, JP Morgan and Newton investment management were pulled out from the Indian market. The Bank of India MF liquidated all its schemes in 2002.

The Indian mutual fund industry during the years 2000-01 and 2001-02 stagnated to around ` 1,00,000 crore assets. The reason for stagnation in the Indian mutual fund industry are stagnated equity markets and in indifferent performance by players. On May 3rd 2002, the aggregate deposits of Scheduled Commercial Banks (SCBs) was ` 11,86,468 crore. Mutual fund Assets Under Management (AUM) form nearly 10% of deposits of SCBs.

During this phase, increase in AUM by 11% led downfall in UTI. The private sector mutual funds earned huge profits from the debacle of US-64 of UTI. The AUM belonging to this

Rahul Publications

sector also increased 60% in March 2002. The asset under management in the year 2004-05 was ` 1,49,554 crore and rose to ` 4,17,300 crore on March 31, 2009. Thus, during this phase Assets Under Management (AUM) underwent phenomenal success.

2.12.3 Regulation of Mutual Funds

Q46. Discuss the various Regulation of Mutual Funds.

Ans :

Important steps taken by SEBI for the regulation of mutual funds are listed below:

1. Formation

Certain structural changes have also been made in the mutual fund industry, as part of which mutual funds are required to set up asset management companies with fifty percent independent directors, separate board of trustee companies, consisting of a minimum fifty percent of independent trustees and to appoint independent custodians.

This is to ensure an arm's length relationship between trustees, fund managers and custodians, and is in contrast with the situation prevailing earlier in which all three functions were often performed by one body which was usually the sponsor of the fund or a subsidiary of the sponsor.

Thus, the process of forming and floating mutual funds has been made a tripartite exercise by authorities. The trustees, the asset management companies (AMCs) and the mutual fund shareholders form the three legs. SEBI guidelines provide for the trustees to maintain an arm's length relationship with the AMCs and do all those things that would secure the right of investors.

With funds being managed by AMCs and custody of assets remaining with trustees, an element of counter-balancing of risks exists as both can keep tabs on each other.

2. Registration

In January 1993, SEBI prescribed registration of mutual funds taking into account track record of a sponsor, integrity in business transactions and financial soundness while granting permission.

This will curb excessive growth of the mutual funds and protect investor's interest by registering only the sound promoters with a proven track record and financial strength. In February 1993, SEBI cleared six private sector mutual funds viz. 20th Century Finance Corporation, Industrial Credit & Investment Corporation of India, Tata Sons, Credit Capital Finance Corporation, Ceat Financial Services and Apple Industries.

3. Documents

The offer documents of schemes launched by mutual funds and the scheme particulars are required to be vested by SEBI. A standard format for mutual fund prospectuses is being formulated.

4. Code of advertisement

Mutual funds have been required to adhere to a code of advertisement.

5. Assurance on returns

SEBI has introduced a change in the Securities Control and Regulations Act governing the mutual funds. Now the mutual funds were prevented from giving any assurance on the land of returns they would be providing. However, under pressure from the mutual funds, SEBI revised the guidelines allowing assurances on return subject to certain conditions.

Hence, only those mutual funds which have been in the market for at least five years are allowed to assure a maximum return of 12 per cent only, for one year. With this, SEBI, by default, allowed public sector mutual funds an advantage against the newly set up private mutual funds.

As per basic tenets of investment, it can be justifiably argued that investments in the capital market carried a certain amount of

Rahul Publications

risk, and any investor investing in the markets with an aim of making profit from capital appreciation, or otherwise, should also be prepared to bear the risks of loss.

6. Minimum Corpus

The current SEBI guidelines on mutual funds prescribe a minimum start-up corpus of Rs. 50 crore for a open-ended scheme, and Rs.20 crore corpus for closed-ended scheme, failing which application money has to be refunded.

The idea behind forwarding such a proposal to SEBI is that in the past, the minimum corpus requirements have forced AMCs to solicit funds from corporate bodies, thus reducing mutual funds into quasi-portfolio management outfits. In fact, the Association of Mutual Funds in India (AMFI) has repeatedly appealed to the regulatory authorities for scrapping the minimum corpus requirements.

7. Institutionalisation

The efforts of SEBI have, in the last few years, been to institutionalise the market by introducing proportionate allotment and increasing the minimum deposit amount to Rs.5000 etc. These efforts are to channel the investment of individual investors into the mutual funds.

8. Investment of funds mobilised

In November 1992, SEBI increased the time limit from six months to nine months within which the mutual funds have to invest resources raised from the latest tax saving schemes. The guideline was issued to protect the mutual funds from the disadvantage of investing funds in the bullish market at very high prices and suffering from poor NAV thereafter.

9. Investment in money market

SEBI guidelines say that mutual funds can invest a maximum of 25 per cent of resources mobilised into money-market instruments in the first six months after closing the funds and a maximum of 15 per cent of the corpus after six months to meet short term liquidity requirements.

Private sector mutual funds, for the first time, were allowed to invest in the call money market after this year's budget. However, as SEBI regulations limit their exposure to money markets, mutual funds are not major players in the call money market. Thus, mutual funds do not have a significant impact on the call money market.

10. Valuation of investment

The transparent and well understood declaration or Net Asset Values (NAVs) of mutual fund schemes is an important issue in providing investors with information as to the performance of the fund. SEBI has warned some mutual funds earlier of unhealthy market

11. Inspection

SEBI inspect mutual funds every year. A full SEBI inspection of all the 27 mutual funds was proposed to be done by the March 1996 to streamline their operations and protect the investor's interests. Mutual funds are monitored and inspected by SEBI to ensure compliance with the regulations.

12. Underwriting

In July 1994, SEBI permitted mutual funds to take up underwriting of primary issues as a part of their investment activity. This step may assist the mutual funds in diversifying their business.

13. Conduct

In September 1994, it was clarified by SEBI that mutual funds shall not offer buy back schemes or assured returns to corporate investors. The Regulations governing Mutual Funds and Portfolio Managers ensure transparency in their functioning.

14. Voting rights

In September 1993, mutual funds were allowed to exercise their voting rights. Department of Company Affairs has reportedly granted mutual funds the right to vote as full-fledged shareholders in companies where they have equity investments.

Rahul Publications

Q47. Explain the advantages and disadvantages of Mutual Funds.

Ans :

Advantages

1. Professional Management

The basic advantage of funds is that, they are professional managed, by well qualified professional. Investors purchase funds because they do not have the time or the expertise to manage their own portfolio. A mutual fund is considered to be relatively less expensive way to make and monitor their investments.

2. Diversification

Purchasing units in a mutual fund instead of buying individual stocks or bonds, the investors risk is spread out and minimized up to certain extent. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others.

3. Economies of Scale

Mutual fund buy and sell large amounts of securities at a time, thus help to reducing transaction costs, and help to bring down the average cost of the unit for their investors.

4. Liquidity

Just like an individual stock, mutual fund also allows investors to liquidate their holdings as and when they want.

5. Simplicity

Investments in mutual fund is considered to be easy, compare to other available instruments in the market, and the minimum investment is small. Most AMC also have automatic purchase plans whereby as little as Rs. 2000, where SIP start with just Rs.50 per month basis.

Disadvantages

1. Professional Management

Some funds doesn't perform in neither the market, as their management is not dynamic enough to explore the available opportunity in the market, thus many investors debate over whether or not the so-called professionals are any better than mutual fund or investor him self, for picking up stocks.

2. Costs

The biggest source of AMC income, is generally from the entry & exit load which they charge from an investors, at the time of purchase. The mutual fund industries are thus charging extra cost under layers of jargon.

3. Dilution

Because funds have small holdings across different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money.

4. Taxes

When making decisions about your money, fund managers don't consider your personal tax situation. For example, when a fund manager sells a security, a capital-gain tax is triggered, which affects how profitable the individual is from the sale. It might have been more advantageous for the individual to differ the capital gains liability.

Q48. Explain the facilities of mutual funds available to investor.

(OR)

State the facilities of mutual funds available to investor.

Ans : **(Dec.-18)**

Mutual funds in India offer several options/ plans/ services. They are :

(a) Growth / Dividend / Reinvestment

(b) Systematic Investment Plan (SIP)

(c) Systematic Withdrawal Plan (SWP)

(d) Switch Facility

(e) Gift Facility

(a) Growth/Dividend/Reinvestment

In the growth option, the scheme makes no declaration regarding dividend and the investors would not obtain any return from the scheme, which would be reflected in the NAV.

Rahul Publications

(b) Systematic Investment Plan (SIP)

It is nothing but a plan where in the investors can invest a fixed amount each month for a pre-determined period at the relevant NAV-related prices.

(c) Systematic Withdrawal Plan (SWP)

The investors under this plan, withdraws a fixed amount of money periodically. It is similar to SIP.

(d) Switch Facility

In a scheme, unit holders choose to switch units among dividend plan, growth plan and various other plans.

(e) Gift Facility

In mutual fund regulations, the gift facility to the level provided is available to the unit holders.

2.13 Role of AMFI

Q49. What is AMFI ? Explain the Role of AMFI.

(OR)

Expand AMFI and briefly explain its role in financial market.

Ans : **(May.-19)**

Association of Mutual Funds in India (AMFI) was set up on 22nd August, 1995. It was established with the aim to function as a non-profit organisation. This association is the chief governing body of all Asset Management Companies (AMC) and is registered with Securities and Exchange Board of India (SEBI).

AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with SEBI, Till date all the AMCs are that have launched mutual fund schemes are its members It functions under the supervision and guidelines of its board of directors.

The members of Asset Management Companies (AMC) have always carried out the responsibility of introducing new mutual fund schemes under the governance and guidelines of its board of directors. Association of mutual funds in India has played a significant role in creating a healthy and professional market for mutual funds. It has elevated the standard of the mutual fund investment patterns by introducing more beneficiary schemes to attract more investors. The association of mutual funds is also the main governing body of all Asset Management Companies (AMC). The Association of Mutual Funds in India (AMFI) has been registered with the Securities and Exchange Board of India (SEBI). The main principle religiously followed by AMFI is to protect and promote the mutual funds along with the investors or shareholders.

Role

1. To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
2. To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
3. To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.
4. To represent to the government, Reserve Bank of India and other bodies on all matters relating to the mutual fund industry.
5. To develop a cadre of well trained Agent distributors and to implement a programme of training and certification for all intermediaries and other engaged in the industry.
6. To undertake nation wide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
7. To provide information on mutual fund industry and to undertake studies and research and development in association with other bodies.

Rahul Publications

2.14 INSURANCE COMPANIES

Q50. Define Insurance. Explain the characteristics of insurance.

Ans :

Meaning

In simple terms, Insurance is a means of transferring insurable risk of a potential loss to an insurance company against a premium. Hence insurance can be defined as pooling of losses by transfer of risk to insurer, who promises to indemnify insured for losses, which are unforeseen and accidental in nature.

Insurance is a systematic approach to handling financial risk.

Definition

According to Dr. R.K. Singla in the book "Business Organization," insurance is a legally binding contract between two parties in which one party, in exchange for fixed denominations of money, agrees to pay a determined sum to the other party either at the end of a certain period or at the occurrence of an event.

Insurance contracts are also termed as indemnity contracts. There are many types of insurance, including life insurance, fire insurance, marine insurance, theft insurance, vehicle insurance and motorcycle insurance.

Characteristics

- **Transfer of Risk** : The risk is transferred from the insured to the insurer.
- **Indemnification** : The insurer is restored to his or her approximate financial position prior to the occurrence of the loss.
- **Payment of unforeseen** : Unexpected and accidental loss. Insurance does not cover intentional loss.
- **Pooling of Losses** : This means sharing of losses incurred by few over the entire group, so that process average loss is substituted for actual loss.

Q51. Explain the different types of Insurance.

Ans :

(A) Life Insurance

The insurance that pays death benefits to the beneficiaries after the death of the insured is known as life insurance.

Types of Life Insurances

The different types of life insurances are,

1. Term Insurance

Term insurance is the insurance that provides temporary protection to the insured for a limited term period.

2. Whole Life Insurance

The whole life insurance is one of the permanent type of insurance and is effective till the insured complete life time.

3. Universal Life Insurance

Universal life contracts have most variable premium payment options. The policy owners have the authority to decide the time and amount of subsequent premiums.

4. Variable Life Insurance

The variable life insurance is a whole-life insurance. In this insurance an insured will have the exclusive right to decide on where to invest the policy's cash value.

5. Adjustment Life Insurance

The policy can be adjusted according to the changing protection needs and the premium payment ability of the policy holder.

The nature of the policy is known by the relationship between the initial face amount and the premium. The coverage amount is selected by the insured at the beginning. The insured also has the option to select the amount of premium to be paid within a limited time period. Therefore, the adjustable life insurance either provides life time protection or limited protection depending upon the choice of an insured person. The premium amount and the face amount can be adjusted at monthly or annually.

Rahul Publications

6. Endowment Life Insurance

The endowment life insurance is a policy in which the insurer promises to pay the face amount upon death of the insured and even on the survival of the insured at the end of the policy term.

7. Participating Life Insurance

The life insurance policy under which dividends are paid out to the policy holder annually are known as participating life insurance.

(B) Non-life Insurance

Non-life insurance refers to insurance of products excluding the life insurance. It might be insurance of property, motor vehicles, accident and so on. The companies which offers the non-life insurance must pay for losses or damages caused to the insured property.

Types

1. Automobile Insurance

It covers loss due to legal liability against the driver and losses to the automobile.

2. Aviation Insurance

It covers hull, spares, war and liability risks.

3. Business Insurance

Business insurance includes professional liability insurance and business owner's policy that covers multiple risks of business owners.

4. Builder's Risk Insurance

It covers risk of losses, damages to property during construction.

5. Credit Insurance

It covers risk of being unpaid because of borrower's disability. If the debtor dies or is disabled, the insurer clears the debt in full or part.

Example

Mortgage insurance.

6. Casualty Insurance

It covers accidents which are not restricted to one specific property.

7. Crime Insurance

It covers losses which arises because of criminal acts of third party.

Example

Company can attain this type of insurance against thefts and robbery.

8. Crop Insurance

It covers farmer's risks involved in growing crops. It insures loss or damage of crops caused due to weather, hail, drought, insects/ diseases etc.

9. Equipment Breakdown Insurance

It is also called as boiler insurance and covers accidental losses to machinery and equipment.'

Q52. Explain the Functions of Insurance.

Ans :

1. Primary Functions
2. Secondary Functions
3. Other Functions

1. Primary Functions

- **Providing protection :** The elementary purpose of insurance is to allow security against future risk, accidents and uncertainty. Insurance cannot arrest the risk from taking place, but can for sure allow for the losses arising with the risk. Insurance is in reality a protective cover against economic loss, by apportioning the risk with others.
- **Collective risk bearing :** Insurance is an instrument to share the financial loss. It is a medium through which few losses are divided among larger number of people. All the insured add the premiums towards a fund and out of which the persons facing a specific risk is paid.

Rahul Publications

- **Evaluating risk :** Insurance fixes the likely volume of risk by assessing diverse factors that give rise to risk. Risk is the basis for ascertaining the premium rate as well.
- **Provide Certainty :** Insurance is a device, which assists in changing uncertainty to certainty.

2. Secondary Functions

- **Preventing losses :** Insurance warns individuals and businessmen to embrace appropriate device to prevent unfortunate aftermaths of risk by observing safety instructions; installation of automatic sparkler or alarm systems, etc.
- **Covering larger risks with small capital :** Insurance assures the businessmen from security investments. This is done by paying small amount of premium against larger risks and dubiety.
- **Helps in the development of larger industries :** Insurance provides an opportunity to develop to those larger industries which have more risks in their setting up.

3. Other Functions

- **Is a savings and investment tool :** Insurance is the best savings and investment option, restricting unnecessary expenses by the insured. Also to take the benefit of income tax exemptions, people take up insurance as a good investment option.
- **Medium of earning foreign exchange :** Being an international business, any country can earn foreign exchange by way of issue of marine insurance policies and a different other ways.
- **Risk Free trade** : Insurance boosts exports insurance, making foreign trade risk free with the help of different types of policies under marine insurance cover.

Insurance provides indemnity, or reimbursement, in the event of an unanticipated loss or disaster. There are different types of insurance policies under the sun cover almost anything that one might think of. There are loads of companies who are providing such customized insurance policies.

Q53. Explain the principles of insurance.

Ans :

1. Insurable Interest

The person getting an insurance policy must have an insurable interest in the property or life insured. A person is said to have an insurable interest in the property if he is benefited by its existence and be prejudiced by its destruction. Without insurable interest the insurance contract is void. The ownership of a property is not necessary for establishing insurable interest.

A banker has an insurable interest in the property mortgaged to it against a loan. An employer can insure the lives of his employees because of his pecuniary interest in them. In the same way, a creditor can insure the life of his debtor. A person cannot insure the property of a third party, because he does not have an insurable interest in it.

In case of fire insurance, insurable interest must exist both at the time of contract and at the time of loss. In marine insurance, however, insurable interest must exist at the time of loss. It may or may not exist at the time of contract.

Insurable interest in different polices can be explained as follows:

a) Life Insurance

Following persons have insurable interest in life insurance contract :

- An employer in the life of an employee during the course of employment.
- A partner is the life of other partners in case of partnership.
- Husband in the life of his wife or vice-versa.

Rahul Publications

- A creditor in the life of his debtor to the limit of the amount of his debt.
- A son in the life of his father on whom he is dependent.
- A dependent to the extent of support his getting.
- A surety in the life of his principal to the extent of his guarantee.

b) Fire and Marine Insurance

Under these contracts, following persons have insurable interest;

- Mortgagee to the extent of amount of loan he has given.
- Owner of the property in his property.
- Wife and husband in each other's property.
- An agent in the goods of his principal.

2. Utmost Good Faith

The insurance contract is founded on the basis of utmost good faith on the part of both the parties. It is obligatory on the part of the proposer (one who wants to get an insurance policy) to disclose all material facts about the subject to be insured. If some material facts come to light later on then the contract can be avoided at the discretion of the insurer.

The amount of premium is fixed on the basis of all the facts supplied to the insurance company. If some facts are withheld, then the amount of premium will not be properly settled. The insurer should also disclose the facts of the policy to the proposer. So utmost good faith on the part of both the parties is a must.

3. Indemnity

The principle of indemnity is applicable to all types of insurance policies except life insurance. Indemnity means a promise to compensate in case of a loss. The insurer promise to help the insured in restoring the position before loss. Whenever there is a loss of property, the loss is compensated. The compensation payable and the loss suffered should be measurable in term of money.

4. Principle of Contribution

Sometimes a property is insured with more than one company. The insured cannot claim more than total loss from all the companies put together. He cannot claim the same loss from different companies. In this case he will be benefited by the insurance which runs counter to the principle of indemnity.

A person cannot be restored to a better position than before the loss occurred. The total loss suffered by the insured will be contributed by different companies in the ratio of the value of policies issued by them. So companies make a contribution to restore the previous position of the insured.

5. Principle of Subrogation

The principle of subrogation is applicable to all insurances other than the life insurance. If the insured party gets a compensation for the loss suffered by him, he cannot claim the same amount of loss from any other party.

The rights of claiming the loss are shifted to the insurer (Insurance Company), for example, a gets his house insured for Rs. 50,000 with an insurance company.

The house is intentionally destroyed by B. A claims the loss from the insurance company. A cannot sue B for getting the compensation because he has already been compensated by the insurance company.

Now, insurance company can sue B on behalf of A because of making good the loss suffered by A, the insurance company steps into the shoes of A.

Q54. Define Life Insurance. Explain the need of life insurance.

Ans :

Meaning

The Life Insurance Corporation (LIC) was established in India with a view to provide an insurance cover against various risks in life. A monolith then, the corporation, enjoyed a monopoly status and became synonymous with life insurance. Its main asset is its staff strength of 1.24

Rahul Publications

lakh employees and 2,048 branches and over six lakh agency force.

Definition

'Life insurance is a contract between two parties whereby one party agrees to pay to the other party, a certain amount of money as premium to make good the loss of life arising out of an uncertain event of death in which the insured has interest.'

Need

The original basic intention of life insurance is to provide for one' family and perhaps others in the event of death. Originally, polices were to provide for short periods of time, covering temporary risk situations, such as sea voyages. As life insurance became more established. It was realized what a useful tool it was in a number of situations, including :

- **Temporary needs threats :** The original purpose of Life Insurance remains an important element, namely providing for replacement of income on death etc.
- **Regular saving** : Providing one's family and oneself, as a medium to long term exercise (through a series of regular payment of premiums). This has been become more relevant in recent times as people seek financial independence from their family.
- **Investment** : Put simply, the building up of saving while safeguarding it from ravages of inflation. Unlike regular saving products are traditionally lump is investments, where the individual makes are one time payment.
- **Retirement** : Provision for one's on later years has become increasingly necessary. Especially in charging culture as social environment, one can buy a suitable insurance policy which will provide periodical payments on one's old age.

2.14.1 Structure and Investment Pattern of Public Sector and Private Sector

Q55. Explain the Structure and Investment Pattern of LIC.

Ans : **(Imp.)**

LIC has so far introduced various insurance policies. Life insurance policies are regarded as a flexible financial instrument. Some basic types of Life insurance policies are as follows,

a) Term insurance
b) Whole life insurance
c) Endowment policies
d) Annuity contracts
e) Individual insurance
f) Group insurance
g) Pension plans
h) Children's plans and
i) Equity-linked plans.

These policies are usually specific to various income and age-groups.

Structure of LIC

i) Whole life policies usually demands the payment of premium i.e. an amount payable by policy holders, for the complete life. It provides life coverage and is regarded as the long-term investments which hedges risk and does not provide any return.

ii) Endowment policies usually demands the payment of premium for a fixed period. It also provide life coverage and gives adequate return.

iii) Irrespective of its Kind life policies usually provides policies "with profits" or "without profits". Policies which provide profits holds greater premium as a form of allowance for the paid bonuses.

Policies which do not provide profits holds less premium and the sum assured is paid on the maturity of the policy or at the death of the person.

iv) Life policy acts as a demand of an amount payable in the future either in lumpsum

Rahul Publications

amount or in installments periodically. The present value of a lumpsum amount or future stream of income minus the value of future premiums results in the value of a policy. There are chances to end the bond to pay all future premiums and acquire the present value of the policy instantly in the following ways,

a) Surrendering the policy for cash

b) "Assigning" it in the open market

c) Raising loan through policy as security and

d) Transforming it into a 'free' or 'paid up' policy.

v) The life assurance policies and pension plans are much in demand as they provide life cover safeguard and saving schemes with additional advantages of sharing profit and several other tax benefits. Life policies serves as a channel/ medium for few activities like buying houses, payment of school fees, purchase of unit trust units and preventing of tax.

vi) LIC provides many schemes, policies and plans to the investors such as individual insurance, group insurance, group gratuity, group superannuation, non-medical insurance, salary saving insurance, annuities and so on.

vii) LIC is being introducing newer and newer plans to its portfolio from time to time and is developing its product under product development process in order to meet the changing needs, preferences and conditions of the investors.

viii) LIC established LIC mutual fund in 1989, in order to increase savings from investors and offer them with better returns liquidity and security. These investors were particularly from rural and semi-urban areas. LIC mutual fund had four new and alluring plans.

ix) LIC introduced two pension plans in 1993, known as "Jeevan Dhara" and "Jeevan Akshay." Jeevan Dhara is a deferred annuity plan, where as Jeevan Akshay is a voluntary immediate pension plan for the senior citizens.

x) So far LIC has instigated 37 new insurance plans. It is operating with 1191 centres in the country and 1774 branches.

xi) The business of LIC in 1986-87 was ` 9108 crore in individual insurance and ` 1085 in group insurance. The new individual and group insurance business increased in 1995-96, with 82 percent and 83 percent of the total sum assured and premium income respectively. The two plans under individual insurance i.e. Endowment Assurance and Money Back Policy generated 80 percent, i.e, 40 percent each, business every year. Inclusion of four more plans with these plans the business generated is 94 percent of sum assured in every year.

LIC Investment Pattern

The Insurance Act 1938, provisions has governed the pattern of investment of LIC funds as follows,

1. Prior to the year the investment pattern of LIC included 50 percent of investment of its controlled funds in government and other approved securities, 15 percent in 'other' investments which comprised of loans to state governments for housing and water supply programmes, municipal securities excluding from category one government guaranteed loans to municipal committees and co-operative sugar factories and 35 percent in 'approved' investments which composed of shares and debentures of public and private limited companies, shares and debentures of co- operative societies, immovable property, loans to its policy-holders, and fixed deposits with scheduled banks and co-operative societies. For category one and two the minimum percentage was being specified where as for category three maximum percentage was being specified.

2. From 1995, the provisions for investment were altered. They are,

   (i) Investment in central government marketable securities should not be less than 20 percent.

Rahul Publications

(ii) Loans to housing banks should be less than 25 percent which includes central govt, marketable securities.

(iii) State government securities inclusive of the govt, guaranteed marketable securities including loans to housing banks should not be less than 50 percent.

(iv) Socially oriented sectors comprising public sector, co-operative sector house building by policy holders, own your house scheme including state govt, securities and govt. Marketable securities should not be less than 75 percent.

(v) Private corporate sector, loans to policy holders for construction and acquisition of immovable property should not be less than 25 percent.

3. The main investment policy under LIC is security of funds and maximisation of rate return on investment is considered as the second priority.

4. The provisions of insurance governing the LIC investments states that the priority sectors and socially oriented sectors in the economy should be financed. LIC is permitted to hold a proportion of its funds in the form of industrial securities, in order to fulfill the financial requirements of the private sector.

5. The significant path for the LIC investment is the government and approved securities whose share in the total investments decreased from 71 percent in 1956 - 61 to 59 percent in 1966-67, 55 percent in 1971-72, and 48 percent in 1978-1993. In 1994-96 there was a minimal increase in the share from 53 to 55 percent.

The subsequent key investment avenues are housing and mortgage loans; and loans to electricity boards and power corporations, and other infrastructural facilities; each emitted for approximately 10 to 13 percent of total investments.

Q56. Write about the structure and investment pattern of General Insurance Companies (GIC).

Ans : **(Imp.)**

In India, general insurance business was transacted by 107 insurance companies (63 domestic and 44 foreign companies) prior to nationalization. After nationalization, the structure pattern of general insurance industry is divided into public sector and private sector.

General Insurance Business is classified into two types :

(a) Commercial Line of Insurance

(b) Personal Line of Insurance

(A) Commercial Line of Insurance

It includes insurance for business, professional and commercial establishments.

1. Policies for Traders

The various insurance policies for traders include Dukan Mitra policy, Fire Policy, Cash policy, Office Umbrella policy, Marine Cargo policy etc.

2. Policies for Cottege, Tiny and Small Sector Industries

The various insurance policies for tiny sector include Burglary policy, Cash policy. Motor policy and other policies.

3. Professional and Specific Professional/ Properties Insurance

It includes Marine Hull insurance, Bankers indemnity insurance, Stock exchange and brokers insurance, Satellite insurance, Jewellers block insurance etc.

4. Rural Industries and Rural Prospects

It incudes Plantation insurance, Pisciculture insurance, Failed well insurance, Sericulture insurance, Prawn insurance, Fish in pond insurance, Honey bee insurance etc.

Rahul Publications

(B) Personal Line of Insurance

This insurance is for individuals and families.

1. Property Insurance

It includes Fire A + B policies, Graha raksha policy, Gun insurance, Motor insurance, Baggage insurance, all risks insurance.

2. Accident Insurance

It includes Personal accident insurance, Suhana safar policy, Destination of India, Cradle care insurance, Margo bandhu insurance etc.

3. Health Insurance

It includes Jan Arogya insurance, Cancer insurance, Mediclaim insurance etc.

4. Liability Insurance Policy

It includes Adhikari suraksha kavach, Doctors indemnity policy, Professional indemnity policy.

Investment Pattern of General Insurance Corporation (GIC)

The investment patterns for non-life insurance are prescribed by insurance Act 1938. A recommendations was also provided by the Malhotra Committee (1994). The committee recommended that the mandated investment of funds of general insurance companies must be reduced to 35 per cent from the existing level of 70 percent.

In April 1995, Government allowed the GIC and its subsidiaries to invest upto 55 percent of the annual accretion of their funds. According to the notification of IRDA regulations in August 2000, the companies should not make investments less than 30 percent in government and other approved authorities. They should make a minimum of 10 percent investment in infrastructure and social sectors. They are required to make atleast 5 percent investment in fire fighting and housing. Out of the remaining 55 percent, 2S per cent can be used to make investment in securities and 30 percent will be managed by prudential norms unapproved.

Q57. Differentiate between Investment Pattern of LIC and GIC.

Ans :

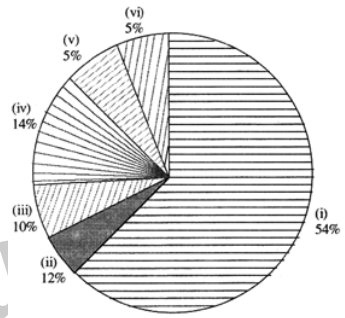
1. The yearly premium income of the GIC and its subsidiaries was more or less similar to LIC till 1980s. However in 1990s, there was rapid growth in LIC when compared to the GIC, and LIC's premium income increased much than GIC.
2. The investments of GIC in the government sector instruments were 42 to 46 percent of the total investments, which were less than the investments of LIC which were 48 to 55 percent of the total investments. Whereas the investments of GIC in corporate sector were at 31 to 34 percent of the total investments which were higher than the investments of LIC at 16 to 18 percent.
3. LIC and GIC both invests majority of their investment in housing development.
4. Loans to banks are one of the key items of GIC investments, Where as this is not the case with LIC.
5. The aggregate volume of investment of LIC is greater then that of the GIC. The total investments of LIC was 18 to 20 percent in 1990s. The earnings of GIC on its investments was slightly higher than that of LIC.

Rahul Publications

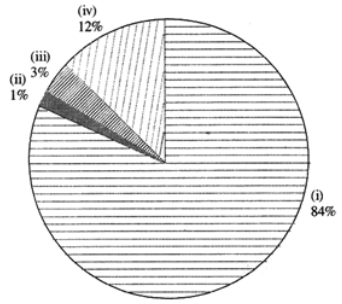
Portfolio Restrictions on LIC and GIC effective from 1995

LIC's investment	Percent	GIC's investment	Percent
(a) Central Government marketable securities, not below	20	(a) Central government securities, not below	20
(b) Loans to housing bank and central government, marketable securities, not below	25	(b) State government and other government guaranteed securities and central government securities, not below	30
(c) State government securities comprising govt, guaranteed marketable securities including point (b), not below	50	(c) Loans to HUDCO and to state governments for housing and fire fighting equipment, not below	15
(d) Socially oriented sectors comprising public sector, co-operative sector house building by policy holders, own your house scheme, including point (c) not below	75	(d) Private sector not higher than	55
(e) Private corporate sector, loans to policy holders for construction and acquisition of immovable property	25		

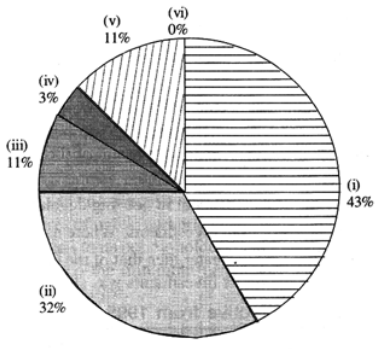
Investment Pattern of LIC and GIC in 1995-96



LIC-Instruments



LIC-Sector



GIC-Instruments

LIC - Instruments

1. Government and other approved securities.
2. Loans for infrastructure facilities.

3. Loans for housing development including mortgage loans.
4. Shares and debentures of companies.
5. Loans to companies including short-term loans.
6. Others.

LIC - Sectoral

1. Public
2. Joint
3. Co-operative
4. Private

GIC - Instruments

1. Government and other approved securities, and special deposits with GOI.
2. Shares, debentures, deposits of companies and term loans to them.
3. Loans to banks and participation certificates/bill rediscounting scheme.
4. Equity shares of public sector undertakings.
5. Loans to HUDCO/DDA/GIC-HF/State governments for housing etc.
6. Others.

2.15 COMPETITION AND INNOVATION IN INSURANCE INDUSTRY

Q58. Discuss the Competition and Innovation in Insurance Industry.

Ans :

Competition in Insurance Industry

Recently there exists an intensified competition in insurance industry mostly in terms of price and quality.

(I) Price Competition

There exists a strict competition among the insurance companies in terms of price of the product. The companies that offer products at low price and premium can gain substantial market share & competitive advantage over the other companies. Agents have no role and control in determining the price except in some cases where the commission of agent is based on the final premium. The price competition between agencies is nothing but the price competition between the companies they work for. Price competent agents work for the companies with price based marketing strategies. Price of the insurance product comprises of production cost and a margin. The common costs associated with insurance products are,

1. Loss adjustment expenses and losses
2. Acquisition expenses
3. Administration expenses
4. Taxes
5. Profit and contingency allowances.

1. Loss adjustment expenses and losses

The major component of production cost include losses. These costs can be reduced by emphasising more on underwriting aspects. The price depends on the nature of individual or product and the degree of possibility to transfer the risks to insures the higher the risk the more will be the premium and vice versa.

2. Acquisition Expenses

Acquisition expenses also have a significant effect on setting the premium. These expenses include commission to agents. Higher will be the premium if the agent commission is high.

3. Administrative Expenses

Administrative expenses incur while providing the product to the customers. They are fixed costs and it's impact on premium differ based on the insurer's efficiency i.e., quality of work force, volume of premium and fixed costs, overhead expenses etc.

4. Taxes and Other Allowances

Taxes and allowances for profit and contingencies also have a substantial effect on the level of premium to same extent.

Rahul Publications

The analysis of common cost of the insurance companies can determine the premium structure. An insure and who can efficiently reduce these cost can definitely reduce the price / premium and can gain substantial market share.

(II) Quality Competition

Intensified competition in terms of quality exists at 2 levels ie., at company level and at agency level. At the company level quality competition among the insurer occur in terms of extent of coverage and other services associated with the product. At agency level the quality include the services offered by him. It is the insured's interest whether to avail the services of agent or not. If he is willing to use agency services then the cost will be higher than that of purchasing directly from the company. As the additional cost involved is the commission to the services provided by the agent. The services include.

- Identification of needs of customers
- Advising the coverage amount
- Assistance in the selection of insurer and in processing claims for losses.

The clients think that benefits will be more if they pay high premium and on utilisation of advise of broker. As the insurers have different levels of underwriting services and the distribution systems, the level of prices also differ which facilitate them to offer wide range of products at different prices to meet different segments of customers. In order to evaluate the competitiveness of the insurance industry, one should analyse the market structure of the industry which possess the following characteristics,

(i) Presence of high number of competitors / insurance companies.

(ii) High degree of freedom to enter the industry ie., less number of entry barriers.

(iii) The changes in the market share. Some other factors that can evident the highly competition of insurance industry are,

(a) Highly cyclical insurance industry where the players could not control the output. Price and profits.

(b) Low profits in the industry when compared to other industries

(c) High number of insolvent insurers.

All these factors and the marks characteristics marks the presence of intensified competition in the insurance industry.

Q59. Explain the Innovations in Insurance Industry.

Ans :

With the intensified competition among insurance companies and the increased needs of the prospective customers, the insurers are required to introduce innovative products into market in both life and non-life insurance. Earlier LIC has offered 60 products and GIC offered 180 products to customers of which most of the products were failed to meet the changing needs of different segments of customers. Thus, insurance industry also require innovations in products and services and product developments in order to better satisfy the needs of customers and also to attract new customers. As the competition become highly intensified it i.e., necessary to introduce innovative services to gain the competitive advantage and to grab substantial market share over the rivals.

The products should be in such a way that they meet the diversified needs and expectations of customers at different levels at low price and premium and at high quality, with the continuous innovations not only in terms of products but also in pricing the firm can attract and retain the potential and prospective customers. The insurers should play a key role in widening the scope of their operations ie., providing services in addition to insurance policies such as consultancy and advisory services. The major customer expectations include,

1. Value added services
2. Development of new products
3. Excellent pricing
4. Technological developments
5. Customer satisfaction.

Rahul Publications

The insurer should consider the expectations of customers while designing the products/services. When compared to LIC, GIC has introduced more number of innovations through remarkable research and development.

Insurance industry facilitate the innovations in all aspects as there exists less number of barriers to enter this industry. Thus, providing a change for innovations to perform better in the highly competitive insurance industry.

Q60. What are the difference between LIC and GIC.

(OR)

Compare and contrast LIC and GIC.

Ans :

Nature	LIC	GIC
1) Contract of Indemnity	Life insurance contract is not a contract of indemnity.	Marine and fire insurance contracts are contracts of indemnity.
2) Doctrines of Subrogation	Since life insurance contract is not a contract of indemnity it is not governed by the doctrines doctrines of subrogation	In fire and marine insurance, the the doctrine of subrogation to all rights, gains, and benefits of the subject matter lost.
3) Insured Event	In life insurance contract, the event is bound to occur.	In fire and marine insurance, the event insured may not occur.
4) Purpose of Insurance	Life insurance contract, bring a combination of protection and investment.	Fire and marine insurance contracts serve as a protection measures and not an investment measures.
5) Claim Amount	A life insurance contract is a valued contract and the assured is paid full amount even if few premiums are paid.	In fire and marine insurance, the insured cannot recover full amount of the sum assured when his loss is more than the sum assured.
6) Term of the Contract	A life insurance contract is a contract for a long period.	Fire and marine insurance contracts are undertaken for a maximum period of one year.
7) Calculation of Premium	Premium on life insurance contracts are calculated on the basis of the age of the assured.	In fire and marine insurance contracts, premiums are calculated on the basis of the value of the property insured.
8) Surrendered of Contracts	Life insurance contracts can be surrendered before maturity but after a period of three years.	Fire and marine insurance contracts cannot be terminated by surrender of policy.

Rahul Publications

2.16 Insurance Regulatory and Development Authority (IRDA)

Q61. Define IRDA. Explain the features of IRDA.

Ans : **(Imp.)**

The IRDA Act has established the Insurance Regulatory and Development Authority ("IRDA" or "Authority") as a statutory regulator to regulate and promote the insurance industry in India and to protect the interests of holders of insurance policies. The IRDA Act also carried out a series of amendments to the Act of 1938 and conferred the powers of the controller of insurance on the IRDA. The members of the IRDA are appointed by the central government from amongst persons of ability, integrity and standing who have knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy, administration etc. The authority consists of a chairperson, not more than five whole-time members and not more than four part-time members.

Features

The following are salient features of the IRDA Act (1999),

1. The insurance sector in India has been thrown open to the private sector. The second and third schedules of the act provide for removal of existing corporations (or companies) to carry out the business of life and general (non-life) insurance in India.
2. An Indian insurance company is a company registered under the Companies Act, 1956, in which foreign equity does not exceed 26 percent of the total equity shareholding, including the equity shareholding of NRIs, FIIs and OCBs.
3. After commencement of an insurance company, the Indian promoters can hold more than 26 percent of the total equity holding for a period of ten years, the balance shares being held by non-promoter Indian shareholders which will not include the equity of the foreign promoters and the shareholding of NRIs, FIIs and OCBs.
4. After the permissible period of ten years, excess equity above the prescribed level of 26 percent will be dis invested as per a phased programme to be indicated by IRDA. The central government is empowered to extend the period of ten years in individual cases and also to provide for higher ceiling on share holding of Indian promoters in excess of which disinvestment will be required.
5. On foreign promoters, the maximum of 26 percent will always be operational. They will thus be unable to hold any equity beyond this ceiling at any stage.
6. The act gives statutory status for the Interim Insurance Regulatory Authority (IRA) set up by the central government through a resolution passed in January 1996.
7. All the powers presently exercised under the Insurance Act, 1938, by the Controller of Insurance (CoI) will be transferred to the IRDA.
8. The IRDA act also provides for the appointment of CoI by the central government when the regulatory authority is superseded.
9. The minimum amount of paid-up equity capital is Rs. 100 crores in case of life insurance as well as general insurance and Rs. 200 crores in the case of reinsurance.
10. Solvency margin (excess of assets over liabilities) is fixed at not less than Rs. 50 crores for life as well as general insurance, for reinsurance solvency margin is stipulated at not less than Rs. 100 crores in each case.
11. Insurance companies will deposit Rs. 10 crores as security deposit before starting their business.
12. In the non-life sector, IRDA would give preference to companies providing health insurance.
13. Safeguards for policy holders' funds include specific provision prohibiting investment of policy holders' funds outside India and provision for investment of funds in accordance with policy directions of IRDA,

Rahul Publications

including social and infrastructure investments.

14. Every insurer shall provide life insurance or general insurance policies (including insurance for crops) to the persons residing in the rural sector, workers in the unorganised or informal sector or for economically vulnerable or backward classes of the society and other categories of persons as may be specified by regulations made by IRDA.

15. Failure to fulfill the social obligations would attract a fine of Rs. 25 lakhs, in case the obligations are still not fulfilled, licence would be cancelled.

Q62. Explain the Role of IRDA.

Ans : **(Oct.-20, May-19)**

IRDA plays a role of a regulator for the insurance industry in India.

(a) Issue of Directions

IRDA is found to follow the directions issued by the government on different issues related to insurance policies other than the technical or administrative nature.

(b) Supersession

Further, the government has right to supersede the IRDA for a period not exceeding six months with prior notification. During the supersession of IRDA, the government may appoint a Controller Of Insurance (COI) as per the insurance Act. 1938. The supersession may be due to the following reasons,

(i) If IRDA is unable to perform its functions due to circumstances beyond its control.

(ii) If IRDA persistently fails to comply with the given direction under the IRDA Act resulting in a weaker financial position.

(iii) Under circumstances that call for sepersession to protect public interest.

Q63. Explain the functions of IRDA.

Ans :

1. Subject to the provisions of this act and any other law for the time being in force, the authority shall have the duty' to regulate, promote and ensure orderly growth of the insurance business and reinsurance business.

2. Without prejudice to the generality of the provisions contained in Sub-section (1), the powers and functions of the authority shall include,

i) To issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration.

ii) Protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holder, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance.

iii) Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents.

iv) Specifying the code of conduct for surveyors and loss assessors.

v) Promoting efficiency in the conduct of insurance business.

vi) Promoting and regulating professional organisations connected with the insurance and reinsurance business.

vii) Levying fees and other charges for carrying out the purposes of this Act.

viii) Calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediary and other organisations connected with the insurance business.

ix) Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of

Rahul Publications

general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938).

x) Specifying the form manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries.

xi) Regulating investment of funds by insurance companies.

xii) Regulating maintenance of margin of solvency.

xiii) Adjudication of disputes between insurers and intermediaries or insurance intermediaries.

xiv) Supervising the functioning of the Tariff advisory committee.

xv) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in Clause (f).

xvi) Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector.

2.17 CHALLENGES OF INSURANCE SECTOR IN INDIA

Q64. Discuss the various challenges faced by the Insurance sector.

Ans : **(May-19, Imp.)**

- The transition of the insurance industry from a public monopoly to a competitive environment presents very interesting challenges, both to the new players and to the customer.
- The insurance penetration as well as size of the average cover is well below international averages, providing great marketing opportunity for the insurance companies.
- Insurance was brought because of convenience, product features, product placement, and safety of funds, advice and not the price.
- Currently product-market relationship is dominated by personalized selling rendered by tied agents.
- Developing sensible approaches not only for the co-existence but flowing of multiple channels for sagacious and pragmatic propositions in product formulation, market segmentation by single distribution network will be an awesome challenge for the insurance companies.
- Also companies will have to transform customer relationship management to value based client relationship.
- The CRM challenge will have the pyramid of three sub-challenge i.e. Product developing, pricing mechanism and Technology management.
- Insurance business is based on averages and spreading of risks. So a flexible pricing structure for sustaining customer confidence and interest will be a challenging task before Indian issuers.
- The bench market of success of organisation will be determined not only by the rate of return but also by the quality of corporate governance. So the insurance company should focus on pricing, distribution, risk management and investment decision-making.
- Insurance companies in India will have to develop appropriate channels to tap this huge market as the core of insurance business hinges on an efficient distribution.
- Direct marketing is one of the most successful channels of distribution in the developed economics. It is a great way to reach a large population. So the product should be sold through telemarketing or direct mail.

Rahul Publications

Short Question and Answers

1. Define Non-Performing Assets.

Ans :

Meaning

Non-performing assets, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest payments are not being made on time.

A loan is an asset for a bank as the interest payments and the repayment of the principal create a stream of cash flows. It is from the interest payments than a bank makes its profits.

Banks usually treat assets as non-performing if they are not serviced for some time. If payments are late for a short time a loan is classified as past due. Once a payment becomes really late (usually 90 days) the loan classified as non-performing.

A high level of non-performing assets compared to similar lenders may be a sign of problems, as may sudden increase. However this needs to be looked at in the context of the type of lending being done. Some banks lend to higher risk customers than others and therefore tend to have a higher proportion of non-performing debt, but will make up for this by charging borrowers higher interest rates, increasing spreads.

2. Expand AMFI and briefly explain its role in financial market.

Ans :

Association of Mutual Funds in India (AMFI) was set up on 22nd August, 1995. It was established with the aim to function as a non-profit organisation. This association is the chief governing body of all Asset Management Companies (AMC) and is registered with Securities and Exchange Board of India (SEBI).

AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with SEBI, Till date all the AMCs are that have launched mutual fund schemes are its members It functions under the supervision and guidelines of its board of directors.

The members of Asset Management Companies (AMC) have always carried out the responsibility of introducing new mutual fund schemes under the governance and guidelines of its board of directors. Association of mutual funds in India has played a significant role in creating a healthy and professional market for mutual funds. It has elevated the standard of the mutual fund investment patterns by introducing more beneficiary schemes to attract more investors. The association of mutual funds is also the main governing body of all Asset Management Companies (AMC). The Association of Mutual Funds in India (AMFI) has been registered with the Securities and Exchange Board of India (SEBI). The main principle religiously followed by AMFI is to protect and promote the mutual funds along with the investors or shareholders.

Role

1. To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
2. To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
3. To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.

3. What are Commercial Banks?

Ans :

Meaning

Commercial banks are an organisation 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

Rahul Publications

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."

4. Define Interest Rate.

Ans :

Interest is the amount which is paid by a borrower for using funds belonging to someone else. It is a transaction between surplus and deficit units. The surplus units lend money because they earn an attractive amount for parting with it. The waiting period involves a 'reward' which includes the lender to forego the use of money.

Again, a lender can part with money for some time limit as he would like it for his own requirements. Thus, in the borrowing and lending transaction, timing is an important consideration as it should be suitable to the borrower and the lender. Interest involves a rate at which funds are borrowed. This rate is need based and dependent on market position of demand and supply of funds. Therefore, an interest rate is to be paid to take a loan.

Definitions

(i) **According to Alfred Marshall** Interest in the price paid for abstinence of money

(ii) **According to Neo – Keynesians** Interest is defined interest as equilibrium between stock and flow variables of the real and monetary section. They developed the theory called the ISLM theory.

In the capital market of the country one of the most useful things is to be familiar with the kind of interest rates that operate in the environment. The investors have to cope with the different kinds of interest rate called by different names. In order to be a successful investor he should be able to recognize the kinds of interest rates and by whom these rates are fixed.

5. Spreads

Ans :

In order to profit from a spread transaction the trader attempts to determine whether the size of the difference between the prices of the two contracts will increase or decrease. A spread earns a profit if the correct direction of the price difference is forecasted and the appropriate spread transaction is set up in conjunction with the changing price structure of the future contracts.

Spreaders must forecast the relevant factors that cause changes in the spreads. Change in financial futures spread depends upon the behaviour of interest rate. A profitable spread creates a gain on one side of the spread that is larger than the loss on the other side of the spread. A pure speculator would make more money by taking only the profitable side of the market; however, a spread reduces the risk of a position in case the forecast is incorrect. In recognition of the reduced risks, margins on spread positions are much less than the margins on pure long or short positions, and hence the leverage for spreads is increased. Risk is reduced, since both sides of spread usually move in the same direction, even though their prices can change by different amounts.

Rahul Publications

6. What do you mean by bank capital and bank capital regulation.

Ans :

(i) Bank Capital

Bank capital reflects the net worth of a bank. It consists of both assets and liabilities. Assets of a bank include cash, securities, interest generated from loans, letter of credit, interbank loans. Liabilities include loan loss reserves and debt.

(ii) Bank Capital Regulation

Banks are included under the most regulated global industries. The regulation in banking sector is mostly in terms of capital regulation. The reasons for the regulation of bank capital is to mitigate the risk due to systematic crisis and the inability of the primary creditors or dependents to monitor the performance of the banks. Banks get insolvent due to their inability in repayment of the debts to the creditors within the stipulated time. According to Modigti and Miller, the capital structure of a firm does not effect it's value if the market is perfect and furnished with complete information. There has been observed a significant effect of deviations of markets from the perfect on the capital structure of the firm. The factors include taxes, financial distress, transaction costs, agency costs and asymmetric information are considered as the imperfections in case of all firms whereas especially in bank the two factors included in addition to these factors are,

(i) Access of bank to safety net or deposit insurance

(ii) The deposits from the small and uninformed depositors act as sources of bank debts.

7. Define Co-operative bank.

Ans :

Meaning

Co-operative Banks in India are registered under the Co-operative Societies Act. The cooperative bank is also regulated by the RBI. They are governed by the Banking Regulations Act 1949 and Banking Laws (Co-operative Societies) Act, 1965. According to NAFCUB the total deposits & lendings of Co-operative Banks in India is much more than Old Private Sector Banks & also the New Private Sector Banks.

Co-operative banks role in rural financing continues to be important day by day, and their business in the urban areas also has increased phenomenally in recent years mainly due to the sharp increase in the number of primary co-operative banks.

8. Non-banking Financial Institutions (NBFI).

Ans :

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering.

Examples of these include insurance firms, pawn shops, cashiers check issuers, check cashing locations, currency exchanges, and micro loan organizations. Alan Greenspan has identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment [which] act as backup facilities should the primary form of intermediation fail."

9. Unit trust of India.

Ans :

The Unit Trust of India or UTI was established on 1st February, 1964 under the Unit Trust of India Act, 1963 by the government of India. Its establishment has been a landmark in the history of investment trusts in India. It completed 35 years on 30th June, 1999. The UTI started the sale of units to the public from the July, 1964.

Objective

The basic objective of the UTI is to offer both small and large investors the means of acquiring shares in the widening prosperity resulting from the steady, industrial growth of the country. There are two primary objectives of UTI, i.e., (i) to promote and pool the small savings from the lower and middle income people who cannot have direct access

Rahul Publications

to the stock exchange, and (ii) to give them an opportunity to share the benefits and fruits of prosperity resulting from rapid industrialization in India.

Functions

The main functions of UTI are as follows :

- To encourage savings of lower and middle-class people.
- To sell units to investors in different parts of the country.
- To covert the small savings into industrial finance.
- To give them an opportunity to share the benefits and fruits of industrialization in the country.
- To provide liquidity to units.

10. Define mutual funds.

Ans :

Meaning

Mutual Fund is a type of collective investment method by which many people pool their money in a fund and invest in various securities like stock, bonds or cash investments. Every mutual fund has a fund manager or investment advisor so it is also called as managed funds.

In world's top stock markets collective investments holds a major share because of its flexibility. Depends on the objective of the funds like long term growth and low risk factor or high income growth with high risk factor or low growth rate and stability of principal, fund manager invests in respective fields on behalf of shareholders. For individual investors it is very easy type of investment because someone else manages their funds, take care of accounts and invest money over many different available securities.

11. Define Insurance.

Ans :

Meaning

In simple terms, Insurance is a means of transferring insurable risk of a potential loss to an insurance company against a premium. Hence insurance can be defined as pooling of losses by transfer of risk to insurer, who promises to indemnify insured for losses, which are unforeseen and accidental in nature.

Insurance is a systematic approach to handling financial risk.

Definition

According to Dr. R.K. Singla in the book "Business Organization," insurance is a legally binding contract between two parties in which one party, in exchange for fixed denominations of money, agrees to pay a determined sum to the other party either at the end of a certain period or at the occurrence of an event.

Insurance contracts are also termed as indemnity contracts. There are many types of insurance, including life insurance, fire insurance, marine insurance, theft insurance, vehicle insurance and motorcycle insurance.

12. Define IRDA.

Ans :

The IRDA Act has established the Insurance Regulatory and Development Authority ("IRDA" or "Authority") as a statutory regulator to regulate and promote the insurance industry in India and to protect the interests of holders of insurance policies. The IRDA Act also carried out a series of amendments to the Act of 1938 and conferred the powers of the controller of insurance on the IRDA. The members of the IRDA are appointed by the central government from amongst persons of ability, integrity and standing who have knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy, administration etc. The authority consists of a chairperson, not more than five whole-time members and not more than four part-time members.

Rahul Publications

13. Role of IRDA.

Ans :

IRDA plays a role of a regulator for the insurance industry in India.

(a) Issue of Directions

IRDA is found to follow the directions issued by the government on different issues related to insurance policies other than the technical or administrative nature.

(b) Supersession

Further, the government has right to supersede the IRDA for a period not exceeding six months with prior notification. During the supersession of IRDA, the government may appoint a Controller Of Insurance (COI) as per the insurance Act. 1938. The supersession may be due to the following reasons,

(i) If IRDA is unable to perform its functions due to circumstances beyond its control.

(ii) If IRDA persistently fails to comply with the given direction under the IRDA Act resulting in a weaker financial position.

(iii) Under circumstances that call for sepersession to protect public interest.

14. ATM and their value added services

Ans :

ATM

- ATM Stands for automated Teller Machine
- ATMs enable a user to withdraw cash, deposits, transfer funds, change ATM PIN or link Aadhaar to the bank account.
- Banks offer ATM cards without any charge at the time of account opening.
- It helps in paying utility bills and several other bills and payments.
- ATMs are conveniently located at multiple locations.
- The facility is available 24×7, 365 days a year.
- It is safe and secure as the use of an ATM card is restricted only to the person who knows the PIN.

Value added services

- Balance enquiry
- Deposit of cash
- Credit Card payment
- Request for Cheque Book

Rahul Publications

UNIT III

Financial and Securities Markets: Structure and functions of Call Money Market, Government Securities Market – T-bills market, Commercial Bills market, Commercial paper and certificate of deposits- Securities markets – Organization and structure, Listing trading and settlement. SEBI and Regulation of Primary and Secondary Markets. Role and functions of Clearing Corporation of India Ltd.

3.1 FINANCIAL MARKETS

Q1. What is financial market? Explain the nature financial markets.

Ans :

Meaning

Financial markets are the centre that facilitate buying and selling of financial instruments, claims or services. It caters the credit needs of the individuals, firms and institutions. It deals with the financial assets of different types such as currency deposits, cheques, bills, bonds etc. it is defined as a transmission mechanism between investors and the borrowers through which transfer of funds is facilitated. It consists of individual investors, financial institutions and other intermediaries who are linked by a formal trading rules and communication network for trading the various financial assets and credit instruments.

Nature

- Financial markets are the centre that facilitate buying and selling of financial instruments, claims or services.
- Financial markets are critical for producing an efficient allocation of capital, allowing funds to move from people who lack productive investments opportunities to people who have them.
- It caters the credit needs of the individuals, firms and institutions.
- Financial market deals with the financial assets or instruments of different types such as currency deposits, cheques, bills, bonds etc.
- The main participants in the financial markets are financial institutions, agents, brokers, dealers, borrowers, savers, lenders and others who are interconnected by law, contract and communication networks.

Q2. What are the functions of financial market?

Ans :

Financial markets serve six basic functions. They are briefly listed below.

1. **Borrowing and Lending :** Financial markets permit the transfer of funds from one agent to another for either investment or consumption purposes.
2. **Price Determination :** It provides means by which prices are set both for newly issued financial assets and for the existing stock of financial assets.
3. **Information Aggregation and Coordination :** It acts as collectors and aggregators of information about financial asset values and the flow of funds from lenders to borrowers.
4. **Risk Sharing :** It allow a transfer of risk from those who undertake investments to those who provide funds for those investments.
5. **Liquidity :** It provides the holders of financial assets with a chance to resell (or) liquidate these assets.
6. **Efficiency :** It reduce transaction costs and information costs.

Rahul Publications

Q3. Explain the classification of financial markets.

Ans :

The Indian financial markets are classified into two types :

1. Organized market
2. Unorganized market

1. Organized market

The organized markets comprises of standard rules and regulations which are used to govern the financial dealings. Organized markets are subdivided into two types :

(i) Money Market

The money market deals with near substitutions for money or near money like trade bills, promissory notes and government papers drawn for a short period not exceeding one year. It is a mechanism which makes it possible for borrowers and lenders who meet together to deal in short term funds. It does not refer a particular place where short term funds are dealt with. It includes all individuals, institutions and intermediaries dealing with short term funds. It meets the short term requirements of the borrowers and provides liquidity or cash to lenders.

Definitions

(i) According to Madden and Nadler, " a money market is a mechanism through which short term funds are loaned and borrowed and through which a large part of the financial transaction of a particular country or of the world are cleared."

(ii) According to The Reserve Bank of India defines money market as, The centre for dealing, mainly of short term character, in monetary assets, it meets the short term requirements of borrowers and provides liquidity or cash the lenders."

Features

The following are the important features of money market

- It is a market for short-term funds or financial assets called near money.
- It deals with financial assets having a maturity period of one year.
- The borrowers will get fund for period varying from a day, a week. a month, three to six months.
- It is a collection of market for following instruments call money, notice money, repos, term money, treasury bills, commercial bills, certificate of deposits, commercial papers inter-bank participation certificates, inter-corporate deposits, swaps, bills of exchange, treasury bills, etc.
- Money market consists of several sub markets such as call money market, trade bills market etc., these sub markets have close inter relationship and free movement of movements of funds from one sub-market to another.
- The borrowers in the money market are traders, manufacturers, speculators and even government institutions.
- It does not refer a particular place where borrowers and lenders meet each other.
- Transactions can be carried through oral or telephonic communications. The relevant documents and written communication can be exchanged subsequently.
- The important components of money markets are the central bank, commercial banks, non-banking financial institutions, discount houses and acceptance houses.
- It does not deal in money but in short term financial instruments or near money assets.
- It is a need based market wherein the demand and supply of money shape the market.

(ii) Capital Market

The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. It is concerned with those private savings, individuals as well as corporate, that are turned into investments through new capital issues and also new public loans floated by government and semi-government bodies. A

Rahul Publications

capital market may be defined as an organized mechanism for effective and efficient transfer of money capital or financial resources from investing parties, i.e., individuals or institutional savers to the entrepreneurs engaged in industry or commerce in the business either be in the private or public sectors of an economy.

Characteristics

The following are the important features of a developed capital market

- Market for long term funds.
- Important component of financial system.
- Facilitates borrowing and lending of funds.
- Helps in raising capital.
- Involves both individual and institutional investors.
- Meets demand and supply of long term capital.

2. Unorganized market

In this market, the regulations are inadequate for financial dealings. The unorganized markets is subdivided into money lenders, traders, indigeneous bankers etc.

3.2 CALL MONEY MARKET

3.2.1 Structure and Functions of Call Money Market

Q4. Define Call money market. Explain structure and Functions of a Call Money Market.

(OR)

State the participants of Call Money Market.

(OR)

What is Call Money Market? Explain structure and Functions of a Call Money Market.

Ans : **(Oct.-20, May-19, Jan-18, Aug.-17, Feb.-15)**

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 are 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.

1. Structure of Call Money Market in the US

There are two markets which are known as call money market in the U.S., namely,

(i) Federal funds market

(ii) Call money market proper.

(i) Federal Funds Market

Mongolian J.R defined federal funds transaction as "any transaction between banks involving the purchase or sale of bank's 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, sometimes 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's 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

Rahul Publications

(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.

Discount houses are provided loans by the commercial banks on the call basis. These are secured loans which are repayable on demand. Therefore they are highly liquid. Discount houses utilizes call loans for holding bills of exchange, treasury bills and other short-term government paper. Call loans facilitates banks in adjusting their reserves, (like the federal funds do in the US). Discount houses bid for marginal funds between themselves before they choose discount window at the Bank of England, besides borrowing from banks.

Inter-bank call market deals with the lendings and borrowings between Scottish banks, merchant banks, British overseas banks and foreign banks. These loans are unsecured. These are overnight loans or for six months. However, they are only for few days. Brokers arrange transactions in this market, but they will not always arrange transactions.

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 of 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. The banks fulfills the sudden demand of funds, large remittances, large payment and maintain cash or liquidity with the R.B.I borrowing from other banks.

Transactions in the call money market we mostly influenced by the brokers till March 1978. But since then RBI has forbidden 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 characterized 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 of a year.

(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 highest 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. An increase in the CRR results in an increase in call money borrowings.

Participation

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 Financial House of India (DFHI) and Securities Trading Corporation of India (STCI). The 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 permitted to participate in call money market.

In April 1991, RBI declared that all those entities which shows the proof that they have huge resources to lend and have no payable amount towards the banks can participate in the call market.

Location

Call money markets are situated in large industries and commercial centres such as Mumbai, Calcutta, Chennai, Delhi and Ahmedabad.

Rahul Publications

Besides big cities, there are also large number of local call markets which are developed and operated by ingenious 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 of 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. The banks may need the funds suddenly due to the short-term mismatch of funds as the withdrawals can be more than the deposits sometimes so, for this purpose they can borrow from call money market.
2. The banks borrow funds from call money market for maintaining their Cash Reserve Requirements (CRR) and Statutory Liquidity Ratio (SLR).
3. The other reason for borrowings is for discounting the commercial bills.
4. Few banks borrow as well as lend in the call money market for earning profit from the differential rates of lending and borrowing.

Q5. Explain the advantages and disadvantages of call money market.

Ans :

Advantages

The various advantages of call money market are :

(a) High Liquidity

Money lent in a call market can be called back at any time when needed. So, it is highly liquid. It enables commercial banks to meet large sudden payments and remittances by making a call on the market.

(b) High Profitability

Banks can earn high profits by lending their surplus funds to the call market when call rates are high and volatile. It offers a profitable parking place for employing the surplus funds of banks temporarily.

(c) Maintenance of SLR

Call market enables commercial banks to maintain their statutory reserve requirements. Banks borrow on a large scale every reporting Friday to meet their SLR requirements. In the absence of call market, banks have to maintain idle cash to meet their reserve requirements. It will tell upon their profitability.

(d) Safe and Cheap

Though call loans are not secured, they are safe since the participants have a strong financial standing. It is cheap in the sense brokers have been prohibited from operating in the call market. Hence, banks need not pay brokerage on call money transactions.

(e) Assistance to Central Bank Operations

Call money market is the most sensitive part of any financial system. Changes in demand and supply of funds are quickly reflected in call money rates and it gives an indication to the central bank to adopt an appropriate monetary policy.

Disadvantages

The various disadvantages of call money market are :

(a) Uneven Development

The call money market in India is confined to only big industrial and commercial centers like Mumbai, Kolkata, Chennai, Delhi, and Bangalore. Call markets are associated with stock exchanges. Hence the market is not evenly developed.

Rahul Publications

(b) Lack of Integration

The call markets in different centers are not fully integrated. Besides a large number of local call markets exists without any integration.

(c) Volatility in Call Money Rates

The major drawback of call markets is the volatile nature of the call money rates. Call rates vary to a greater extent in different centers in different seasons on different days within a fortnight. The rates vary between 12% and 85%.

3.3 Treasury Bills Market

Q6. Define Treasury bill market? Explain the features of treasury bill market?

(OR)

What is the Treasury Bills Market?

Ans : **(Oct.-20, Dec.-19, May-19)**

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.

Features

The features of treasury bills are as follows,

1. **High Liquidity :** Treasury bills are highly liquid. Commercial banks, DFHI, STCI and other institutions provide ready market for these bills. RBI also provides ready market for it.
2. **Low Transaction Cost :** DFHI offers two-way quotes, i.e., buying and selling rates daily. Difference between the two rates is the transaction cost. The difference between the two is very low and the transaction cost is found to be very low.
3. **Ready Availability :** TBs are readily available throughout the week at the rates announced daily. On day one can invest its surplus funds in it.
4. **Assured Yield :** The fluctuation in the discount rate is found to be very low and thus it provides the assured yield on investment.
5. **Zero-default Risk :** RBI issues these bonds on behalf of central government. Therefore, there is no risk at all in these bills since they are guaranteed by the government.
6. **Eligible Security for SLR :** The commercial banks have to satisfy the Statutory Liquidity Ratio (SLR). The TBs are the eligible security for the calculation of SLR.. This gives on added advantage to commercial banks. That's why, the commercial banks are the dominant dealers in the treasury bills.

Q7. Discuss the classifications of treasury bill market.

(OR)

What are the types of treasury bill market.

Ans : **(Dec.-19)**

Treasury bills may be classified into four categories,

1. 14-Day Treasury Bills

These bills are of two types, one on April, 1, 1997 which is known as Treasury Intermediate Bill (TIB) and the second on May 20, 1997. The TB has replaced the old treasury bill of 91-days. State governments, foreign central banks and other specified bodies are entitled to buy these intermediate treasury bills as an alternate

Rahul Publications

arrangement in place of 91-day treasury bills for investing their temporary cash surpluses. A scheme for the sale of a new category of 14-day treasury bills on an auction basis was announced on May 20, 1397 to meet the cash management needs of various segments of the society. The first auction took place on June 6, 1997 and the amount outstanding as at end of March 2003, stood at Rs. 300 crores in 2000-03. No amount was outstanding in the year 2001-02 and 2002-03. These bills are discounted by RBI since 2002-03,

2. 91-Day Treasury Bills

This is the oldest type of treasury bill. In India, there were two types of 91-day treasury bills-ordinary and adhoc. The first type of bills, i.e., ordinary treasury bills are issued to the public and to the RBI. These bills enable the central government to meet the temporary requirement for funds. The other type of 91-day treasury bill, i.e., adhoc treasury bills created in favour of RBI. The issuing of adhoc treasury bills was introduced in India in 1937. The government of India and RBI entered into an agreement in 1937 and 1955. It was decided in the agreement that government shall maintain with the RBI, a cash balance of not less than Rs. 50 crores on Fridays and Rs. 4 crores on other days free of obligation to pay interest thereon and when the balance falls below these minimums, the government account will be replenished by creating adhocs in favour of RBI. But the government of India and RBI entered into an agreement to phased out adhocs in 3 years following the budget speech of then finance minister in 1994-95. The limit for adhocs was Rs. 5000 crores in 1994-95, 1995-96 and 1996-97. From 1997-98, the system of adhocs was Rs. .5000 crores in amount of Rs, 1,00,592 crores was raised during 2004-05 as against Rs. 36,786 crores in the year 2003-04. The average interest rate was 4.60% in 2004-05.

3. 182-Day Treasury Bills Market

A major financial innovation in the form of a new money market instrument is the 182-day Treasury Bills. It was sad that the introduction of this bill was a contribution by the GOI towards the development of short-term money market, which also provided an additional avenue for the government to raise financial resources for its budgetary expenditure.

This Treasury bill was also a new fiscal instrument. It used to be sold in the market by the RBI in auctions which were monthly in the beginning; they were made fortnightly from July 1988. No specific amount of funds was sought to be raised through the auctions of these bills. The amount raised in each auction depended upon the funds available with the market participants, and the funds they desired to invest in these bills.

These bills could be purchased by any person resident in India, including individuals, firms, companies, banks and financial institutions. They are not purchased b state governments and provident funds. RBI did not purchase these bills at all. It was liquid because of the availability of refinance facilities against it and the existence of the secondary market in it.

4. 364-day Treasury Bills Market

This Treasury bill came into effect from April 1992. Its first auction took place on April 28, 1992, and since, it is being auctioned regularly every fortnight. It features are very similar to those which the 182-day bill had. The RBI does not purchase and rediscount this bill. It has evoked a moderate to good response from the investors, which is reflected in terms of the number of bids and the amount tendered at the time of each auction.

The investor response to it appears to depend, among other things, on the uncertainties in the government securities market, variations in the SLR, and the yield. The number of bids and the amount accepted also have been moderate to large. The cut-off yield on it undergoes ups and downs an a year, indicating its flexible nature. The yield of this bill has been quite attractive and it has been higher than the yield on the other bill.

Rahul Publications

Q8. Explain the advantages and disadvantages of treasury bill market.

Ans : **(Dec.-19, Feb.-16)**

Advantages

TBs being an important money market instruments provide the following benefits,

1. Liquidity

Treasury bills command high liquidity. A number of institutions such as RBI, the DFHI, STCI, commercial banks etc., take part in the TB market. In addition, the central bank is always prepared to purchase or discount TBs.

2. No Default Risk

Since there is a guarantee by the central government, TBs are absolutely free from the risk of default of payment by the issuer. Moreover, the government itself issues the TBs.

3. Availability

RBI has the policy of making available on a steady basis, the TBs especially through the tap' route since July 12, 1965. This greatly helps banks and other institutions to park their funds temporarily in TBs.

4. Low Cost

Trading in TBs involves 'less transaction costs. This is because two-way quotes with a fine margin are offered by the DFHI on a daily basis.

5. Safe Return

The biggest advantage of TBs is that they offer a steady and safe return to investors. There are not many fluctuations in the discount rate. It is also possible for the investors to earn attractive return by keeping investment in non-earning cash to the minimum and supplementing it with TBs.

6. No Capital Depreciation

Since TBs command high order of liquidity, safety and yield, there is very little scope for capital depreciation in them.

7. SLR Eligibility

TBs are of great attraction to commercial banks as it helps them park their funds (net demand and time liabilities) as per the norms of SLR announced by the RBI from time to time. This reason makes commercial banks dominant dealers in TBs.

8. Funds Mobilisation

TBs are used as an ideal tool by the government for raising short- term funds required for meeting temporary budget deficit.

9. Monetary Management

It is also possible for the government to mop up excess liquidity in the economy through the issue of TBs. Since TBs are subscribed by the investors other than the RBI, the issue would neither lead to inflationary pressure nor result in monetization.

10. Better Spread

TBs facilitate proper spread of asset mix with different maturity as they are available on tap basis as well as in fortnightly auctions.

11. Perfect Hedge

TBs can be used as a hedge against volatility of call loan market and interest rate fluctuations.

12. Fund Management

TBs serve as effective tools of fund management because of the following reasons,

i) Ready market availability, both for sale and purchase at market driven prices, thus imparting flexibility.

ii) Facility of rediscounting TBs on tap bases, lis) Facility of refinancing from the RBI,

iv) Plethora of options available to fund managers to invest in TBs and for raising funds against TBs especially through and with the help of DFHI.

v) Ideally suited for investment of temporary surplus,

Rahul Publications

vi) Possibility of building up portfolio of TBs with dates of maturities matching the dates; of payment of liabilities, such as certificates of deposits ana deposits of short-term maturities.

vi) Possibility of meeting the temporary difficulties of funds by entering into buyback transactions for surplus TBs and reversing the transactions when the financial need is over.

vii) Possibility of making enhanced profit by indulging in quick raising of money against TBs for investing in call money market when call rates are high and doing the reverse when call rates dip.

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 Commercial Bills Markets

Q9. Define Commercial bills. Explain the features of commercial bill market.

Ans : **(May-19)**

Meaning

A commercial bill or a bill of exchange is a short-term, negotiable and self-liquidating money market instrument which evidences the liability to make a payment on a fixed date when the goods are bought on credit.

It is an asset with high degree of liquidity and a low degree of risk.

RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in this market. Bill of exchange means the liability to make the payment on a specified date when goods are bought and sold.

Features

A bill market is considered a developed bill market if it possesses the following characteristics,

1. Genuine Trade Bills

An important requisite for a developed bill market is that there should be a large number of trade and commercial transactions. Moreover, genuine trade bills should support these transactions.

2. Borrowing Practice

The practice of borrowing against commercial bills should be well established and widely prevalent. For, such a practice would nurture the growth of an efficient bill market.

3. Supply of Bills

For a bill market to flourish and grow, there must be available a continuous and sufficient supply of a large quantity of commercial bills in the money market.

4. Financial Discipline

Discipline among the parties to a bill of exchange is an essential requirement for a developed bill market. It is important that both borrowers and lenders subject themselves to strict financial discipline.

5. Ideal Security

Commercial banks should use bill of exchange as an ideal avenue for providing credit to their customers. Such a practice will encourage more and more people in the trade and industry to increasingly make use of bill financing.

Rahul Publications

6. Facilities for Rediscounting

In order that banks are encouraged to accept bills as a viable mode of lending, it is imperative that abundant facilities for rediscounting the bills are available in the bill market. For instance, the central bank should be ready to rediscount bills throughout the year. In other words, the market should have a well-developed secondary market for commercial bills.

7. Velocity of Bills

There must be a wide spread use of bills as a source of financing. This requires that there should be high velocity of circulation of bills, i.e., they should be discounted and rediscounted greater number of times.

8. Existence of Intermediaries

There should be available adequate number of intermediaries such as commercial banks, other financial institutions or acceptance house facility for 'acceptance' of bills at low cost. This will considerably reduce the risk of default. The intermediaries are expected to ensure smooth functioning of bill market.

9. Credit Information

Adequate information must be available to judge the creditworthiness of different parties. Credit investigating agencies play an important role in investigating and obtaining vital and credible information about the parties involved in the bill market.

Q10. Explain the different types of Commercial Bills.

Ans :

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.

Q11. Explain the importance of the commercial bill markets.

Ans :

Commercial bill market is important for trade and industry and also for the development of money market in the following ways,

Rahul Publications

1. Ideal Source of Credit

Bill financing is considered to be the most common method of meeting the short-term credit needs of trade and industry. It is quite possible for even banks to rediscount the bills in their possession. In this manner, banks are able to meet their shown term liquidity requirements.

2. High Liquidity

The level of liquidity of commercial bills is very high. This advantage emanates from their self-liquidating character. Such bills have a fixed and short tenure of maturity. They can be easily discounted.

3. Financial Discipline

As the payment must be made on the due date of the bill, the use of commercial bills as an instrument of credit imposes financial discipline on-the borrowers.

4. Ideal Parking of Funds

Discounting of bills offers an excellent avenue for short-term investments of the funds of banks. The existence of a bill market enables banks and other financial institutions to park their surplus funds profitably by selecting appropriate maturities.

5. Flexibility

An important function of an efficient bill market is that it imparts flexibility to the money market by functioning as its effective constituent. The bill market helps ease out liquidity crunch in the banking system.

Q12. Explain the advantages of commercial bills markets.

Ans :

Commercial bill market is an important source of short-term funds for trade and industry. It provides liquidity and activates the money market.

The various advantages of commercial bills markets are:

(a) Liquidity : Bills are highly liquid assets. In times of necessity, bills can be converted into cash readily by means of rediscounting them with the central bank

(b) Self-Liquidity and Negotiable Asset : Bills are self-liquidity in character since they have a fixed tenure they are negotiable instruments and hence they can be transferred freely by a mere delivery or by endorsement and delivery.

(c) Certainty of Payment : Bills are drawn and accepted by business people. Business people are used to keeping their words and the use of bills imposes a strict financial discipline on them. Bills would be honoured on the due date.

(d) 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.

(e) Simple Legal Remedy : In case the bills are dishonoured, the legal remedy is simple. Such dishonoured bills have to be simply noted and protested and the whole amount should be debited to the customer's accounts.

(f) High and Quick Yield : The financial institutions earn high and quick yields. The discount is deducted at the time of discounting itself whereas in the case of other loans and advances, interest is payable only when it is due. The discount rate is also comparatively high.

(g) Easy Central Bank Control : The central bank can easily influence the money market by manipulating the Bank rate or the rediscounting rate. Suitable monetary policy can be taken by adjusting the bank rate depending upon the monetary conditions prevailing in the market.

Q13. Explain the limitations of commercial bills markets.

Ans :

Inspite of the merits, the bill market has not been developed in India. The reasons for the slow growth are :

Rahul Publications

(a) Absence of Bill Culture

Business people in India prefer O.D. and cash credit to bill financing. Banks usually accept bills for the conversion of cash credits and overdrafts of their customers. Hence bills are not popular.

(b) 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. In order to enlarge the rediscounting facility, the RBI has permitted financial institutions like LIC, UTI to rediscount genuine eligible trade bills of commercial banks. Even then, bill financing is not popular.

(c) Stamp Duty

Stamp duty discourages the use of bills. Stamp papers of required denomination are not available.

(d) Absence of Secondary Market

There is no active secondary market for bills. Rediscounting facility is available in important centres and that too it is restricted to the apex level financial institutions. Hence, the size of the bill market has been curtailed to a large extent.

(e) Limited Foreign Trade

In many developed countries, bill markets have been established mainly for financing foreign trade. In India, foreign trade as a percentage to national income remains small and it is reflected in the bill market also.

(f) Absence of Acceptance Services

There are no discount houses or acceptance houses in India. Hence specialized services are not available in the filed of discounting or acceptance.

(g) Attitude of Banks

Banks are shy of rediscounting bills even with the central bank. They have a tendency to hold the bills till maturity and hence it affects the velocity of circulation of bills. Again, banks prefer to purchase bills instead of discounting them.

3.5 COMMERCIAL PAPER

Q14. Define commercial papers? Explain the features of commercial papers.

(OR)

What is commercial papers? What are its features?

Ans : **(Dec.-19, Aug.-16, Aug.-16)**

CPs are short-term usance promissory notes with fixed maturity issued mostly by the leading, nationally reputed, credit-worthy and highly rated large corporations. CPs are also known as industrial paper, finance paper and corporate paper the names depend upon whose liability the paper is. If it the liability of the business or industrial or commercial or manufacturing concern, it is known as industrial or commercial paper.

If it is the liability of the financial company, it can be called either a finance paper. Corporate is a wider term indicating that it is issued by corporations which may be either financial or non-financial. CPs are issued in domestic as well as international financial markets, in the latter they are known as euro-commercial paper.

Features

Following are the features of commercial papers,

1. Nature

These are unsecured debts of corporates. They are issued in the form of promissory notes. These are redeemable at par to the holder at maturity. The issuing company should have a minimum tangible net worth to the extent of Rs. 4 crores. Moreover, the working capital (fund-based) limit of the company should not be less than Rs. 4 crores and this allows corporates to issue CPs upto 100 percent of their fund based working capital limits.

CPs is issued at a discount to face value in multiples of Rs. 5 lakhs. CPs attracts stamp duty. No prior approval of RBI is needed to issue CPs and no underwriting is mandatory. The issuing company has to bear all expenses

Rahul Publications

(such as dealers fees, rating agency fee and charges for provision of stand-by facilities) relating to the issue of CP. The issue of CPs serves the purpose of releasing the pressure on bank funds for small and medium sized borrowers, besides allowing highly rated companies to borrow directly' from the market.

2. Market

The market for the CPs comprises of issues made by public sector and private sector enterprises. CPs issued by top rated corporates is considered as sound investments. Conditions attached to the issue are less stringent than those applicable for raising CPs. Beginning from September 1996, Primary Dealers (PDs) were also permitted by RBI to issue CPs for augmenting their resources. This is one of the steps initiated by the RBI to make the CPs market popular.

3. Rating

As per the guidelines of the RBI, CPs is required to be graded by the organization issuing them. Accordingly, a rated CP is considered to be a quality and sound instrument. With the liberalization of interest rate structure, the rate of interest is market-determined. This causes wide variation in the prevailing rates of interest.

4. Interest Rates

The rate of interest applicable to CPs varies greatly. This variation is influenced by a large number of factors such as credit rating of the instrument, economic phase, the prevailing rate of interest in CPs market, call rates, the position in foreign exchange market etc. It is however to be noted that there is no benchmark for the interest rate.

5. Marketability

The marketability of the CPs is influenced by the rates prevailing in the call money market and the foreign exchange market. Accordingly, where attractive interest rates prevail in these markets, the demand for CPs will be affected. This is because, investors will divert their investment into these markets.

6. Maturity

The minimum maturity of CP has been brought down from 3 months to 30 days and was further reduced to 15 days with effect from May 25, 1998. This was done with a view to encouraging issuance of CPs.

7. CPs in Lieu of WC

The nature of credit policy announced by the RBI allows highly rated corporates to have the advantage of banks offering an automatic restoration of working capital limits on the repayment of CP. Accordingly, short-term working capital loans were substituted with cheaper CPs. This was done by the RBI to hasten the growth of the CP market.

Q15. Discuss the RBI directions for commercial paper.

(OR)

State the RBI guidelines on issue commercial papers.

Ans :

The important directions of the RBI are as follows,

1. Applicability

The directions apply to all non-banking companies financial and FERA companies which raise deposits by issuing CP.

2. Eligibility

i) Tangible net worth of the company (Equity + Uncommitted reserves including share premium account, capital and debentures redemption reserves) is not less than Rs. 4 crores.

ii) The fund based working capital facilities enjoyed by the company from the banking system are not less than Rs. 4 crores.

iii) Equity shares of the company are listed in one or more stock exchanges (government companies are exempt from this condition), closely held companies whose shares are not listed on any of the stock exchanges will also

Rahul Publications

be eligible to borrow CPs, provided all other criteria are met.

iv) Credit rating of the company from credit rating agency. Credit Rating Information Service of India Ltd., (CRISIL) shall be a minimum P2 while the minimum rating from the Investment Information and Credit Rating Agency of India Ltd., (ICRA) shall be A2 and the same shall not be more than two months old at time of issue.

v) The company's borrowal account is classified under the health code 1 as per the RBI guidelines (indicating the financial regulator of the company) by the financing bank/bankers.

vi) The current ratio as per the latest balance sheet shall be a minimum of 1.33:1.

vii) The CP can be issued for a period of not less than three months and not more than six months. Unlike the normal bills of exchange, the CP will not have the grace period, on maturity. If the due date happens to fall on a holiday, the company shall arrange to repay the amount on the immediate preceding working day.

3. Maximum Limit

The RBI has made mandatory for banks, consortium and syndicates to restrict the cash credit component to 75 percent of the maximum permissible bank finance on the overall capacity of each borrower to issue CPs is 56 percent of borrower's maximum permission bank finance.

4. Denomination and Minimum Size

The denomination of CP could be in multiples of Rs. 5 lakhs subject to the minimum size of an issue to a single investor being Rs. 25 lakhs (face value).

5. Discount Rate

The rate of discount is to be determined by the company which is issuing CP.

6. Issue Expenses

All expenses pertaining to dealer's fees, rating agency fee and stamp duty to be borne by the issuing company. Now the RBI abolished the facility of stand-by arrangement as a result it is no longer mandatory for banks to automatically restore the cash credit limits of corporate bodies.

Q16. Explain the various issues relating to commercial papers?

Ans :

1. Intending company has to submit its application to the bank leader of the consortium with which it enjoys the working capital facilities.
2. The bank leader of the consortium if satisfied shall permit the issue of CP. The bankers are required to submit fortnightly returns to the Reserve Bank of India on a post-sanction basis.
3. The company shall make arrangements for privately placing the issue and ensure that the issue of CP is complete within a period of two weeks from the date of permission.
4. The fund-based working capital limits of the borrowing company shall be reduced by the financing banks to the extent the issue is actually placed.
5. The banks are prohibited from underwriting (or) co-accepting the CP issue.

Q17. Explain the advantages and dis-advantages of commercial papers?

Ans : **(Dec.-18)**

Advantages

1. When compared to other sources like bank loans and loans from other financial institutions, commercial papers can provide more funding at a lower interest rate.
2. It a debt instrument trade at the money market, commercial papers are highly liquid and comes with a range of maturities offering investors with high flexibility.
3. It does not contain any restrictions on it. Also, they are highly secure as they are issued by companies with high credit ratings.
4. Companies can save some funds by issuing commercial papers that they had to otherwise

Rahul Publications

pay as interest for bank loans. Investors can earn good returns on them while maintaining the liquidity of the invested amount.

5. These are instruments that produce a continuing source of funds. The reason is the maturity of these funds can be customized to suit the requirements of the issuing entity. Additionally, the matured commercial papers can be repaid by issuing fresh commercial papers at the money market. Thus the company will have to go through minimum losses.

Disadvantages

1. It is available only to a few selected blue chip and profitable companies.
2. By issuing commercial paper, the credit available from the banks may get reduced.
3. Issue of commercial paper is very closely regulated by the RBI guidelines.

3.6 Certificate of Deposits

Q18. What are certificate of deposits? Explain the features of certificate of deposits?

Ans : **(May-19, Dec.-19, Dec.-18)**

Meaning

CDs are marketable receipts in bearer or registered form of funds deposited in banks, for a specified period of time at a specified rate of interest. They are transferable, negotiable, short- term, fixed-interest bearing, maturity dated, highly liquid and risk-less money market instruments. Banks issue or sell CDs either directly to the investors or through dealers. They may be issued on the initiative of the secondary market dealers who may persuade banks to issue particular CDs either to hold in their own portfolios or often to meet the requirements of customers who approach them instead of their banks.

Features

Enumerate the basic characteristics of certificate deposits?

1. Eligibility

CDs can be issued only by the scheduled commercial banks excluding Regional Rural Banks (RRBs).

2. Aggregate Amount

CDs issued by a bank and outstanding at any point of time should not exceed 5 percent of the fortnightly average aggregate deposit during the financial year 1989-90. The ceiling on the amount of CDs which can be issued arc communicated to each bank separately.

3. Minimum Size of Issue and Denomination

The denomination of CDs should be in multiples of Rs. 5 lakh subject to the minimum size of an issue to a single investor being Rs. 25 lakh.

4. Who can Subscribe

CDs can be issued to individuals, corporations, companies, crusts, funds, associations etc. Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis which should be clearly stated on the certificate. Such CDs can not be endorsed to another NRI in the secondary market.

5. Maturity

The maturity period of CDs should be not less than 3 months and not more than one year.

6. Discount

CDs should be issued at a discount on face value. The issuing bank is free to determine the discount rate.

7. Reserve Requirement

Banks have to maintain CRR and SLR on the issue price of the CDs.

8. Transferability

CDs will be freely transferable by endorsement and delivery but only after 45 days of the date of issue.

Q19. State the RBI guidelines on issue of certificate of deposits.

Ans :

The RBI launched the scheme of CDs with effect from March 27, 1989. Following guidelines were laid down in this regard,

Rahul Publications

1. **Eligible Issuers :** The institutions that are eligible to issue CDs are scheduled commercial banks (excluding RRBs) and specified all-India financial institutions, namely, IDBI, IFCI, ICICI, SIDBI, IRBI and EXIM bank.
2. **Eligible Subscribers :** The parties who are eligible to buy CDs are individuals, associations, companies, corporations, trust funds etc. NRIs can also subscribe to the CDs. However, this is possible only on a non-repatriation basis. It is not possible for an NRI tenders CDs to another NRI in the secondary market.
3. **Negotiation :** CDs are freely transferable by endorsement and delivery after the initial lock- in period of 15 days. The instrument can be purchased by any of the above subscribers and DFHI in the secondary market.
4. **Maturity :** The maturity period of CDs issued by banks ranges from 3 days to 12 months and that issued by specified financial institutions can have a maturity period upto 3 years. With the announcement of credit policy on April 27, 2000 the maturity period was reduced from 3 months to 15 days.
5. **Discount :** CDs are to be issued at a discount to face value, with the maturity period not having any grace period.
6. **Limits of issue :** The maximum amount of issue by a bank, which was originally fixed at 1 percent of its fortnightly aggregate average deposits, was raised to 10 percent in 1992. This was subsequently abolished totally. The minimum size of issue to a single investor, which was originally fixed at Rs. 10 lakhs, was reduced to Rs. 5 lakhs with effect from October 21, 1997. Issue of CDs above Rs. 5 lakhs can now be made in multiples of Rs. 1 lakh. CDs can now be issued for a minimum amount of Rs. 5 lakhs, which was originally Rs. 25 lakhs. Banks have to maintain SLR and CRR on issue price of CDs for which there is no ceiling.
7. **Stamp Duty** : Stamp duty is payable on CDs as applicable to any other negotiable instrument.
8. **Security Paper** : CDs are transferable by endorsement and delivery and shall therefore be issued on a good quality security paper.
9. **Other Requirements** : They are follows,
   i) No loans can be granted by banks against CDs.
   ii) Banks cannot have any buyback arrangement of their own CDs before maturity.
   iii) Banks are to submit fortnightly report on their CDs to the RBI under section 42 of the RBI Act, 1935.
   iv) Banks are to show CDs under the head 'liabilities' in the balance sheet.

Q20. Discuss the Interest rates of certificate of deposits.

Ans :

CDs are offered at interest rates higher than the time deposits of banks. However, the rate of interest is dependent upon many factors such as urgency of requirement for funds, alternative opportunities for investment of funds mobilized etc. The rate of discount being deregulated is now determined by the demand and supply of CDs. CDs are issued at a discount to their face value and redeemed at par. CDs are issued at a front-end discount and in such a case, the effective rate of interest is higher than the quoted discount rate.

Effective rate of interest may be calculated as follows,

$$ERR = [(1 + QDR \div 100 \times N/M)\, N/M - 1] \times 100$$

where,

ERR = Effective rate of interest,

QDR = Quoted discount rate,

N = Total period in a year, say 12 months or 365 days etc.

M = Maturity period in months or days as the case may be.

Q21. Explain the factors inhibiting growth of CD's.

Ans :

1. CDs of commercial banks form only 2 percent of their (financial institutions) aggregate deposits. Hence, there is a large scope for the development of this instrument. The

Rahul Publications

following factors, however, limit the growth of CDs,

i) Transactions in the secondary market have not developed because the numbers of participants are limited, interest rates are quite high and certificates of deposit are not listed.

ii) The secondary market for certificates of deposit has been slow to develop. With banks offering higher interest rates on these deposits, investors find it profitable to hold them till maturity.

2. The reliance of financial institutions on CDs has decreased. It can be increased if the tenure of the certificates of deposit of the financial institutions is rationalized.
3. There is no facility or loans against the deposits by banks nor can banks buy them back prematurely.
4. The market is limited to few investors as the minimum level of investment is still high.
5. The stamp duty on the certificates of deposit has also affected their growth.
6. Certificates of deposit carry a fixed rate of discount. To enlarge the market of these deposits, it is necessary to introduce floating rate CDs.

Q22. State the merits of Certificate of Deposits.

Ans : **(Dec.-18)**

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.

Q23. Compare and contrast commercial papers and certificate of deposits.

Ans :

S.No.	Criteria	Commercial Paper (C.P.)	Certificate of Deposit (C.D.)
1.	**Meaning**	It's an unsecured, short term, promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period.	CD's are unsecured, short term, negotiable instruments in bearer form (Short term tradable time deposit).
2.	**Issuer**	Leading credit worthy and highly rated corporate (to meet there working capital requirement), Primary dealers and All India financial institutions (to meets sort term funds).	Bank and Financial Institutions (FI's)
3.	**Investors**	Individuals, Banks (Schedule Commercial Banks excluding Regional Rural Banks and Local are banks), Corporate, NRI's, FII's.	Individuals, corporations, companies, trust, associates, funds, others.
4.	**Maturity**	Minimum- 7 days, Maximum- up to 1 year from date of issue.	Minimum- 7 days Maximum- Not more than 1 year. For FIs-Minimum 1 year not exceeding 3 years.
5.	**Denomination**	Minimum 5 lakhs and multiples there of.	Minimum 1 lakhs and multiples there after.
6.	**De-Mat**	CP can be issued as a promissory note and dematerialized form. Issuers and subscribers are encouraged to prefer exclusive reliance in De-Mat form, banks, FI's and primary dealers are advice to invest only in De-Mat	Banks or FI's should issue CD only in dematerialized form

Rahul Publications

3.7 GOVERNMENT SECURITIES

Q24. What do you mean by Government securities. Explain the features of Government securities market.

Ans :

Meaning

The marketable debt issued by the government or semi-government bodies, which represents a claim on the government, is known as a government security or gilt-edged security (or) Stock. A redeeming feature of government securities is that they are considered to be a totally secure financial instrument as they ensure safety of both capital and income. Central government securities are supposed to be the safest amongst all securities.

Government securities are issued for the purposes of refunding the maturing securities, for advance refunding of securities, which have not yet matured and for cash financing, i.e., raising fresh cash resources.

A market whereby the government or gilt-edged securities can be bought and sold is called 'government securities market'.

Features

Following are the characteristics of a government securities/market, which plays a significant role in the Indian stock market,

1. Agencies

Government securities are issued by agencies such as central government, state governments, semi-government authorities like local government authorities, example, city governments and municipalities, autonomous institutions such as metropolitan authorities, port trusts, improvement or development trusts, state electricity boards, public sector enterprises and other governmental agencies like IDBI, IFCI, SFCs, NABARD, LDBs, SIDCs, housing boards etc.

2. RBI's Special Role

RBI takes a special and an active role in the purchase and sale of these securities as part of its monetary management exercise. There is no underwriting or guaranteeing required in the sale of government securities, as RBI is policy-bound to buy a substantial portion of the loan un-subscribed by the public.

3. Nature of Securities

Securities offer a safe avenue of investment through guaranteed payment of interest and repayment of principal by the government. They offer relatively a lower fixed rate of interest compared to interest rate on other securities. They are issued in the denominations of Rs. 100 and Rs. 1000. They have a fixed maturity spanning a period of time. Interest is paid half-yearly.

4. Liquidity Profile

The liquidity profile of gilt-edged securities varies. Accordingly liquidity profile of securities issued by central government is high. However, the securities issued by state governments and local government organizations have limited liquidity.

5. Tax Rebate

A striking feature of these securities is that they offer wide-ranging tax incentives to investors. This has made these securities very popular. Rebates for investment in these securities are available under the Income Tax and other Acts.

6. Market

As each sale and purchase has to be negotiated separately, the gilt-edged market is an 'over-the-counter' market. The government securities market in India has two segments namely primary market and secondary market.

7. Forms

The securities of central and state government take such forms as inscribed stock or stock certificate, promissory note and bearer bond. The securities such as bearer bonds and stock certificates are not popular with Indian investors.

8. Participants

The participants in government securities market include the government sector comprising central and state governments

Rahul Publications

whose holdings represent inter- government transfer of resources, banking sector comprising RBI, SBI, other commercial and cooperative banks, the institutional sector comprising insurance companies including Life Insurance Corporation and General Insurance Companies, provident funds-both statutory and non-statutory and other institutions including special financial institutions, joint stock companies, local authorities, trusts, individuals and non-residents.

Q25. Discuss the various modes of issue of government securities.

Ans :

Although the secondary market for government securities is narrow, small and less active, banks and corporate holders who purchase and sell government securities on the stock exchanges participate in trading. The securities are mainly traded at Bombay Stock Exchange. In terms of size, the primary market for government securities is much bigger than the industrial securities market.

(A) Type of Trading

The type of trading practiced by the RBI in dealing with government securities is described below,

1. Grooming

Gradual acquisition of securities nearing maturity through the stock exchanges by the RBI in order to facilitate redemption is described as 'grooming'. The object is to keep the whole process of issue and redemption of government securities continuous and thereby facilitate availability of securities on 'tap'.

2. Switching

The purchase of one security against the sale of another security carried out by the RBI in the secondary market as part of its open market operations is described as 'Switching'. Banks and financial institution are greatly benefited by the switch operations as it helps them improve the yield on their investments, in government securities. The RBI fixes an annual quota for the switch transactions of each bank.

3. Auctioning

A method of trading whereby merchants bid against one another and where the securities are sold to the highest bidder is known as 'auctioning'. This system, for the sale of dated government securities, was introduced in the year 1992. Under the auction sale mechanism operated by the RBI, a number of instruments of wide ranging period, such as 14 days, 91 days, 182 days and 364 days treasury bills and dated securities of government of India are sold. Bidders furnish written and sealed quotations restricted to notified amounts.

(B) Trading Mechanism

The mechanism of trading in government securities takes place through the following methods,

1. DS Method

Under the Direct Sales (DS) method, public debt office effects direct sale of government securities. This is done by pre-specifying the loan amount and the date of opening of subscription for government loans.

2. SGL Accounts Method

Under the Securities General Ledger (SGL) method, RBI records the transactions as book entries only in the ledger, on the date of the transaction, by specifying the value at which the transaction takes place. In respect of each separate dealing, the purchasing banker maintains a separate SGL account with RBI in respect of the purchase and the balance of the central government securities. Selling banker effects the transactions by filling out the prescribed SGL form, which is then lodged with RBI?

3. BR Method

Under the Banker Receipt (BR) method, the bank selling government securities, issues a Bank Receipt (BR). This is done in the case of Repo' or Ready Forward (RF) transactions. These are facilitated by the SGL where it is possible to avoid physical transfer of securities.

Rahul Publications

A 'repo' or Ready Forward (RF) refers to a sale transaction, which buys back the securities at a stipulated future date at a price determined on the date of sale transaction. Under the 'repo' or RF, short operations are conducted by banks which sell government securities without owning them with a view to neutralising the transaction by buying them at a later date (though issue of bankers receipt is being discouraged by RBI).

Q26. Explain the classifications of Govt. Securities?

Ans :

Government of India issues from time-to-time, the following type of government securities,

1. Securities with Fixed Coupon Rates

i) The securities will carry a specific coupon rate remaining fixed during the term of the security and is payable periodically.

ii) Issue of security may be at a discount, at par or at a premium to the face value.

iii) Redemption of the security will be at par.

2. Securities with Variable Coupon Rates viz. Floating Rate Bonds etc.

i) The security will carry a coupon rate, which will vary according to the change in the base rate to which it is related. The description of the base rate and the manner in which the coupon rate is linked to the base rate will be announced in the specific notification.

ii) The coupon rate may be subject to a floor or cap, if any, as prescribed in the specific notification.

iii) Where the base rate is pre-announced and the security is issued at par, the method of issue in respect of securities/ bonds with variable coupon rate will be as announced in the specific notification.

3. Zero Coupon Bonds

i) Zero coupon bonds are issued at a discount and redeemed at par. No interest payment is made on such bonds.

ii) In respect of zero coupon bonds issued by auction, the price at which the zero coupon bonds are proposed to be purchased per Rs. 100/- (nominal), expressed upto two decimal places should be clearly stated in the application. Applications which do not contain details such as the nominal value of the bonds, the price per Rs. 100/- at which the bonds are proposed to be purchased or which contain incomplete details are liable to be rejected, without any reference to the applicant.

4. Installment Securities

The securities are issued either by auction or by pre-announcing a coupon rate. The special feature of the securities is that either the payment for the securities is received in specified installments or the repayment of the securities is made in specified installments as notified in the specific notification relating to the issue of the security.

5. Securities with Embedded Derivatives (Example, Call and Put Options)

Government securities may be issued with embedded derivative features, known as call and put options. The government security may be repaid at the option of government of India, before the specified redemption date, where a "call option" is specified in the specific notification it may be repaid, at the option of the holder of the security, before the specified redemption date, where a 'put option' is specified in the specific notification.

6. Tap Stock

Securities that are issued but are not fully subscribed and are released into the market slowly as and when its market price reaches predetermined levels are known as tap stock. There are two types of tap stocks. Short dated stocks are called 'short taps' and long-taps are 'long dated stocks'. Government of India introduced these stocks with effect from July 29, 1994.

7. Partly Paid Stock

Where, in respect of securities issued, the payment is made in installments, such

Rahul Publications

securities are known as partly paid stock. Government introduced these innovative stocks with effect from November 15, 1994. These instruments are designed for those institutions, which have regular flow of investible resources requiring regular investment outlets. The instrument is actively traded.

8. Capital Index Bonds

These bonds came to be floated on December 29, 1997 on tap basis with the objective of providing a complete hedge against inflation for the principal amount of the investment. The bonds are of four-year maturity period and carry a coupon rate of 6 percent.

9. STRIPS

"STRIPS" stands for Separately Traded Registered Interest and Principal of Securities. Under the STRIPS, coupon interest and the principal are separated and traded independently. Accordingly, a bond having a maturity period of 5 years will have a ten semiannual coupon payments and one payment of principal. This will comprise of ten STRIPS of interest coupons and one principal STRIP.

Q27. Discuss various dealers in government bonds/securities.

Ans :

The dealers in government securities may be categorized into primary dealers and satellite dealers as described below,

1. Primary Dealers (PDs)

Banks and institutions that are used by the RBI for conducting the activities relating to secondary market in government securities are called 'primary Dealers'.

The RBI issued detailed guidelines regarding the primary dealers in March 1995. The purpose was to achieve a broad based development of secondary market in government securities.

Objectives

The enlistment of primary dealers was done keeping in mind the following objectives,

i) **Broad Basing :** To make the government securities market vibrant, liquid and broad based by strengthening the infrastructure.

ii) **Developing Capabilities :** To ensure the development of underwriting and market making capabilities for government securities outside the RBI.

iii) **Improved Trading :** To contribute for price discovery, enhanced liquidity and turnover and voluntary holding of government securities amongst a wider investor base by means of improving the secondary market trading system.

iv) **OMO :** To allow the efficient conduct of Open Market Operations (OMO) by using primary dealers as effective conduit.

Role and Obligations

The role and obligations of primary dealers that stem from the standing arrangement with the RBI include the following,

i) **Bidding :** Primary dealers shall aggregately bid for minimum amounts in central government dated securities and treasury bill auctions thus maintaining a success ratios of 33.33 percent and 40 percent respectively.

ii) **Underwriting :** Primary dealers shall involve themselves in underwriting a pre-determined part of the slack in subscriptions/accepted bids against notified amount.

iii) **Offering Quotes :** Primary dealers shall offer firms two-way quotes for government securities.

iv) **Achieving Turnover :** Primary dealers shall achieve an annual turnover, based on month- end average stock of the order of at least 5 times in government dated securities and 10 times in treasury bills, with the minimum turnover on outright basis of 3 times for government dated securities and 6 times for treasury bills.

Rahul Publications

v) **Maintaining CAS :** Primary dealers shall maintain minimum Capital Adequacy Standards (CAS) as prescribed by RBI for Non-banking Financial Companies and Residuary Non- banking Companies, the base being the risk weighted assets.

Promoting Primary Dealers

RBI, has in the recent past, initiated a host of measures in order to tone up and to promote the business of primary dealers. Following are the important measures undertaken in this regard,

i) **Infrastructure :** Creation of necessary institutional infrastructure for the development of an active Secondary market in government securities.

ii) **Financial Support :** Provision of financial support to PDs by way of "repo" facilities against 91-days treasury bills and government dated securities subject to limits fixed on the basis of the business plan submitted by each PD.

iii) **Resources Augmentation :** Permission to PDs by RBI to issue commercial papers and to raise inter-corporate deposits subject to certain conditions so as to enable them to augment their resources, with effect from September 1996.

iv) **Incentives :** With a view to enabling the PDs to widen the investors base, to bring about proper alignment in the primary and secondary market yields and to meet unforeseen losses in adverse market conditions, RBI introduced with effect from July 10, 1996, a scheme of paying commission (which was later on replaced by underwriting fee) to PDs in respect of central government securities purchased by them. However, the scheme of payment of underwriting fee was introduced with effect from May 21, 1997, to replace the scheme for payment of commission on all subscriptions including development up to the fixed percentage committed by each PD. Accordingly, a minimum of 25 percent of each issue of government of India dated securities and treasury bills was offered for underwriting.

Liquidity Support

RBI offers liquidity support to PDs in government securities market in the following manner,

i) **Repos :** Through repos operations in 91-days, 364-days auction treasury bills and central government dated securities at the bank rate.

ii) **SGL Accounts :** Through the security of holdings in Subsidiary General Ledger (SGL) accounts whereby demand loans were provided against the security of their holdings in SGL accounts.

iii) **Advances :** Through the advances against the collateral of holdings of government of India dated securities and 91/364-days auction treasury bills in SGL accounts maintained with the reserve bank.

iv) **Liquidity** : By linking liquidity support to PDs bidding commitments and secondary market operations.

2. Satellite Dealers (SDs)

Dealers who are required to engage in the task of setting up a second tier in trading and distribution of government securities with a view to further activating the government securities market, providing easy liquidity to the securities and establishing retail outlets in order to widen investor base, are called 'satellite Dealers'. SDs would primarily supplement the PD system and would later on become a primary dealer.

Support Facilities

Following are the support facilities that are extended by the RBI for the SDs,

i) **Liquidity Support :** RBI provides liquidity support through reverse repos transactions with the reserve bank in central government dated securities and auction treasury bills, upto 50 percent of the outstanding stocks (face value)

Rahul Publications

thereof at the end of the previous working day.

ii) **Financial Support :** RBI provides the facility of repos since March 18, 1998. In this regard, permission has been granted to SDs to issue Commercial Papers (CPs) with maturity ranging from 15 days to one year with effect from June 23, 1998.

Q28. Discuss the general terms and conditions applicable to government securities.

Ans :

The general terms and conditions applicable to all issues of government securities will be as under,

1. Eligibility for Investment

Any person including firms, companies, corporate bodies, institutions, state governments, provident funds and trusts may make investment in the government securities. Non-Resident Indians (NRIs viz., Indian citizens and individuals of Indian origin), overseas corporate bodies predominantly owned by NRIs and foreign institutional investors registered with SEBI and approved by Reserve Bank of India are also eligible to invest in government securities.

However, investment by a person resident outside India (whether a citizen of India or not), or a person who is not a citizen of India but is resident in India or a company which is not incorporated under any law in force in India or any branch of such company shall be subject to the provisions of the Foreign Exchange Regulation Act, 1973 or the Foreign Exchange Management Act, 1999 in addition to the other provisions of laws applicable to Government securities as per the terms stipulated hereinafter.

2. Minimum Subscription

Government securities will be issued for a minimum amount of Rs. 10,000/- (face value) and in multiples of Rs. 10,000/- thereafter.

3. Procedure for Application

Offers for purchase of government securities shall be submitted by interested persons in the form of application (including electronic form), as specified by Reserve Bank of India from time to time. FIIs, NRIs and overseas corporate bodies predominantly owned by NRIs, however, should submit their applications through the designated banks, which have been authorised by the Reserve Bank of India to act as a banker to FIIs or authorised to deal in foreign exchange as the case may be. Applications duly filled in should be submitted to the office of Reserve Bank of India or any other institution notified for the purpose, before the close of banking hours on the specified dates. Interested persons submitting applications for purchase of government securities shall be bound also by the terms and conditions.

4. Payment for Government Securities

Payment for the government securities shall be made by the applicants/investors on such dates as mentioned in the specific notification, by means of cash or cheque drawn on Reserve Bank of India, Mumbai or any specified office of Reserve Bank of India or banker's pay order or by authority to debit their current account with Reserve Bank of India or by electronic fund transfer in a secured environment or by any other means as specified by Reserve Bank of India.

5. Form of Security

The government securities shall be issued to the investors by credit to their subsidiary general ledger account or to a constituents' subsidiary general ledger account of the institution as specified by them, maintained with Reserve Bank of India or by credit to their bond ledger account maintained with Reserve Bank of India or with any institution authorised by the Reserve Bank of India in this regard as per the Public Debt Rules 1946 or in the form of stock certificate. The form of stock certificate will be notified separately, where necessary.

Rahul Publications

6. Payment of Interest

Interest on government securities will be paid at the public debt offices of the Reserve Bank of India at Ahmedabad, Bangalore, Bhubaneswar, Kolkata, Chennai, Guwahati, Hyderabad, Jaipur, Kanpur, Mumbai, Nagpur, New Delhi, Patna and Thiruvananthapuram (or) any other office of Reserve Bank of India notified for this purpose from time to time or at branches of State Bank of India and associate banks conducting government business or at any treasury or sub-treasury served by the public debt office where there is no office of Reserve Bank of India or branch of State Bank of India or its associates except in the states of Jammu & Kashmir and Sikkim.

7. Repayment of Government Securities

The government securities will be repaid at public debt offices of the Reserve Bank of India or any other institution at which they are registered at the time of repayment. The government security may be repaid at the option of government of India, before the specified redemption date, where a "call option" is specified in the specific notification relating to the issue of a government security. The government security may be repaid, at the option of the holder of the security, before the specified redemption date, where a 'put option' is specified in the specific notification relating to the issue of a government security.

The government security will be repaid on the date of redemption specified in the specific notification, where neither a "call option' nor a 'put option' is specified/exercised.'

8. Transferability of Government Securities

Government securities can be renewed, sub-divided, consolidated, converted ana transferred in accordance with the provisions of the Public Debt Act, 1944 (or any other Act repealing the Public Debt Act, 1944), the Public Debt Rules, 1946 framed thereunder (or any other rules repealing the Public Debt Rules, 1946) and the terms of this notification and any further notification which may be issued by the government of India from time to time in this behalf. The conversion of the security issued pertaining to the security from one form to the other will be subject to the restriction with respect to the forms in which the government securities shall be issued.

The transfers of government securities by FIIs, will be subject to SEBI (FIIs) regulations and those of NRIs and overseas corporate bodies predominantly owned by NRIs will be subject to RBI guidelines.

9. Laws Applicable

The rights of all persons subscribing to or holding the government securities shall be determined with all such questions as are dealt with by the Public Debt Act, 1944 (or any other act repealing the Public Debt Act, 1944) and the Public Debt Rules, 1946 (or any other Rules repealing the Public Debt Rules, 1946) read with the terms of this notification and such other notification as may be issued from time to time or by the terms of press releases as may be issued in future by Reserve Bank of India, in consultation with government of India in this regard. The provisions of the prevailing tax laws in India will be applicable for the purposes of assessing and determining the tax liability of the investor or holder of the government securities. The courts in India shall decide any dispute in relation to the government securities.

10. Participation by RBI

The Reserve Bank of India may also, if it considers appropriate to do so, participate in the auction as a "non-competitor" or subscribe to the government securities in other issues. Allotment of securities to Reserve Bank of India will be at the cut-off price/yield emerging in the auction or at any other price/yield decided by the government of India.

Rahul Publications

3.8 Security Market

3.8.1 Organization and Structure

Q29. Define Security Market. Explain the organization and structure of Security Market.

(OR)

Elaborate the organization and structure of security market.

Ans : **(Aug.-15)**

The securities markets provide a regulated framework for efficient flow of capital (equity and debt) from investors to business in the financial market system. Securities markets are basically a platform for allocation of savings to investments

Organization and Structure

Securities markets are broadly classified into two types :

1. Primary Market
2. Secondary Market

1. Primary Market

Meaning

Primary market is known as new issue market. The new issue market is also called as "public issue". In the primary market, new securities are sold or exchanged for cash credit or other securities. The new securities that can be issued by the existing companies are newly floated companies. The primary market can be defined as, "A market where new securities are bought and sold for the first time."

Primary market is a new issue market. The funds are raised through the sale of new securities flow from the buyers of securities to the issuer of securities. The financial institutions play a key role in moving funds from the savings sector to the investment sector. A large manufacturing company requires bulk amount of capital for its needs. It raises funds both publicly and privately with more confident. Raising funds from the public is known as public issue. Public issue can be defined as, "Sale of bonds or stock to the general public." The securities are sold to the lakhs of investors under a formal contract: overseen by the government authorities. The required funds can also be raised privately to a limited number of investors. This process is known as "private placement." The primary market creates financial claims. In this market the public can only buy the shares. Two parties are involved in this market, they are lenders and the borrowers. The funds are flow from the Senders to the borrowers.

Features

1. The capital market is freely accessible by any company for raising funds from the public.
2. The corporates have freedom in fixing of issue price of a share subject to some SEBI guidelines.
3. The companies approach capital market rather than banks and financial institutions for raising of funds.
4. The mushroom growth of companies and a spate of new issue by both new companies as well as existing companies.
5. Securities are sued by companies for setting new business and for expanding or modernising existing business.
6. It facilitates capital formation in the economy.
7. Funds generated in this market are utilized for the purchase of fixed assets.
8. It does not include long-term loans from financial institutions.
9. It is the process of going public, i.e., converting private capital into public capital.

Issue Ways / Mechanics of Floating New Issue

There are four ways in which a company may raise equity capital in the primary market,

(i) Public Issue

By far the most important method of issuing securities, a public issue involves ' sale of securities to the public at large. Public issues in India are governed by the provisions of the Companies Act, 1956, SEBI guidelines on investor protection and the listing agreement between the, issuing company and the stock exchanges. The Companies Act, describes the procedure to the followed in offering shares to the public and the type of information to be disclosed in the prospectus and the SEBI guidelines impose certain conditions on the issuers besides specifying the additional information to be disclosed to the investors.

Rahul Publications

(ii) Rights Issue

A rights issue involves selling securities is the primary market by issuing rights to the existing shareholders. When a company issues decisional equity capital, it has to be offered in the first instance to the existing shareholders on a pro rata basis. This is required under Section 81 of the Companies Act, 1956. The shareholders, however, may by a special resolution forfeit this right, partially or fully, to enable a company to issue additional capital to the public.

According to Section 81, the company has to satisfy certain conditions to issue right shares, they are as follows,

i) Right shares must be offered to the equity shareholders in proportion to the capital paid on those shares.

ii) A notice should be issued to specify the number of shares issued.

iii) The time given to accept the right offer should not be less than 15 days.

iv) The notice also should state the right of the shareholders to renounce the offer in favour of others.

v) After the expiry of the time given in the notice, the board of directors has the right to dispose the unsubscribed shares in such a manner, as they think most beneficial to the company.

(iii) Private Placement

Private placement and preferential allotment involve sale of securities to a limited number of sophisticated investors such as financial institutions, mutual funds, venture capital funds, banks and so on.

In a preferential allotment, the identity of investors is known when the issuing company seeks the approval of its shareholders, whereas in a private placement, the identity of investors is not known when the offer document (popularly known as the information memorandum) is prepared.

In the Indian context we find that broadly,

i) Private placement refers to sale of equity or equity related instruments of an unlisted company or sale of debentures of the listed or unlisted company.

ii) Preferential allotment refers to sale of equity or equity related instruments of a listed company.

Advantages of Private Placement

1. **Cost Effective :** Private placement is a cost-effective method of raising funds. In a public issue underwriting, brokerage, printing, mailing and promotion account for 8 to 10 percent of the issue cost. In the case of the private placement several statutory and non-statutory expenses are avoided.

2. **Time Effective :** In the public issue the time required for completing the legal formalities and other formalities takes usually six months or more. But in the private placement the requirements to be fulfilled are less and hence, the time required to place the issue is less, mostly 2 to 3 months.

3. **Structure Effectiveness :** It can be structured to meet the needs of the entrepreneurs. It is flexible to suit the entrepreneurs and the financial intermediaries. To make the issue more attractive the corporate can provide discounts to the intermediaries who are buying it. This is not possible with the public issue with stringent rules and regulations.

4. **Access Effective :** Through private placement a public limited company listed or unlisted can mobilise capital. Like-wise issue of all size can be accommodated through the private placement either small or big whereas in the public issue market, the size of the issue cannot fall below a certain minimum size.

(iv) Preferential Allotment

An issue of equity by a listed company to selected investors 'at a price which may or may not be related to the prevailing market price is referred to as preferential allotment in the Indian capital market. A preferential allotment is not related to a public issue and it should not be confused with reservations that may be made on a preferential basis for certain categories of investors in a public issue. Preferential allotment in India is given mainly

Rahul Publications

to promoters or friendly investors to ward off the threat of takeover. This is now a very popular means of raising fresh equity capital because,

i) The cost and uncertainty associated with the public issue is high.

ii) Sophisticated investors like mutual funds and private equity investors are likely to pay a higher price.

The price at which a preferential allotment of shares is made should not be lower than the higher of the average of the weekly high and low of the closing prices of the shares quoted on the stock exchange during the six months period before the relevant date or during the two weeks period before the relevant date.

The four methods of floatation discussed above are public issue, rights issue, private placement, preferential allotment. In India, offer to public through prospectus and right issues to existing shareholders is popular for the flotation of shares.

2. Secondary Market

Meaning

A stock exchange is a market where stocks and shares are bought and sold. It is a place where any individual wishing to buy or sell a particular security can find a ready customer. It is not necessary for the buyer or seller to go to the market personally, neither is he required to haggle over the rates. This is done on his behalf by others who are experts in the line and who make it their profession to buy and sell securities.

They are the members of the stock exchange, through whom alone the public can deal on the market. Of course, any individual can buy and sell shares without a broker and an exchange, but the process of buying and selling would involve great difficulty and delay. The seller, for example, win have to hunt round to find a purchaser who wants to buy exactly those shares which the seller wants to sell and in exactly the same number. Presuming the seller does find a buyer, there would still remain the difficulty of knowing the fair price of the shares. On the other hand, if there is a stock exchange, all that an individual wishes to sell shares need do is to pass on the order to his broker. The potential buyer, who may be some hundreds of miles away, also passes on his order to his broker. The two brokers meet on the "floor" of the exchange to execute the orders and it is a matter of only a few minutes for the transaction to be completed.

Definitions

(i) According to Pyle, "Security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation." Stock exchanges allow trading in securities both to the genuine investors and speculators.

(ii) According to Securities Contract (Regulation) Act, 1956, "Stock exchange means anybody of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling in securities."

(iii) According to this definition, the stock exchange allows trading in securities under certain rules and regulations.

(iv) According to Husband and Dockeray, "Securities or stock exchanges are privately organized markets which are used to facilitate trading in securities." As per this definition the stock exchanges are the organized places where securities are purchased and sold.

Features

1. Secondary market deals in previously issued securities.
2. This market is not the place of the origin of the security.
3. Securities are not issued directly by the company to investors.
4. Securities are sold by the existing investors to another investors.
5. The intending buyer and seller can buy and sell securities through brokers.
6. Securities market provides liquidity to the investment and enhances the marketability of securities.
7. Secondary markets merely transfer existing securities between buyers and sellers.

Rahul Publications

8. Secondary markets do not directly contribute to capital formation.

Purpose

1. It helps in the capital formation of the country.
2. It maintains active trading.
3. It increases liquidity of assets.
4. It also helps in price recovery process.

Functions

1. Maintains Active Trading

Shares are traded on the stock exchanges, enabling the investors to buy and sell securities. The prices may vary from transaction to transaction. A continuous trading increases the liquidity or marketability of the shares traded on the stock exchanges.

2. Fixation of Prices

Price is determined by the transactions that flow from investors' demand and suppliers' preferences. Usually the traded prices are made known to the public. This helps the investors to make better decisions.

3. Ensures Safe and Fair Dealing

The rules, regulations and by-laws of the stock exchanges' provide a measure of safety to the investors. Transactions are conducted under competitive conditions enabling the investors to get a fair deal.

4. Aids in Financing the Industry

A continuous market for shares provides a favourable climate for raising capital. The negotiability and transferability of the securities helps the companies to raise long-term funds. When it is easy to trade the securities, investors are willing to subscribe to the initial public offerings. This stimulates the capital formation.

5. Dissemination of Information

Stock exchanges provide information through their various publications. They publish the share prices traded on daily basis along with the volume traded. Directory of corporate information is useful for the investors' assessment regarding the corporate. Handouts, handbooks and pamphlets provide information regarding the functioning of the stock exchanges.

6. Performance Inducer

The prices of stocks reflect the performance of the traded companies. This makes the corporate more concerned with its public image and tries to maintain good performance.

7. Self-regulating Organization

The stock exchanges monitor the integrity of the members, brokers, listed companies and clients. Continuous internal audit safeguards the investor against unfair trade practices. It settles the disputes between member brokers, investors and brokers.

8. Mobilising Surplus Savings

The stock exchanges provide a ready market for various securities. The investors do not have any difficulty in investing their savings by purchasing shares, bonds etc., from the exchanges. If this facility is not there then many persons who want to invest their savings will not find avenues to do so. In this way stock exchanges play an important role in mopping up surplus funds of investors.

9. Helpful in Raising New Capital

The new and existing concerns need capital for their activities. The new concerns raise capital for the first time and existing units increase their capital for expansion and diversification purposes.

10. Listing of Securities

Only listed securities can be purchased at stock exchanges. Every company desirous of listing its securities will apply to the exchange authorities. The listing is allowed only after a critical examination of capital structure, management and prospects of the company.

Rahul Publications

11. Platform for Public Debt

The increasing government's role in economic development has necessitated the raising of huge amounts for this purpose. The stock exchanges provide a platform for raising public debts. The stock exchanges are also organized markets of government securities. However, there is no provision for a separate counter for government securities but these are traded through brokers dealing in these securities.

12. Clearing House of Business Information

The companies listing securities with exchanges have to provide financial statements, annual reports and other reports to ensure maximum publicity of corporation operations and working. The economic and other information provided at stock exchanges help companies to decide their policies.

Tradable Securities in Secondary Market

The securities which are traded in the secondary market may be classified as follows,

On the basis of issuer, securities may be classified as,

1. Industrial Securities

Industrial securities issued by industrial and common undertakings in the private and public sector whereas government, state governments, municipalities and public utilities.

2. Government Securities

Government securities are generally considered risk-free, low return securities compared to industrial securities.

3. Financial Intermediaries Securities

Besides these two classes of issues, financial intermediaries are emerging as the third important group. The securities issued by financial institute and banks would fall, in terms of risk-return features, somewhere in between the industrial securities and government securities.

3.8.2 Listing, Trading and Settlement

Q30. Discuss the Listing, Trading and Settlement process in stock exchange.

(OR)

Explain the Listing, Trading and Settlement procedure in stock market.

Ans : **(Ferb.-17, Feb.-15)**

(i) Listing

"A security is said to be listed when its name is added to the list of securities in which trading on a particular exchange is permitted."

Only listed securities are traded on the stock market. Listed securities are also known as quoted securities. With effect from 13th February 1989, any company can list, delist and relist its securities by paying a stipulated fee, provided its equity capital is at least Rs. 3 crores and at least Rs. 1.8 crores (i.e., 60%) of this capital is offered for public subscription.

(ii) Trading and Settlement

The business transactions in stock exchanges involves the following stages,

1. Order Placement with Broker

In the first stage, an order is placed by the client with the stock broker who is responsible for conducting the business in the stock exchange for purchasing or selling the firm's shares at the best market prices.

2. Order Execution

In this stage, the order is executed by the broker or by his authorized clerk and the information about this will appear in the regular official list of stock exchange which includes, the price and number of shares at which the transactions has taken place.

3. Reporting the Deal to the Client

After the deal is transacted, client will receive contract note from the broker which provides information about the security that is purchased or sold the price, the broker's commission etc.

Rahul Publications

4. Settlement of Transactions

The transaction can settled in two ways,

(i) For the settlement of the ready delivery transactions, the payments should be made instantly on the transfer of securities or within a time period ranging from one to seven days.

(ii) For settling the forward delivery transactions, the payment has to be made on a fixed day. This method also includes carry-over system which means delaying or post-poning the delivery. It also offers a huge scope to speculate in the forward market.

Q31. Explain the purpose and qualification of Listing

Ans :

Purpose

The main purpose of listing requirement is

1. To ensure proper supervision and control of dealings in securities.
2. To protect the interests of shareholders and general investors.
3. To avoid the concentration of economic power.
4. To give promoters an opportunity to invest sufficiently in the company for their self-benefit and
5. To require promoters to have a reasonable stake in the company.

Qualification

There are certain minimum requirements for a security to be listed in a stock exchange. They are given below,

1. Minimum Issued Capital

According to the regulation laid down by the ministry of finance and department of economic affairs the minimum issued capital should be Rs. 3 crores and the minimum public offer is Rs. 75 lakhs. In 1995 the Bombay Stock Exchange raised the limit from Rs. 3 crores to Rs. 5 crores In 1996, it has been further raised to Rs. 10 crores. Some other stock exchanges have also increased the limit to Rs. 5 crores.

2. Payment of Excess Application Money

According to the direction given by the SEBI, the amended listing agreement of Mumbai Stock Exchange (1996) made the allotment of securities to be done within 30 days of the closure of the public issue. The refund orders should be despatched within the specified period. Beyond the period they shall be liable to pay an interest rate of 15 p.a. Similar amendments are made in the Delhi Stock Exchange agreement too.

3. Listing of Multiple Exchanges

When the paid up capital of the company is above Rs. 5 crores, it is obligatory for the company to seek listing on more than one stock exchange.

4. The Number of Shareholders

To ensure wide distribution of shares among the general public and to prevent undue concentration of large holdings with the company, minimum number of shareholders are prescribed. For every Rs. 1 lakh of fresh issue of capital, there should be atleast 10 shareholders. In the case of sale of existing capital of Rs. 1 lakh, it should ensure atleast 20 public shareholders. In 1996, Bombay Stock Exchange has reduced the above said numbers to 5 and 10 respectively. If the number of shareholders falls below the prescribed number, then the concerned company's security would be delisted.

5. Appointment of Market Maker

A company where the paid up capital is Rs. 3 crores but not more than Rs. 5 crores and having a commercial operation for less than two years should appoint a market maker. The market maker should provide two way quotes for the concerned stock for a minimum period of 18 months from the spread should not exceed 10 percent. The market maker should have an inventory of 5 percent of the post issue capital as on the date of allotment.

Rahul Publications

6. Articles of Association

The articles of association of the company should be intune with the sound corporate practice. If veto power has been provided to a director or a class - of directors to over rule the majority decision, the security of the company is not qualified for listing.

7. Cost of Public Issue

To be listed the company should adhere to the ceiling in the expenditure of public issue as prescribed by the SEBI.

8. Advertisement

The company should not advertise in newspapers that 'issue over subscribed' or 'thanks to the investing public for their overwhelming response' etc., during the subscription period. If the company gives such an advertisement, listing will be refused by the stock exchange after intimation to the stock exchange divisions of the ministry of finance.

9. Minimum Subscription

A minimum of Rs. 5,000 (500 shares of Rs 10 each) subscription has been fixed by SEBI. But, due to the slackness in the primary market, it is reduced to Rs. 2000 of 200 shares of Rs. 10 each. This should be given in the prospectus.

10. Applying Mode

The prospectus should provide information on 'how the investor should apply. It should clearly state that the application must be made in the prescribed form stating the number of shares applied for. It should be applied in single name or joint names of not mote than three. Application can be made in the name of limited companies, corporations or institutions and not in the name of a trust firm or partnership. The names should be given in block letters in English. An individual can make only one application.

11. Public Offer Size

The size of the public offer and value of the share should be stated in the first page of the prospectus. If the shares are issued at premium, that also should be stated. Preferential allotment to the directors and workers of the company and the reservation for allotment to the non-resident Indians should be indicated clearly on the prospectus.

Q32. Explain the procedure of listing of securities.

Ans :

Obtaining the listing permission from stock exchanges involves various steps. The steps are as follows,

1. Preliminary Discussion

The company desirous of getting its security listed on the stock exchange should have detailed discussion with the stock exchange authorities. The discussion enables it to understand the various compliances to be complied with for listing its securities.

2. Article of Association Approval

The articles of association will be approved only if it fulfills certain requirements. They are,

i) Common form of transfer should be used.

ii) Once the shares are fully paid, they should be free from all lien and in the case of partly paid shares the company's lien is restricted to the call money alone.

iii) The calls carried out in advance are entitled to interest rate but not for dividends or any other declared profits.

iv) The free dealings in company's shares should not be restricted by any provision.

v) The company should comply with the Section 205-A of Companies Act in the case of dividends.

If the company is not able to comply with any of the requirements of the Rule I9(2)(a) of the Securities Contract Regulation Act, the company should give an undertaking to make necessary amendments iri the articles of association as required in the next annual general meeting of the company: On the basis of the undertaking, the security will be

Rahul Publications

permitted to trade on the stock exchanges. If the article of association provides veto powers to any director/or group of directors, the relevant article should be amended to remove such powers to get the security listed.

3. **Draft Prospectus Approval** : Getting approval for the draft prospectus is the essential pre-requisite for the security to be listed. Before finalising the draft prospectus the company authority should hold a discussion with the stock exchange authorities. While seeking approval, the prospectus should contain all the conditions put by the stock exchange. The prospectus should clearly state the following,

   i) The name of regional stock exchange and any other stock exchanges(s) where it intends to enlist its securities.

   ii) It should specify the date of commencement of the subscription and the date of closing of the subscription. It is essential to keep the subscription list open for a minimum period of three working days. It may extend, upto 10 working days at the discretion of the board of directors. The date of closure of subscription list should be notified to the stock exchange where listing is sought.

High Powered Committee Recommendation

The high powered committee's recommendations on stock exchanges on listing of industries securities are given below,

1. Once the completed listing application is submitted to the stock exchanges, it should not take more than three working days for the admission of securities for dealings.
2. Stock exchanges should set up guidance cells to provide required help to the companies seeking enlistment. A uniform check list exhibiting the standard set norms required by the stock exchanges for the admission of the securities for trading should be prepared.
3. An update brouchure on matters related to listing should be prepared by the stock exchanges. An annual review should be made regarding the compliances of the provisions of listing agreement by the companies. It should also publicise the names of the companies that have not complied with the listing requirement and the government also has to be informed.

These recommendations have been accepted by the government.

Q33. Discuss briefly about Delisting of Securities

Ans :

The securities listed on NSE can be delisted from the exchange as per the SEBI (delisting of securities) guidelines, 2003 in the following manner,

1. Voluntary Delisting of Companies

Any promoter or acquire desirous of delisting securities of the company under the provisions of these guidelines shall obtain the prior approval of shareholders of the company by a special resolution passed at its general meeting, make a public announcement in the manner provided in these guidelines, make an application to the delisting exchange in the form specified by the exchange and comply with such other additional conditions as may be specified by the concerned stock exchanges from where securities are to be delisted.

Any promoter of a company which desires to delist from the stock exchange shall also determine an exit price for delisting of securities in accordance with the book building process as stated in the guidelines. The stock exchanges shall provide the infrastructure facility for display of the price at the of the trading members to enable the investors to access the price on the screen to bring transparency to the delisting process.

2. Compulsory Delisting of Companies

The stock exchanges may delist companies which have been suspended for a minimum period of six months for non-compliance with the listing agreement. The stock exchanges have to give adequate and wide public notice through newspapers and also give a show cause notice to a company.

Rahul Publications

The exchange shall provide a time period of 15 days within which representation may be made to the exchange by any person who may be aggrieved by the proposed delisting. Where the securities of the company are delisted by an exchange, the promoter of the company shall be liable to compensate the security holders of the company by paying them the fair value of the securities held by them and acquiring their securities, subject to their option to remain security-holders with the company.

Q34. Explain merits and demerits and recent developments of listing.

Ans :

Advantages

1. **Liquidity :** Listed shares can be sold at any recognized stock exchange and converted into cash quickly. Finding out buyers would be easy in the security market through brokers and screen based trading.
2. **Best Prices :** The price quotations and the volume traded regarding the listed shares appear in the news papers. According to the demand and supply of the shares, prices are determined. This results in best price.
3. **Regular Information :** The transactions of the listed shares regularly appear in the news paper, providing adequate information regarding the current worth of the secure. Buying and selling activities can be decided on the basis of the price quotations.
4. **Periodic Reports :** Listed companies have to provide periodic report to the public. Half yearly financial reports should be published in the financial news papers or in any other news papers. In 1985, it has been made obligatory for all listed companies to submit unaudited financial results on a half yearly basis within 2 months of the expiry of that half year. At present quarterly reports have to be published.
5. **Transferability :** Listing provides free transferability of securities. After the incorporation of Section 22-A in the Securities Contract (Regulation) Act, free transfer of shares has been ensured.
6. **Income Tax Benefit :** Income-tax act treats the listed companies as widely need companies. The advantages available to a widely held company are applicable to the listed company.
7. **Wide Publicity :** Since the prices are quoted in the newspaper, the listed companies get wide publicity. This not only does good to the investor but also to the corporate to attract the public for further issues.

Disadvantages

1. **Regulatory :** Listed companies are subjected to various regulatory measures of the stock exchanges and SEBI.
2. **Information Submission :** Essential information has to be submitted by the listed companies to the stock exchanges.
3. **Misuse Expenditure :** Annual general meeting, annual reports have to be sent to a large number of shareholders. This creates large amount of unnecessary expenditure.
4. **Expensive Exercise :** Public offer itself is an expensive exercise. But, this is a prerequisite for the company's shares to be listed.

Recent Developments

Share of the companies listed on exchanges other than the Bombay Stock Exchange and seeking listing on it, will be required to have a minimum market capitalization Rs. 20 crores as against the previous criterion of Rs. 10 crores of issued capital.

The BSE board has decided that companies should have necessarily recorded profits for the last three years, traded on atleast half the total trading days with a minimum of five trades and 500 shares on any given day and have 200 percent of the stock held with the public.

The board also decided to institute awards for investor friendly companies. Categorised into three, companies would be awarded for best returns, being proactive in servicing investor needs and corporate governance. Non-friendly companies and signed category, the exchange has identified 300 such as companies.

Rahul Publications

Q35. Explain the classifications of brokers.

Ans :

The following are the types of brokers. They are,

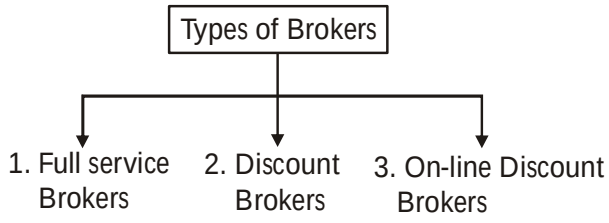


Fig.: Classifications of Brokers

1. Full-service Brokers

Brokerage firms provides huge services to investors in terms of information and advice. Full-service brokers information regarding existing economy, individual companies, bond market etc. Some of the brokers information which the investors get consist of prudential, Paine Webber, Merrill lynch, Morgan Stanley Dean writer etc. These brokers provide necessary advice to customers regarding trading of securities, execute customer's orders, send publications related to individual stocks, industries bonds etc. Full-service stock brokers are otherwise called financial consultants or investment executives because they get their less than 50% income from the services provided to the investors.

2. Discount Brokers

Investors can also avail discount brokers services. The difference between, full-service brokers and discount brokers is that, full-service brokers provides all services by charging fees whereas discount broker provide services at low cost and offer no advice or publications. Some of the popular discount brokers include Charles Schwab, Quick and Reilly, Fidelity investments etc.

According to the survey journal American Association of Individual Investors, the discount brokers have the following,

(i) The commissions they offer differs and the nature of providing their services toward securities trading for investors. The brokers who were earlier on-line brokers charge flat-rate for the services offered.

(ii) Few discount brokers provide information regarding research and investment.

(iii) 62% of discount brokerage firms provide on-line trading by internet.

(iv) Most of the discount brokerage firms facilitates touch-tone phone system to receive information and to place stock orders.

3. On-line Discount Brokers

As the name implies, the on-line discount brokers provide trading of securities and information to investors through on-line trading/internet.

Q36. Discuss the types of brokerage accounts.

Ans :

The following are the types of brokerage accounts,

(i) Cash Account : It is one of the type of brokerage account in which the investors pays the whole price for the purchase of securities to the brokerage house. Customers open margin account because it facilitates investors the facility of borrowing from brokerage firm in order to purchase a security the minimum amount necessary to open, this type of account for NYSE is $ 2000.

(ii) Asset Management Account : This account can be opened by having a minimum balance from $ 1000 to $ 25,000 and the payment of an annual fee (in the following cases),

(a) From zero for discount brokerage like Schwab,

(b) To $100 or more than that for full-service brokerage firms.

This account offers automatic reinvestment associated with account holder's free credit balances in shares for both money market and government fund. Account holders of this type are issued bank checks and a bank card.

Rahul Publications

(iii) Wrap Accounts : It is the new type of brokerage account. All costs such as cost related to broker consultant and money manager, transactions, costs, custody fees, cost of detailed performance reports are wrapped in one fee. Brokers in this type of account can be either middlemen or matching clients with independent money managers.

One of the well-known brokerage house offering this account is Merrill Lynch with five different types of wrap programs to investors and the investors can take decisions related to buy and sell of securities. Other financial companies like bank trusts also provide this type of account. A new type of wrap account is the 'mutual fund wrap account'.

Q37. Explain the classification of orders.

Ans :

There are three types of orders which the investors use. They are,

(i) Market Orders : It is the most common type of order this orders gives instruction to brokers to buy or sell the securities at the earliest at the best price available.

(ii) Limit Order : It instructs a particular price to be met or bettered. Investors have the option of using limit orders as day order for 1 day only, and for open orders which have its effect for 6 months till the orders are cancelled or renewed. Limit orders concerning more than one share are to be filled in whole or in part till completed, unless the order is specified as all or none or immediate or cancel or fire or kill.

(iii) Stop Order : Stop orders are exercised when the price level reaches to a certain extent for buying and selling of securities. A buy stop orders is always above the current market price and the sell stop orders is considered below the current market price. If the stop limit price is met then the stop limit order itself becomes the limit order.

Q38. Explain the cleaning procedures of listing of securities.

Ans :

The settlement date is three business days after the completion of trade date. The customer / investor becomes the sale owner of the securities held by then on the settlement date. Most of the customers prefer to keep their securities in a street name or brokerage firms. The customers receives monthly statements of their securities held and the information regarding funds borrowed from broker on lend etc. The Depository Trust Company (DTC) carry out the transactions of securities by the help of computers. Dealers and brokers processing stock certificate deposit them in an account and these securities are traded to another dealer by following the system if both-keeping.

Time of Settlement

Forward contracts are settled over a period of six days, they are,

1. **First Day :** The memorandum slips are compared by the buying and selling brokers.
2. **Second Day :** The clearance lists are submitted by the brokers to the clearing house. The members lists indicated the balance of securities to be taken or to be delivered and the net amount due in the clearing lists. This is called the ticked day or clearance day.
3. **Third Day :** The day of actual delivery of shares to clearing houses.
4. **Fourth Day :** The fourth day like the third day is also for the purpose of actual delivery of shares to clearing houses.
5. **Fifth Day :** The members submit their statements. Balance in statements is debited or credited to the account of the person. This is also called the 'pay* day' or 'account day'. A member enable to pay his balance before noon the next day after ten pay day is declared a 'defaulter'. If the account of the member is squared up, it is scored out.
6. **Sixth Day** : Sixth day is also known as 'settlement day' when members receive payments from the clearing house.

Rahul Publications

3.9 Security Exchange Board of India (SEBI)

Q39. 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.

Q40. 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.

Q41. 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,

Rahul Publications

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.

Q42. Explain the powers of SEBI.

Ans :

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.

Q43. 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 : **(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

Rahul Publications

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.

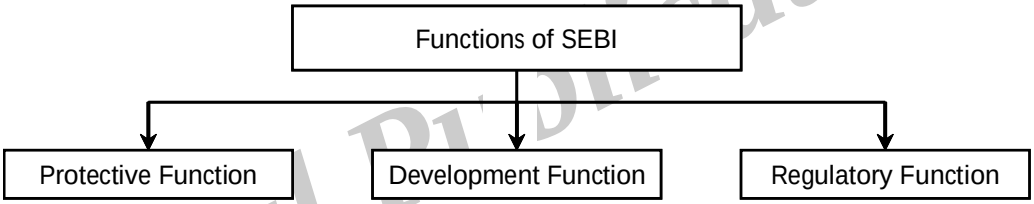
(iv) SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

(v) SEBI promotes fair practices and code of conduct in security market by taking following steps:

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.



Rahul Publications

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.

3.9.1 SEBI Role in Primary Market

Q44. Discuss the Role of SEBI in primary market.

(OR)

Write a note on the role of SEBI in regulating primary market.

(OR)

Explain how SEBI regulates primary markets in India.

(OR)

Elucidate the SEBI guidelines for regulation of primary markets in India.

(OR)

Briefly explain the role of SEBI in the regulation of primary markets in India.

Ans : **(May-19, Dec.-18, Sep.-16, Aug.-15)**

To protect the interest of the investors and to bring back the small investor to the market several measures have been undertaken by SEBI. Entry and disclosure norms are tightened to prevent the exploitation of investors by the unscrupulous promoters. Allocation of shares and promoters' contribution are regulated.

1. **Entry Norms** : SEBI has issued guidelines to tighten the entry norms for companies access sir the capital market.
   i) A company should have a track record of dividend payment for a minimum period of 3 years preceding the issue.
   ii) A company whose shares are already listed would fulfill the entry level requirement only if the post issue networth becomes more the five times the pre issue networth.
   iii) If a manufacturing company does not have such a track record, it could access the public issue market, provided its project is appraised by a public financial institution or a schedule commercial bank. The appraising entity should also participate in the project fund.
   iv) It would be necessary for a corporate body making a public issue to have atleast five public shareholders for every Rs. 1 lakh of the net capital offer made to the public
   v) SEBI would not vet offer documents of companies having a track record of 3 year consistent dividend payment. Likewise, offer documents of companies seeking list - on OTCEI would not be vatted by SEBI. Further banks are required to satisfy the criter of two years of profitability for issues above par.
2. **Promoters' Contribution :** Promoters' contribution means contribution by those described in the prospectus *his* promoters, directors, friends, relatives and associates.
   i) Promoters' contribution should not be less than 20% of the issued capital irrespective of the issue size.
   ii) The entire promoters' contribution should be received before the public issue. If the issue size exceeds Rs. 100 crores, the promoters can bring in not less than 50% of their contribution before opening of the issue and bring in the balance before the calls are made on the shareholders.

Rahul Publications

iii) SEBI announced that not more than 20 percent of the entire contribution brought in by promoters cumulatively in public or preferential issue would be locked in for 5 years. SEBI lifted the provision of lock in period for promoter, contribution in case of listed companies with 3 years track record of dividend payment.

iv) According to the decision taken by the SEBI Board, in case of non-under written public issue promoters could bring own money or procure subscription from elsewhere within 60 days of the closure of the issue subject to such disclosures in the offer document.

3. **Disclosure :** The draft prospectus filed with SEBI is made as a public document to enhance transparency. The draft prospects should provide all the needed information to the investor regarding, the present position of the company, the future prospect and the risk factors associated with the investment of the company. In August 1997 SEBI introduced compendium of disclosure and investor protection guidelines, deleting the provisions that have lost relevance and rationalising the over lapping provision. In accordance with the recommendation of C.B. Bhave committee, SEBI has advised all the listed companies to publish unaudited financial results on a quarterly basis.

4. **Book Building :** Book building has been accepted as one of the modes of public issue. SEBI issued guideline relating to 100 percent book-building in an issue of security to the public through prospectus. It recommended a two-tier underwriting system for book built issues. The syndicate members would be responsible for the primary underwriting and the book runners would take on their liability in case of default. SEBI also stipulated that there should be atleast 30 book building centres with the syndicate members being present at each centres.

5. **Allocation of Shares :** To bring back the small investors to the primary market, the minimum application of share has been reduced from 500 to 200. Proportionate allotment of shares is made. A reservation of minimum 50% of net offers to the small investors is being made. Small investors mean those who have applied for 1000 or fewer shares or securities. The companies were required to complete the allotment of securities within 30 days of the closure of the public issue. There after, they would be required to pay an interest at the rate of 15 percent annum, if refund of application money is not made within the specified period.

6. **Market Intermediaries :** Licensing of merchant bankers or authorization by SEBI was the first step undertaken to regulate the intermediaries. This licensing of merchant bankers is based on the capital adequacy as well as the track record of the capital market related activities. In course of time, other financial intermediaries such as underwriters, registrars and transfer agents came to be licensed. SEBI has the right to inspect the records of the intermediaries.

3.9.2 SEBI Role in the Secondary Market

Q45. Discuss the role of SEBI in secondary market.

(OR)

Write a note on the role of SEBI in regulating secondary market.

(OR)

Explain how SEBI regulates secondary markets in India.

(OR)

Elucidate the SEBI guidelines for regulation of secondary markets in India.

(OR)

Briefly explain the role of SEBI in the regulation of secondary markets in India.

Rahul Publications

Ans : **(May-19, Dec.-18, Sep.-16, Aug.-15)**

SEBI has introduced a wide range of reforms in the secondary market, "he important areas are as given below,

1. Governing Board

Governing board of the stock exchanges were reconstituted according to the SEE's directives. Broker and non-broker representations are made 50:50. Sixty percent of non-broker representation was given in the arbitration, disciplinary and default committees of the exchanges. Regulations regarding the public representatives and the government nominees on the government boards of stock exchanges were issued. As non participants in the market, they have to ensure an impartial and fair governance in the stock exchanges. As per the new guidelines of SEBI, trading members will be given only 40% representation in the governing council of derivatives.

2. Infrastructure

To sophisticate the trade on the stock exchange NSE was established with the screen based trading. Then SEBI has allowed the stock exchanges to expand its on-line screen based trading terminals to locations outside their jurisdiction subjected to certain criteria. SEBI decided that recognition to new stock exchanges would be allowed subject to the conditions on line screen based trading for trade purpose.

3. Settlement and Clearing

Carry forward transactions were withdrawn and reintroduced by SEBI with modified regulations. SEBI notified all stock exchanges to introduce weekly settlement. Besides, auctions have to be conducted by stock exchanges within eight days of the settlement in case members fail to deliver the shares. The renewal of contract in cash groups from one settlement to another is not permitted.

In the case of short sales, in terms of recommendation of the B.D. Shaw committee, SEBI issued directives to all stock exchanges to submit scrip-wise information (for select scrips) on net short sales position at the end of each trading day for dissemination of information to the public.

SEBI advised all the stock exchanges to set up clearing house. Clearing corporations or settlement guarantee fund for expediting the process of dematerialization of securities and settlement transaction in the depository mode. SEBI has introduced rolling the settlement trading in the demat segment for all companies with effect from January 15, 1998.

Warehousing facility has been permitted by the SEBI. The 'warehousing' of transaction facilitates execution of a firm client's order for a large quantity in parts during the same trading cycle and the issue of only one contract note at the weighted average price in the end of the trading cycle. SEBI allowed, institutional investors, FIIs, stock brokers, stock exchanges to make use of the facility of 'warehousing' of trades, subject to certain conditions.

4. Debt Market Segment

Wholesale debt market segment in the NSE enables the traders to trade in debt instruments. To expedite the settlement SEBI (Depository and participants) Regulations 1996, has been amended. It allowed dematerialization of government securities SEBI has allowed the listing of debt instrument on the stock exchange even if the company's equity was not listed earlier. FIIs were allowed to invest up to 100 percent of the funds in debt instruments of India companies through 100 percent, dedicated debt fund.

SEBI has made it mandatory for all the debt instruments to be rated from any one of the authorised credit rating company. Recently, SEBI made dual rating mandatory the issues of size above. Rs: 500 million. By doing this the SEBI expects to put an end to credit sting shopping, which allows a company not to disclose an adverse rating and instead seek a favourable rating from other agency. A company will not be allowed to get a rating from an agency which is its associated firm.

Rahul Publications

5. Price Stabilisation

SEBI has set up a division to monitor the unusual movements in prices, in coordination with the stock exchanges. SEBI has asked stock exchanges to monitor the prices of newly listed permitted scrips from the first day of trading. Necessary circuit breaker system and other market monitoring restrictions could be applied. In case of newly listed scrips, when there is an abnormal price variation, the exchange would impose a special margin of 25 percent or more on purchase in addition to regular margin. The penal margin is retained by the exchanges for a period of three months or one month after delivery. Intra day margin, gross exposure margin, net exposure margin, mark to market margin, concentration margin and special margins are also imposed on the traders by the stock exchanges to reduce the price volatility.

To prevent circular trading and price rigging, SEBI has introduced a host of price filters. Intra day price band permits the stock to be traded within a range during a trading session. It aims at preventing intra day price swings. Inter week price band has a wide range within that stocks are permitted to be traded in a week. It prevents wild swings in prices rippling into the next settlement cycle. SEBI imposed a uniform intra-day price and band of 10 percent for all securities on all stock exchanges, in addition to the 25 percent weekly price cap being followed by all exchanges.

6. Delisting

SEBI tightened the delisting norms by permitting delisting only in accordance with the norms specified by Chandratre committee. The norms are,

i) On voluntary delisting from regional stock exchanges the company would have to make a buy offer of all the shareholders in the particular region.

ii) The promoters would have to buy or arrange buyers for the security and

iii) The listing fees for the years should be taken from the companies at the time of delisting and be kept in Escrow Account with the stock exchange.

7. Brokers and SEBI

The regulation of the functioning of the brokers starts with the registration of the brokers. The registration is given on the basis of the eligibility to be a member of any stock exchange, infrastructure facilities like adequate office space, equipment and man power. He should have past experience in the business of buying, selling or dealing in securities. Capital adequacy norms are laid down depending on the stock exchanges and the members turnover. Registration fees also has to be paid by the brokers.

3.10 CLEARING CORPORATION OF INDIA LIMITED

Q46. Discuss briefly about clearing corporation of India Limited.

(OR)

Explain the role clearing corporation of India Limited.

Ans : **(May-19)**

- The Clearing Corporation of India Ltd. (CCIL) was set up in April, 2001 for providing exclusive clearing and settlement for transactions in money, and foreign exchange markets.
- The prime objective has been to improve efficiency in the transaction settlement process insulate the financial system from shocks emanating from operations related issues and to undertake other related activities that would help to broaden and deepen the money, debt and forex markets in the country.
- The company commenced operations on February 15, 2002 when the negotiated dealing system (NDS) of RBI went live.
- CCIL started providing the settlement of forex transactions since November 2002.

Rahul Publications

- CCIL launched the collateralised borrowing and lending obligation (CBLO) in January 2003, a money market product based on Gilts as collaterals.
- It has developed a forex trading platform "FX-CLEAR" which went live on August 7, 2003.
- CCIL has started the settlement of cross-currency deals through the CLS Bank from April 6, 2005. At the request of RBI,
- CCIL developed and currently manages the NDS-OM and NDS-CALL electronic trading platforms for trading in the government securities and call money. It has also developed the NDS-Auction module for treasury bills auction by RBI.
- CCIL has introduced many innovative products/tools like ZCYC, bond and T-bills indices, sovereign yield curve, benchmark reference rates like CCIL-MIBOR/MIBID and CCBOR/CCBID, etc.
- CCIL regularly comes out with many publications for the benefit of the market participants. The committee identified six 'core promoters' for CCIL - State Bank of India (SBI), Industrial Development Bank of India (IDBI), ICICI Ltd., LIC (Life Insurance Corporation of India), Bank of Baroda, and HDFC Bank.
- The authorised share capital was decided at Rs 50 crore. Banks, financial institutions and primary dealers have 62.5 percent, 20.5 percent and 17 percent shares respectively in CCIL.

Q47. Explain the functions of Clearing Corporation of India Limited.

Ans : **(Dec.-19)**

Provision of guaranteed clearing and settlement functions to various markets. Apart from secondary market, Clearing Corporation also deals with transactions in:

- **Money Markets -** Used to manage their liquidity positions through lending and borrowing loans for period less than one year:
- **Foreign Exchange Markets -** Largest financial market where participants can sell, buy, exchange and speculate on currencies.
- **Government Securities (G-Sec) -** Tradable debt obligation from government to its fiscal deficit.
- **Derivatives Market -** Market for trading instruments derived from other forms of assets namely futures and options.
- **Improving market efficiency -** Ensuring transparency, liquidity and risk management are its prime functions.
- It conducts a background check on the financial strengths of the traders involved, in transactions, in order to avoid failure of performance or partial fulfillment of obligations.
- It offers settlement services to the government.
- Clearing corporation is most helpful in settlement of complex transactions like future contracts. (Where the buyer and seller agree to trade a commodity at a predetermined future price and date).
- CCIL also covers trade settlements for wholesale market entities like banks, insurance companies and mutual funds.
- CCIL acts as a calculation agent to FBIL – Financial Benchmark India Pvt Ltd. It takes responsibility for administering the value of government securities.
- It eliminates the need for any post settlement arbitrations.

Rahul Publications

Short Question and Answers

1. Advantages of Commercial Paper.

Ans :

1. When compared to other sources like bank loans and loans from other financial institutions, commercial papers can provide more funding at a lower interest rate.
2. It a debt instrument trade at the money market, commercial papers are highly liquid and comes with a range of maturities offering investors with high flexibility.
3. It does not contain any restrictions on it. Also, they are highly secure as they are issued by companies with high credit ratings.
4. Companies can save some funds by issuing commercial papers that they had to otherwise pay as interest for bank loans. Investors can earn good returns on them while maintaining the liquidity of the invested amount.
5. These are instruments that produce a continuing source of funds. The reason is the maturity of these funds can be customized to suit the requirements of the issuing entity. Additionally, the matured commercial papers can be repaid by issuing fresh commercial papers at the money market. Thus the company will have to go through minimum losses.

2. Explain the role clearing corporation of India Limited.

Ans : **(May-19)**

- The Clearing Corporation of India Ltd. (CCIL) was set up in April, 2001 for providing exclusive clearing and settlement for transactions in money, and foreign exchange markets.
- The prime objective has been to improve efficiency in the transaction settlement process insulate the financial system from shocks emanating from operations related issues and to undertake other related activities that would help to broaden and deepen the money, debt and forex markets in the country.
- The company commenced operations on February 15, 2002 when the negotiated dealing system (NDS) of RBI went live.
- CCIL started providing the settlement of forex transactions since November 2002.
- CCIL launched the collateralised borrowing and lending obligation (CBLO) in January 2003, a money market product based on Gilts as collaterals.
- It has developed a forex trading platform "FX-CLEAR" which went live on August 7, 2003.
- CCIL has started the settlement of cross-currency deals through the CLS Bank from April 6, 2005. At the request of RBI,
- CCIL developed and currently manages the NDS-OM and NDS-CALL electronic trading platforms for trading in the government securities and call money. It has also developed the NDS-Auction module for treasury bills auction by RBI.
- CCIL has introduced many innovative products/tools like ZCYC, bond and T-bills indices, sovereign yield curve, benchmark reference rates like CCIL-MIBOR/MIBID and CCBOR/CCBID, etc.
- CCIL regularly comes out with many publications for the benefit of the market participants. The committee identified six 'core promoters' for CCIL - State Bank of India (SBI), Industrial Development Bank of India (IDBI), ICICI Ltd., LIC (Life Insurance Corporation of India), Bank of Baroda, and HDFC Bank.
- The authorised share capital was decided at Rs 50 crore. Banks, financial institutions and primary dealers have 62.5 percent, 20.5 percent and 17 percent shares respectively in CCIL.

Rahul Publications

3. STCI

Ans :

STCI Finance Ltd (formerly Securities Trading Corporation of India Limited), is a Systemically Important Non-Deposit taking NBFC registered with Reserve Bank of India (RBI). Presently STCI Finance Ltd is classified as a loan NBFC.

In May 1994, STCI Finance Limited was promoted by RBI with the main objective of fostering an active secondary market in Government of India Securities and Public Sector bonds. RBI owned a majority stake of 50.18% in the paid up share capital of the company. In 1996, the Company was accredited as the first Primary Dealer in the India. As one of the leading Primary Dealers in the country, the Company was a market maker in government securities, corporate bonds and money market instruments. Its other lines of activities included trading in interest rate swaps and trading in equity - cash & derivatives segment. The Company enjoyed a successful track record of achieving profits during consecutive years spanning nearly a decade. RBI divested its entire shareholding in STCI in two stages- first in 1997 to bring it down from 50.18% to 14.41% and the balance in 2002 to the existing shareholders. Bank of India became the largest shareholder in the company with 29.96% stake.

4. What is financial market? Explain the nature financial markets.

Ans :

Meaning

Financial markets are the centre that facilitate buying and selling of financial instruments, claims or services. It caters the credit needs of the individuals, firms and institutions. It deals with the financial assets of different types such as currency deposits, cheques, bills, bonds etc. it is defined as a transmission mechanism between investors and the borrowers through which transfer of funds is facilitated. It consists of individual investors, financial institutions and other intermediaries who are linked by a formal trading rules and communication network for trading the various financial assets and credit instruments.

Nature

- Financial markets are the centre that facilitate buying and selling of financial instruments, claims or services.
- Financial markets are critical for producing an efficient allocation of capital, allowing funds to move from people who lack productive investments opportunities to people who have them.
- It caters the credit needs of the individuals, firms and institutions.
- Financial market deals with the financial assets or instruments of different types such as currency deposits, cheques, bills, bonds etc.
- The main participants in the financial markets are financial institutions, agents, brokers, dealers, borrowers, savers, lenders and others who are interconnected by law, contract and communication networks.

5. Define Call money market.

Ans :

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 are 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.

6. Define Commercial bills.

Ans :

Meaning

A commercial bill or a bill of exchange is a short-term, negotiable and self-liquidating money market instrument which evidences the liability to make a payment on a fixed date when the goods are bought on credit.

It is an asset with high degree of liquidity and a low degree of risk.

RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in this market. Bill of exchange means the liability to make the payment on a specified date when goods are bought and sold.

Rahul Publications

7. Define commercial papers.

Ans :

CPs are short-term usance promissory notes with fixed maturity issued mostly by the leading, nationally reputed, credit-worthy and highly rated large corporations. CPs are also known as industrial paper, finance paper and corporate paper the names depend upon whose liability the paper is. If it the liability of the business or industrial or commercial or manufacturing concern, it is known as industrial or commercial paper.

If it is the liability of the financial company, it can be called either a finance paper. Corporate is a wider term indicating that it is issued by corporations which may be either financial or non-financial. CPs are issued in domestic as well as international financial markets, in the latter they are known as euro-commercial paper.

8. 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.

9. Secondary Market

Ans :

A stock exchange is a market where stocks and shares are bought and sold. It is a place where any individual wishing to buy or sell a particular security can find a ready customer. It is not necessary for the buyer or seller to go to the market personally, neither is he required to haggle over the rates. This is done on his behalf by others who are experts in the line and who make it their profession to buy and sell securities.

They are the members of the stock exchange, through whom alone the public can deal on the market. Of course, any individual can buy and sell shares without a broker and an exchange, but the process of buying and selling would involve great difficulty and delay. The seller, for example, win have to hunt round to find a purchaser who wants to buy exactly those shares which the seller wants to sell and in exactly the same number. Presuming the seller does find a buyer, there would still remain the difficulty of knowing the fair price of the shares. On the other hand, if there is a stock exchange, all that an individual wishes to sell shares need do is to pass on the order to his broker. The potential buyer, who may be some hundreds of miles away, also passes on his order to his broker. The two brokers meet on the "floor" of the exchange to execute the orders and it is a matter of only a few minutes for the transaction to be completed.

Definitions

(i) According to Pyle, "Security exchanges are market places where securities that have been listed thereon may be bought and sold for either investment or speculation." Stock exchanges allow trading in securities both to the genuine investors and speculators.

(ii) According to Securities Contract (Regulation) Act, 1956, "Stock exchange means anybody of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling in securities."

(iii) According to this definition, the stock exchange allows trading in securities under certain rules and regulations.

(iv) According to Husband and Dockeray, "Securities or stock exchanges are privately organized markets which are used to facilitate trading in securities." As per this definition the stock exchanges are the organized places where securities are purchased and sold.

Rahul Publications

10. 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).

11. Powers of SEBI.

Ans :

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.

Rahul Publications

UNIT IV

Asset /Fund Based Financial Services : Lease Finance- Conceptual and Regulatory Framework, Classification and Financial leasing, Hire Purchase and Consumer Credit , Factoring and Forfeiting, Housing finance, Venture capital financing.

4.1 Asset / Fund Based Financial Services

Q1. Discuss briefly about Fund based various financial services.

Ans :

Financial services means the activities benefits and satisfaction that are offered to users and customers. The variety of financial services in the country determines the efficiency of financial system. The main sector which provides the financial services are banks, financial institutions and non-banking financial companies. The service provided by them can be broadly categorised into two parts,

1. Assets / Fund based services.
2. Fee based / Advisory services.

The assets/fund based financial services includes the following services,

1. Equipment leasing/lease financing.
2. Hire purchase and consumer credit.
3. Venture capital.
4. Bill discounting.
5. Housing finance.
6. Insurance services.
7. Factoring.

4.2 Lease Finance

Q2. Define Leasing. Explain the characteristics of leasing.

(OR)

What are the characteristics of leasing?

(OR)

What is lease finance? Explain the characteristics of leasing.

(May-19, Dec.-19, Aug.-19, Aug.-17, Imp.)

Ans :

Meaning

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

1. A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.
2. The document in which this contract is written.
3. A great way companies can conserve capital.
4. An easy way vendors can increase sales.

A lease transaction is a commercial arrangement whereby an equipment owner or Manufacturer conveys to the equipment user the right to use the equipment in return for a rental. In other words, lease is a contract between the owner of an asset (the lessor) and its user (the lessee) for the right to use the asset during a specified period

Rahul Publications

in return for a mutually agreed periodic payment (the lease rentals). The important feature of a lease contract is separation of the ownership of the asset from its usage.

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.

Q3. Explain the Essential Elements of Leasing.

Ans :

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.

Rahul Publications

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.

4.2.1 Classification and Financial Leasing

Q4. Explain the classification of leasing.

Ans : **(Oct.-20, Dec.-19, May-19, June-18, Imp.)**

The lease is broadly classified into two 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 in also known as capital lease.

Finance lease is generally noncancellable in nature and the lesser 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.

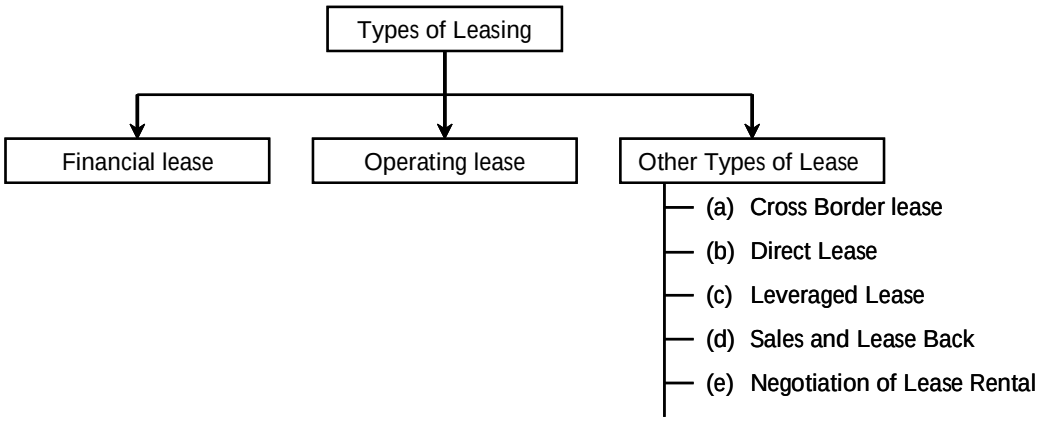


Fig. : Types of Leasing

Rahul Publications

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 considered 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 represented by the break even rental of the lessor and the lessee. 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.

Rahul Publications

Q5. Differences between Financial Lease and Operating Lease.

(OR)

Compare and contrast Financial Lease and Operating Lease.

Ans : **(Dec.-19)**

S.No.	Financial Lease	S.No.	Operating Lease
1.	It is like an installment loan. It is 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.	1.	It is rental agrement. The lessee is not committed to paying more than the original cost of equipment during contractual period.
2.	It excludes provisions for maintenance or taxes which are paid separately by the lessee.	2.	Operating lease provides for maintenance expenses and taxes of the lessor.
3.	The risk of obsolescence is assumed by the lessee.	3.	Leasing company assumes risk of obsolescence.
4.	Contract period ranges form medium to long them.	4.	Contract period ranges from intermeriate to short-term.
5.	Contracts are usually non concellable.	5.	Contracts are usually cancellable either by the lessee or the lessor.
6.	Air crafts, land and building, heavy, machinery are leased.	6.	Computers, office equipments, automobiles, trucks etc., are leased.
7.	The lease involves a financial commitment similar to a loan by a leasing company. It places the lease in a position of borrow.	7.	The financial commitment is restricted to regular rental payment. The rentals find a place in the profit and loss account of the lessee.
8.	The lessor fulfills financial function.	8.	The lessor fulfills service function.

Rahul Publications

Q6. Explain the Legal Aspects of Leasing.

Ans :

In India, separate law for equipment leasing does not exists. The provisions relating to bailment in the Indian Contract Act are treated as same for equipment leasing agreements. Section 48 of the Indian Contract Act defines bailment as,

The delivery of goods by one person to another, for some purpose, upon a contact that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person delivering the goods is called the 'bailor' and the person to whom they are delivered is called the 'bailee'. Provisions of Section 150 and 168 of the Indian Contract Act defined that as equipment lease transaction is treated same as contract of bailment. Hence obligations of the lessor and the lessee will be similar to those of the bailor and the bailee.

The following implications are given by the provisions for the lessor and the lessee,

1. It is the duty of lessor to deliver the asset to the lessee for giving legal authorisation to lessee to use the asset and the asset should be left in possession of the lessee during the currency of the agreement.

2. The lessee has the obligation to pay the lease rentals as mentioned in lease agreement, to protect the lessors title, to take reasonable care protect the lossors title, to take reasonable care of the asset and to return the leased asset on the expiry of the lease period.

Q7. What are the steps involved in Leasing?

Ans :

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.

Q8. 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

Rahul Publications

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.

Q9. Explain the advantages and disadvantages of Leasing.

Ans : **(June-13)**

Advantages

i) Permit Alternative Use of Funds

A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

ii) Faster and Cheaper Credit

Depending on tax structure of the lessee it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going through thorough formal scrutiny procedure. Hence acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

iii) Flexibility

Leasing arrangements may be tailored to the lessee's needs more easily than ordinary financing. Lease rentals can be structured to match the lessee's cash flows. It can be skipped during the months when the cash flows are expected to be low.

iv) Facilities Additional Borrowings

Leasing may increase long-term ability to acquire funds. The lessee can utilize more funds for working capital needs. Acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for additional borrowings in case need arise.

v) Boon to Small Firms

The firms which are either small or have uncertain records of earning are able to obtain the use of asset through lease financing. It is a boon to small firms and technocrats who are able to make promoter's contribution as required by financial institutions.

vi) Hundred Percent Financing

Lease financing enables the firm to acquire the use of an asset without having to make a down payment. So hundred percent financing is assured to the lessee.

vii) No Restrictive Covenants

The restrictive covenants such as debt equity ratio, declaration of dividend etc which are usually imposed under debenture or loan agreement are absolutely absent in a leas agreement.

viii) Protection against Obsolescence

A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

Rahul Publications

Disadvantages

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. Incase 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.

Rahul Publications

4.2.2 Conceptual and Regulatory Framework of Leasing

Q10. Explain the conceptual and 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.

(i) 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:

(ii) General Provisions

The general provisions of contract act as follows:

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

(i) 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.

(ii) A contract must have a lawful consideration i.e., each of the parties to the agreement must give/get something.

(iii) Contract must be made between competent parties i.e., of 18 years of age and of sound mind.

(iv) The parties involved in contract must give free consent which must be free from coercion, fraud, mistake, etc.

(v) The agreement must not be void if so it cannot be legally enforced.

(b) Discharge of Contracts: There are different ways to discharge a contract, some of them includes:

- By performance
- By frustration
- By mutual agreement
- By operation of law and
- By remission.

(c) 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.

- Damages/compensation
- Specific performance
- Suit for injunction
- Suit for quantum merit.

(d) Indemnity and Guarantee: The provisions relating to indemnity and guarantee involved in the contract act are essential for leasing and hire-purchase contracts.

(i) Indemnity: Indian contract Act defines contract of indemnity as "A contract by which are party

Rahul Publications

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.

(ii) 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.

(e) 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.

(i) 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 bailer.
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.

(ii) 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.

Rahul Publications

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.

(iii) 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.

(f) RBI NBFCs Directions: RBI is issuing directions or stipulating certain guidelines from time to time under the RBI act in order to coordinate, regulate and control the operations of all non banking financial companies. These directions are also applicable to leasing and hire-purchase companies.

(g) Other Acts/Laws

(i) Motor Vehicles Act: In motor vehicles act, the lessor is treated as a dealer but the legal ownership rests with in the lessor, the lessee is treated as the owner in order to register the Vehicle under the act. In case of vehicle financed under lease/hire purchase/hypothecation agreement, the lessor is regarded as a financier.

(ii) Indian Stamp Act: Indian stamp act requires payment of stamp duty on all those instruments/documents which creates a right/liability in monetary terms. The contracts for equipment leasing are subject to stamp duty, it changes from one state to another.

Q11. Explain the problems of leasing in India.

Ans :

Leasing has great potential in India. However, leasing in India faces serious handicaps which may bar its growth in future. The following are the some of the problems.

1. Unhealthy competition

There is over supply of lessor in India. The stiff competition between these lessors are force them to reduce their profit margin to bare minimum level. More over subsidiaries of banks and financial institution have competitive edge over private sector lessor due their cheap source of finance.

2. Lack of qualified personnel

Leasing requires qualified and experienced personnel at the helm of its affairs. In India, leasing is of recent one and hence it is difficult to get right man to deal with leasing business.

3. Tax Consideration

In reality, the lessee's tax shelter is lessors' burden**.** The lease becomes economically viable if lessors effective tax rate is low. more over taxes like sales tax, wealth tax, additional tax , surcharge etc, add to the cost of leasing. It makes leasing relatively more expensive.

4. Stamp Duty

States treats the leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as pure lease transactions. Accordingly heavy stamp duty imposed on lease document.

Rahul Publications

5. Delayed payment and bad debts

The problem of delayed payment of rents and bad debts add to the cost of lease. This problem would disturb prospects of leasing business.

4.3 HIRE PURCHASE

Q12. Define Hire Purchase. Explain the features of hire purchase.

(OR)

What do you mean by Hire Purchase? Explain the features of Hire Purchase.

Ans : **(May-19, Dec.-18, Imp.)**

Meaning

Hire purchase is a mode of financing the price of the goods to be sold on a future date. In a hire purchase transaction the goods are let on hire, the purchase price is to be paid in installments and the hirer is allowed an option to purchase the goods by applying all the installments. The ownership of the property remains with creditor and passes on to hirer on the payment of the last installment.

Features

- Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installment.
- Each installment is treated as hire charges.
- The ownership of the goods passes from buyer to seller on the payment of the installment.
- In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as a hire charge.

The hirer has the right to terminate the agreement any time before the property passes. He has the option to return the goods in which case he need not pay installments falling due thereafter. However, he cannot recover the sums already paid as such sums legally represent hire charge on the goods in question.

Q13. Explain the Legal Framework for Hire Purchasing in India.

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:

Rahul Publications

(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 shied 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 assesses, 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 abridge between the lessor and the lessee. Instead of a direct lease an intermediate financier is introduced.

2. Sales tax aspects

The Salient Features of Sales Tax are as follows:

(a) Higher purchase as Sale: Higher-purchase, though not sale in the true sense, is demand 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 higher (hire purchaser) even if the transaction does not fructify in to 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

Rahul Publications

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 states 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 the Income-tax Act.

Q14. Explain the advantages and disadvantages of Hire Purchase System.

Ans : **(Feb.-12)**

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:** Inspite of buyer using the goods carefully if damage occurs then it is the responsibility of the owner to make arrangements for

Rahul Publications

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 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).

Rahul Publications

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 though 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.

Q15. What are the differences between Hire Purchase and Leasing.

(OR)

Compare and contrast Hire Purchase and leasing.

(OR)

Differentiate between Hire Purchase and Lease Financing.

(OR)

Distinguish between Hire Purchase and Lease.

Ans : **(May-19, Dec.-18, Feb.-12)**

S.No.	Nature	Hire Purchase	Leasing
(i)	**Ownership**	The ownership of the goods passes from the buyer to seller on the payment of the installment.	In a contract of lease, the ownership rests with the lessor throughout and the lessee has not option to purchase the goods.
(ii)	**Method of Financing**	Hire purchase is a method of financing both business assets and consumer articles.	Leasing is a method of financing business assets.
(iii)	**Depreciation**	Depreciation and investment allowance can be claimed by the hirer.	Depreciation and investment allowance cannot be claimed by the lessee.
(iv)	**Tax benefits**	Only the interest component of hire purchase installment is tax deductible.	The entire lease rental is tax deductible.

Rahul Publications

(v)	**Salvage value**	The hirer, in purchase, being the owner of the assets, enjoys salvage value of the asset.	The lessee, not being the owner of the asset, does not enjoy the salvage value of the asset.
(vi)	**Deposit**	20% deposit is required in hire purchase.	Lessee is not required to make any deposit.
(vii)	**Rent-purchase**	We buy the goods.	We rent the goods.
(viii)	**Extent of finance**	A margin equal to 20-25 % of the cost of the asset is to be paid by the hirer.	Lease financing is invariably 100 % financing.
(ix)	**Maintenance**	The cost of maintenance of the hired asset is to be borne by the hirer himself.	In case of finance lease only, the maintenance of leased asset is the responsibility of the lessee.
(x)	**Reporting**	The asset on hire purchase is shown in the balance sheet of the hirer.	The leased assets are shown by way of foot note only.

4.4 CONSUMER CREDIT

Q16. Define consumer credit. Explain the features of consumer credit.

Ans : **(Imp.)**

Meaning

The term consumer credit refers to the activities involved in granting credit to consumer-enable them possess own goods meant for everyday use. It is known by several names such as credit merchandising, deferred payments, installment buying, hire purchase, pay-out- of income scheme, pay-as-you earn scheme, easy payment, credit buying, installment credit plan etc.

Definitions

(i) **According to E.R.A. Seligman,** an authority on consumer credit, "The term consumer credit refers to a transfer of wealth, the payment of which is deferred in whole or in part, to future and is liquidated piecemeal or in successive fractions under a plan agreed upon at the time of the transfer."

(ii) **According to Reavis Cox,** an authority on economics of consumer credit, "Business procedure through which the consumers purchase semi-durables and durables other than real estate, in order to obtain from them a series of payments extending over a period of three months to five years and obtain possession of them when only a fraction of the total price has been paid."

Features

The salient features of consumer credit are

1. **Parties to the Transaction :** The parties to a consumer credit transaction depend upon the nature of the transaction. In

(i) A bipartite arrangement, there are two parties, namely, borrower-consumer-customer and dealer-cum-financier.

Rahul Publications

(ii) A tripartite arrangement where the parties are dealer, financier and the customer. The dealer in this type of arrangement arranges the credit from the financier,

2. **Structure of the Transaction :** A consumer credit arrangement can be structured in three ways,

   i) **Hire-purchase :** The customer has the option to purchase the assets. But he may not exercise the option and return the goods according to the terms of the agreement. Most of the tripartite consume credit transactions are of this type.

   ii) **Conditional Sale :** The ownership is not transferred to the customer until the total purchase price including the credit charge is paid. The customer cannot terminate the agreement before the payment of the full price.

   iii) **Credit Sale :** The ownership is transferred to the customer on payment of the first installment. He cannot cancel the agreement.

3. **Mode of Payment:** From the point of view of payment, the consumer credit arrangements fall into two groups,

   i) **Down Payment Schemes :** The down payment may range between 20-25 percent of the cost.

   ii) **Deposit-linked Schemes :** The deposit may vary between 15-25 percent of the amount financed at compound rate of interest. Some arrangements also provide zero deposit schemes with higher Equated Monthly Installment (EMI).

4. **Payment Period and Rate of Interest :** A wide range of options are available. Typically, the repayment period ranges between 12-60 monthly installments. The rate of interest is normally expressed at a flat rate, the effective rate of interest is generally not disclosed. In some schemes, the rate of interest is not disclosed, instead the EMI associated with the different repayment periods is mentioned. Most of the schemes provide for easy repayment. They also provide for either a rebate for prompt payment and charge for delayed payment.

5. **Security :** Security is generally in the form of a first charge on the asset. The consumer cannot sell/pledge/hypothecate the asset.

Q17. Explain the classification of consumer credit.

(OR)

What are the different types of consumer credit?

Ans : **(Sep.-16, Imp.)**

1. Revolving Credit

The types of credit falling under this category usually do not involve a predetermined number of repayments. The best known product in this category is credit cards but there are other types of revolving credit such as lines of credit made available for a consumer to draw upon when needed.

2. Unsecured Finance

Unsecured loans are monetary loans that are not secured against the borrower's assets. These may be available from financial institutions under many different marketing packages,

i) Personal loans

ii) Bank overdrafts

iii) Credit facilities or lines of credit

iv) Corporate bonds

3. Secured Finance

The most common form of secured finance is a home loan. Here are the basics that are universally the same. The first thing you must know that, even though it is secured finance which has relatively fewer risks for the lender than an unsecured loan, it is still a major purchase and a loan of a substantial amount of money for a private individual to borrow.

Rahul Publications

When the credit granted by the financial institution is secured collateral, the collateral is taken by credit in order to satisfy the dept., in the events of defaults by the borrower. The collateral may be in the form of personal property, liquid assets or real property.

4. Cash Loan

Under this type of credit banks or other financial institutions provide money with which the consumer buy article for personal consumption, here the lender and the seller are different. The lender does not have responsibility of a seller.

Q18. Explain the sources of Consumer Credit.

Ans :

The various sources of consumer finance available to people are explained below:

1. Traders

The predominant agencies that are involved in the provision of consumer finance are traders. They include sales finance companies, hire purchase and other such financial (non-bank) institutions.

2. Commercial Banks

Commercial banks take keen interest in providing, directly or indirectly, the finance for consumer durables. Banks lend large sums of money at 'wholesale' rates to commercial or sales finance companies, hire purchase concerns and other such financial intermediaries. Recently, banks have also started directly financing consumers through personal loans, which are meant for purchasing consumer durable goods. Personal loans are granted without a security. They are cheaper than hire purchase credit.

3. Credit Card Institutions

Credit card institutions arrange for credit purchase of consumer articles through the respective banks which issue the credit cards. The credit card system enables a person to buy goods and services on credit. The credit card scheme operates in the following way:

On presentation of the credit card by the buyer, the seller prepares three copies of the sales voucher-the first for the seller, the second for the bank or Credit Card Company and the third for the buyer. The seller gives one copy to the buyer and the other is forwarded to the bank for collection. The seller's bank forwards all such bills to the card issuing bank or company. The bank credits the seller's account and debits the amount to the customer's account. The buyer receives a monthly statement from the card issuing bank or company and the outstanding amount is to be paid within a period of 20 to 45 days without any additional charge. If payment is delayed, bank charges interest per year on the amount outstanding.

4. NBFCs

Non-banking finance companies constitute another important source of consumer finance. Consumer finance companies, also known as small loan companies, personal finance companies or licensed lenders, are non-savings institutions whose prime assets constitute sale-finance receivables, personal cash loans to consumers, short and intermediate-term business receivables, etc. These finance companies charge substantially higher rates of interest than the market rates. Consumers approach them as a last resort. Such companies run an equal risk of high collection charges too.

5. Credit Unions

A credit union is an association of people who agree to save their money together and in turn provide loans to each other at relatively lower rates of interest. These are called cooperative credit societies in India. The first credit union was started in Germany in the year 1848. These are non-profit, deposit-taking and low-cost credit institutions.

6. Middlemen

Middlemen, such as dealers of consumer articles, also grant credit to consumers as part of their promotion campaign. In many cases, dealers work in unison with banks and finance companies, and direct the consumers

Rahul Publications

to the friendly finance companies. This type of arrangement helps dealers maintain a close and loyal relationship with customers.

Q19. Discuss briefly about Consumer Credit Scoring.

Ans :

As part of the evaluation of credit worthiness of a consumer, and for ascertaining the acceptability criteria of customers, some methods are used. Some of the commonly used methods include:

1. **Dunham Greenberg Formula :** Under this method, points are allotted to various aspects of the consumer's loan proposal, the total points being 100. It is composed of the following:

Parameter	Score (points)
Applicant employment record	20
Applicant's income	25
Applicant's finance	10
Type of security offered	20
Past payment record	25
Total	100

An applicant is said to enjoy a good credit standing provided the score is 70 points or above.

2. **Specific Fixed Formula :** According to this method, a score of over 3.5 would indicate an excellent borrower and a score of over 2.5 indicates a marginal borrower. The scheme of scoring is as follows:

Parameter	Credit Score
Age	0.1 – 0.5
Sex	04
Stability of residence	0.042 – 0.42
Occupation	0.16 – 0.55
Industry	021
Stability of employment	0.059 – 0.59
Assets	0.20 – 0.45

3. **Machinery Risk Formula :** This method is prominently used in government offices for granting loans to employees. According to this method, the loan amount to be sanctioned is determined as follows:

Down payment + (0.124 × Monthly income) + (6.45 × Length of service in months).

Q20. What are the advantages and disadvantages of Consumer Credit ?

Ans :

Advantages

Consumer credit plays an important role in the mass production and distribution of consumer durables such as motorcars, refrigerators, TV sets, radios, typewriters, sewing machines, electrical appliances and many other goods. Offering credit is a great convenience to consumers. Further, credit has come to occupy an important place in the modern competitive market. Following are the advantages of consumer credit"

1. Enjoying Possession

An important benefit of consumer credit is that it allows people to enjoy the possession of goods without having to pay for them immediately. The user does not have to wait and save money for purchasing a dream product.

2. Compulsory Saving

Consumer credit allows for a mechanism of compulsory saving. This has this effect of inducing people into using their income more wisely. It promotes thrift among people and enables people with limited to group to acquire goods.

3. Meeting Emergency

Consumer credit is useful in meeting emergencies, such as illness, accident and death, which involve unexpected expenses. This also helps save the esteem of the consumer in dire circumstances.

4. Maximization of Revenue

Consumer credit facilitates speedy disposal of goods, which would have remained unsold

Rahul Publications

in the absence of a credit facility to customers. Credit induces more business. This is quite true with regard to nonessential or luxury goods, such as motorcars, trucks, refrigerators, typewriters, all kinds of electrical appliances, TV sets, sewing machines, etc.

5. Realization of Dreams

Consumer credit is a boon for a consumer who can enjoy the possession of goods without paying for them immediately. The installments can be conveniently paid, spread over a fixed future period. Consumers are in a position to budget for the purchase of even expensive capital items out of their regular, fixed and limited income.

Disadvantages

Despite the fact that consumer credit for costly and durable goods is convenient and beneficial to all parties concerned, one must guard against excess indiscriminate credit demands. Consumer credit suffers from the folk drawbacks:

1. Thoughtless Buying

Consumer credit being attractive tempts people to buy goods indiscriminately. The danger may perhaps lie in acquiring them even if they are not needed.

2. Insolvency

Credit forces people to mortgage a substantial portion of their fixed future income. This may lead to insolvency and bad debts on a large scale, which may even ruin the life of the buyer.

3. Costly Credit

Consumer credit, along with its benefit of convenient buying, brings with it the severe consequence of costliness of credit. This is because; the effective rate of interest is much higher than the paper rate of interest. Moreover, the price of goods sold on credit will usually be higher.

4. Risk to Traders

Consumer credit poses considerable risk to traders. For instance, in the case of hire purchase financing, although the trader enjoys the right of repossession of the goods sold if the buyer defaults on payments, the article cannot be sold at full price that would be sufficient to pay for the remaining installments.

5. Artificial Boom

Consumer credit creates artificial boom in the consumer durable industry. Hence the economy witnesses only artificial prosperity.

6. Bad Debt Risk

Although the various modes of consumer credit generate a substantial amount of revenue for traders, there is always a danger of bad debts. This may jeopardize the interest of the traders many a time. Similarly, granting credit on liberal terms is filled with the problem of negative consequences to the business community, which may have the effect of tremendous on the entire economy too.

4.5 FACTORING

Q21. Define factoring. Explain the features of factoring.

Ans : **(Dec.-19)**

Meaning

Factoring is a fund-based financial service which provides resources to finance receivables and facilitates the collection of receivables. Factoring is defined as a method of financing whereby a company sells its trade debts at a discount to a financial institution. It is a continuous arrangement between a financial institution and a company which sells goods and services to trade customers on credit.

Definition

According to Robert W. Johnson, Factoring is a service involving the purchase by a financial organisation, called a factor of receivables owned to manufacturers and distributors by their customers with the factor assuming full credit and collection responsibilities.

Factoring means an arrangement between a factor and his client which includes at least two of the following services :

Rahul Publications

(a) Finance

(b) Maintenance of accounts

(c) Collection of debts

(d) Protection against credit risk

Features

The features of Factoring & Discounting include :

1. Improved Cash Flow

A better cash flow helps to save time and money, leads to greater profits and increases confidence in future planning.

2. Flexibility

Factoring/Discounting is one of the most flexible forms of finance available to business, as the available funds increase with the value of the credit-approved invoices.

3. Costs

Factors/Discounters usually charge a service fee plus interest on funds utilised. The fees depend on volume of sales and the level of services that are provided.

4. Collections

With its professionalism and weight in the marketplace, a Factor can often collect debts more quickly and effectively then a small independent business.

5. Credit Management

The Factor/Discounter can provide the business with regular, up-to-date information on the status of its sales ledger and the performance fits trade debtors.

6. Credit Protection

The Factor/Discounter undertakes credit checks on the business's debtors and may set a rate for credit protection under a non-recourse arrangement. The Factor/Discounter will pay the business, regardless of whether the invoice has been paid.

7. Credit Assessment

A Factor/Discounter has access to credit reference databases that many businesses may not be able to afford. A Factor / Discounter can advise the business on the credit-worthiness of current and potential debtors.

Q22. What are the objectives of factoring?

Ans :

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

Q23. Explain the functions of Factoring.

Ans :

A factor performs the following functions :

(a) Administration of Sales Ledger

The factor maintains the client's sales ledgers. On transacting a sales deal, an invoice is sent by the client to the customer and a copy of the same is sent to the factor. The ledge is maintained under the open-term method. The customer's account clearly reflects the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables, receipts of payments from the customers and other useful information.

(b) Provision of Collection Facility

The factor undertakes to collect the receivables on behalf of the client relieving him of the problems involved in collection and enables him to concentrate on other important functional areas of his business. This

Rahul Publications

also enables the client to reduce the cost of collection by way of savings in manpower, time and efforts.

(c) Financing Trade Debts

The factor purchases the book debts of his client at a price and the debts are assigned in favour of the factor that is usually willing to grant advance to the extent of 80-85 % of the assigned debts. The balance 15-20 % is retained as a factor reserve.

(d) Credit Control and Credit Protection

This service is provided where debts are factored without recourse. The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to purchase all trade debts of the customer without recourse. There are two important benefits to the client. They are,

(i) Factoring relieves the client of the collection work

(ii) With access to extensive information available on the financial standing and credit rating of individual customers and their track record of payments

Thus the factor is able to advise the client on the credit worthiness of potential customers leading to better credit control.

(e) Advisory Services

These services are spin-offs of the close relationship between a factor and a client. By virtue of their specialised knowledge and experience in finance and credit dealings and access to extensive credit information, factors can provide a variety of incidental advisory services to their clients.

(f) Cost of Services

The factors provide the various services at a charge. The charge for collection and sales ledger administration is in the form of a commission expressed as a percent of the value of debt purchased. It is collected in advance.

Q24. Explain the classification of factoring.

(OR)

Explain different types of factoring.

Ans : **(Oct.-20)**

(i) Recourse and Non-recourse Factoring

In this type of arrangement, the financial institution, can resort to the firm, when the debts are not recoverable. So, the credit risk associated with the trade debts are not assumed by the factor.

On the other hand, in non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.

(ii) Disclosed and Undisclosed Factoring

The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.

Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

(iii) Domestic and Export Factoring

When the three parties to factoring, i.e. customer, client, and factor, reside in the same country, then this is called as domestic factoring.

Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.

(iv) Advance and Maturity Factoring

In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

Rahul Publications

In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

Q25. Explain the Working Mechanism of Factoring.

(OR)

Explain the process of factoring.

Ans : **(Aug.-17, Feb.-15)**

1. Borrowing company or the client sells the book debts to the lending institution (factor).
2. Factor acquires the receivables and extend money against the receivables, after deducting and retaining the following sum, i.e. an adequate margin, factor's commission and interest on advance

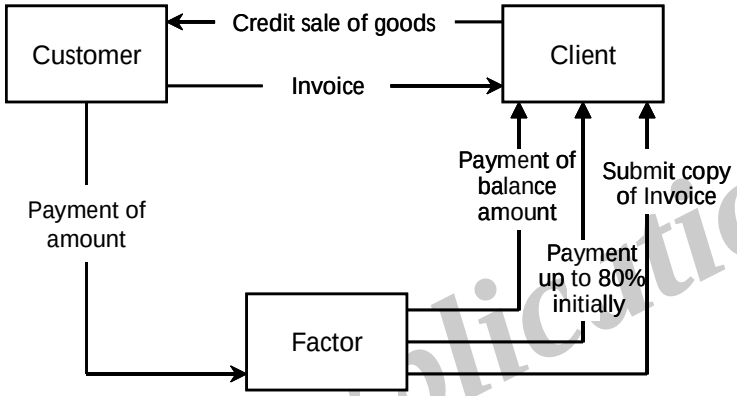


Fig. : Process of Factoring

3. Collection from the customer is forwarded by the client to the factor and in this way, the advance is settled.
4. Other services are also provided by the factor which includes:
   - Finance
   - Collection of debts
   - Maintenance of debts
   - Protection of Credit Risk
   - Maintenance of debtors ledger
   - Debtors follow-up
   - Advisory services

Q26. Discuss the Financial Evaluation of Factoring.

Ans :

For using factoring as a feasible source of short- term financing it is necessary to take into consideration the relative costs and benefits involved in the factoring option. Factoring as an option of financing is assessed in the following manner.

A) Principles of Factoring

The following are the principles which assists in evaluating the factoring as an option of financing,

Rahul Publications

(a) Factoring advance is ascertained based on the average level of receivables factored.

(b) Factoring advance is the average level of receivables factored less the factoring commission, reserve maintained by the factor and the interest or discount charged on factoring.

(c) The receivables associated with costs and benefits are computed based on the Average Collection Period (ACP) on an annual basis.

B) Methods of Evaluation

The methods which are for evaluating the effectiveness of factoring finance are as follows,

1. Next benefit method and
2. Effective rate of interest method.

1. Next Benefit Method

Factoring is treated as a feasible short-term financing option, if the expected benefits are more than the expected costs. In this method, the desirability of factoring is ascertained based on the net benefit occurring I from it.

Net benefit = Expected benefits > Expected costs

2. Effective Rate of Interest Method

In this method, the decision relating to factoring in made based on the effective rate of interest which is incurred due to factoring by the firm.

Q27. Explain the advantages and dis-advantages of Factoring.

Ans : **(Aug.-17, Feb.-15, Imp.)**

Advantages

1. Financial Service

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. The major benefit of the factoring service is that the clients will be able to covert their trade debts into cash upto 80% immediately as soon as the credit sales are over. The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus he can avail of cash discount facilities also.

2. Collection Service

Collection of debts in a problematic area for many concerns. Delay in collection process often leads to delay n production and supplies. This collection work is completely taken up by the factoring organization, leaving the client to concentrate on production along. The cost of collection is also cut down as a result of the professional expertise of a factor.

3. Credit Risk Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the client is assured of complete realization of his book debts. Even is the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client. It is the greatest advantage of factoring.

4. Provision of Expertise Sales Ledger Management Service

Administration of sales ledger is the factor's responsibility. It is the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. Factoring offers an excellent credit control for the client.

5. Consultancy Services

Factors helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters.

Disadvantages

1. The Stigma

The most common thing small business owners don't know about factoring, Napolitano says, is that their customers are

Rahul Publications

notified when a factor takes the receivables over. "The customers are no longer paying you, they're paying the factoring company," he says. That may alert them to your cash flow trouble.

2. Less Control

Once you accept cash for your receivables, you give up a measure of control. For example, the factoring company could deny your ability to do business with a particular customer because of its poor credit history or rating, says Napolitano.

3. The Cost

While it may be necessary to have immediate access to cash, it will come at higher price than loans. Factoring companies usually keep between 1% and 4% of a receivable as their fee. Additionally, Napolitano says, they charge interest on the cash advance, typically at prime rate plus 2%. That all can add up to more than 30% in annual interest.

Q28. Discuss the Factoring Scenario in India.

Ans :

Banks do provide non-banking financial services such as housing finance, leasing and hire-purchase, factoring and forfeiting. An amendment was made in the Banking Regulation Act in 1983, whereby banks were permitted to provide these services either through their own departments or divisions or through their subsidiaries. Direct and indirect lending services were provided by setting up merchant banking and mutual funds subsidiaries.

Factoring and forfeiting services were of recent origin following the recommendation of the Kalyansundarm Committee, set up by the RBI in 1988. The Committee was constituted to examine the feasibility of factoring services in India, their constitution, organizational setup and scope of activities. The group recommended setting up of specified agencies or subsidiaries for providing the factoring services in India.

While attempting to assess the potential demand for factoring services in India, the study group under the leadership of Mr. C. S. Kalyansundram estimated the value of outstanding open account credit sales available for financing during 1989-90 at Rs. 12,000 crores in respect of SSI and Rs. 4500 crores for medium and large scale sector. Assuming only 50% of the above business will be available for factoring, the aggregate potential demand for factoring was expected to be around Rs. 4000 crores per annum mainly emerging from the SSI and large and medium companies.

Rahul Publications

4.6 FORFEITING

Q29. Define forfeiting. Explain the steps involved in forfeiting.

Ans :

Meaning

The term 'forfeit' is a French world. It means 'to surrender something' or 'give up one's right'. Thus forfeiting means giving up the right of exporter to the forfeitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without resource' basis. This means that in case the importer makes a default the forfeiter cannot go back to the exporter to recover the money. Under forfeiting the exporter surrenders his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount. Here the exporter passes to the forfeiter all risks and responsibilities in collecting the debt. The exporter is able to get 100% of the amount of the bill immediately.

Thus he gets the benefit of cash sale. However, the forfeiter deducts the discount charges and he gives the balance amount to the exporter. The entire responsibility of recovering the amount from the importer is entrusted with the forfeiter. The forfeiter may be a bank or any other financial institution.

In short, the non-recourse purchase of receivables arising from an export of goods and services by a forfeiter is known as forfeiting.

Forfeiting is not the same as international factoring. The tenure of forfeiting transaction is long. International factoring involves short term trade transactions. In case of forfeiting, political and transfer risks are also borne by the forfeiter. But in international factoring these risks are not borne by the factor.

Steps :

The following steps are followed in forfeiting,

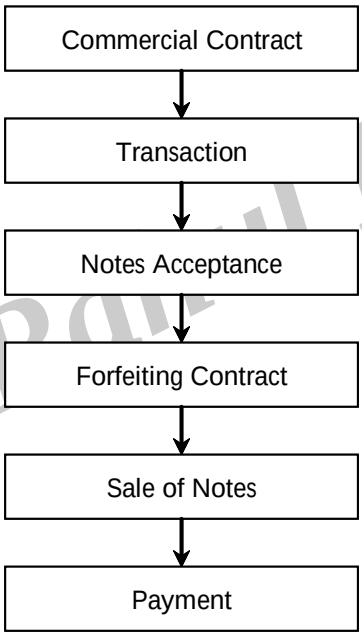


Fig.: Steps in Forfeiting

1. Commercial Contract

A contract is made between the buyer and the seller, which includes the various basic terms like the forfeiting cost, margin to cover risk, commitment cost, grace days, fee to compensate the forfeiter for loss of interest because of transfer and payment delays, forfeiting period, repayment instalment, interest rate and so on. The factoring cost depends on the term of the bill, the denominated currency, the credit rating, the nation, importer's risk and so on.

2. Transaction

The seller sells and delivers the goods to the buyer on the deferred payment system.

3. Notes Acceptance

The buyer accepts the promissory notes in favour of the seller for payment inclusive of the interest charges. These notes are then being sent to the seller. Bank guarantee with respect to the promissory note is also acquired.

4. Forfeiting Contract

The seller and the forfeiting agent signs a forfeiting contract, along with the forfeiter which is mostly re- owned bank inclusive of the seller's bank.

5. Sale of Notes

The seller sells the note or a bill to the forfeiter at a discount without recourse.

6. Payment

The seller makes the payment to the forfeiter as the face value of the note or bill, with less discount. The forfeiter can keep these notes or bills upto their maturity for making payment by the importer's bank or securities them for selling them as short-term high-yielding unsecured paper in the secondary market.

Cost of Forfeiting

(i) Discount fees for offering finance on the basis of the degrees of risk levels in the transaction. Usually, 1 % of the face value of the receivable is being paid as commission but the exporters are ready to pay 15% extra for the additional services.

(ii) Front-end management fee to EXIM bank.

(iii) A commitment fee for one year's undertaking.

Rahul Publications

Q30. What are the characteristics of forfeiting.

Ans :

The main characteristics of forfeiting are:

1. It is 100% financing without recourse to the exporter.
2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'aval').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfeiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

Q31. Explain the elements of forfeiting.

Ans :

The pricing consists of four elements: discount rate, commitment fees, grace days, and handling fee.

1. Discount Rate

Discount rate is the interest element and reflects the cost of funds. It is the rate at which the face value of a negotiable instrument is discounted. The discount rate is usually quoted as a margin over London Inter-Bank Offer Rate (LIBOR). The margin depends upon the country/bank risk and the credit period. A high country risk and longer credit period will attract higher margins.

2. Commitment Fees

The commitment fees is calculated from the date the forfeiter is committed to undertake the financing until the date of discounting.

3. Grace Days

These are the number of days beyond the stated maturity. They represent the anticipated number of days required for transmission and receipt of funds at maturity. It normally ranges from 2-5 days and can extend upto 15 days and beyond.

4. Handling Fee

A handling fee is applicable for documentation and custom clarification.

Q32. What are the advantages and disadvantages of Forfeiting ?

Ans :

Advantages

Following are the benefits of financial assistance through forfeiting:

1. Simplicity and Flexibility

Forfeiting provides service in such a manner to meet the needs of the exporters and importers. One of the greatest advantages of forfeiting is its simplicity and flexibility. Forfeiting can be used to finance any export transaction. This technique is highly useful for medium-term fixed rate financing.

2. Non-Recourse Basis

Since the transaction does not have a recourse basis, it helps the exporters convert their credit sale into a cash sale.

3. Fixed Interest Rate and No Currency Risk

Where the exporter's bankers are not quick enough to provide additional credit limit for extended period, the forfeiting route, with the advantage of a fixed interest rate and no currency risk, acts an export facilitator.

4. No Need to Carry Receivables

The biggest advantage of forfeiting is that exporters do not have to carry the receivables in their balance sheet.

Rahul Publications

5. EXIM Bank

The exporters do not deal with the forfeiter. Instead, the EXIM bank does everything for them.

6. No Hassles of Collection

Exporters are saved of all the hassles in collecting dues as once sold to the forfeiter, they are out of the transaction.

7. Simple Documentation

Documentation procedure is simple and, therefore, it provides an opportunity to structure the deal.

8. Measure of International Risk

Forfeiting is a very good measure of international risk. Therefore, now Indian banks are allowed to discount their overseas customers' bills without adding their name.

Initially, forfeiting was used mainly for capital goods but the situation today has changed and the forfeiting company is now willing to look at smaller export orders.

Disadvantages

1. High Interest Rates

The main disadvantage is the high interest rates and the fact that the forfeiter assumes the risk.

2. Unfavourable Exchange and Administrative Controls

The exchange and administrative controls in some countries are not favorable for forfeiting.

3. Reluctant Importers

Importers are often not very willing to offer collateral or a guarantee.

4. No Legal Framework

There is, presently, no legal framework to protect the banker or forfeiter except the existing covers for the risks involved in any foreign transactions.

5. Insufficient Data

Data available on credit rating agencies or importer or foreign country is not sufficient. Even EXIM bank does not cover high-risk countries like Nigeria.

Rahul Publications

Q33. Distinguish between Factoring and Forfeiting.

(OR)

Compare and contrast Factoring and Forfeiting.

Ans : **(May-19, Feb.-16, Imp.)**

Factoring	Forfaiting
1. Used for short term financing.	1. Used for medium term financing.
2. May be with or without recourse.	2. Always without recourse.
3. Applicable to both domestic and export receivables.	3. Applicable to export receivables only.

4. Normally 70 to 85% of the invoice value is provided as advance.	4. 100% finance is provided to the exporter.
5. The contractor is between the factor and the seller.	5. The contract is between the forfeiter and the exporter.
6. Other than financing, several other things like sales ledger administration, debt collection etc. is provided by the factor.	6. It is a financing arrangement only.
7. A bulk finance is provided against a number of unpaid invoices.	7. It is based on a single export bill resulting from only a single transaction.
8. No minimum size of transaction is specified.	8. There is a minimum specified value per transaction.

4.7 HOUSING FINANCE

Q34. Define Housing finance. Explain the Evolution of Housing finance.

Ans :

Meaning

Housing finance is considered as a separate sector. It does not come under the service sector or the manufacturing sector. Five year plans have been emphasizing on the need for promoting housing finance schemes particularly for the poorer and weaker sections of the society.

Evolution

National Housing Bank was set up in July 1988 with the equity support from the Reserve Bank of India and is proposed to act as the APEX institution for. Coordinating and developing the housing finance schemes. In 1989, the UTI (Now known as 'Axis') set up, a Housing and Construction Investment Fund for direct investment in construction projects and real estate' development. The entry of Life Insurance Company and General Insurance Company and many banks like State Bank of India and Canara Bank through their subsidiaries has been stated to be another landmark in the promotion of housing industry.

Banks have been directed by the Reserve Bank of India to handle the housing financing as a priority sector as follows,

1. Banks are permitted to allocate 1.5% of the incremental deposits far housing finance purposes.
2. About 30% of this allocation will go by way of direct lending of which half of the amount will be ear marked for rural and semi-urban areas.
3. About 40% of the banks allocation will go as term loans to HFCs housing boards and public housing agencies.
4. The rest of the 4% will be provided in the form of subscription to guaranteed bonds and debentures of NHB, HOC, HUDCs etc.

Some banks have started housing finance directly like the corporation bank, while the others have done this through their subsidiaries, like corporation banks, SBH and ICICI.

In India, there is an ever expanding gap between the supply and demand for housing. The shortage of housing is estimated at 7.57 million in urban areas and 13.66 million in rural areas. The funds requirement

Rahul Publications

of this order of housing construction is estimated at Rs. 1,50,000 crores. With a population growth at 2.2% p.a. and increasing trend to breakdown of joint family system, the individual family units will grow and the requirements for housing will grow onward. A differentiating feature of housing industry is that here is a large component of demand for housing finance from real estate developers and speculators.

The housing industry suffers from high volumes and low margins. Most HFCs concentrate on financing of high Income and middle income group housing requirements and not rural and low income group segments. The failure rate of repayments of housing finance installments is more in the latter category. Depending upon the flow of black money into this industry, another aspect of housing industry is that there are stages of growth and recession. NRI's are allowed to invest in housing construction, ownership and real estate development, but the flow of funds from housing sector is insignificant.

Q35. Explain the Recent Development in Housing Finance.

Ans :

Some recent developments in the housing finance sector are as follows,

1. The banks have set up their own housing finance subsidiaries like SBI Home Finance Ltd., PNB Housing Finance Ltd., Canfina Homes Ltd., Ind Bank Housing Finance Ltd. etc., which accelerated the mortgage housing movement in India recently.
2. Since 2000, many private sector banks like ICICI bank and HDFC bank have entered the ravel in a Dig way.
3. In 1991, the Life Insurance Company entry into direct household mortgage loan field through Life Insurance Company 'Housing Finance Ltd'.
4. Permission, for NRIs to enter into real estate investment in India.
5. In 1990, the entry of General Insurance Company into time loan extension process, through a subsidiary, namely, General Insurance Company 'Griha Vitta Ltd'.
6. In 1989, the floatation of housing and construction Investment Fund by Axis (UTI).

Q36. Explain the features of Housing Finance.

Ans :

1. Reserve bank controls the commercial and cooperative banks in respect of their housing finance schemes.
2. The existing maximum amount of any bank's advances for housing purposes continues to be 1.5% of incremental deposits.
3. In order to provide flexibility to banks in the development of their allocated funds, sub-allocations into those for direct- finance or investment in bonds of NHB/HUDCO were completely removed.
4. Any investments by banks in special bonds issued by NHB/HUDCO were to be considered as part of priority sector advances of banks.
5. NHB continued to develop the housing finance sector through its regulatory and developmental role.
6. During 1996-97, NHB has deregulated the interest rates paid on deposits accepted by Housing Finance Companies, with network of Rs. 50 laks and above. Similarly their ending rates for all loans above Rs. 50,000 are freed even for the purpose of recognition by NHB for its refinance schemes.
7. It has also introduced a refinance scheme for the Regional Rural Banks, for their housing finance advances.
8. HUDC was incorporated as a fully owned government company with the role objective of facilitating and promoting the financing of the housing and urban development projects in the country.
9. HUDC's resources are raised from term loans from GIC and its subsidiaries, NHB, Government loans, under various schemes linked to external agencies like OECD, government guaranteed bonds, borrowing

Rahul Publications

from banks, HUDC bonds, interest bearing cash securities from borrowing agencies and public deposit schemes etc.

Q37. Discuss the various banks Financing the Housing Finance Policy.

(OR)

Explain about Housing Finance in India.

Ans : **(Dec.-19, Imp.)**

1. Housing and Urban Development Corporation (HUDC)

HUDC is approved by the government for financing the urban infrastructure development projects. HUDC and NHB are working together in the field of housing.

i) HUDC is an agency for implementing government programmes, for reducing the manual hunting, for providing cover to the poor and for low income groups. HUDC has been giving loans through urban local boards, housing boards, slum boards etc.

ii) HDFC supports the efforts of other agencies in housing finance field. IIDFC gets its resources from deposits of public, refinance from national housing bank, term loans, bonds etc.

iii) HDFC provides finance through loans to co-operatives, companies, institutions, for building houses.

iv) HDFC also provides individual loans for helping low cost housing projects for the poor SC/ST/BC etc., which has been given due attention by the HUDC.

v) These agencies are coordinated by national housing bank and the government. The Reserve Bank of India has been a responsibility for bank finance in areas which are underdeveloped through their directives to banks for housing purposes.

2. National Housing Bank (NHB)

i) The national housing bank was set up by the Reserve Bank of India as a fully owned subsidiary. National Housing Credit (NHC) Fund was started to make funds available to NHB for refinance facilities that it makes available to banks, housing finance companies, cooperative housing financial societies etc.

ii) National housing bank has given a vital role by the government and planning commission, to the provision of housing finance in India.

iii) The RBI has permitted banks to allot one and half percent of their incremental deposits for housing finance purposes.

iv) The institutions engaged in housing (finance, require long-term funds. That is why LIC and GIC have entered this field as they have the long-term insurance funds with them.

v) Some public sector banks have set up subsidiaries for housing finance.

- State Bank of India House Finance, set up in Ap' 1988 has started lending in Eastern and Northeastern States in India.
- Canfina Homes Limited by Canara Bank.
- Ind Bank Housing Financial Services by Indian Bank and
- Andhra Bank Homes Finance Ltd., by Andhra Bank.

vi) In May 1988, the National Housing Policy was announced for promoting expansion of housing facilities in a planned way for all classes of population, particularly the weaker and backward classes in the form of a separate entity to guarantee the payment of principal and interest, namely India Mortgage Credit Guarantee corporation (1MCGC).

The national housing bank has formulated some schemes linking saving using loans like Home Loan Account Scheme. The amount of loan that a saver can get is linked to the amount that he has saved in his account. This scheme is operated by banks, commercial and cooperative.

Rahul Publications

3. Housing Development and Finance Corporation (HDFC)

In the private sector, the housing development and finance corporation was set up by ICICI, which accepts long-term deposits and raises funds through bonds, for housing finance.

i) The HDFC has initiated two schemes as follows,

- Home Savings Plan and
- Home Loans (Individuals) Scheme.

ii) HDFC loans to companies and institutions to finance their house construction for employees, staff quarters etc.

iii) HDFC loans granted by Life Insurance Company (LIC). General Insurance Company (GIC) and housing subsidiaries of banks are for small amounts of a few thousands to few lakhs. The interest rates vary from one and half to 18% depending upon the period of maturity and amount of loan.

iv) HDFC has opened up a variety of housing loans such as group loans, housing complexes, societies etc. Its sources of funds are public deposits, term loans from banks, bonds and refinance from NHB.

Q38. Explain the various schemes of Housing Finance.

Ans :

The housing financing companies housing schemes are following types,

1. For purchase of a new house for undertaking extensions/repairs, straight loans against mortgage of the house.
2. Loans related to savings made by the customer over a period of time.
3. Special approval of loans to those who have placed deposits with the company.

The housing schemes have many attractive features. In stuff they are the same whereas the terms and conditions under which they offer loans may differ.

1. Special treatment is given to the individuals who save with them in the form deposits with them.
2. The loan proceeds after the approval of loans against first mortgage of the house/flat bought by housing finance companies.
3. According to the requirements of the borrower, repayment schedule is adjusted.
4. Repayment period ranges from 15 to 20 years for which the minimum rate of interest on the highest slab of offering is 17% and the loan amount is a maximum of Rs. 10 lakhs.

Q39. Discuss the major issues of Housing finance in India.

Ans :

The housing sector in India has been put under a lot of strain since independence. Builders and developers too face varied problems. The major issues facing the Indian housing financial sector are discussed below,

1. Archaic Laws

There are certain legislations that hamper the growth of housing finance in India. For instance, the archaic Urban Land Ceiling Regulation Act (ULCRA) has been a failure in the Indian housing finance system. The act has only helped contribute towards the galloping prices of land, because it has failed to release adequate land for the purpose of housing development and financing.

2. Lack of Clear Title

Another major issue confronting Indian housing is the lack of clear title to property. Around 90 percent of all the land in India does not have a clear title. The ownership is unclear and hence the land is off the market, thereby creating scarcity of land. This problem could be attributed to poor record keeping and complicated processes.

Rahul Publications

3. High Stamp Duty

The cost of transferring land, stamp duty and registration charges payable are prohibitively high. This dissuades people from seeking housing development and financing. Moreover the procedure followed is also not transparent.

4. Obsolete Rental Laws

Obsolete tenancy and rental control laws keep a large part of the urban properties off the market. The rental laws must be revised to protect the owner and the property from the tenant. It is incumbent that steps are taken to get rid of all the old tenancies, remove restrictions on increase of rentals and empower owners to reclaim their properties without any court proceedings, which currently may even take decades.

5. Foreclosure Laws

Though the level of foreclosure for the housing finance companies are relatively low at around 1.5 to 2 percent, the foreclosure laws are obsolete and outdated. The laws for non-payment of Equated Monthly Installment (EMI) and consequent foreclosure and repossession of the property must be revised.

6. Inadequate Building Codes and Standards

Although there are several building guidelines and standards in various cities and states, neither the housing developers follow them and nor do the authorities implement them. The system needs to be made more transparent and direct, so that there is no room for ambiguity and confusion. Presently too much of paperwork- in the form of different permissions that needs to be obtained from too many authorities.

7. Inadequate Development and Planning

The city or state authorities must use professionals to plan and execute ail development plans for cities and towns, with future development in mind. This must be done without any political compulsions. The plans must be prepared in advance and executed without any exceptions and all regulations must be strictly enforced.

8. Inadequate Infrastructure

This is one problem area which needs to be tackled on a war footing. Most Indian cities lack the infrastructure since they fail to keep pace with the growth in population and development. The central and state governments must provide sufficient power, water and roads to cope with the growth.

9. Recognition of Housing as an Industry

This is one issue that the government cannot afford to ignore any longer. The Indian real estate industry has been lagging behind the rest of the world for too long and this is one industry which can provide a boost to the overall economy.

10. Slum Clearance and Public Housing

Developing countries sought to solve the problems of poverty and housing deficiencies by removing the poor from slum neighborhood and rehousing them in more durable shelters. The failure of these policies led many developing countries to try massive public housing construction during the sixties and the seventies. The problems of the poor were defined primarily by the condition of their housing.

11. Land Supply

The limited supply of land, which accounts for 75 percent of the housing costs in urban areas, makes it the most valuable factor of production. The ULCRA and the Land Acquisition Act (LAA) further constrain land availability. In Delhi, for instance only 34 percent of the total usable land is available for housing. The ULCRA, which was enacted in 1976 to prevent profiteering and speculation, banned individuals or companies from holding vacant land above certain city-specific limits.

12. Rent Control Act

Land is just one hurdle in housing sector development. The antiquated act was

Rahul Publications

originally meant to protect tenants from greedy landlords. It did that but ended up hurting the landlord by legalizing payment of ridiculously low rents.

13. Peal-estate Mortgages

Even after ULCRA has revoked the implementation of the RCA, the cost of housing is unlikely to fall significantly, given the huge demand potential. At best, the price-increase will only be moderate. To bridge, the huge price-incoming gap, government needs to liberalise housing finance by creating a mortgage market, but the pace of reforms could be affected by state-specific restrictions on the sale and resale of residential portions.

4.8 VENTURE CAPITAL FINANCING

Q40. What is Venture Capital Financing? Explain the characteristics of Venture Capital Financing.

(OR)

State the features of venture capital.

Ans : **(Oct.-20, Dec.-18, Aug.-17, Imp.)**

Meaning

The term venture capital comprises of two words, namely, 'venture' and 'capital'. The term 'venture' literally means a 'course' or 'proceeding', the outcome of which is uncertain (i.e., involving risk). The term capital refers to the resources to start the enterprise. Thus venture capital refers to capital investment in a new and risky business enterprise. Money is invested in such enterprises because these have high growth potential.

A venture capital company can be broadly defined as a financing institution, which joins entrepreneur as a co-promoter in a project and shares the risks and rewards of the enterprise.

Venture capital has the response of investible funds to capitalise an opportunity to earn very high returns as compared to conventional security backed lending, by enabling high risk but high promise projects to realise their full potential. The growth of venture capital is typically the response to the demand created for more risk bearing funds, to finance commercialisation of few technologies and innovative market solutions.

Venture Capital Funds play an important role in supplying management and marketing expertise also to such units the list of assisted industries may vary, but electronics, chemicals, plastics, biotechnology, high profitability and high and new technology and young, first generation, small entrepreneurs.

The form of investments of Venture Capital Funds varies from company to company, but they are usually characterized by substantial control over management decisions, some protection against downside risk, and a share in capital appreciation.

Characteristics

The main characteristics of the venture capital are long time horizon, lack of liquidity, high risk, equity participation and participation in management.

- **Long Time Horizon**: Venture financing is a long-term illiquid investment; it is not repayable on demand. It requires a long-term investment attitude that necessitates the venture capital firms to wait for a long-period, say 5 to 10 years, to make substantial profits.
- **Lack of Liquidity:** Because venture capital investment is made in private companies, the investments are illiquid until the company goes public or is sold and the proceeds are distributed to the limited partners. This illiquidity is inherent in the nature of the securities that venture capitalists' purchase and in the stages of development that a typical partnership must go through.
- **High Risk**: Within a given portfolio of venture capital investments the returns will vary widely. A few will return many times the initial investments, others will fail completely, and many will simply struggle and become part of what is commonly known as 'the living dead'.
- **High Returns**: Venture capital has historically achieved high rates of return. But venture capital performance has also varied

Rahul Publications

greatly. This wide variation in returns over time emphasizes the importance of diversifying across time as well as industry and stage of investment.

- **Equity Participation**: Actual or potential equity participation through direct purchase of shares, options or convertible securities. The objectives are to make capital gains by selling off the investment once the enterprise becomes profitable.
- **Participation in Management:** Continuing participation of the venture capitalist in the management of the entrepreneur's business. This hands-on management approach helps him to protect and enhance the investment by actually involving and supporting the entrepreneur. More than finance, a venture capitalist provides his marketing technology, planning and management skills to the new firms.

Q41. Explain the importance of Venture Capital Financing.

Ans :

The importance of VCF can be explained as follows,

1. Benefits to investing Public

a) The investors would be able to reduce or avoid risk by investing in venture fund as these venture capital institutions invest in a profitable venture out of their experience and knowledge.

b) Venture capital institutions analyses the business prospects very carefully.

2. Benefits to Promoters

a) Public issue of equity share involved lots of efforts such as statutory obligations, underwriting and brokers arrangement. Venture fund eliminates all these efforts.

b) In order to go public, it needs large amount of investment for maintaining share registry cell, stock exchange listing, fee, printing and posting expenditure of annual reports. Assistance from venture funds does not incur such expenditure.

3. Benefits in General

a) The time period between a technological innovation and its commercialization is reduced.

b) Develops new processes and products.

c) Assists in business borrowings.

d) Improves the productivity and better utilization of capacity.

e) Paves the way for the private sector to share the responsibility with public sector.

Q42. 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.

Q43. 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 :

Rahul Publications

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 present 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:

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

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 × Estimated revenue multiplier

Rahul Publications

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.

Q44. Explain the Venture Capital Financing Scenario in India.

(OR)

Discuss the strategic role of Venture Capital financing in the development of a country.

Ans : **(Dec.-18, Imp.)**

Prior to independence, we had one formal venture capital type of financing in our country. The Tata Group's Investment Corporation of India successfully promoted a number of enterprises like Associated Bearings, National Rayons and Ceat Tyres in that area. These enterprises were hi-tech areas at that time. However, in the post independence period, the government term-lending institutions eclipsed such ventures.

Under public sector auspices, venture capital fund was first started by Industrial Finance Corporation of India (IFCI). It started the Risk Capital Foundation (RCF) way back in 1975. This has been converted into a company known as Risk capital and Technology Finance Corporation Ltd., (RCTFC) as a subsidiary of the IFCI with effect from 12th January 1988 for providing technology development finance. It is funded by the Unit Trust of India, the IFCI and the World Bank. In 1976 the seed capital scheme was introduced by IDBI. Till 1984 venture capital took the form of risk capital and seed capital. In 1986 ICICI launched a venture capital scheme to encourage new technocrats in the private sector in emerging fields of high-risk technology.

Consequently, Government of India felt the need of venture capital funds in India in the context of structural development and growth of small-scale business enterprises. In 1986-87 a 5 per cent cess was levied on all know-how payments to create a venture capital fund by IDBI. The ICICI also became a partner of the venture capital industry in the same year.

During 1988-89 the new and young entrepreneurs were facing difficulties to raise equity capital from the conventional market. Under the circumstance, the scheme to launch venture capital funds was formulated. Initially, a fund under the nomenclature of 'venture capital fund' was required to be established with certain corpus for being invested in the new and young firms with high potential of returns. Government decided to allow then concessional treatment of capital gains arising out of liquidation of equity holding in the assisted firms.

At present, several venture capital firms are incorporated in India. The Indian venture capital industry is just about a decade old as compared to that in Europe and US. In this short span it has nurtured close to 1000 ventures, mostly in SME segment and has supported budding technocrat/ professionals all through. The VC industry, through its investments in high growth companies as well as companies adopting newer technologies backed by first generation entrepreneurs, has made a substantial contribution to economy.

The Indian venture capital industry is dominated by public sector financial institutions. A few private sector venture capital firms have been set up recently. At present three are about fifteen venture capital funds in India that have provided venture finance of over Rs. 4.6 billion to several ventures. VCFs in India are not pure venture capitalists. They pursue both commercial as well as developmental objectives.

Venture finance is made available to high-tech as well non-tech businesses. A large number of high-tech ventures financed by VCFs are in thrust areas of national priority such as energy conservation, quality upgradation, advanced materials, biotechnology, reduced material consumption, environment protection, improved international competitiveness, development of indigenous technology, etc.

Q45. Explain the Exit strategies of venture capital financing.

Ans :

Exit Strategies of Venture Capital Financing

Exit strategies are followed by VCF as the last stage, in order to realize the investment and

Rahul Publications

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

Goint 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 (v) 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 VCIs 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.

Rahul Publications

(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 VCUs 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 VCIs 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 VCIs 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

Rahul Publications

predetermined route. For example in case of a loan the loan the loan can be terminated only at the completion of its time period. If the loan allows then a port 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 VCF of the likely return on the loan.

Q46. Explain various stages of venture capital financing.

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

Venture capital takes different forms at different stages of a project. The various stages in the venture capital financing are as follows:

1. Early stage financing:

This stage has three levels of financing. These three levels are:

(a) Seed financing: This is the finance provided at the project development stage. A small amount of capital is provided to the entrepreneurs for concept testing or translating an idea into business.

(b) Start up finance / first stage financing: This is the stage of initiating commercial production and marketing. At this stage, the venture capitalist provides capital to manufacture a product.

(c) Second stage financing: This is the stage where product has already been launched in the market but has not earned enough profits to attract new investors. Additional funds are needed at this stage to meet the growing needs of business. Venture capital firms provide larger funds at this stage.

2. Later stage financing

This stage of financing is required for expansion of an enterprise that is already profitable but is in need of further financial support. This stage has the following levels:

(a) Third stage/development financing: This refers to the financing of an enterprise which has overcome the highly risky stage and has recorded profits but cannot go for public issue. Hence it requires financial support. Funds are required for further expansion.

(b) Turnarounds: This refers to finance to enable a company to resolve its financial difficulties. Venture capital is provided to a company at a time of severe financial problem for the purpose of turning the company around.

(c) Fourth stage financing/bridge financing: This stage is the last stage of the venture capital financing process. The main goal of this stage is to achieve an exit vehicle for the investors and for the venture to go public. At this stage the venture achieves a certain amount of market share.

(d) Buy-outs: This refers to the purchase of a company or the controlling interest of a company's share. Buy-out financing involves investments that might assist management or an outside party to acquire control of a company. This results in the creation of a separate business by separating it from their existing owners.

Q47. What are the advantages of Venture Capital?

Ans :

Venture capital has a number of advantages over other forms of finance. Some of them are:

1. It is long term equity finance. Hence, it provides a solid capital base for future growth.
2. The venture capitalist is a business partner. He shares the risks and returns.
3. The venture capitalist is able to provide strategic operational and financial advice to the company.

Rahul Publications

4. The venture capitalist has a network of contacts that can add value to the company. He can help the company in recruiting key personnel, providing contracts in international markets etc.
5. Venture capital fund helps in the industrialization of the country.
6. It helps in the technological development of the country.
7. It generates employment.
8. It helps in developing entrepreneurial skills.
9. It promotes entrepreneurship and entre-preneurism in the country.

Rahul Publications

Short Question and Answers

1. State the features of venture capital.

Ans :

The main characteristics of the venture capital are long time horizon, lack of liquidity, high risk, equity participation and participation in management.

- **Long Time Horizon**: Venture financing is a long-term illiquid investment; it is not repayable on demand. It requires a long-term investment attitude that necessitates the venture capital firms to wait for a long-period, say 5 to 10 years, to make substantial profits.
- **Lack of Liquidity:** Because venture capital investment is made in private companies, the investments are illiquid until the company goes public or is sold and the proceeds are distributed to the limited partners. This illiquidity is inherent in the nature of the securities that venture capitalists' purchase and in the stages of development that a typical partnership must go through.
- **High Risk**: Within a given portfolio of venture capital investments the returns will vary widely. A few will return many times the initial investments, others will fail completely, and many will simply struggle and become part of what is commonly known as 'the living dead'.

2. Compare and contrast Factoring and Forfeiting.

Ans :

Factoring	Forfaiting
1. Used for short term financing.	1. Used for medium term financing.
2. May be with or without recourse.	2. Always without recourse.
3. Applicable to both domestic and export receivables.	3. Applicable to export receivables only.
4. Normally 70 to 85% of the invoice value is provided as advance.	4. 100% finance is provided to the exporter.
5. The contractor is between the factor and the seller.	5. The contract is between the forfeiter and the exporter.
6. Other than financing, several other things like sales ledger administration, debt collection etc. is provided by the factor.	6. It is a financing arrangement only.

3. Define factoring.

Ans :

Meaning

Factoring is a fund-based financial service which provides resources to finance receivables and facilitates the collection of receivables. Factoring is defined as a method of financing whereby a company sells its trade debts at a discount to a financial institution. It is a continuous arrangement between a financial institution and a company which sells goods and services to trade customers on credit.

Rahul Publications

Definition

According to Robert W. Johnson, Factoring is a service involving the purchase by a financial organisation, called a factor of receivables owned to manufacturers and distributors by their customers with the factor assuming full credit and collection responsibilities.

Factoring means an arrangement between a factor and his client which includes at least two of the following services :

(a) Finance

(b) Maintenance of accounts

(c) Collection of debts

(d) Protection against credit risk

4. Define Leasing.

Ans :

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent.

Lease can be defined as the following ways:

(i) A contract by which one party (lessor) gives to another (lessee) the use and possession of equipment for a specified time and for fixed payments.

(ii) The document in which this contract is written.

(iii) A great way companies can conserve capital.

(iv) An easy way vendors can increase sales.

5. 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. Infact finance lease in also known as capital lease.

Finance lease is generally noncancellable in nature and the lesser 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.

6. Operating Lease

Ans :

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.

Rahul Publications

7. Differences between Financial Lease and Operating Lease.

Ans :

S.No.	Financial Lease	S.No.	Operating Lease
1.	It is like an installment loan. It is 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.	1.	It is rental agrement. The lessee is not committed to paying more than the original cost of equipment during contractual period.
2.	It excludes provisions for maintenance or taxes which are paid separately by the lessee.	2.	Operating lease provides for maintenance expenses and taxes of the lessor.
3.	The risk of obsolescence is assumed by the lessee.	3.	Leasing company assumes risk of obsolescence.
4.	Contract period ranges form medium to long them.	4.	Contract period ranges from intermeriate to short-term.

8. Define Hire Purchase.

Ans :

Meaning

Hire purchase is a mode of financing the price of the goods to be sold on a future date. In a hire purchase transaction the goods are let on hire, the purchase price is to be paid in installments and the hirer is allowed an option to purchase the goods by applying all the installments. The ownership of the property remains with creditor and passes on to hirer on the payment of the last installment.

Features

- Under hire purchase system, the buyer takes possession of goods immediately and agrees to pay the total hire purchase price in installment.
- Each installment is treated as hire charges.
- The ownership of the goods passes from buyer to seller on the payment of the installment.
- In case the buyer makes any default in the payment of any installment the seller has right to repossess the goods from the buyer and forfeit the amount already received treating it as a hire charge.

9. Define consumer credit.

Ans :

Meaning

The term consumer credit refers to the activities involved in granting credit to consumer-enable them possess own goods meant for everyday use. It is known by several names such as credit merchandising, deferred payments, installment buying, hire purchase, pay-out- of income scheme, pay-as-you earn scheme, easy payment, credit buying, installment credit plan etc.

Rahul Publications

Definitions

(i) According to E.R.A. Seligman, an authority on consumer credit, "The term consumer credit refers to a transfer of wealth, the payment of which is deferred in whole or in part, to future and is liquidated piecemeal or in successive fractions under a plan agreed upon at the time of the transfer."

(ii) According to Reavis Cox, an authority on economics of consumer credit, "Business procedure through which the consumers purchase semi-durables and durables other than real estate, in order to obtain from them a series of payments extending over a period of three months to five years and obtain possession of them when only a fraction of the total price has been paid."

10. Objectives of factoring

Ans :

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

(i) To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.

(ii) To minimize the risk of bad debts arising on account of non-realisation of credit sales.

(iii) To adopt better credit control policy.

(iv) To carry on business smoothly and not to rely on external sources to meet working capital requirements.

(v) To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

11. Define forfeiting.

Ans :

The term 'forfeit' is a French world. It means 'to surrender something' or 'give up one's right'. Thus forfeiting means giving up the right of exporter to the forfeitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without resource' basis. This means that in case the importer makes a default the forfeiter cannot go back to the exporter to recover the money. Under forfeiting the exporter surrenders his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount. Here the exporter passes to the forfeiter all risks and responsibilities in collecting the debt. The exporter is able to get 100% of the amount of the bill immediately. Thus he gets the benefit of cash sale. However, the forfeiter deducts the discount charges and he gives the balance amount to the exporter. The entire responsibility of recovering the amount from the importer is entrusted with the forfeiter. The forfeiter may be a bank or any other financial institution.

In short, the non-recourse purchase of receivables arising from an export of goods and services by a forfeiter is known as forfeiting.

12. Advantages of Venture Capital?

Ans :

Venture capital has a number of advantages over other forms of finance. Some of them are:

(i) It is long term equity finance. Hence, it provides a solid capital base for future growth.

(ii) The venture capitalist is a business partner. He shares the risks and returns.

(iii) The venture capitalist is able to provide strategic operational and financial advice to the company.

(iv) The venture capitalist has a network of contacts that can add value to the company. He can help the company in recruiting key personnel, providing contracts in international markets etc.

(v) Venture capital fund helps in the industrialization of the country.

(vi) It helps in the technological development of the country.

(vii) It generates employment.

(viii) It helps in developing entrepreneurial skills.

(ix) It promotes entrepreneurship and entrepreneurism in the country.

Rahul Publications

UNIT V

Fee-based / Advisory Services: Investment Banking – Introduction, Functions and activities of Merchant bankers, Lead Managers, underwriting, bankers to an issue, debenture trustees, portfolio managers. Challenges faced by investment bankers. Stock broking, Custodial Services, Depository system, Credit rating – Role of agencies, Process, regulations. CIBIL

5.1 Fee-based Advisory Services

Q1. What are Fee-based Advisory Services? Explain them briefly.

Ans :

The following are the fee based advisory:

- Managing the capital issue in accordance with SEBI guidelines enabling promoters to market their issue.
- Making arrangements for placement of capital and debt instruments with investment institutions.
- Arrangement of funds from financial institutions for clients project cost or working capital.
- Assisting in getting all Government and other clearances.

1. Merchant banking

Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The merchant banker merely acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an institution which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. SEBI (Merchant Bankers) Rule, 1992 has defined 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 securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management".

2. Credit rating

Credit rating means giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay both interest and principal over the period of the rated instrument. It is a judgement about a firm's financial and business prospects. In short, credit rating means assessing the creditworthiness of a company by an independent organization.

3. Stock brooking

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

4. Custodial services

In simple words, the services provided by a custodian are known as custodial services (custodian services). Custodian is an institution or a person who is handed over securities by the security owners for safe custody. Custodian is a caretaker of a public property or securities. Custodians are intermediaries between companies and clients (i.e. security holders) and institutions (financial institutions and mutual funds). There is an arrangement and agreement between custodian and real owners of securities or properties to act as custodians of those who hand over it. The duty of a custodian is to keep the securities or documents under safe custody. The work of custodian is very risky and costly in nature. For rendering these services, he gets a remuneration called custodial charges.

Rahul Publications

Thus custodial service is the service of keeping the securities safe for and on behalf of somebody else for a remuneration called custodial charges.

5. Loan Syndication

Loan syndication is an arrangement where a group of banks participate to provide funds for a single loan. In a loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided by the corporate enterprises, depending on confidence in the lead manager.

A single bank cannot give a huge loan. Hence a number of banks join together and form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing.

6. Securitisation

Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. Now loans become liquid. They get the characteristic of marketability. This is done through the process of *securitization*. Securitisation is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitised.

Securitisation is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the transformation of illiquid, non-marketable assets into securities which are liquid and marketable assets. It is a process of transformation of assets of a lending institution into negotiable instruments.

Securitisation is different from factoring. Factoring involves transfer of debts without transforming debts into marketable securities. But securitisation always involves transformation of illiquid assets into liquid assets that can be sold to investors.

5.2 Investment Banking

5.2.1 Introduction

Q2. Define merchant banking. Explain the evolution of merchant banking.

(OR)

Define investment banking.

Ans : **(May-19, Imp.)**

Merchant banking is also known as investment banking.

The word 'merchant banking' was originated among the Dutch and Scottish traders. Later on it was developed and professionalised in the UK and the USA. Now this has become popular throughout the world.

Meaning

Merchant banking is non-banking financial activity. But it resembles banking function. It is a financial service. It includes the entire range of financial services.

The term merchant banking is used differently in different countries. So there is no universal definition for merchant banking. We can define merchant banking as a process of transferring capital from those who own it to those who use it.

Definition

According to Random House Dictionary, "merchant bank is an organization that underwriters securities for corporations, advices such clients on mergers and is involved in the ownership of commercial ventures. These organizations are sometimes banks which are not merchants and sometimes merchants who are not bankers and sometimes houses which neither merchants nor banks".

According to SEBI (Merchant Bankers) Rules 1992, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant advisor or rendering corporate advisory services in relation to such issue management".

Rahul Publications

In short, "merchant bank refers to an organization that underwrites securities and advises such clients on issues like corporate mergers, involving in the ownership of commercial ventures".

Thus merchant banking involves a wide range of activities such as management of customer services, portfolio management, credit syndication, acceptance credit, counseling, insurance, preparation of feasibility reports etc. It is not necessary for a merchant banker to carry out all the above mentioned activities. A merchant banker may specialise in one activity, and take up other activities, which may be complementary or supportive to the specialized activity.

In short, merchant banking involves servicing any financial need of the client.

5.2.2 Functions of Merchant Bankers

Q3. Explain the functions of merchant bankers.

(OR)

Explain the scope of merchant banking.

Ans : **(Imp.)**

Merchant banks have been playing an important role in procuring the funds for capital market for the corporate sector for financing their operations. They perform some valuable functions. The functions of merchant banks in India are as follows:

1. Corporate counseling

One of the important functions of a merchant banker is corporate counseling. Corporate counseling refers to a set of activities undertaken to ensure efficient functioning of a corporate enterprise through effective financial management. A merchant banker guides the client on aspects of organizational goals, vocational factors, organization size, choice of product, demand forecasting, cost analysis, allocation of resources, investment decisions, capital and expenditure management, marketing strategy, pricing methods etc. The following activities are included in corporate counseling:

(a) Providing guidance in areas of diversification based on the Government's economic and licensing policies.

(b) Undertaking appraisal of product lines, analyzing their growth and profitability and forecasting future trends.

(c) Rejuvenating old-line companies and ailing sick units by appraising their technology and process, assessing their requirements and restructuring their capital base.

(d) Assessment of the revival prospects and planning for rehabilitation through modernization and diversification and revamping of the financial and organizational structure.

(e) Arranging for the approval of the financial institutions/banks for schemes of rehabilitation involving financial relief, etc.

(f) Monitoring of rehabilitation schemes.

(g) Exploring possibilities for takeover of sick units and providing assistance in making consequential arrangements and negotiations with financial institutions/banks and other interests/authorities involved.

2. Project Counseling

Project counseling relates to project finance. This involves the study of the project, offering advisory services on the viability and procedural steps for its implementation. Project counseling involves the following activities:

(a) Undertaking the general review of the project ideas/project profile.

(b) Providing advice on procedural aspects of project implementation.

(c) Conducting review of technical feasibility of the project on the basis of the report prepared by own experts or by outside consultants.

(d) Assisting in the preparation of project report from a financial angle, and advising and acting on various procedural steps including obtaining government consents for implementation of the project.

(e) Assisting in obtaining approvals/licenses/permissions/grants, etc from government agencies in the form of letter of intent, industrial license, DGTD registration, and government approval for foreign collaboration.

Rahul Publications

(f) Identification of potential investment avenues.

(g) Arranging and negotiating foreign collaborations, amalgamations, mergers, and takeovers.

(h) Undertaking financial study of the project and preparation of viability reports to advise on the framework of institutional guidelines and laws governing corporate finance.

(i) Providing assistance in the preparation of project profiles and feasibility studies based on preliminary project ideas, covering the technical, financial and economic aspects of the project from the point of view of their acceptance by financial institutions and banks.

(j) Advising and assisting clients in preparing applications for financial assistance to various national financial institutions, state level institutions, banks, etc.

3. Pre-investment Studies

Another function of a merchant banker is to guide the entrepreneurs in conducting pre-investment studies. It involves detailed feasibility study to evaluate investment avenues to enable to decide whether to invest or not. The important activities involved in pre-investment studies are as follows:

(a) Carrying out an in-depth investigation of environment and regulatory factors, location of raw material supplies, demand projections and financial requirements in order to assess the financial and economic viability of a given project.

(b) Helping the client in identifying and short-listing those projects which are built upon the client's inherent strength with a view to promote corporate profitability and growth in the long run.

(c) Offering a package of services, including advice on the extent of participation, government regulatory factors and an environmental scan of certain industries in India.

4. Loan Syndication

A merchant banker may help to get term loans from banks and financial institutions for projects. Such loans may be obtained from a single financial institution or a syndicate or consortium. Merchant bankers help corporate clients to raise syndicated loans from commercial banks. The following activities are undertaken by merchant bankers under loan syndication:

(a) Estimating the total cost of the project to be undertaken.

(b) Drawing up a financing plan for the total project cost which conforms to the requirements of the promoters and their collaborators, financial institutions and banks, government agencies and underwriters.

(c) Preparing loan application for financial assistance from term lenders/financial institutions/banks, and monitoring their progress, including pre-sanction negotiations.

(d) Selecting institutions and banks for participation in financing.

(e) Follow-up of term loan application with the financial institutions and banks, and obtaining the approval for their respective share of participation.

(f) Arranging bridge finance.

(g) Assisting in completion of formalities for drawing of term finance sanctioned by institutions by expediting legal documentation formalities, drawing up agreements etc. As prescribed by the participating financial institutions and banks.

(h) Assessing working capital requirements.

5. Issue Management

Issue management involves marketing or corporate securities by offering them to the public. The corporate securities include equity shares, preference shares, bonds, debentures etc. Merchant bankers act as financial intermediaries. They transfer capital from those who own it to those who need it. The security issue function may be broadly classified into two – pre-issue management and post-issue management. The pre-issue management involves the following functions:

Rahul Publications

(a) Public issue through prospectus.

(b) Marketing and underwriting.

(c) Pricing of issues.

These may be briefly discussed as follows:

(a) Public issue through prospectus: To being out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. First the prospectus should be drafter. The copies of consent of experts, legal advisor, attorney, solicitor, bankers, and bankers to the issue, brokers and underwriters are to be obtained from the company making the issue. These copies are to be filed along with the prospectus to the Registrar Companies. After the prospectus is ready, it has to be sent to the SEBI for clearance. It is only after clearance by SEBI, the prospectus can be filed with the Registrar. The brokers to the issue, principal agent and bankers to issue are appointed by merchant bankers.

(b) Marketing and underwriting: After sending 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 campaigns and fixing date of board meeting to approve and pass the necessary resolutions. The role of merchant banker in publicity campaigns to help selecting the media, determining the size and publications in which the advertisement should appear. The merchant bank shall decide the number of copies to be printed, check accuracy of statements made and ensure that the size of the application form and prospectus are as per stock exchange regulations. The merchant banker has to ensure that he material is delivered to the stock exchange at least 21 days before the issue opens and to the brokers to the issue, and underwriters in time.

(c) Pricing of issues: Pricing of issues is done by companies themselves in consultation with the merchant bankers. An existing listed company and a new company set up by an existing company with 5 year track record and existing private closely held company and existing unlisted company going in for public issues for the first time with 2 ½ years track record of constant profitability can freely price the issue. The premium can be determined after taking into consideration net asset value, profit earning capacity and market price. The price and premium has to be stated in the prospectus.

Post-issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedures, mailing of allotment letters, share certificates and refund orders. Merchant bankers help the company by co-ordinating the above activities.

6. Underwriting of public issue

In underwriting of public issue the activities performed by merchant bankers are as follows:

(a) Selection of institutional and broker underwriters for syndicating/ underwriting arrangements.

(b) Obtaining the approval of institutional underwriters and stock exchanges for publication of the prospectus.

(c) Co-ordination with the underwriters, brokers and bankers to the issue, and the Stock Exchanges.

7. Portfolio Management

Merchant bankers provide portfolio management service to their clients. Today every investor is interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. Merchant bankers help the investors in this regard. They study the monetary and fiscal policies of the government. They study the financial statements of companies in which the investments have to be made by investors. They also keep a close watch on the price movements in the stock market.

8. Merger and Acquisition

A merger is a combination of two or more companies into a single company where one

Rahul Publications

survives and others lose their corporate existence. A take over refers to 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.

9. Foreign Currency Financing

The finance provided to fund foreign trade transactions is called 'Foreign Currency Finance'. The provision of foreign currency finance takes the form of export import trade finance, euro currency loans, Indian joint ventures abroad and foreign collaborations.

10. Working Capital Finance

The finance required for meeting the day-to-day expenses of an enterprise is known as 'Working Capital Finance'. Merchant bankers undertake the following activities as part of providing this type of finance:

(a) Assessment of working capital requirements.

(b) Preparing the necessary application to negotiations for the sanction of appropriate credit facilities.

Q4. Discuss the legal framework of merchant banking system in India.

Ans :

Registration

It is mandatory for the merchant bankers to register (under SEBI Merchant Banking Regulation Act 1992). As per 1990 guidelines of SEBI, following is the criteria for authorization to merchant bankers to carry out business.

- Professional qualification in finance law or business.
- Adequate infrastructure.
- Employment of atleast two experienced merchant bankers.
- Capital adequacy.

As per the 1992, guidelines. Merchant Bankers into four categories.

1. Merchant bankers carrying on issue management activates belonged to category I, It included activities like preparation of prospectus, tie up financiers, determining the financial structure, final allotment of securities, underwriting consultant to an issue, portfolio management etc.
2. The second category constituted merchant bankers playing the role of advisors, consultants, co-managers, underwriters to an issue etc.
3. The third category merchant bankers could act as underwriter advisor or consultant to an issue.
4. Merchant bankers of fourth category were authorized to act only as advisors or consultants. We see that only category I merchant bankers were authorised to act as lead managers. This classification was however valid only upto 1997. Now, only category I merchant bankers are required to be registered by SEBI.

Grant of Certificate

Based on the above criteria, SEBI grants a certificate of registration to the corporate bodies other than a non-banking financial corporate, or merchant bankers registered by the RBI to act as primary or satellite dealer to carry on merchant banking.

Capital Adequacy

Based on the classification, the minimum networth requirement for each of the four, categories was Rs. 1 crore, Rs. 50 lakhs, Rs. 20 lakhs and respectively.

SEBI is authorised to collect a fee for original registration, annual fee, as well as the few time of renewal. With effect from 1999, merchant bankers have to pay a renewal fee Rs. 2.5 lakhs every three years from the fourth year of initial registration, least the registration may be suspended.

Rahul Publications

Restriction on Business

Merchant bankers are not allowed to carry on funds asset-based (like leasing hire purchasing) business etc. Besides, banks and financial institutions in public sector, however. Merchant banks registered with RBI as primary satellite dealers can carry on business other than that in the securities market.

Number of Lead Managers

SEBI requires all public issues to be managed by atleast one merchant banker acting as lead manager. The minimum number of lead managers depends on the size of the issue. Generally a maximum of two lead managers are appointed as lead managers for issues less than Rs. 50 crores. For issues exceeding 100 crores, 200 crores maximum of four lead managers can be associated. With the approval of SEBI the number may be raised to five or more for an issue size of 200-400 crores and above.

Responsibilities of Lead Managers

Merchant bankers should submit to the SEBI in case of greater than one lead manager the specific responsibilities of each lead manager before the issue. General responsibilities include the following.

- Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relation to issues. Particularly, the agreement should consider disclosure, allotment and refund, preparation and maintenance of books of accounts and half-yearly reports.
- The agreement details has to be submitted with the SEBI atleast 30 days prior to the opening issues of the subscription.
- No lead managers can manage an issue of its associate companies.
- Leader merchant bankers should not associate with merchant bankers who are not registered with the SEBI.
- Lead managers of category one merchant bankers ought to accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakhs whichever is less. If he fails, associate merchant banker should underwrite the equal amount by intimating it to the SEBI. Under capital adequacy requirement, merchant bankers are excepted to submit half-yearly unaudited financial results for SEBI to monitor capital adequacy.

Due Diligence Certificate

The lead manager is also responsible for verifying the contents of prospectus or letter of offer of an issue. According to SEBI, every lead manager has to submit a due diligence certificate at least 15 days before the issue. He should verify that,

(a) The prospectus or the offer letter confirm the document relevant to the issue.

(b) All legal requirements have been complied with.

(c) The disclosures are adequate for an investor to make an investment decision and that they are true and fair.

Submission of Documents

Lead manager should submit issue particulars, prospectus, other literature for investors and shareholders and other legal documents and prospectus should be submitted with the prescribed fee atleast two weeks before the date of tiling with the registrar of companies or regional stock exchanges.

Acquisition of Shares

SEBI prohibits merchant bankers from acquiring securities of any company using unpublished, price sensitive information obtained during the professional services as merchant banker. If any securities are acquired of the issuing company he is serving the merchant banker should submit full particulars to the SEBI within 15 days of the date of transactions.

Disclosures

A merchant banker is required to disclose the following information to the SEBI when needed.

(a) His responsibilities related to the issue management.

(b) Any change in previously submitted information.

Rahul Publications

(c) Names of the companies whose issue to has manage or associated with.

(d) Particulars regarding the breach of capital adequacy requirements.

(e) Particulars of his activities as manager. Underwriting, consultants etc.

Code of Conduct

Merchant bankers are required to follow the code of conduct prescribed by the SEBI. He should make all efforts to protect investors interest. He should render high quality of service all the time and exercise due diligence, and independent professional judgment. He should act in ethical manner and make no discrimination in client except in commercial conditions. The bankers should fulfill all the obligation and adhere to the code of conduct with high degree of fairness.

Inspection

SEBI is entitled to inspect a merchant bankers books of accounts, records and documents in order to ensure that all the provisions of the regulations are duly complied with. The objective may also be to investigate complaints received from investors or others, merchant bankers should obligate and furnish the required documents for inspection and assist the inspecting authority. However, merchant banker is allowed reasonable time after the notice of inspection before the inspection takes place. The merchant bankers is also given an opportunity to explain after the inspection report is submitted. The SEBI may then advise the concerned merchant banker to take measure and comply with the SEBI rules and regulations.

Regulations as to Default

SEBI is empowered to suspend or cancel the registration of the merchant banker who violates the regulations of SEBI. The penalty of suspension may be granted in the following cases.

(i) Violation of provisions of the SEBI act.

(ii) Failure to furnish or faulty submission of required information.

(iii) Guilt of misconduct or indulgence in price ragging or manipulation of activities.

(iv) Violation of conditions of registration.

The registration may be cancelled under the following conditions,

(i) Deliberate manipulation of activities affecting investors interest or price rigging.

(ii) Deterioration of financial position of the merchant banker.

(iii) Guilt of fraud or a criminal offence and

5.3 Activities of Merchant Bankers

5.3.1 Lead Managers

Q5. Who is a lead manager? Explain the responsibilities of lead managers.

Ans : **(Dec.-18, Imp.)**

Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relating to such issues, and in particular to disclosures allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. In case of more than one lead manager/merchant banker, the statement has to provide details about their respective responsibilities. He can not associate with a merchant banker who does not hold a certificate of registration with the SEBI.

A merchant banker should not lead manage an issue/be associated with any activity undertaken under any other SEBI regulation if he is a promoter/ director/associate of the issuer/any person making an offer to sell/purchase securities in terms of any SEBI regulation. However, he may be appointed if he is involved only in the marketing of the issue/ offer. A merchant banker would be deemed to be an associate of the issuer/person if

(a) Either of them directly/indirectly

(i) Through its subsidiary/holding controls at least 15 per cent of the voting rights in the other,

(ii) By itself/in combination with other persons exercises control over the other or

Rahul Publications

(b) There is a common director (excluding nominee director) amongst the issuer, its subsidiary/holding company to the merchant banker.

Q6. Explain the role of merchant banker as a lead manager.

(OR)

What is a role of merchant banker as a lead manager?

Ans : **(Dec.-18, Imp.)**

The most important aspect of Merchant Banking business is to function as lead mangers to the issue management.

The following are the duties of lead managers :

a) It is the duty of every lead manger to enter into an agreement with the issuing companies stating the details regarding their responsibilities, liabilities, mutual rights, functions, disclosures, refund, allotment etc. a copy of this agreement should be submitted to the SEBI at least one month before the opening of the issue for subscription.

b) A lead manager is under an obligation to accept a minimum underwriting obligation of 5 percent of the total underwriting commission or Rs. 25 lakhs whichever is less. If he is not able to comply with the above provision it is his duty to make managements with another merchant banker associated with that issue to underwrite the said amount.

c) A lead manger has to exercise due care and diligence in the verification of prospectus or letter of offer.

d) A lead manger cannot undertake the work of issue management if the issuing company is its associate.

e) One merchant banker can not have association with another merchant banker who does not hold a certificate of registration with the SEBI.

f) He has to submit due diligence certificate rating that the prospectus or letter of offer is in conformity with the documents relevant to the issue, the disclosures are true, fair and adequate and all legal requirements connected with the issue have been duly complied with.

g) Every lead manger is responsible for ensuring timely refund of excess application money received from the applicants.

h) Every lead manger has to submit all the particular of an issue, draft prospectus or letter or offer etc to the SEBI at least two weeks before the date of filing with the Registrar of Companies or Regional Stock Exchange or both.

i) In case of any suggestions or modifications given by the SEBI, he has to ensure that they are properly incorporated in the appropriate areas.

j) It is his duty to mail the share or debenture certificate immediately on allotment or inform it to the depository participant.

k) In the case of development, the lead manager has to ensure the collection of the specified amount from the underwriters.

Qualities required for Merchant Bankers

Merchant bankers play a significant role as a catalyst to transform the project ideas into industrial ventures. They help promotion of the enterprise by undertaking various activities such as market surveys, choice of suitable location and its size, preparation of documents and obtaining consent from various authorities. To perform these services efficiently the merchant bankers are expected to possess certain qualities which are :

i) Ability to analyze various aspects such as technical, financial and economic aspects concerning the formation of an industrial project.

ii) Knowledge about the various aspects of capital markets, trends in stock exchange, psychology of investing public, change in the economic and technological environment in the country.

iii) Ability to build up the bank-client relationship and live upto the clients expectations with total involvement in the project assigned to them.

iv) Innovative approach in developing capital market instruments to satisfy the ever changing needs of investing public.

v) Integrity and maintenance of high professional standards are the essential requisites for the success of merchant bankers present scenario.

Rahul Publications

5.3.2 Underwriting

Q7. Define underwriters. Explain general obligations and responsibilities of underwriters.

(OR)

What is underwriting?

Ans : **(Dec.-18)**

The important intermediary in the new issue/ primary market is the un-derwriters to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organisation is an important element of the primary market. Underwriters are appointed by the issuing companies in consulta-tion with the lead managers/merchant bankers to the issues. A statement to the effect that in the opinion of the lead manager, the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

1. Make all efforts to protect the interests of its clients.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Ensure that it and its personnel will act in an ethical manner in all its dealings with a body corporate making an issue of securities (i.e. the issuer).
4. Endeavour to ensure all professional dealings are effected in a prompt, efficient and effective manner.
5. At all times render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
6. Not make any statement, either oral or written, which would misrepresent (a) the services that the underwriter is capable of performing for its client, or has rendered to any other issuer company; (b) his underwriting commitment.
7. Avoid conflict of interest and make adequate disclosure of his interest.
8. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in the an equitable manner.
9. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as underwriter which would impair its ability to render fair, objective and unbiased services.
10. Not divulge to other issuer, press or any party any confidential information about its issuer company, which has come to its knowledge and deal in securities of any issuer company without making disclosure to the SEBI as required under these regulations and also to the Board directors of the issuer company.
11. Not discriminate amongst its clients, save and except on ethical and commercial considerations.
12. Ensure that any change in registration status/ any penal action taken by SEBI or any material change in financial which may adversely affect the interests of clients/ investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/ investors.
13. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act, regulations, circulars and guidelines issued by the SEBI. The underwriter should also comply with the award of the Ombudsman under the SEBI (Ombudsman) Regulations, 2003.

5.3.3 Bankers to an Issue

Q8. "Merchant banker act as a bankers to an issue". Discuss?

Ans :

The bankers' to an issue are engaged in activities such as acceptance of "applications along with application money from the investors in respect of issues of capital and refund of application money. The term issue means an offer of sale/purchase of security by any body corporate/person/group of

Rahul Publications

persons on his/its/their behalf to or from the public/ the holders of securities of the body corporate/ person/group of persons.

Registration

For merchant bankers to function as a banker to issue, they should obtain a certificate of registration from SEBI. SEBI registers for bankers to an issue based on the following requirements.

(i) Applicant has needed infrastructure.

(ii) Applicant is not involved in any litigation related to the securities market.

(iii) Applicant is a scheduled bank and

(iv) Applicant seeks the certificate in the investors interest.

Fee

The annual fee for the registration in force since 1999 is Rs. 5 lakhs for the initial registration. The renewal fee, Rs. 2.5 lakhs is payable after the fourth year for every three years.

Responsibilities of Banker to an Issue

A banker to an issue should furnish the following particulars to the SEBI.

(i) The number of issues for which he is acting as banker.

(ii) The number of applications and details of application money received.

(iii) Dates of forwarding investors applications to the issuing company and the dates and amount of refund to the investors.

A bankers to an issue should maintain books of account for atleast 3 years.

Bankers to an issue enters into an agreement with the issuing company that contains the particulars like number of collection centers. Submission of daily statements etc.

If there is any disciplinary action against a banker to an issue, he should immediately inform the SEBI.

Inspection

At the request of the SEBI, RBI inspects a banker to an issue to ensure that the books of accounts are properly maintained. The objective of an inspection could also be to investigate the complaints received against the banker.

Action in Case of Default

SEBI is vested with the power to suspend the registration of a banker to an issue under the following circumstances.

(i) Violation of the SEBI act.

(ii) Failure to furnish the required information or submission of false information.

(iii) Failure to resolve investors complaints.

(iv) Guilty of misconduct.

(v) Failure to pay the prescribed fee.

SEBI may cancel the registration in case of repeated defaults resulting in suspension, deterioration of the financial position of the banker or if the banker is guilty of a criminal offence.

5.3.4 Debenture Trustees

Q9. Who is a Debenture Trustee ? Explain briefly the responsibilities and obligations of a Debenture Trustee.

Ans : **(Imp.)**

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private place-ment of debentures by a listed/proposed to be listed company. A trust deed means a deed executed by the body corporate in favour of the trustees named therein for the benefit of the debenture holders. An issue means an offer of sale or purchase of securities by any body corporate/ other person/ group of persons on its/their behalf to the public/holders of securities of the body corporate/persons/group of persons.

To act as a debenture trustee, a certificate of registration from the SEBI is necessary. Only banks, public financial institutions, insurance companies and body corporates fulfilling the capital adequacy requirement of `2 crore in terms of networth [i.e. aggregate of value of paid-up capital and free reserves (excluding reserves created out of revaluation) minus aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not written off)] as per the latest audited balance sheet can act as trustees.

Rahul Publications

While considering the application for registration, the SEBI takes into account

(i) The necessary infrastructure like adequate office space, equipment and manpower to effectively discharge duties,

(ii) Any past experience as a debenture trustee or employment of minimum two persons with experience in matters relevant to a debenture trustee,

(iii) Any person directly/ indirectly connected with the applicant has not been granted registration by the SEBI under the SEBI Act,

(iv) Employment of at least one person who possesses the professional qualification in law from a government recognised institution,

(v) Any of its directors/principal officer (i.e. a secretary/manager/director of the body corporate or any person connected with the management/ administration of the body corporate upon whom the Board of Directors has served notice of its intention of treating him as its principal officer) is/has any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.

The responsibilities and duties of a debenture trustee as discussed below.

Obligation before Appointment

A debenture trustee has to enter into a written agreement with the body corporate before the opening of the subscription list for issue of debentures. The agreement should, *inter alia,* contain (i) that the debenture trustee has agreed to act as the trustee* under the trust deed for securing an issue of debentures for the body corporate and (ii) the time limit within which the security for the debenture holders would be created. However, a debenture trustee cannot act as trustee for any issue of debenture if (a) it is an associate [i.e. (i) who directly/ indirectly by himself or in combination with relatives exercises control in terms of Regulations 2(C) of the SEBI Substantial Acquisition of Shares and Takeover Regulations over the debenture trustee/the body corporate or (ii) in respect of whom the debenture trustee/body corporate directly/ indirectly exercises control or (iii) whose director is also a director of the debentures trustee/body corporate], (b) it has lent and the loan is yet not fully rapid/is proposing to lend money to the body corporate.

Obligations

A debenture trustee should, among other matters, accept the trust deed containing matters specified below.

Contents of Trust Deed

Every debenture trustee should ensure that the trust deed executed between a body corporate and debenture trustee should, amongst other things, provide for the following matters, namely:

Preamble

This section should, inter alia, state the rights of the debenture holders and the manner in which these rights are vested in the trustee.

Description of Instruments

This section should, inter alia, state the purpose of raising finance through debenture issue, description of debentures as regards amount, tenure, interest/coupon rate, periodicity of payment, period for redemption, options available, terms of conversion/ redemption of the debentures in terms of the issue to the debentureholders, debt equity and debt service coverage ratio, if applicable.

1. To maintain register of debentureholders with address with record of subsequent transfers and changes of ownership.
2. To keep proper books of account open for inspection by the debenture trustee.
3. To furnish whatever required information to debenture trustee including copies of reports, balance sheets, profit and loss accounts and so on.
4. To keep charged property/security adequately insured and in proper condition.
5. To permit debenture trustee to enter and inspect the state and condition of charged assets.
6. To pay all taxes, cases, insurance premia with respect to charged property/security, on time.

Rahul Publications

7. To inform debenture trustee before declaring or distributing dividend.
8. To comply with all guidelines/directions issued by any regulatory authority, with respect to the instant debenture issue.
9. To create debenture redemption reserve as per the SEBI Disclosure and Investor Protection Guidelines, 2000 and the provisions of Companies Act and submit an auditor's certificate to the trustee.
10. To convert the debenture into equity in accordance with the terms of the issue, if applicable.
11. To inform debenture trustee about any change in nature and conduct of business by company before such change.

Q10. Explain the duties and code of conduct of a debenture trustee.

Ans :

Duties

The duties of the debenture trustees include the following:

1. (a) Call for period reports from the body corporate,
   (b) Take possession of trust property in accordance with the provisions of the trust deed, (ba) Supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption fund.
   (c) Enforce security in the interest of the debentureholders,
   (d) Do such acts as are necessary in the event the security becomes enforceable,
   (e) Carry out such acts as are necessary for the protection of the debentureholders and do all things necessary in order to resolve the grievances of the debenture holders,
   (f) Ascertain and satisfy itself that
      (i) In case where allotment letter has been issued and debenture certificate is to be issued after registration of charge, the debenture certificate has been despatched by the body corporate to the debentureholders within 30 days of the registration of the charge with the Registrar of Companies,
      (ii) Debenture certificates have been despatched to the debenture holders in accordance with the provisions of the Companies Act.
      (iii) Interest warrants for interest due on debentures have been despatched to the debenture holders on/before the due dates.
      (iv) Debentureholders have been paid the money(ies) due to them on the date of the redemption of the debentures.
   (g) Ensure on a continuous basis that the property charged to the debentures is available and adequate at all times to discharge the interest and principal amount payable to them and that the property is free from any other encumbrances save and except those which are specifically agreed to by the debenture trustee,
   (h) Exercise due diligence to ensure compliance by the body corporate with the provisions of the Companies Act, the listing agreement/trust deed,
   (i) Take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trustee deed law comes to its notice.

Code of Conduct

A debenture trustee should:

1. Make all efforts to protect the interest of debentureholders.
2. Maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. Fulfil its obligations in a prompt, ethical and professional manner.

Rahul Publications

4. At all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. Take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation and maintain record of the same.
6. Ensure that any change in registration status/ any penal action taken by the SEBI or any material change in financial position which may adversely affect the interests of clients/ debentureholder is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
7. Avoid conflict of interest and make adequate disclosure of its interest.
8. Not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
9. Put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, should take reasonable steps to resolve the same in an equitable manner.
10. Make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as debenture trustee which would impair its ability to render fair, objective and unbiased services.
11. Not indulge in any unfair competition, which is likely to harm the interests of other trustees or debentureholders or is likely to place such other debenture trustees in a disadvantageous position while competing for or executing any assignment nor should it wean away the clients of another trustee on assurance of lower fees.
12. Not discriminate among its clients, except and save on ethical and commercial considerations.

5.3.5 Portfolio Managers

Q11. What do you mean by the term portfolio management in the context of merchant banking.

Ans :

Portfolio managers are the persons who enter into a contract with clients and accordingly advise and undertake the management of portfolio of securities on behalf of the clients. Portfolio refers to the total holdings of securities of an investor.

Registration

Portfolio managers have to obtain certificate of registration from the SEBI to act as portfolio managers. SEBI grants the certificate after taking into account the infrastructure. Minimum of two experienced persons, capital adequacy and professional qualification of the applicant. The person should not have been convicted of any offence and not directly or indirectly connected with the applicant.

Fee

SEBI issues the registration certificate on receiving the registration fee. The fee has been raise from Rs. 2.5 lakhs for first two years and 1 lakh for the third year to Rs. 5 lakhs from November 1999. Renewal fee payable from fourth year for every three years is Rs. 2.5 lakhs.

General Responsibilities of portfolio manager

- Every portfolio manager is required to enter into an agreement with the client. The agreement should define the relationship with the client and their mutual rights and duties.
- The portfolio manager should manage the clients funds to meet the client's needs and objectives.
- The portfolio manager cannot take any direct or indirect advantage from the clients funds.
- The portfolio manager should ensure that the complaints received from clients are duly handled and proper action is taken in time.
- Portfolio managers should accept money for not less than one year. However, the client can withdraw money before the maturity

Rahul Publications

period at his own risk, under certain circumstances. The portfolio fund can also renewed on the maturity in which case, it is deemed to be a fresh placement for minimum one year.

- The funds can be invested in money markets but not in bill disconducting or badla financing. The funds should not be used for specification.
- For each client the portfolio manager should buy and sell securities separately. If the securities are purchased in bulk to derive the economic of scale it should be allocated on prorate basis to the clients.
- Any transaction between the portfolio manager and a client or between the clients should be at the market price.
- The portfolio manager is required to keep of account and maintain records and documents. At the end of an accounting period, the portfolio manager should submit a copies of Profit and Loss Account, balance sheet, audit report and statement of financial position to the SEBI. The books and documents should be preserved for atleast five years.

Yearly Audits

The portfolio manager should maintain separate records and accounts for each client which have to audited every year by a qualified auditor.

The auditors certificate to the portfolio manager to certify that all accounts and records have properly been maintained and that the portfolio manager has done his duties properly, has to be submitted with SEBI.

The portfolio manager should submit a periodical report to the client. The report should contain details like value of the portfolio, value of each security in the portfolio, transactions incurred, benefits received on debentures, bonus share and rights shares, expense incurred, risk predicted etc.

Compliance Officer

The portfolio manager is required to appoint a compliance officer who would monitor the activities of the portfolio manager and ensure compliance with SEBI rules and regulations and that the investors grievances are redressed. Any non-compliance is immediately reported to the SEBI.

Inspection

SEBI has the right to inspect the books of accounts, records and other documents of the portfolio manager. The inspection is carried on to ensure that the books are properly maintained and the provisions of the SEBI are completed with. Another objective is to investigate the complaints received by SEBI.

Action in Default

SEBI is empowered to suspend the registration if the portfolio manager fails to furnish the required information or submit false information, fails to resolve investors complaints, is guilty of misconduct or indulges in price rigging, fails to maintain capital adequacy or violates any of the registration conditions.

The registration may be cancelled under these circumstances.

- Indulgence in deliberate manipulation and price rigging.
- Deterioration of the portfolio managers financial position.
- Guilty of fraud or a criminal offence.
- Guilty of repeated "defaults resulting in suspension.

5.4 CHALLENGES FACED BY INVESTMENT BANKERS

Q12. Discuss the various Challenges Faced by Investment Bankers.

(OR)

Explain the challenges faced by the Investment Bankers.

Ans : **(May-19, Imp.)**

1. SEBI guidelines help merchant banker in many ways. However the stipulation also hinder the growth of merchant banking for instance, stipulation of minimum networth of 1 crore handicaps small merchant bankers with goods professional skills and potential for growth.

Rahul Publications

2. Merchant bankers are authorized to carry out issue related functions except that a portfolio management. As a result, merchant bankers have to start a new subsidiary to isolate the activities from their core activities.

3. Issuing companies do not cooperate with merchant bankers in allotment of securities. It considers merchant bankers responsible for timely allotment and refund the application of money.

5.5 Stock Broking

Q13. Explain briefly about stock broking.

(OR)

Write a short note on stock brokers.

Ans : **(Imp.)**

Stockbroker means a person having trading rights in any recognised stock exchange including a trading member. A certificate of registration from the SEBI is mandatory to act as a broker. No separate registration is required for a SEBI-registered broker to operate in more than one stock exchange subject to the approval of the concerned stock exchange. A SEBI-registered clearing member (i.e. a person having clearing and settlement rights in any recognised clearing corporation including a person having clearing and settlement rights on a commodity derivative exchange) would also not require a separate registration to act as a bro-ker in the concerned stock exchange with its approval. A clearing corporation is an entity that undertakes clearing and settlement of trade in securities, other instruments/products dealt with/ traded on a stock exchange and includes a clearing house.

Registration

A broker seeking registration with the SEBI has to apply through the stock exchange of which he is a member. The application must be forwarded by the exchange to the SEBI within 30 days from the date of receipt. The application should be accompanied by a nonrefundable fee of `50,000. For granting registration to the broker, the SEBI takes into account all matters relating to trading/ settling/dealing in securities and in particular whether or not he is eligible to be admitted as a member of a stock exchange, has the necessary infrastructure including manpower to effectively discharge his activities, has past experience in the business of buying, selling or dealing in securities and is subject to disciplinary proceedings under the rules, regulations and bye-laws of the stock exchange with respect to his business, is a fit and proper person, has financial liability due/payable in terms of the SEBI Act, Securities (Regulation) Act/ rules/ regulations, has obtained certification in terms of SEBI Certification of Associated Persons in the Securities Market Regulation, and satisfies the minimum networth and deposit requirements. Networth means paid-up capital, free reserves and other SEBI-approval securities but not include fixed assets, pledged securities, value of a member's card, unlisted securities, bad deliveries, doubtful debts and advances overdue for more than 90 days or given to associates, prepaid expresses, losses, intangible assets and 30 per cent value of marketable securities. The net worth requirement is ?1 crore for currency derivatives segment and ?50 lakh for debt segment. For determining whether an applicant/stock broker, is a fit and proper person, the SEBI may take into account the criteria specified in the SEBI Intermediaries Regulation, 2008.

Payment of Fee

A stock broker has to pay a registration fee of ` 5,000 for each financial year on 'annual turnover upto ` 1 crore, ` 5000 plus one-hundredth of 1 per cent of the turnover in excess of crore. To keep registration in force, after five years from the date of initial registration, he would have to pay `5000 for every block of five years commencing from the sixth year after registration. Every stock broker has to pay to the SEBI a fee in respect of securities transactions including off-market transaction undertaken by him as specified below:

Cash Segment

0.0002 per cent (i.e. `20 per crore) of the price at which securities (other than debt securities) are purchased/sold;

Equity and Currency Derivatives Segment

0.0002 per cent of turnover (i.e. value of all trades executed and settled on the expiration of the contracts):

Rahul Publications

Interest Rate Derivative Segment

0.00005 per cent (i.e. ` 5 per crore) of turnover. In case of option contracts, turnover would be computed on the basis of premium traded and where the option is exercised/assigned, it should be additionally computed in the basis of notional value.

Debt Segment

0.00002 per cent (i.e. `2 per crore) of turnover.

Q14. Discuss the various types of intermediaries in stock broking.

Ans :

The stock broking activity consists of various intermediaries. They are

A) Stock brokers

B) Sub-brokers

C) Foreign brokers

A) Stock Brokers

A stock broker or stockbroker is a qualified and regulated professional who buys and sells (trades) shares (in other words, stocks) and other securities through market makers on behalf of investors. These broker also give knowledge guidance to their high net worth individuals, clients, for managing their finance well and investing in portfolio for considerable wealth creation.

To work as a stockbroker registration with SEBI is mandatory. SEBI is empowered to impose conditions while granting the certificate of registration.

1. Registration

A broker seeking registration with SEBI, has to apply through the stock exchange of which he is member. For registering SEBI checks - eligibility of the applicant to become the member of stock exchange, has the necessary infrastructure to effectively discharge his duties, past experience etc. Every registered stockbroker is required to pay annual fee @ Rs. 5,000 for turn over up to Rs. 1 crore and 0.01% of turnover exceeding Rs. 1 crore. For calculating turnover underwriting and collection of deposits are not taken into account for the purpose of calculating the turnover. The authenticity of the annual turnover is to be certified by the stock exchange concerned.

2. Capital adequacy norms for brokers

An absolute minimum of Rs. 5 lakh as a deposit with the exchange is to be maintained by the members of the BSE & CSE and Rs. 3.5 lakh for DSE and ASE irrespective of volume of business. In case of other SE the minimum requirement is Rs. 2 lakhs. The security deposit kept by the members in the SE forms part of the base minimum capital; 25% of the base minimum capital is to be maintained in case with the exchange. Another 25% remains in the form of a long term fixed deposit with a bank on which the SE is given free lien. The remaining requirement is being maintained in the form of securities with a 30% margin. The securities should be in the name of the member and are pledged in favor of SE.

3. Additional Capital related to Volume of Business

The additional or optional capital required from a member should, at any point of time, be such that together with the base minimum capital it is not less than 8% of the gross outstanding business in the exchange defined as the aggregate of up-to-date sales and purchases by a member broker in all the securities put together.

4. Duty to the Investor

The duties of a broker to the investor are,

i) He should be faithful to the clients in his dealings with them and execute orders as per the instructions.

ii) He should issue to his clients a contract note without any delay for all transactions in the form specified by the SE.

iii) To avoid breach of trust, he should not disclose or discuss with any other person details of investment and transaction of clients.

Rahul Publications

iv) He should not mislead clients merely to generate business.

v) He should avoid dealing with a client who is a defaulter in his dealings with other brokers.

vi) When dealing with a client, he is required to disclose whether he is acting as a principal or as an agent.

vii) He should not give investment advice to any client unless sought by him.

viii) A stockbroker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.

ix) He should extend full cooperation to other brokers in protecting the interest of his clients regarding their rights to dividends, bonus shares, rights issues and any other rights related to such securities.

B) Sub Brokers

A sub-broker acts on behalf of a stockbroker as an agent or otherwise for assisting investors in buying, selling or dealing in securities through such brokers but he is not a member of a stock exchange. To act as a sub-broker, registration with SEBI is required. It grants a certificate of registration to a sub- broker subject to the conditions that he has to pay the prescribed fee, he takes adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keeps SEBI informed about the number, nature and other particulars of the complaints, he is authorized in writing by a broker for affiliation in buying, selling or dealing in securities.

1. Registration of Sub-brokers

According to SEBI regulations currently in force, a sub-broker is required to submit along with the application

i) Recommendation from a stockbroker with whom he will be affiliated and

ii) Payment in respect of securities sold and arrange for prompt delivery of securities purchased. He should issue promptly to his clients.

2. Duty to the investors

A sub-broker in his dealings with the clients and general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price and promptly inform his clients about the execution of an order and make payment in respect of securities sold and arrange for prompt delivery of securities purchased. He should issue promptly to his clients.

i) Purchase or sale notes for all the transactions entered into by him with his clients, or through the principal broker

ii) Scrip-wise details. He should not furnish misleading information to his clients to generate business. He should not recommend his clients any scrip / security unless the client has asked for the advice.

C) Foreign Brokers

Foreign institutional investors (FIIs) now play a significant role in the stock markets. With a view to helping the FIIs to follow the procedures and encourage them to invest in India, SEBI has issued a different set of guidelines :

1. Registration with SEBI

It is mandatory for a foreign broker to get registered with SEBI in order to do business in India While applying for registration, a foreign broker has to disclose to SEBI name(s) and registration number(s) of the stock exchanges where he is registered in the capacity of a broker dealer together with an undertaking that he would operate and assist only on behalf of the registered FIIs and would not deal in securities on his own account as principal in India.

2. Transaction in Accounts

The foreign currency denominated accounts of registered foreign brokers would be credited with inward remittance brought in by him and inward remittance to make initial payment against the purchase contracts on behalf of registered FIIs. The rupee account will be credited with the commissions / brokerages earned by him in India. Initial payment on account of purchase contract on

Rahul Publications

behalf of registered FIIs would be made through Rupee account. Reimbursement of this initial payment would be made by the designated bank/custodian of the registered FII. The brokers are allowed to freely repatriate commission/ brokerage earned in India after transferring them to the foreign currency denominated account subject to payment of taxes on the basis of conversion of rupees to foreign currency at the prevailing market rates.

Types of Stock Broking Service

There are three types of stockbroking service:

1. **Execution-Only:** Which means that the broker will only carry out the client's instructions to buy or sell.
2. **Advisory Dealing:** Where the broker advises the client on which shares to buy and sell, but leaves the final decision to the investor.
3. **Discretionary Dealing:** Where the stockbroker ascertains the client's investment objectives and then makes all dealing decisions on the client's behalf.

In addition to actually trading stocks for their clients, stock brokers may also offer advice to their clients on which stocks, mutual funds, etc., to buy.

Brokerage Terms

1. **Front Office**

This is a description of the part of a brokerage firm that is "client facing". The sales staff, brokers and traders are part of the front office. Functions of the front office include acquisition and entry of orders, fulfillment of the orders, and all the regulatory reporting for the orders.

2. **Back Office**

The back office is where the clearance processing of the trades is done. Transfer of securities and money and the tracking of "failure to deliver" is handled. Securities lending for a brokerage firm, wherein shares of a security that is being sold short are located to ensure they can be delivered, is usually included in the back office as well.

5.6 Custodial Services

Q15. Discuss briefly about custodial services.

Ans :

The provision of efficient custodial services forms an important element in the evolution of a matured stock market system. The custodians of securities who provide custodial services play a critical role in the secondary market. Recognizing their importance in the securities market, the SEBI Custodian of Securities Regulations, 1996 was framed for the proper conduct of their business. According to the SEBI regulations, custodial services in relation to securities of a client or gold/gold related instrument held by a mutual fund or title deeds of real estate assets held by a real estate mutual fund mean safe-keeping of such securities or gold/gold related instruments or title deeds of real estate assets and providing services incidental thereto, including.

(i) Maintaining their ac-counts,

(ii) Collecting the benefits/rights to the client in respect of them,

(iii) Keeping the client informed of the action(s) taken/to be taken by the issuer having a bearing on the benefits/rights accruing to the client and

(iv) Maintaining and reconciling records of services referred to above.

- Maintaining accounts of the securities of a client;
- Collecting the benefits/rights accruing to him in respect of securities;
- Keeping him informed of the actions taken/ to be taken by the issuer of securities, having a bearing on the benefits/rights accruing to him; and
- Maintaining and reconciling records of the services referred to above.

The main elements of the SEBI framework of regulations for custodians of securities, briefly discussed in this section, are:

Rahul Publications

(i) Their registration,

(ii) Their general obligations and responsibilities,

(iii) Inspection and audit,

(iv) Action in case of default and

(v) Uniform norms and practice.

Q16. Explain general obligations and responsibilities of custodial services.

Ans :

General obligations and responsibilities of custodians are:

(i) Code of conduct

(ii) Segregation of activities

(iii) Monitoring/review/evaluation/inspection of systems/controls

(iv) Separate custody account and Agreement with clients

(v) Internal controls and

(vi) Maintenance of records.

(i) Code of Conduct

The custodians of securities should abide by the code of conduct set out below. He should

- Maintain the highest standard of integrity, fairness and professionalism in the discharge of his duties.
- Be prompt in distributing dividends/interest/ any such accruals of income received/ collected by him on behalf of his clients, on the securities held in custody.
- Be continuously accountable for the movement of securities in/out of custody account, deposit and withdrawal of cash from the clients accounts and provide complete audit trail whenever called by the client/SEBI.
- Establish and maintain adequate infrastructural facility to discharge custodial services to the satisfaction of clients and the operating procedures/systems should be well-documented and backed by operation manuals.
- Maintain client confidentiality in respect of his affairs.
- Take precautions to ensure that, where records are electronically maintained, continuity in record keeping is not lost/ destroyed, and sufficient back-up of the records is available.
- Create and maintain records of securities in such a manner that the tracing of securities/ obtaining duplicate documents is facilitated in the event of loss of original records for any reason.
- Extend to other custodial entities/depositories/ clearing organisations, all cooperation necessary for conduct of business in the areas of inter-custodial settlements and transfer of securities/funds. Ensure an arms' length relationship from other businesses, both in terms of staff and systems. Exercise due diligence in safekeeping/administration of assets of clients in custody.
- A custodian of securities or any of his employees should not directly/indirectly render any investment advance about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest, including long/short position in the security, has been made while rendering such advice. In case an employee is rendering such advice, he should also disclose the interest of his dependent family members and employer, including their short/ long position.

(ii) Segregation of Activities

The activities relating to his business as the custodian of securities should be separate and segregated from his all other activities. Similarly, its officers/employees engaged in custodial services should not be engaged in any other activity carried out by him.

(iii) Monitoring/Review/Evaluation/ Inspection of Systems of Controls

The custodian should have adequate mechanism for the purposes of reviewing, monitoring and evaluating the custodian's controls/ systems/procedures and safeguards. It should be inspected annually by an expert. The inspection report should be sent to the SEBI within three months of inspection.

Rahul Publications

Prohibition of Assignment

A custodian can assign/delegate its functions only to another custodian. It can, however, engage a non-custodian person for physical safekeeping of a mutual fund client having a gold exchange traded fund scheme provided

(a) It would remain responsible for safe-keeping including any associated risks.

(b) All books/documents/records would be maintained in its premises or made available if required by the SEBI, and

(c) It would continue to fulfill all duties to the client except for physical safe-keeping.

(iv) Separate Custody Account and Agreement with Clients

A separate custody account for each client should be opened by the custodian and the assets of one client should not be mixed with those of others. The custodian should enter into an agreement with each client providing for the circumstances under which he would

(a) Accept/release securities, asses/ documents and money from the custody account, and

(b) Receive rights/entitlement on the securities of the client. It should also include circumstances and the manner of registration of securities in respect of each client and details of insurance to be provided for by the custodian.

(v) Internal Controls

The custodians should have

(a) Adequate internal control to prevent the manipulation of records/documents including audit for securities and rights/ entitlements arising from securities held on behalf of clients and

(b) Appropriate safekeeping measures to ensure that securities, assets and documents are protected from theft and natural hazards.

(vi) Maintenance of Records

The custodians should maintain records/ documents on behalf of/for each client containing details of: securities, assets/documents received/ released, money received/ released, rights/ entitlements arising from the securities held, registration of securities, ledger, instructions received from/to clients, and all reports submitted to the SEBI. These records should be maintained for at least five years and the place where they are maintained to the SEBI should be intimated.

5.7 DEPOSITORY SYSTEM

Q17. Write brief note on depository system.

Ans : **(Imp.)**

A major reform of the Indian stock markets has been the introduction of the depository system and scripless trading mechanism, since 1996. This system of trading based on physical transfer/ custody of securities militated against the efficient functioning of markets, particularly in the context of the large scale entry of Foreign Institutional Investors (FIIs). The main problems faced the investors in general and FIIs in particular were:

- Inordinate delays in transfer of securities,
- Return of share certificates as bad deliveries on account of forged signatures/mismatch of signatures or fake certificate/forged transfer deed,
- Delay in the receipt/non-receipt of securities after allotment/refund orders to non-allottees.
- Delay in getting duplicate shares/debentures certificates, and
- Inadequate infrastructure in banking and postal segments to handle a large volume of application and storage of share certificate.

Q18. Discuss the main provisions of depository as per SEBI Regulations.

Ans :

Registration of Depository

Depositories must be registered with the SEBI. The application for The grant of certificate of registration, in the prescribed form, should be

Rahul Publications

accompanied by an application fee of ` 5,00,000 payable by the sponsor and `15,000 payable by participant together with draft bye-laws of the proposed depository. The sponsors of depositories who act alone or in combination w ith others proposing to establish a depository and undertaking to perform the obligations under these regulations can be: a (i) public financial institution, (ii) bank, (iii) foreign bank operating in India with RBI's approval, (iv) recognised stock exchange, (v) body corporate engaged in financial services, at least 75 per cent of whose capital is held by institutions in categories (i) to (iv) jointly or severally, (vi) body corporate constituted/recognised in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Government and (yii) an institution engaged in financial services outside India and approved by the Government.

Eligibility for Acquiring/Holding Shares

Only a fit and proper person can directly/ indirectly acquire / Hold shares/voting rights of a depository'. Acquisition of shares directly/indirectly individually or together with person(s) acting in concert resulting in his share holding in excess of 2 per cent of the paid-up capital of the depository would require SEBI's approval within 15 days. The excess would have to be divested forthwith in case of non-approval by the SEBI. Person(s) holding more than 2 per cent of the equity capital should file a declaration within 15 days from the end of the financial year to the depository that he complies with the fit and proper person criteria. Any instrument directly/indirectly held/owned/controlled by any person entitling him/providing for entitlement to the voting rights or equity shares or any other rights over equity shares at any future date would also be included for determining his share holding.

Conditions for Registration The certificate of registration of a depository would be subject to the following:

- Payment of a registration fee of `1,00,00,000 payable by depository and `2,00,000 payable by participant within 15 days;
- Compliance with the provisions of the Depositories Act/bye-laws/agreements/these regulations;
- Prohibition on carrying on any activity other than that of a depository, unless it is incidental to the depository;
- Compliance with the share holding and governance structure requirement.
- At least 51 per cent of the equity capital of the depository should be held by the sponsor(s).
- No participant can hold more than 5 per cent. However, stock exchange-sponsor cannot hold more than 24 per cent;
- A DP can hold upto 5 per cent of the capital of the depository;
- No resident/non-resident person, other than a sponsor would at any time individually or together with persons acting in concert hold more than 5 per cent of the equity capital for a depository;
- Subject to limits prescribed by Government, the combined holdings of all non-resident persons in the equity capital of a depository could be upto a maximum of 49 per cent.
- A foreign portfolio investor (i) can acquire shares of a depository only through the sec-ondary market and (II) would have no representation on the Board of Directors of the depository;
- The depository should immediately inform the SEBI if any information previously submit-ted by the sponsor/depository is found to be false/ misleading or if there is any change in such information.

5.8 CREDIT RATING

Q19. Define credit rating ? Explain the nature of credit rating.

Ans : **(Oct.-20, June-18, Imp.)**

Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to

Rahul Publications

honour its obligations contained in the debt instrument through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

Definitions

i) "A corporate credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted."

ii) "Credit rating is an unbiased and independent opinions as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security.

A credit rating doe not create a fiduciary relationship between the rating agency and the users of rating since there is no legal basis for such relationships. Credit rating in India is done for a specific debt security and not for a company as a whole. No rating agency tells that it is an indicator of the financial status of the company. All that a rating agency claims is that the rating symbols indicate the capacity of the company to honour the terms of contract of a debt instrument.

Nature

1. **Rating is based on information:** Any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Cooperation from the issuers as well as their willingness to share even confidential information are important pre-requisites. The rating agency must keep information of confidential nature possessed during the rating process, a secret.

2. **Many factors affect rating :** Rating does not come out of a predetermined mathematical formula. Final rating is given taking into account the quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability a number of qualified professionals are involved in the rating process. The rating Committee, which assigns the final rating, consists of specialised financial and credit analysts. Rating agencies also ensure that the rating process is free from any possible clash of interest.

3. **Rating by more than one agency:** In the well developed capital markets, debt issues are, more often than not, rated by more than one agency. And it is only natural that ratings given by two or more agencies differ from each other e.g., a debt issue, may be rated 'AA+' by one agency and 'AA' or 'AA-' by another. It will indeed be unusual if one agency assigns a rating of AA while another gives a 'BBB'.

4. **Monitoring the already rated issues:** A rating is an opinion given on the basis of information available at particular point of time. Many factors may affect the debt servicing capabilities of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues rated by them as part of their investor service. The rating agencies should put issues under close credit watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.

5. **Publication of ratings:** In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuers are published. Thus, once a rating is accepted it is published and subsequent changes emerging out of the monitoring by the agency will be published even if such changes are not found acceptable by the issuers.

6. **Right of appeal against assigned** rating**:** Where an issuer is not satisfied with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will undertake a review and thereafter give its final decision. Unless the rating agency had over looked critical information at the first stage chances of the rating being changed on appeal are rare.

Rahul Publications

7. **Rating of rating agencies:** Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency is measured by the quality of the services offered, consistency and integrity.

8. **Rating is for instrument and not for the issuer Company :** The important thing to note is that rating is done always for a particular issue and not for a company or the Issuer. It is quite possible that two instruments issued by the same company carry different ratings, particularly if maturities are substantially different or one of the instruments is backed by additional credit reinforcements like guarantees. In many cases, short-term obligations, like commercial paper (CP) carry the highest rating even as the risk profile changes for longer maturities.

9. **Rating not applicable to equity shares:** By definition, credit rating is an opinion on the issuers capacity to service debt. In the case of equity there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating does not apply to equity shares.

10. **Credit vs. financial analysis :** Credit rating is much broader concept than financial analysis. One important factor which needs consideration is that the rating is normally done at the request of and with the active co-operation Of the issuer. The rating agency has access to unpublished information and the discussions with the senior management of issuers give meaningful insights into corporate plans and strategies. Necessary adjustments are made to the published accounts for the purpose of analysis. rating is carried out by specialised professionals who are highly qualified and experienced. The final rating is assigned keeping in view the number of factors.

11. **Time taken in rating process:** The rating process is a fairly detailed exercise. It involves, among other things analysis of published financial information, visits to the issuers offices and works, 'intensive discussion with the senior executives of issuers, discussions with auditors, bankers, creditors etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time, a rating agency may take 6 to 8 weeks or more to arrive at a decision. For rating short-term instruments like commercial paper (CP), the time taken may vary from 3 to 4 weeks, as the focus will be more on short-term liquidity rather than on long-term fundamentals. rating agencies do not compromise on the quality of their analysis or work under pressure from issuers for quick results. Issuers are always advised to. approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

Q20. Explain the functions of credit rating agency.

Ans :

A credit rating agency serves following functions:

1. **Provides unbiased opinion:** An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:
   i. It has no vested interest in an issue unlike brokers, financial intermediaries.
   ii. Its own reputation is at stake.

2. **Provides quality and dependable information**: A credit rating agency is in a position to provide quality information on credit risk which is more authenticate and reliable because:
   i. It has highly trained and professional staff who has better ability to assess risk.
   ii. It has access to a lot of information which may not be publicly available.

3. **Provides information at low cost**: Most of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.

Rahul Publications

4. **Provide easy to understand information**: **Rating** agencies first of all gather information, then analyse the same. At last these interpret and summarise complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.

5. **Provide basis for investment**: An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

6. **Healthy discipline on corporate borrowers:** Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/discipline on corporate.

7. **Formation of public policy:** Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional portfolio.

Q21. What are the advantages and disadvantages of Credit Rating ?

Ans : **(May-19)**

Advantages

i) **Low Cost Information :** Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information are done by a specialized agency which a group of investors can trust.

ii) **Quick Investment Decision :** In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

iii) **Independent Investment Decision :** For rated instruments, investors need not depend upon the advice of the financial intermediaries. As the rating symbol suggests the credit worthiness of the instrument and indicated the degree of risk involved in it, the investors can make direct investment decisions.

iv. **Investors Protection :** Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. The creditable and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

Disadvantages

Credit rating suffers from the following limitations

1. **Non-disclosure of significant information**: Firm being rated may not provide significant or material information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating company. Thus any decisions taken in the absence of such significant information may put investors at a loss.

2. **Static study**: **Rating** is a static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after the assignment of rating symbols may defeat the very purpose of risk indicativeness of rating.

3. **Rating is no certificate of soundness**: Rating grades by the rating agencies are only an opinion about the capability of the company to meets its interest obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.

4. **Rating may be biased**: Personal bias of the investigating team might affect the quality of the rating. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the risk involved in the instrument.

Rahul Publications

5. **Rating under unfavorable conditions**: Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavorable conditions when rated. Thus, misleading conclusions may be drawn by the investors which hampers the company's interest.

6. **Difference in rating grades**: Same instrument may be rated differently by the two **rating** agencies because of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

Q22. Explain the classifications of credit rating.

Ans :

Types of Credit Rating

Credit rating is classified into four major types which are as follows,

1. **Bond Rating:** Bond rating deals with grading of bonds or securities which are issued by a company, government or semi-government institution. It denotes the possibilities of payment on the maturity of the bond. In other words, it ascertains whether the level of risk involved is more or less.

2. **Equity Rating:** The rating of shares which are traded in capital market are called as equity rating.

3. **Commercial Paper Rating:** A company is statutorily bound to avail rating level from a rating agency before issuing commercial paper. It is known as commercial paper rating. In India, the rating of commercial papers issued by corporate bodies is com-pulsory.

4. **Sovereign Rating:** Sovereign rating is related with the payment of the credit of the government of a country.

Q23. Explain the Purpose of Credit Rating.

Ans :

Credit rating is applicable to various purposes such as,

1. Long-term/medium-term debt obligations like debentures, bonds, preference shares or project finance debt are treated as long-term and debts that are ranging from 1 to 3 years like fixed deposits are treated as medium-term,

2. Short-term debt obligations which are for a period of one year or less than one year and includes money market instruments like com-mercial paper, credit notes, cash certificates etc.

3. Credit rating is applicable to equity grading and assessment, structured obligations, municipal bonds, mutual fund schemes, plantation schemes, real estate projects, infrastructure-related debts, ADR, GDR issues, bank securities, etc.

5.8.1 Role of Credit Rating Agencies

Q24. Write a note on credit rating agencies in India and their performance.

(OR)

Briefly describe the top three Indian credit rating agencies.

(OR)

Discuss the role of credit rating agencies in investor protection.

Ans : **(Dec.-19, May-19, Imp.)**

1. CRISIL

It is the first credit rating agency in India which was jointly promoted by ICICI and UT1. It has pioneered the concept of credit rating in the country.

(a) Rating Services: The principal objective of CRISIL is to rate debt obligations of Indian companies. It now rates rupee-denominated credit instruments both long term and short term, namely debentures, deposits, structured obligations, preference shares and commercial papers.

(b) Information Services: Though the primary business of CRISIL is credit rating, it has diversified into information services as a thrust area for future. The extensive compilation and analysis of data for rating business is also used to provide information services to the corporate clients.

Rahul Publications

The main information product is the CRISIL Card. It has also launched the CRISIL-500 equity index a market value weighted composite index of 500 companies.

(c) Advisory Services: A thrust area in the context of the emerging financial scenario is the provision of the advisory services by the CRISIL to the Government, banks, financial institutions and so on.

It utilizes its information base and expertise in credit rating to provide counselling on aspects such as privatization of public sector undertakings, debt securitisation, credit evolution system and so on.

Performance of CRISIL

During 1994-95, CRISIL rated 379 instruments covering a debt volume of Rs. 34544 crores.

The cumulative number of instruments rated by CRISIL since its inception in January 1988, till the end of March 1995 has been 1305 and the value of instruments covered has been Rs. 78151 crores.

The CRISIL has published CRISIL bond yield tables to provide handy reference to investors for determining yield-to-maturity on a debenture, given the price of debenture, its coupon rate and its maturity period.

During the year 1990-91 CRISIL started a quarterly publication called CRISIL Rating Scan containing rating reports on companies whose instruments have been rated by CRISIL during the quarter and which are using the rating.

These rating reports contain details of rating instruments, rationale fro rating assigned, brief details of the business of the borrower and the key issues involved in the rating. CRISIL Rating Scan also includes details of rating in use, ratings reviewed during the quarter, the instruments which have been placed under 'rating watch' and rating symbols with definition.

"CRISIL CARD" service was developed by CRISIL during the year 1990-91.

The service provides details about a company such as business it is engaged in share holding pattern, key management personnel, plant location, equity share record, analyzed profit and loss accounts and balance sheet for the last four years, account practices, key financial ratios, raw material consumption, major competitors, major lenders, excerpts from the Directors reports and events after the balance sheet date.

CRISIL has won international recognition. It is one of the four international companies short listed by the Asian Development Banks for being appointed as consultant for setting up a credit rating organisation in Thailand. CRISIL has set up an information company in collaboration With Extel Financial Limited of the U.K. called Crisil Information Limited.

Standard and Poor's Rating Services, a global rating agency from the USA, has formed strategic alliance with CRISIL for providing analytical and business development cooperation.

2. ICRA

Investment Information and Credit Rating Agency of India (ICRA) has been promoted by the IFCI Ltd., as the main promoter to meet the requirements of the companies based in the north. The other shareholders of ICRA are SBI, UT1, PNB, LIC, GIC, etc. It started operations in 1991.

The primary objective of ICRA is to rate the credit instruments, to award a grade in consonance with the risk associated with them, to reflect their capability of timely servicing of debt.

ICRA has ventured into "Earning Prospects Risk Analysis" (EPRA), which focuses on equity rating. The main emphasis of EPRA is on grading the primary market at the instance to the issuer and assessment of the secondary market at the instance of the investor. ICRA also undertakes rating of LPG/ kerosene, dealers/banks etc.

In addition to credit rating, it also provides two services, credit assessment and general assessment.

Rahul Publications

(a) Credit Assessment: It takes up assignments for credit assessment of companies who intend to use such assessment for obtaining specific line of assistance from commercial banks, financial institutions, factoring companies, etc.

(b) General Assessment: It provides services of general assessment at the request of banks or any other potential users. This service is also likely to be useful for other non-banking nonfinancial agencies for the purpose of merger, joint venture, acquisition, collaboration, amalgamation and factoring of debts.

Performance of ICRA

During 1994-95 ICRA rated 212 debt instruments covering a debt volume of Rs 5,343 crores. The cumulative number of instruments rated since its inception till March 1995 has been 485 covering a total debt volume of Rs. 17638 crores.

3. Credit Analysis and Research limited (CARE)

Launched in 1993, CARE offers credit rating services to areas such as corporate governance, debt ratings, financial sector, bank loan ratings, issuer ratings, recovery ratings, and infrastructure ratings. Headquartered in Mumbai, CARE offers two different categories of bank loan ratings, long-term and short-term debt instruments. The company also offers ratings for Initial Public Offerings (IPOs), real estate, renewable energy service companies (RESCO), financial assessment of shipyards, Energy service companies (ESCO) grades various courses of educational institutions. CARE Ratings has also ventured into valuation services and offers valuation of equity, debt instruments, and market linked debentures. Moreover, the company has launched a new international credit rating agency 'ARC Ratings' by teaming up with four partners from South Africa Brazil, Portugal, and Malaysia. ARC Ratings has commenced operations and completed sovereign ratings of countries, including India.

4. Brickwork Ratings (BWR)

Brickwork Rating was established in 2007 and is promoted by Canara Bank. It offers ratings for bank loans, SMEs, corporate governance rating, municipal corporation, capital market instrument, and financial institutions. It also grades NGOs, tourism, IPOs, real estate investments, hospitals, IREDA, educational institutions, MFI, and MNRE. Brickwork Ratings is recognized as external credit assessment agency (ECAI) by Reserve Bank of India (RBI) to carry out credit ratings in India.

5. India Rating and Research Pvt. Ltd.

India Ratings is a wholly-owned subsidiary of the Fitch Group. It offers credit ratings for insurance companies, banks, corporate issuers, project finance, financial institutions, finance and leasing companies, managed funds, and urban local bodies. In addition to SEBI, the company is recognized by the Reserve Bank of India and National Housing Bank.

6. Acute Ratings & Research Limited

Acute Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 8,300 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and section of industries. It has its Registered and Head Office in BKC, Mumbai.

7. Infomerics Valuation and Rating Private Limited

An RBI-accredited and SEBI-registered credit agency, Infomerics Valuation and Rating Private Limited saw its inception by eminent finance professionals and is now run under the leadership of Mr. Vipin Mallik. The credit bureau strives to offer an unbiased and detailed analysis and evaluation of credit worthiness to NBFCs, banks, corporates and small and medium scale units. It is through their rating and grading system that they determine the credit worthiness of an organisation. Infomerics helps in reducing any kind of information asymmetry amongst investors and lenders. Keeping transparency as it is core value, the credit bureau makes sure to deliver comprehensive and accurate reports and records of all their clients.

Rahul Publications

Q25. Explain the methodology followed by CRISIL in rating credit instruments.

Ans : **(Dec.-18)**

1. Business analysis

(a) Industry risk: CRISIL evaluates the industry risk by taking into consideration various factors like nature and basis of competition, key success -factors, demand and supply position, structure of industry, government policies etc. Industry strength is evaluated within the economy considering factors like inflation, energy requirements and availability, international competitive situation and socio-political scenario; demand projection growth stages and maturity of markets; cost structure of industry in domestic and international scenario; or, the government policies toward industry. Industry risk analysis may set upper limit on rating. This calling is not crossed by an individual company which operates within the industry.

(b) Market position of the company within the industry: Market position of the company within the industry is evaluated from different angles: i.e., market share and stability of market share; competitive advantage through marketing and distribution strength and weakness; marketing/support service infrastructure; diversity of products and customers base; research and development and its linkage to product obsolescence; quality important programme; as finally, the long term sales contract, strong marketing position of the company within the industry attracts better grade rating.

(c) Operating efficiency: Operating efficiency of the company is assessed vis-a-vis competitor's comparison. For instance, the pricing or cost advantage; availability, cost, quality of raw material; availability of labour and labour relations; integration of manufacturing operations and cost effectiveness of plant and equipments; level of capital employed and productivity; energy cost; or finally, the compliance to pollution control requirement on taken into comideration.

(d) Legal position: Legal position of issue of debt instrument is assessed by: letter of offer; terms of debenture trust deed, trustees and their responsibilities; system of timely payment of interest and principal; or protection of forgery and fraud. Thus, business covers all relevant aspects as related to business operations of the client company to assess the creditworthiness of the company.

2. Financial analysis

Under financial analysis all relevant aspects connected with the business and financial position of the company are assessed in the following four important segments.

(i) Firstly the accounting finally is seen as qualifications of auditors; focus on determining extent to which performance is overstated; method of income recognition; depreciation policies and inventory calculations; Under Valued/Over Valuing of assets; or off balance sheet liabilities.

(ii) Secondly the Earning Potential return to long term earning potential under varying conditions is assessed. Key considerations are: Profitability ratios; pretax coverage ratios; earnings on assets/capital employed; source of future earnings; or ability to finance growth internally.

(iii) Thirdly, the adequacy of the Cash Flows is appraised in relation to debt and fixed and working capital requirements of the company.

Main focus of analysis is on variability of future cash flows; capital spending flexibility; cash flows to fixed and working capital requirements; or Working Capital management.

Rahul Publications

(iv) Fourthly, the Financial Flexibility is assessed through financial plans in times of stress and their reliability; ability to attract capital; capital spending flexibility; asset redeployment potential; or the debt service schedule.

3. Management evaluation

The track record of management is evaluated by observing the goals and philosophies; strategies and ability to overcome adverse situations; judgement of management performance based on past operating and financial results; planning and control systems; conservatism or aggressiveness with reference to financial risk; depths of managerial talents and succession plans; shareholding pattern and constitution of Board of Directors; relationship with shareholders; or mergers and acquisition considerations.

5.8.2 Credit Rating Process

Q26. Outline the steps involved in credit rating process.

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

1. Receipt of the Request

The rating process begins, with the receipt of formal request for rating from a company desirous of having its issue obligations under proposed instrument rated by credit rating agencies. An agreement is entered into between the rating agency and the issuer company.

The agreement spells out the terms of the rating assignment and covers the following aspects:

i) It requires the CRA (Credit Rating Agency) to keep the information confidential.

ii) It gives right to the issuer company to accept or not to accept the rating.

iii) It requires the issuer company to provide all material information to the CRA for rating and subsequent surveillance.

2. Assignment to Analytical Team

On receipt of the above request, the CRA assigns the job to an analytical team. The team usually comprises of two members/ analysts who have expertise in the relevant business area and are responsible for carrying out the rating assignments.

3. Obtaining Information

The analytical team obtains the requisite information from the client company. Issuers are usually provided a list of information requirements and broad framework for discussions. These requirements are derived from the experience of the issuers business and broadly confirms to all the aspects which have a bearing on the rating. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

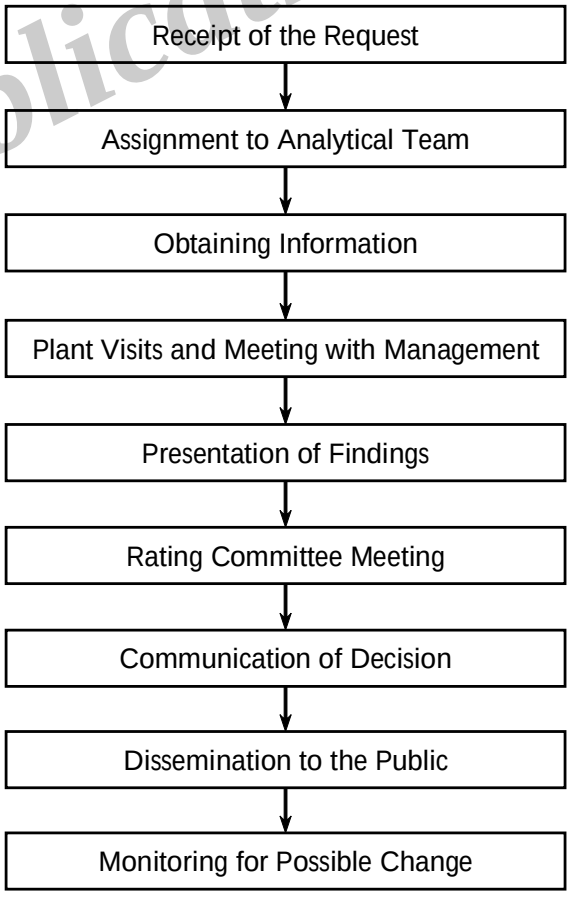


Fig.: Credit Rating Process

Rahul Publications

4. Plant Visits and Meeting with Management

To obtain classification and better understanding of the client's operations, the team visits and interacts with the company's executives. Plants visits facilitate understanding of the production process, assess the state of equipment and main facilities, evaluate the quality of technical personnel and form an opinion on the key variables that influence level, quality and cost of production. A direct dialogue is maintained with the issuer company as this enables the CRAs to incorporate non-public information in a rating decision and also enables the rating to be forward looking. The topics discussed during the management meeting are wide ranging including competitive position, strategies, financial policies, historical performance, risk profile and strategies in addition to reviewing financial data.

5. Presentation of Findings

After completing the analysis, the findings are discussed at length in the Internal Committee, comprising senior analysts of the credit rating agency. All the issues having a bearing on rating are identified. An opinion on the rating is also formed. The findings of the team are finally presented to Rating Committee.

6. Rating Committee Meeting

This is the final authority for assigning ratings. The rating committee meeting is the only aspect of the process in which the issuer does not participate directly. The rating is arrived at after composite assessment of all the factors concerning the issuer, with the key issues getting greater attention.

7. Communication of Decision

The assigned rating grade is communicated finally to the issuer along with reasons or rationale supporting the rating. The ratings which are not accepted are either rejected or reviewed in the light of additional facts provided by the issuer. The rejected ratings are not disclosed and complete confidentiality is maintained.

8. Dissemination to the Public

Once the issuer accepts the rating, the credit rating agencies disseminate it through printed reports to the public.

9. Monitoring for Possible Change

Once the company has decided to use the rating, CRAs are obliged to monitor the accepted ratings over the life of the instrument. The CRA constantly monitors all ratings with reference to new political, economic and financial developments and industry trends. All this information is reviewed regularly to find companies for, major rating changes. Any changes in the rating are made public through published reports by CRAs.

5.8.3 Regulations of Credit Ratings

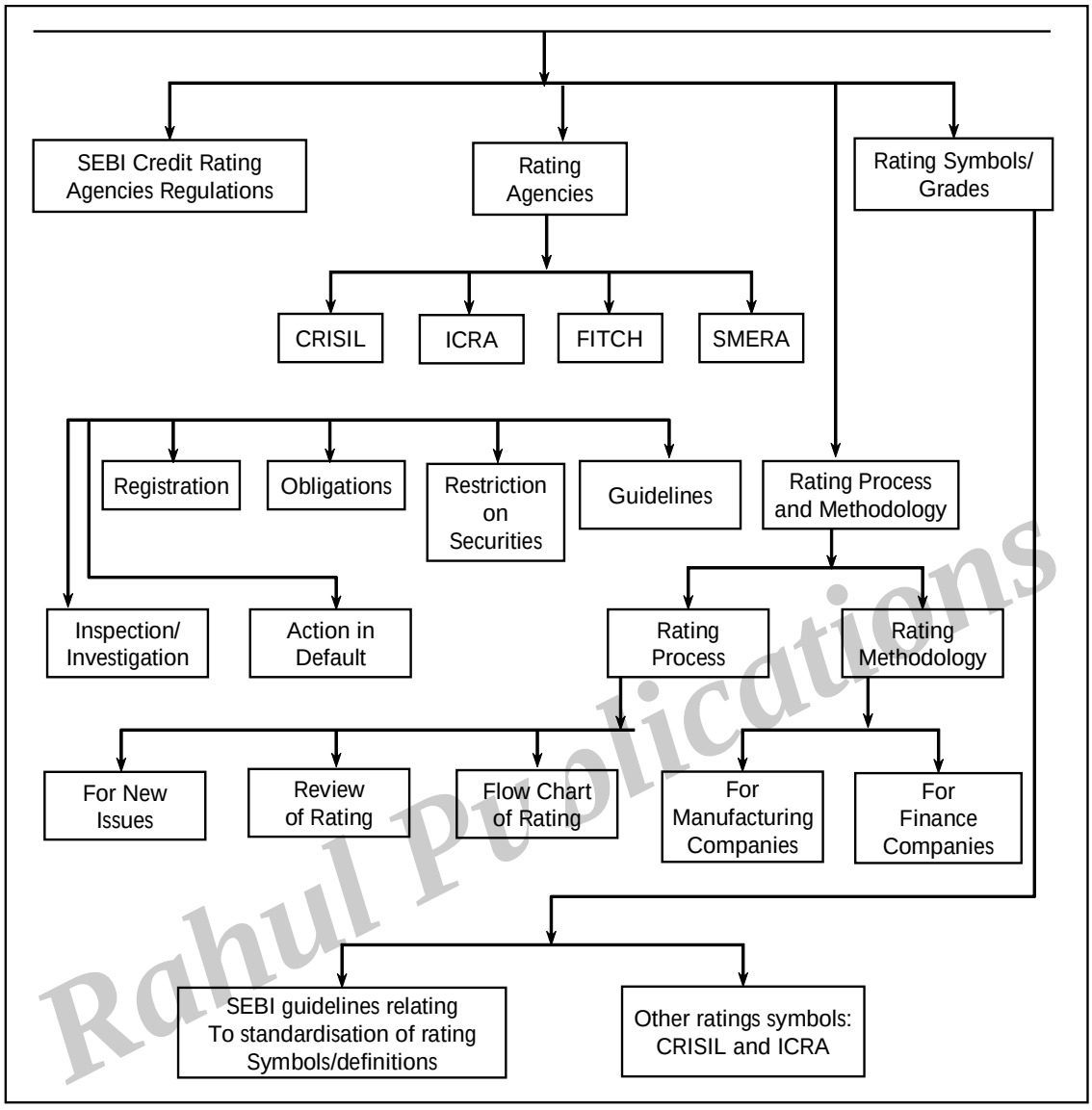
Q27. Discuss the regulatory framework of credit rating system.

Ans : **(Imp.)**

Registration of Credit Rating Agencies

Registration with the SEBI is mandatory for carrying on the rating business. The application for the grant of certificate of initial registration should be made to the SEBI in Form A (Appendix 14-A on the website) and accompanied by a non refundable fee of `50,000.

Rahul Publications



Rahul Publications

A credit rating agency means a body corporate engaged/proposed to be engaged in the business of rating of securities offered by way of public/rights issues. Rating is defined by the SEBI Regulations as an opin-ion regarding securities, expressed in the form of standard symbols/in any other standardised form, assigned by a credit rating agency and used by the issuer of such securities to comply with a requirement specified by these (SEBI) regulations.

Promoter of Credit Rating Agency

A credit rating agency (CRA) can be promoted by a (i) public financial institution, (PFI), as defined in Section 4-A of the Companies Act, (ii) scheduled bank, (iii) foreign bank operating in India with RBI approval, (iv) foreign credit rating agency, having at least five years experience in rating securities and (v) any company incorporated under the Companies Act/body corporate, having a continuous networth [i.e. paid-up equity capital plus free reserves (excluding reserves created out of revaluation) less accumulated losses and deferred expenditure, including miscellaneous expenses not written off] of a minimum of `100 crore as per its audited annual accounts for the previous five years prior to filing of the application with the SEBI for registration.

Eligibility Criteria

The eligibility criteria for a rating agency are as specified below. The agency:

- Is set up and registered as a company;
- Has specified rating activity as one of its main objects in its Memorandum of Association;
- As a minimum networth of `5 crore;
- Has adequate infrastructure

General Obligations

The general obligations of CRAs are as specified below:

Code of Conduct

A credit rating agency should:

- Make all efforts to protect the interests of investors.
- In the conduct of its business, observe high standards of integrity, dignity and fairness in the conduct of its business.
- Fulfil its obligations in a prompt, ethical and professional manner.
- At all times exercise due diligence, ensure proper care and exercise independent professional judgement in order to achieve and maintain objectivity and independence in the rating process.
- Have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in depth rating researches. It should also maintain records to support its decisions.
- Have in place a rating process that reflects consistent and international rating standards.
- Not indulge in any unfair competition nor should it wean away the clients of any other agency on assurance of higher rating.

Restrictions on Rating of Securities

Restrictions on rating by CRAs relate to securities issued by,

(i) Promoters and

(ii) Certain other entities.

Securities Issued by Promoters

A CRA is prohibited from rating securities issued by its promoter(s), who holds 10 per cent, or more, of its shares. If the promoter is a lending institution, its chairman/director(s)/employee(s) cannot hold a similar position in the CRA or its rating committee. However, a CRA may rate a security issued by its associate having a common independent director (i.e. a director who apart from receiving remuneration as a director does not have any other material pecuniary relationship/ transactions with the company/its promoters/its management/its subsidiaries which in the judgement of the Board of the company may affect the independence of the judgement of such director) with it or rating company if,

- The independent director does not participate in the discussion in the rating decision; and
- The CRA makes a disclosure in the rating announcement of such associate (about the existence of common independent director) on its Board or of its rating committee and that the independent director did not participate in the rating process or in the meeting of the Board of Directors or in the meeting of the rating committee when the securities rating of the associate.

Procedure for Inspection/Investigation

The SEBI is empowered to appoint inspecting officer(s) to undertake inspection/ investigation of the books of accounts/records/documents of the CRAs: (i) to ascertain whether they are being maintained properly, (ii) to ascertain whether the provisions of the SEBI Act/these regulations are being complied with, (iii) to investigate into complaints from investors/clients, whose securities are rated by any other person, regarding any matter having a bearing on the activities of the CRA and (iv) in the interest of the securities market/ investors.

The inspection would ordinarily not go into an examination of the appropriateness of ratings assigned on merit. In case of complaints of a serious nature, however, the appropriateness of the ratings may also be covered by the inspection, which would be carried out either by the officer(s) of the SEBI or independent experts with relevant experience, or a combination of both.

Rahul Publications

Before ordering an inspection/investigation, the SEBI would give at least 10 days' written notice to the CRA, except where satisfied that, in the interest of investors, no notice is required. The CRA and its directors/officers/employees are duty bound to produce, to the investigating/ inspecting officer, all books/ accounts/documents in their custody/control as well as furnish all the statements and information required, within a reasonable/specified period. It should (1) al-low the officer(s) reasonable access to the premises occupied by it/any other person on his behalf, (2) make available any books/records/ documents and computer data in his possession and (3) provide copies of documents/other material relevant to the officer(s) for the purpose of investigation/inspection. The investigation officer would be entitled to examine/ record statements of officers/directors/employees of the CRA in this connection. They are bound to render all the assistance that he may require. After consideration of inspection/investigation report, the SEBT/ Chairman would take such action as deemed fit and appropriate including action under the SEBI Intermediaries Regulation, 2008.

Action in Case of Default

The CRAs that (a) fail to comply with any condition, subject to which certificates of registration had been granted, or (b) contravene any of the provisions of the SEBI Act/these regulations/ any other regulation under the SEBI Act, would be dealt with in the manner provided under the SEBI Intermediaries Regulation.

5.8.4 Credit Information Bureau India Limited (CIBIL)

Q28. What is CIBIL? Who are its members? What are the objectives of CIBIL?

(OR)

Write a short note on CIBIL.

Ans : **(Dec.-19, May-19, Imp.)**

Credit Information Bureau (India) Limited, commonly known as CIBIL, is India's first Credit Information Company or Credit Bureau. It maintains records of all credit-related activity of individuals and companies including loans and credit cards . The records are submitted to CIBIL by registered member banks and other financial institutions on a periodic (usually monthly) basis. Based on this data, CIBIL issues a Credit Information Report or CIR (commonly referred to as a credit report) and a credit score.

CIBIL was founded in 2000 in order to bring greater efficiency and transparency in the credit space. Trans Union International (a global credit bureau) and Dun and Bradstreet (a global provider of credit information) are technical partners of CIBIL in India. CIBIL's mission is "To catalyze growth of Credit in India through: solutions that enable well informed Credit decisions; technology that enables superior information availability; and people that provide high quality services." It has an ISO 27001 rating, which is the highest security standard in the world.

Shareholders in CIBIL include TransUnion International, ICICI, SBI, IOB, HSBC, Union Bank of India, Bank of India, Bank of Baroda, and Allahabad Bank.

CIBIL has two focus areas: A Consumer Bureau that deals with consumer credit records and a Commercial Bureau that deals with the records of companies and institutions.

It is important to note that CIBI is a database of credit information. It does not make any lending decisions. It provides data to banks and other lenders who use it as a quick and efficient resource to filter loan applications.

Rahul Publications

CIBIL is one of the four authorized credit bureaus in India which provide a credit score, the others being Equifax, Experian and CRIF High Mark.

The most important factor in your credit score is your repayment history. Your payment record forms approximately 30% of your credit score. Making your all your credit repayments (on loans and credit cards) on time and in full plays a substantial role in building a good credit score. Below are some of the important factors that impact your credit score.

Members

The following are the members of CIBIL

1. Financial Institution
2. Banks
3. SFC
4. NBFC
5. Housing financial companies

Objectives of CIBIL

- CIBIL aims to give full information to lenders by collecting, collecting and distributing credit information related both to lenders as well as the borrowers.
- Banks, Financial Institutions, Non-Banking Financial Companies, Housing Finances Companies and Credit Card Companies use CIBIL services.
- Data is shared with only those members who have submitted all their credit data.
- It takes pride in having the topmost credit information sharing in India that makes enable the credit grantor in accepting payment and information backed decisions.
- CIBIL has gained knowledge, experience and expertise to offer data and technology backed solutions
- Wide gamut solutions were developed diligently for helping our customers in making intelligent decision in entire stage of customer life cycle.

Rahul Publications

Short Question and Answers

1. Define credit rating.

Ans :

Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

Definitions

i) "A corporate credit rating provides lenders with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted."

ii) "Credit rating is an unbiased and independent opinions as to issuer's capacity to meet its financial obligations. It does not constitute a recommendation to buy/sell or hold a particular security.

2. What is underwriting?

Ans :

The important intermediary in the new issue/ primary market is the un-derwriters to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Though underwriting is not mandatory after April 1995, its organisation is an important element of the primary market. Underwriters are appointed by the issuing companies in consulta-tion with the lead managers/merchant bankers to the issues. A statement to the effect that in the opinion of the lead manager, the underwriters' assets are adequate to meet their obligation should be incorporated in the prospectus.

3. Write a short note on CIBIL.

Ans :

Credit Information Bureau (India) Limited, commonly known as CIBIL, is India's first Credit Information Company or Credit Bureau. It maintains records of all credit-related activity of individuals and companies including loans and credit cards . The records are submitted to CIBIL by registered member banks and other financial institutions on a periodic (usually monthly) basis. Based on this data, CIBIL issues a Credit Information Report or CIR (commonly referred to as a credit report) and a credit score.

CIBIL was founded in 2000 in order to bring greater efficiency and transparency in the credit space. Trans Union International (a global credit bureau) and Dun and Bradstreet (a global provider of credit information) are technical partners of CIBIL in India. CIBIL's mission is "To catalyze growth of Credit in India through: solutions that enable well informed Credit decisions; technology that enables superior information availability; and people that provide high quality services." It has an ISO 27001 rating, which is the highest security standard in the world.

Shareholders in CIBIL include TransUnion International, ICICI, SBI, IOB, HSBC, Union Bank of India, Bank of India, Bank of Baroda, and Allahabad Bank.

4. Portfolio Managers.

Ans :

Portfolio managers are the persons who enter into a contract with clients and accordingly advise and undertake the management of portfolio of securities on behalf of the clients. Portfolio refers to the total holdings of securities of an investor.

Registration

Portfolio managers have to obtain certificate of registration from the SEBI to act as portfolio managers. SEBI grants the certificate after taking into account the infrastructure. Minimum of two experienced persons, capital adequacy and

Rahul Publications

professional qualification of the applicant. The person should not have been convicted of any offence and not directly or indirectly connected with the applicant.

Fee

SEBI issues the registration certificate on receiving the registration fee. The fee has been raise from Rs. 2.5 lakhs for first two years and 1 lakh for the third year to Rs. 5 lakhs from November 1999. Renewal fee payable from fourth year for every three years is Rs. 2.5 lakhs.

5. Define investment banking.

Ans :

Merchant banking is also known as investment banking.

The word 'merchant banking' was originated among the Dutch and Scottish traders. Later on it was developed and professionalised in the UK and the USA. Now this has become popular throughout the world.

Meaning

Merchant banking is non-banking financial activity. But it resembles banking function. It is a financial service. It includes the entire range of financial services.

The term merchant banking is used differently in different countries. So there is no universal definition for merchant banking.

6. Who is a lead manager?

Ans :

Every lead manager has to enter into an agreement with the issuing companies, setting out their mutual rights, liabilities and obligations relating to such issues, and in particular to disclosures allotment and refund. A statement specifying these is to be furnished to the SEBI at least one month before the opening of the issue for subscription. In case of more than one lead manager/merchant banker, the statement has to provide details about their respective responsibilities. He can not associate with a merchant banker who does not hold a certificate of registration with the SEBI.

7. Who is a Debenture Trustee ?

Ans :

A debenture trustee is a trustee for a trust deed needed for securing any issue of debentures by a company/body corporate or any private place-ment of debentures by a listed/proposed to be listed company. A trust deed means a deed executed by the body corporate in favour of the trustees named therein for the benefit of the debenture holders. An issue means an offer of sale or purchase of securities by any body corporate/ other person/ group of persons on its/their behalf to the public/holders of securities of the body corporate/persons/group of persons.

To act as a debenture trustee, a certificate of registration from the SEBI is necessary. Only banks, public financial institutions, insurance companies and body corporates fulfilling the capital adequacy requirement of `2 crore in terms of networth [i.e. aggregate of value of paid-up capital and free reserves (excluding reserves created out of revaluation) minus aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not written off)] as per the latest audited balance sheet can act as trustees.

8. Stock broking.

Ans :

Stockbroker means a person having trading rights in any recognised stock exchange including a trading member. A certificate of registration from the SEBI is mandatory to act as a broker. No separate registration is required for a SEBI-registered broker to operate in more than one stock exchange subject to the approval of the concerned stock exchange. A SEBI-registered clearing member (i.e. a person having clearing and settlement rights in any recognised clearing corporation including a person having clearing and settlement rights on a commodity derivative exchange) would also not require a separate registration to act as a bro-ker in the concerned stock exchange with its approval. A clearing corporation is an entity that undertakes clearing and settlement of trade in securities, other instruments/products dealt with/ traded on a stock exchange and includes a clearing house.

Rahul Publications

9. Depository system.

Ans :

A major reform of the Indian stock markets has been the introduction of the depository system and scripless trading mechanism, since 1996. This system of trading based on physical transfer/ custody of securities militated against the efficient functioning of markets, particularly in the context of the large scale entry of Foreign Institutional Investors (FIIs). The main problems faced the investors in general and FIIs in particular were:

- Inordinate delays in transfer of securities,
- Return of share certificates as bad deliveries on account of forged signatures/mismatch of signatures or fake certificate/forged transfer deed,
- Delay in the receipt/non-receipt of securities after allotment/refund orders to non-allottees.
- Delay in getting duplicate shares/debentures certificates, and
- Inadequate infrastructure in banking and postal segments to handle a large volume of application and storage of share certificate.

10. Explain the classifications of credit rating.

Ans :

Types of Credit Rating

Credit rating is classified into four major types which are as follows,

1. **Bond Rating:** Bond rating deals with grading of bonds or securities which are issued by a company, government or semi-government institution. It denotes the possibilities of payment on the maturity of the bond. In other words, it ascertains whether the level of risk involved is more or less.
2. **Equity Rating:** The rating of shares which are traded in capital market are called as equity rating.
3. **Commercial Paper Rating:** A company is statutorily bound to avail rating level from a rating agency before issuing commercial paper. It is known as commercial paper rating. In India, the rating of commercial papers issued by corporate bodies is compulsory.
4. **Sovereign Rating:** Sovereign rating is related with the payment of the credit of the government of a country.

Rahul Publications

Internal Assessment (Mid Examinations)

The pattern of Mid Exams or Continuous Internal Evaluation (CIE) prescribed by the JNTU-H as per the Regulations 2019 (R19) for all the semesters is as follows,

- There would be two Mid Exams or Continuous Internal Evaluation (CIE) for each semester,
  - The **Ist Mid Term Examinations** would be conducted during the Middle of the Semester.
  - The **IInd Mid Term Examinations** during the last week of instructions.
- The Mid Exam I and II would have the same pattern of question paper which would carry **25 Marks** each and the time duration for conducting each Mid exam would be 120 min.
- The pattern of Mid Exam Question Paper would consist of two parts i.e., **Part-A** and **Part-B.**
  - **Part-A** consist of 5 compulsory questions each carries 2 marks (i.e 5 × 2 = 10 marks).
  - **Part-B** consist of 5 questions out of which 3 questions should be answered, each question carries 5 marks (i.e 5 × 3 = 15 marks).
- The average of the two Mid exams will be added with the 75 marks of External end examination which equals to 100 marks (i.e 25 + 75 = 100).

UNIT - I

Part - A

1.	Cash Reserve Ratio	(Refer Unit-I, SQA-2)
2.	Statutory Liquidity Ratio	(Refer Unit-I, SQA-3)
3.	Financial sectors Reforms.	(Refer Unit-I, SQA-5)
4.	Define SEBI.	(Refer Unit-I, SQA-9)
5.	NABARD	(Refer Unit-I, SQA-11)

Part - B

1.	Define financial system. Discuss the functions of financial system.	(Refer Unit-I, Q.No. 1)
2.	Discuss the structures of Indian Financial System.	(Refer Unit-I, Q.No. 2)
3.	What is meant by equilibrium in financial markets?	(Refer Unit-I, Q.No. 5)
4.	Explain the role of financial system in achieving economic development in India.	(Refer Unit-I, Q.No. 8)
5.	Explain the financial sectors reforms after 1991.	(Refer Unit-I, Q.No. 11)

6. Discuss the various techniques of monetary control of RBI. (Refer Unit-I, Q.No. 21)
7. Define SEBI. Explain the objectives and role of SEBI. (Refer Unit-I, Q.No. 28)
5. Explain the functions of NABARD. (Refer Unit-I, Q.No. 41)

UNIT - II

Part - A

1. Define Non-Performing Assets. (Refer Unit-II, SQA-1)
2. What are Commercial Banks? (Refer Unit-II, SQA-3)
3. Define Interest Rate. (Refer Unit-II, SQA-4)
4. Spreads (Refer Unit-II, SQA-5)
5. Unit trust of India. (Refer Unit-II, SQA-9)
6. Define mutual funds. (Refer Unit-II, SQA-10)

Part - B

1. Draw a chart depicting the banking structure in India. (Refer Unit-II, Q.No. 1)
2. Explain the organizational structure of commercial banks. (Refer Unit-II, Q.No. 4)
3. Explain the classification of public sector banks. (Refer Unit-II, Q.No. 7)
4. Discuss the Recent innovations in banking sector. (Refer Unit-II, Q.No. 24)
5. What are the norms prescribed by the RBI capital adequacy of banks? (Refer Unit-II, Q.No. 23)
6. Explain the functioning of UTI. (Refer Unit-II, Q.No. 42)
7. Explain the Structure of Mutual Funds. (Refer Unit-II, Q.No. 44)
8. Explain the Role of IRDA. (Refer Unit-II, Q.No. 62)
9. Discuss the various challenges faced by the Insurance sector. (Refer Unit-II, Q.No. 64)

UNIT - III

Part - A

1. Advantages of Commercial Paper. (Refer Unit-III, SQA-1)
2. Define Call money market. (Refer Unit-III, SQA-5)
3. Define Commercial bills. (Refer Unit-III, SQA-6)
4. Define SEBI. (Refer Unit-III, SQA-10)
5. Powers of SEBI. (Refer Unit-III, SQA-11)

Part - B

1. Define Call money market. Explain structure and Functions of a Call Money Market. (Refer Unit-III, Q.No. 4)
2. Discuss the classifications of treasury bill market. (Refer Unit-III, Q.No. 7)
3. Define Commercial bills. Explain the features of commercial bill market. (Refer Unit-III, Q.No. 9)
4. What are certificate of deposits? Explain the features of certificate of deposits? (Refer Unit-III, Q.No. 18)

5. Define Security Market. Explain the organization and structure of Security Market. (Refer Unit-III, Q.No. 29)
6. Discuss the Listing, Trading and Settlement process in stock exchange. (Refer Unit-III, Q.No. 30)
7. Briefly explain the role of SEBI in the regulation of primary markets in India. (Refer Unit-III, Q.No. 44)

UNIT - IV

Part - A

1. State the features of venture capital. (Refer Unit-IV, SQA-1)
2. Define factoring. (Refer Unit-IV, SQA-3)
3. Define Hire Purchase. (Refer Unit-IV, SQA-8)
4. Define consumer credit. (Refer Unit-IV, SQA-9)
5. Advantages of Venture Capital? (Refer Unit-IV, SQA-12)

Part - B

1. What is lease finance? Explain the characteristics of leasing. (Refer Unit-IV, Q.No. 2)
2. Explain the classification of leasing. (Refer Unit-IV, Q.No. 4)
3. Define Hire Purchase. Explain the features of hire purchase. (Refer Unit-IV, Q.No. 12)
4. Explain the classification of consumer credit. (Refer Unit-IV, Q.No. 17)
5. Explain the advantages and dis-advantages of Factoring. (Refer Unit-IV, Q.No. 27)
6. Distinguish between Factoring and Forfeiting. (Refer Unit-IV, Q.No. 33)

UNIT - V

Part - A

1. What is underwriting? (Refer Unit-V, SQA-2)
2. Write a short note on CIBIL. (Refer Unit-V, SQA-3)
3. Portfolio Managers. (Refer Unit-V, SQA-4)
4. Depository system. (Refer Unit-V, SQA-9)
5. Explain the classifications of credit rating. (Refer Unit-V, SQA-10)

Part - B

1. Define merchant banking. Explain the evolution of merchant banking. (Refer Unit-V, Q.No. 2)
2. Explain the functions of merchant bankers. (Refer Unit-V, Q.No. 3)
3. Explain the role of merchant banker as a lead manager. (Refer Unit-V, Q.No. 6)
4. Discuss the various Challenges Faced by Investment Bankers. (Refer Unit-V, Q.No. 12)
5. Write a note on credit rating agencies in India and their performance. (Refer Unit-V, Q.No. 24)
6. What is CIBIL? Who are its members? What are the objectives of CIBIL? (Refer Unit-V, Q.No. 28)

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERBAD

M.B.A III - Semester Examination

October / November - 2020

R17

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

Time : 2 Hours] [Max. Marks : 75

Answer any five questions

All questions carry equal marks

ANSWERS

1. Discuss the recent developments of Indian Financial System. **(Unit-I, Q.No. 12)**

2. (a) Explain the techniques of monetary control of RBI. **(Unit-I, Q.No. 21)**

   (b) List out objectives of IDFC and SFCs. **(Unit-I, Q.No. 40,44)**

3. (a) Write a note on growth and structure of Commercial Banks. **(Unit-II, Q.No. 4,6)**

   (b) List out the problems faced by Commercial Banks in India. **(Unit-II, Q.No. 3)**

4. Discuss the role of IRDA in regulating the Indian Insurance Companies. **(Unit-II, Q.No. 62)**

5. Explain about :

   (a) Call Money Market **(Unit-III, Q.No. 4)**

   (b) T-Bill Market **(Unit-III, Q.No. 6)**

6. (a) What is Lease Financing? Explain different types of Leasing. **(Unit-IV, Q.No. 2, 4)**

   (b) Explain different types of Factoring. **(Unit-IV, Q.No. 24)**

7. What is Venture Capital Financing ? Discuss various stages of Venture Capital Financing. **(Unit-IV, Q.No. 40,46)**

8. What is Credit Rating ? Explain the process of rating equity issue by a company. **(Unit-V, Q.No. 19, 26)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA III-Semester Examinations

April / May - 2019

R17

FINANCIAL INSTITUTIONS, MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 75

Note: This question paper contains two **Part A** and **B**.

Part A is compulsory which carries 25 marks. Answer all questions in **Part A.**

Part B consists of 5 Units. Answer any **One** full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

ANSWERS

PART - A (5 × 5 = 25 Marks)

1. (a) What do you mean by equilibrium in financial markets? **(Unit-I, SQA-1)**

   (b) Expand AMFI and briefly explain its role in Financial Market. **(Unit-II, SQA-2)**

   (c) Explain the role of Clearing Corporation of India. **(Unit-III, SQA-2)**

   (d) Write about Factoring Vs. Forfeiting. **(Unit-IV, SQA-2)**

   (e) Write a short note on CIBIL. **(Unit-V, SQA-3)**

PART - B (5 × 10 = 50 Marks)

2. Discuss the Role, Fun.ctions and different techniques of monetary control of RBI.

(Unit-I, Q.No.18,19,21)

OR

3. Critically examine the Financial Sector Reforms in India after 1991**.** **(Unit-I, Q.No.11)**

4. (a) How is Risk Management done in Banking ? **(Unit-II, Q.No.28)**

   (b) Explain the innovations in Indian banking system. **(Unit-II, Q.No.24)**

OR

5. Explain the role of IRDA and discuss the challenges of insurance sector in India. **(Unit-II, Q.No.62,64)**

6. What are the functions of call money market? Explain any five instruments in Indian money market. **(Unit-III, Q.No.4,6,9,14,18)**

OR

7. Briefly explain the Role of SEBI in the regulation of Primary and Secondary market in India. **(Unit-III, Q.No.44,45)**

8. What is Lease Finance? Explain the features and different types of leasing. **(Unit-IV, Q.No.2,4)**

OR

9. (a) What do you mean by Hire Purchase? **(Unit-IV, Q.No.12)**

   (b) Differentiate Hire purchase and Lease Finance. **(Unit-V, Q.No.15)**

10. Define Investment banking. Explain the challenges faced by the investment bankers. **(Unit-V, Q.No.2,12)**

OR

11. (a) Discuss the role of credit rating agencies in investor protection. **(Unit-V, Q.No.24)**

    (b) Explain the advantages and disadvantages of credit rating. **(Unit-V, Q.No.21)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERABAD

MBA III-Semester Examinations

December - 2019

R17

FINANCIAL INSTITUTIONS, MARKETS AND SERVICES

Time : 3 Hours] [Max. Marks : 75

Note: This question paper contains two **Part A** and **B**.

Part A is compulsory which carries 25 marks. Answer all questions in **Part A.**

Part B consists of 5 Units. Answer any **One** full question from each unit.

Each question carries 10 marks and may have a, b, c as sub questions.

ANSWERS

PART - A (5 × 5 = 25 Marks)

1. Write a short note on the following :

   (a) Cash Reserve Ratio **(Unit-I, SQA-2)**

   (b) ATMs and their Value Added Services **(Unit-II, SQA-14)**

   (c) State Trading Corporation of India (STCI) **(Unit-III, SQA-3)**

   (d) Factoring **(Unit-IV, SQA-3)**

   (e) Role of Portfolio Managers **(Unit-V, SQA-4)**

PART - B (5 × 10 = 50 Marks)

2. What is IFCI? What are its functions? What is its contribution to the National Economy? **(Unit-I, Q.No.35,36,38)**

OR

3. What is SEBI? What are its Objectives and Functions? **(Unit-I, Q.No.28,29)**

4. (a) What is the structure of the Indian Banking System? Depict the same with a diagram and explain its-components. **(Unit-II, Q.No.1)**

   (b) Discuss about innovation in Banking. **(Unit-II, Q.No.24)**

OR

5. (a) Discuss the growth of Mutual Funds in India. **(Unit-II, Q.No.45)**

   (b) How can we reduce the NPAs of Banks & Financial Institutions? **(Unit-II, Q.No.20)**

6. (a) What is the T-Bills Market? **(Unit-III, Q.No.6)**

   (b) What are the types and advantages of the T-Bills? **(Unit-III, Q.No.8)**

OR

7. (a) What are Commercial Paper (CP) and Certificates Deposits (CDs) ? Differentiate between them. **(Unit-III, Q.No.14,18,23)**

   (b) Explain the functions of clearing corporation of India Ltd. **(Unit-III, Q.No.47)**

8. Explain about Housing Finance in India and Factoring services. **(Unit-IV, Q.No.37,21)**

OR

9. What is Leasing? What are the two basic types of Leases? Differentiate between them. **(Unit-IV, Q.No.2,4,5)**

10. What is Credit Rating? What is the Credit Rating Methodology? Briefly describe the top three Indian Credit Rating Agencies. **(Unit-V, Q.No.19,25,24)**

OR

11. What is CIBIL? Who are its members? What are the objects of CIBIL? **(Unit-V, Q.No.28)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERBAD

M.B.A III - Semester Examination

December - 2018

R17

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

Time : 3 Hours] [Max. Marks : 75

Note : This question paper contains two parts A and B.
Part A is compulsory which carries 25 marks. Answer all questions in Part - A.
Part - B contains of 5 Units. Answer any one full question from each unit.
Each question carries 10 marks and may have a, b, c as sub questions.

PART - A (5 × 5 = 25 Marks)

ANSWERS

1. (a) Explain the characteristics features of financial system. **(Unit-I, SQA-4)**

   (b) Define non-performing assets. **(Unit-II, SQA-1)**

   (c) Explain the advantages of commercial paper. **(Unit-II, SQA-1)**

   (d) State the features of Venture Capital. **(Unit-IV, SQA-1)**

   (e) What is underwriting ? **(Unit-V, SQA-2)**

PART - B (5 × 10 = 50 Marks)

2. Explain the role of financial system in achieving economic development in India. **(Unit-I, Q.No.8)**

OR

3. What is monetary Policy ? Describe the various techniques of monetary control of RBI. **(Unit-I, Q.No.18,21)**

4. Explain the motives initiated by the Government in order to strengthen the Co-Operative Banks in India. **(Unit-II, Q.No.34)**

OR

5. Describe the structure of the Mutual Fund Operations in India. State the facilities available to Investors. **(Unit-II, Q.No.44,48)**

6. What are the features and advantages of Certificate of Deposits ? **(Unit-III, Q.No.18,22)**

OR

7. Elucidate the SEBI guidelines for regulation of Primary and Secondary Markets in India. **(Unit-III, Q.No.44,45)**

8. Explain the features of Hire Purchase. Distinguish between Hire Purchase and Lease. **(Unit-IV, Q.No.12,15)**

OR

9. Describe the strategic role of Venture Capital Financing in the development of a country. **(Unit-IV, Q.No.44)**

10. What is the role of Merchant Bankers as lead Managers ? Explain the duties and responsibilities of Lead Managers. **(Unit-V, Q.No.6,5)**

OR

11. Explain the methodology followed by CRISIL in rating credit instruments. **(Unit-V, Q.No.25)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERBAD

M.B.A III - Semester Examination R19

Model Paper - I

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

Time : 3 Hours] [Max. Marks : 75

Note: This question paper contains two parts A and B.
Part A is compulsory which carries 25 marks. Answer all questions in Part A.
Part B consists of 5 Units. Answer any one full question from each unit.
Each question carries 10 marks and may have a, b. c as sub questions.

PART - A **(5 × 5 = 25 Marks)** **ANSWERS**

(Short Answer Questions)

1. (a) Non-bank Statutory Financial Organization. **(Unit-I, SQA-11)**
   (b) Define Non-Performing Assets. **(Unit-II, SQA-1)**
   (c) Secondary Market **(Unit-III, SQA-9)**
   (d) Define factoring. **(Unit-IV, SQA-3)**
   (e) Stock broking. **(Unit-V, SQA-8)**

PART - B **(5 × 10 = 50 Marks)**

(Essay Type Questions)

2. Discuss the structures of Indian Financial System. **(Unit-I, Q.No. 2)**

OR

3. Define SEBI. Explain the objectives and role of SEBI. **(Unit-I, Q.No. 28)**
4. Define Bank. Explain the structure of Banking in India. **(Unit-II, Q.No. 1)**

OR

5. Discuss the government Initiatives that Strengthens the Development of Co-operative Banks. **(Unit-II, Q.No. 34)**
6. Define Call money market. Explain structure and Functions of a Call Money Market. **(Unit-III, Q.No. 4)**

OR

7. Define Security Market. Explain the organization and structure of Security Market. **(Unit-III, Q.No. 29)**
8. Explain the classification of leasing. **(Unit-IV, Q.No. 4)**

OR

9. Discuss the various banks Financing the Housing Finance Policy. **(Unit-IV, Q.No. 37)**
10. Who is a Debenture Trustee ? Explain briefly the responsibilities and obligations of a Debenture Trustee. **(Unit-V, Q.No. 9)**

OR

11. What is CIBIL? Who are its members? What are the objectives of CIBIL? **(Unit-V, Q.No. 28)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERBAD

M.B.A III - Semester Examination R19

Model Paper - II

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

Time : 3 Hours] [Max. Marks : 75

Note: This question paper contains two parts A and B.
Part A is compulsory which carries 25 marks. Answer all questions in Part A.
Part B consists of 5 Units. Answer any one full question from each unit.
Each question carries 10 marks and may have a, b. c as sub questions.

PART - A **(5 × 5 = 25 Marks)** **ANSWERS**

(Short Answer Questions)

1. (a) Define Monetary policy. **(Unit-I, SQA-8)**
   (b) Define mutual funds. **(Unit-II, SQA-10)**
   (c) Define SEBI. **(Unit-III, SQA-10)**
   (d) Define forfeiting. **(Unit-IV, SQA-11)**
   (e) Depository system. **(Unit-V, SQA-9)**

PART - B **(5 × 10 = 50 Marks)**

(Essay Type Questions)

2. Explain the financial sectors reforms after 1991. **(Unit-I, Q.No. 11)**

OR

3. Explain the functions of NABARD. **(Unit-I, Q.No. 41)**
4. Discuss the Recent innovations in banking sector. **(Unit-II, Q.No. 24)**

OR

5. Explain the Role of IRDA. **(Unit-II, Q.No. 62)**
6. Discuss the Listing, Trading and Settlement process in stock exchange. **(Unit-III, Q.No. 30)**

OR

7. Discuss the Role of SEBI in primary market. **(Unit-III, Q.No. 44)**
8. Differences between Financial Lease and Operating Lease. **(Unit-IV, Q.No. 5)**

OR

9. Explain the advantages and dis-advantages of Factoring. **(Unit-IV, Q.No. 27)**
10. Discuss the various Challenges Faced by Investment Bankers. **(Unit-V, Q.No. 12)**

OR

11. Write a note on credit rating agencies in India and their performance. **(Unit-V, Q.No. 24)**

JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY HYDERBAD

M.B.A III - Semester Examination

R19

Model Paper - III

FINANCIAL INSTITUTIONS, MARKETS & SERVICES

Time : 3 Hours] [Max. Marks : 75

Note: This question paper contains two parts A and B.
Part A is compulsory which carries 25 marks. Answer all questions in Part A.
Part B consists of 5 Units. Answer any one full question from each unit.
Each question carries 10 marks and may have a, b. c as sub questions.

PART - A **(5 × 5 = 25 Marks)** **ANSWERS**

(Short Answer Questions)

1. (a) Statutory Liquidity Ratio **(Unit-I, SQA-3)**
   (b) Define Interest Rate. **(Unit-II, SQA-4)**
   (c) Define commercial papers. **(Unit-III, SQA-7)**
   (d) Objectives of factoring **(Unit-IV, SQA-10)**
   (e) Define credit rating. **(Unit-V, SQA-1)**

PART - B **(5 × 10 = 50 Marks)**

(Essay Type Questions)

2. Discuss the role of financial system of economic development. **(Unit-I, Q.No. 8)**

OR

3. Explain briefly about IDFC. List out the objectives of IDFC. **(Unit-I, Q.No. 40)**
4. Define Non-Performing Assets. Explain the factors affecting Non-performing assets. **(Unit-II, Q.No. 17)**

OR

5. Explain the classification of risk. **(Unit-II, Q.No. 28)**
6. Define Commercial bills. Explain the features of commercial bill market. **(Unit-III, Q.No. 9)**

OR

7. Discuss the role of SEBI in secondary market. **(Unit-III, Q.No. 45)**
8. What are the differences between Hire Purchase and Leasing. **(Unit-IV, Q.No. 15)**

OR

9. Explain the Venture Capital Financing Scenario in India. **(Unit-IV, Q.No. 44)**
10. Explain the role of merchant banker as a lead manager. **(Unit-V, Q.No. 6)**

OR

11. Outline the steps involved in credit rating process. **(Unit-V, Q.No. 26)**