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FOUR YEAR BACHELOR'S DEGREE COURSE
(CBCS in Accordance with NEP 2020)

SEMESTER-III

INDIAN FINANCIAL SYSTEM

COMMERCE

Maniram Dewan School of Management
KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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COURSE INTRODUCTION

This course "**Indian Financial System**" has been structured to give the learners of B. Com. programme the basic idea about the financial system in our country. The Indian financial system consists of financial institutions, financial markets, financial instruments and financial services. In the first unit we will discuss the meaning of finance, its features, classification of finance, financial system and components, electronic banking etc. The second unit of this course is the Indian Money Market where we will discuss the structure of Indian Money Market, different instruments of money market etc. In the third unit we will discuss the capital market, instruments and intermediaries of this market etc. In the fourth unit, you will get an idea about the various types of interest rates, administered interest rate, market determined interest rate etc. Another important aspect covered by this course is the concept of mutual fund, its importance, different mutual fund schemes etc. In the sixth unit we will discuss the meaning of lease financing, its features, different classes of lease, meaning of hire purchase and installment purchase system, their features, differences etc. As you move towards the end of this course, you will get an idea about the Derivatives, Credit rating Services, Depository as well as the regulating framework of financial markets in India.

While going through a unit, you will notice that some along-side boxes, which have been included to help you know some of the difficult, unseen terms. Some ''ACTIVITY'' (s) has been included to help you to apply your own thoughts. Again, we have included some relevant concepts in ''LET US KNOW'' along with the text. At the end of sections, you will get ''CHECK YOUR PROGRESS'' questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with ''ANSWERS TO CHECK YOUR PROGRESS'' given at the end of each unit.

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UNIT 1 : NATURE AND ROLE OF FINANCIAL SYSTEM

UNIT STRUCTURE

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1.3 Concept of Finance

1.4 Features of Finance

1.5 Role of Finance In an Economy

1.6 Classification of Finance

1.7 Financial System and Its Components

- 1.7.1 Financial Intermediaries or Institutions
- 1.7.2 Financial Markets
- 1.7.3 Financial Instruments
- 1.7.4 Financial Services

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1.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- define the term finance
- identify the role of finance in an economy
- describe various kinds of finance
- explain the financial system and its components
- discuss the different financial intermediaries
- describe various functions of financial market and instruments
- outline the services of electronic banking and ATM.

1.2 INTRODUCTION

Economic development of a nation, inter alia, depends on the rate of increase in savings and investment. When there is an increase in income, a part of it is saved and in course of time this savings is used in productive activities. In the accomplishment of this networking a well organized financial system is indispensable. The advent of liberalisation in 1990-91 integrated the different components of financial system and facilitated various new developments and role of finance become more and more important for economy. This unit highlights role of finance, classification of finance, financial system and its components, financial intermediaries, financial markets and their functions. It also presets an overview of electronic banking and ATM services of modern banks.

1.3 CONCEPT OF FINANCE

Can you imagine a human being without blood? The simple answer is 'No'. In the same way there cannot be an economic entity without finance. Finance is the lifeblood of all economic activity. In the modern money-oriented economy, finance is one of the basic foundations of all kinds of economic activity. It is the master key which provides access to all the sources for being employed in manufacturing and merchandising activities. Without finance neither a business can be started nor its development is possible. The success of business depends upon sufficient finance and its effective management. Finance is how people study and figure out how people, businesses and groups make and use money. It can mean:

- Thinking about money and other monetary assets,
- The management and control of those assets
- Thinking about how to control money to make profit,
- Studying how to take chances in projects that make money,
- As a verb, "to finance" is to make money for business. .

According to Horward and Upton, "Finance is that administered area or set of administrative functions in an organization which relate with the arrangement of cash and credit, so that the organization may have the means

to carry out its objectives as satisfactory as possible". Therefore, it is rightly termed as science of money.

1.4 FEATURES OF FINANCE

After conceptualising the meaning of 'Finance', let us explain its features

- Finance studies and addresses the ways in which individuals, business, and organizations raise, allocate, and use monetary resources over time, taking into account the risks entailed in their projects.
- The activity of finance is the application of a set of techniques that individuals and organizations (entities) use to manage their money, particularly the differences between income and expenditure and the risks of their investments.
- Finance is used by individuals (personal finance), by governments (public finance), by businesses (corporate finance), as well as by a wide variety of organizations including schools and non-profit organizations. In general, the goals of each of the above activities are achieved through the use of appropriate financial instruments, with consideration to their institutional setting.
- Finance is one of the most important aspects of business management. Without proper financial planning a new enterprise is unlikely to be successful. Managing money (a liquid asset) is essential to ensure a secure future, both for the individual and an organization.
- The process of finance is learning how people and groups act in managing their money, and most of all how they manage making money, and making a profit, with spending money, and making a loss.

1.5 ROLE OF FINANCE IN AN ECONOMY

Finance plays an important role in an economy. Following points explain some of the pivotal role of finance in an economy:-

a) One of the important functions of finance is to link the savers and investors and thereby help in mobilizing and allocating the savings efficiently and effectively,

b) It also permits continuous upgradation of technologies for promoting growth on a sustainable basis,

c) It not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investors,

d) It provides payment mechanism for the exchanges of goods and services and transfer economic resources through time and across geographic regions and industries,

e) One of the most important roles of finance is to achieve optimum allocation of risk bearing. It limits, pools and trades the risk involved in mobilizing savings and allocating credit,

f) It also makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions,

g) It provides financial services such as insurance and pension and offers portfolio adjustments facilities,

h) It helps in the creation of a financial structure that lowers the cost of transactions. It has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowings.

i) It also helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). Financial broadening refers to building an increasing number and a variety of participants and instruments.

Thus, Finance helps in production, capital accumulation and growth. It does this through - encouraging savings, mobilizing savings and allocation of funds among alternative uses and users.



CHECK YOUR PROGRESS

Q 1: State two important features of finance.

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1.6 CLASSIFICATION OF FINANCE

The subject of finance has been traditionally divided into two classes - Public Finance and Private Finance.

Public Finance

Public finance means the state finance. The study of public finance is done to analyse how the different public authorities arrange their finance. The different public authorities include the Central Government, State Government and Local Public authorities like Municipal Corporation etc. It is seen in public finance that how the government obtain the income and how it spends the income in public interest. The public finance includes the public debt also.

Private Finance

Private finance means the finance of a person and/or private institutions. Under this we study how different persons and private institutions obtain their income/funds and how they spend the income for the fulfillment of their objectives. Private Finance is divided into three sub-types -

i) **Personal Finance** - This is finance for people. It is about:
   - how much money will be needed by a person, now and when they get old?
   - where from will this money come (e.g. savings or borrowing)?
   - how can people protect themselves against problems with money in their lives?
   - how can family money be given to children and grandchildren?
   - how do taxes affect money choices?

ii) **Business Finance** Business finance is about finding money for the companies' activities. It studies trying to make more profit than loss, and taking good risks for the chance to make more money. It also study the principles, practices, procedures and problems concerning financial management of profit making organisation engaged in the field of industry, trade and commerce.

iii) **Finance of Non-Profit Organisation** is concerned with the principles, procedures and problems involved in financial management of charitable, religious, educational, social and other similar organisations.

1.7 FINANCIAL SYSTEM AND ITS COMPONENTS

By now, you know the meaning, features and role of finance. You also get an idea of various classes of finance. Now let us describe the financial system and its components. First we will explain 'Financial System'. Then we will elaborate four components of the system: Intermediaries, markets, instruments and services. The term "Financial System" is comprised of two words- Finance and System. Finance means monetary resources comprising ownership funds and debts. System indicates a set of interrelated parts working together to achieve some purpose. An economy's financial system exists to organize the settlement of payments, to raise and allocate finance, and to manage the risks associated with financing and exchange. A developed financial system is one that has a secure and efficient payment system, security markets and financial intermediaries that arrange financing, and derivative markets and financial institutions that provide access to risk management instruments.

The financing system has two general roles — to mobilize surplus funds from people and organizations, and to allocate them among deficit people and organizations. An investor is an example of a surplus unit, whereas a borrower is an example of a deficit unit. Mobilizing funds generates returns for surplus units, which generally enhances their wealth and economic well-being. It also allows deficit units to enhance their productive and purchasing capacities, and thus improves an economy's production and consumption potential. Funds are mobilized either as debt or equity. Debt funds are supplied as a loan and generally the repayments are scheduled, whereas equity funds acquire part ownership of a business and their returns depend on the future profitability of the business.

The global financial system (GFS) is a financial system consisting of institutions and regulations that act on the international level, as opposed to those that act on a national or regional level. The main players are the global institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government departments, e.g., central banks and finance ministries, and private institutions acting on

the global scale, e.g., banks and hedge funds.

Indian Financial System (IFS) refers to a set of institutional arrangement through which financial surplus of our economy are mobilised from surplus units and transferred to the deficit units. This institutional arrangements includes -

i) The conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments,

ii) Working of financial markets, and

iii) Organisation and operation of financial institutions.

Hedge Funds: A private investment fund like, mutual fund

Components of Financial System: There are four main components of the financial system, they are –

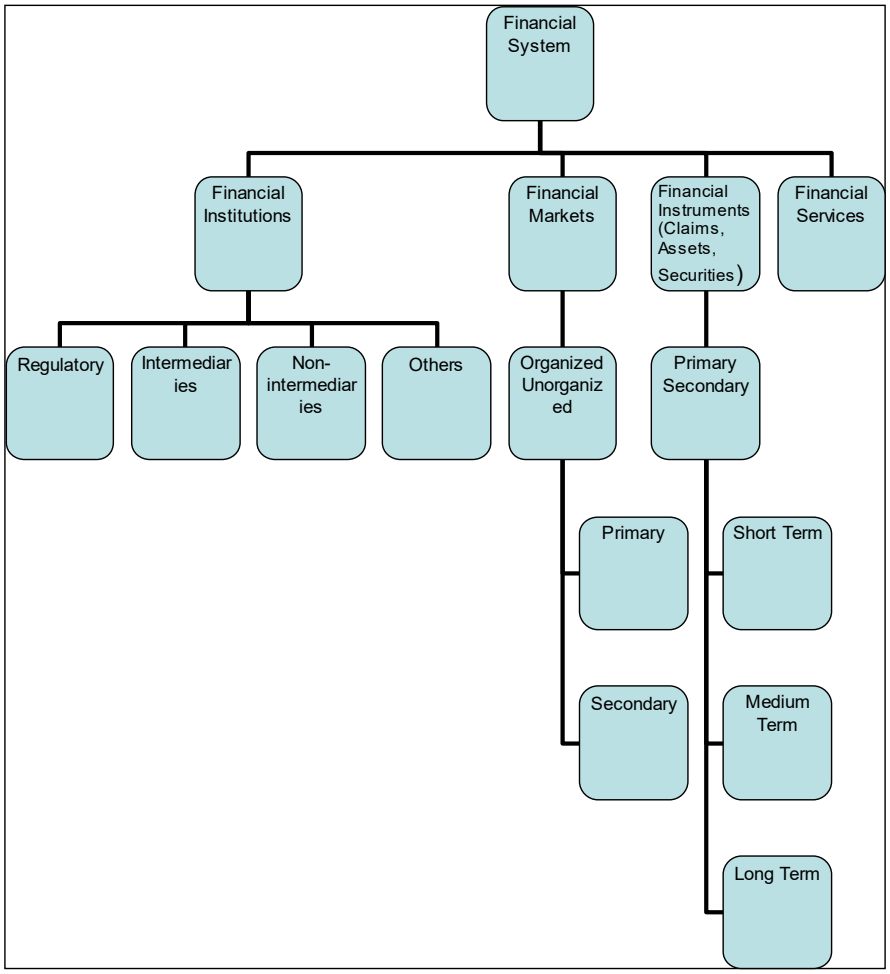


Fig: Financial System

1.7.1 Financial Intermediaries or Institutions

The term financial intermediary may refer to an institution, firm or individual who performs intermediation between two or more parties in a financial context. Typically the first party is a provider of a product or service and the second party is a consumer or customer. A financial intermediary is typically an institution that facilitates the channeling of funds between lenders and borrowers indirectly. That is, savers (lenders) give funds to an intermediary institution (such as banks), and then that institution in turn gives those funds to spenders (borrowers). This may be in the form of loans or mortgages. Alternatively, they may lend the money directly via the financial markets which is known as financial disintermediation. In the indirect process, known also as financial intermediation, funds are raised by deposit-taking institutions and then lent to borrowers. The funds raised are generally in the form of deposits.



Demand Deposits: where customers can deposit or withdraw money any number of times subject to availability of funds

Financial institutions or financial intermediaries act as half-way houses between the primary lenders and the final borrowers. They borrow funds (or accept deposits) from those who are willing to give up their current purchasing power and lend to (or buy securities from) those who require the funds for meeting the current expenditures. Financial institutions are generally divided into two categories - banks and non-bank financial institutions. The main difference is that the banks possess while the non-bank do not possess the demand deposits or credit creating power. Banking institutions can be divided into various categories according to their functions i.e. commercial banks, development banks, investment banks, cooperative banks and regional rural banks. On the other hand, non-banking finance companies can be categorized as loan and finance companies, leasing and hire-purchase companies, housing finance companies, insurance companies, chit funds and mutual benefit funds and other residual finance companies.

1.7.2 Financial Markets

Financial markets are markets which cater to the financial needs of individuals, firms and institutions required for short as well as for long period. Financial markets could also mean:

- The mechanism that facilitate the parking of surplus money of individuals, firms and investment bankers to earn return.
- Organizations that facilitate the trade in financial products i.e. Stock exchanges facilitate the trade in stocks, bonds and warrants.

Hence, financial market is a mechanism that allows people to easily buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient market hypothesis. Financial markets facilitate:

- The raising of capital (in the capital markets);
- The transfer of risk (in the derivatives markets); and
- International trade (in the currency markets)..

Financial market include different sub- markets-

- Money markets, which provide short term debt financing and investment
- The capital markets consist of primary markets and secondary markets. Newly issued securities are bought or sold in primary markets. Secondary markets allow investors to sell securities that they hold or buy.
- Commodity markets, which facilitate the trading of commodities.
- Derivatives markets, which provide instruments for the management of financial risk.
- Futures markets, which provide standardized forward contracts for trading products at some future date.
- Insurance markets, which facilitate the redistribution of various risks.

- Foreign exchange markets, which facilitate the trading of foreign currencies.

However, the financial markets are broadly and commonly divided into two types -

i) Money Market - The money market is the market which deals with short-term funds in the economy. It refers to the institutional arrangements facilitating borrowings and lending of short-term funds. It is the market in which financial institutions, mainly banks lend and borrow money or near money assets from each other, trade in securities, treasury bills and other financial instruments such as certificates of deposits or enter into agreements such as Repos and Reverse Repos. In a money market, funds can be borrowed for a short period varying from a day, a week, a month or 3 to 6 months, sometimes up to one year and against different types of instruments, such as, treasury bills, bill of exchange, bankers' acceptances, and bonds etc., called "near money".

The basic functions of money market are-

- To provide efficient mechanism for adjustment of liquidity positions of commercial banks, non-bank financial institutions, business firms and other investors.
- To provide a platform for the central bank of the country to control and manage the money supply and the liquidity in the economy.
- To bridge between short term surpluses and deficits.
- To provide a realistic price for short term money.

Participants who enters into the transactions in the money market are-

- Central Government
- State Government
- Public Sector Undertaking
- Scheduled Commercial Banks
- Private Sector Companies
- Provident Funds

- Life Insurance Companies
- General Insurance Companies
- Mutual Funds
- Non-banking Financial Companies
- Primary Dealers

ii) Capital Market - The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. A capital market may be defined as an organised mechanism for effective and efficient transfer of money capital or financial resources from the investing parties, i.e. individuals or institutional savers to the entrepreneurs engaged in industry or commerce on the business would either be in the private or public sectors of an economy. All the long term capital needs are met by the capital market. Capital market is a central coordinating and directing mechanism for free and balanced flow of financial resources into the economic system operating in a country.

Functions of Capital market

- Provides a platform for raising long term funds
- Act as an intermediaries between buyers and sellers of securities
- Facilitate an organized trading mechanism for stock and securities.
- Provide a standard price for the securities.
- Nexus between savings and investment.

Classification of Capital market

Capital markets consist of:

a. Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.

b. Bond markets, which provide financing through the issuance of Bonds, and enable the subsequent trading thereof.

c. Derivative market where derivative products like stock futures, index futures and options are traded. Financial derivative is an

agreement between two parties for buying or selling an underlying asset (Stock or index) whose value is derived from the underlying financial assets or claim.



CHECK YOUR PROGRESS

Q 2: Which of the following is not a money market participant?

(a) State Government (b) Public Sector Undertaking

(c) Scheduled Commercial Banks (d) Stock Exchange

Q 3: Which of the following is a capital market instrument?

(a) Certificates of Deposits (b) Equity Share

(c) Commercial Paper (d) Treasury Bills

In terms of the access, the financial market can be classified as primary market and secondary market.

a. Primary market is the market where initial issues are sold and bought. When a company issues shares for the first time, it is trade through primary market .This market is also known as new issue market (NIM). The primary market is facilitated by the intermediaries like issue managers, issuing banks, registrars, book-runners etc. who intermediate between investors and issuers.

b. The secondary market consists of stock exchanges and over the counter exchanges. In the secondary market the secondhand issues are sold and bought and securities change hands from one investor to another. Stock brokers play an important role as the intermediaries between stock exchanges and the investors. Functioning of the capital market is regulated by the Securities and Exchange Board of India (SEBI).



ACTIVITY 1.1

Visit a stock broking firm and observe the functions performed by it. On return list them out.

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1.7.3 Financial Instruments

The financial instruments are the claims to money and perform some functions of money. Financial instruments denote any form of funding medium - mostly those used for borrowing and investing in financial markets, e. g. bills of exchange, bonds, etc. They have high degree of liquidity but are not as liquid as money.

From the intermediary point of view, financial instruments can be categorized into two types -

i) **Primary or Direct instruments -** They are the financial claims against real-sector units created by real-sector units as ultimate borrowers for raising funds to finance their deficit spending, they are the obligation of ultimate borrowers. The examples are bills, bonds, equities, book debts etc.

ii) **Secondary or Indirect Instruments -** they are financial claims issued by financial institutions against themselves to raise funds from the public. These assets are the obligations of the financial institutions. The examples are bank deposits, life insurance policies, units of Unit Trust of India etc.

LET US KNOW



Financial instruments can also be categorized by form depending on whether they are cash instruments or derivative instruments:

- Cash instruments are financial instruments whose value is determined directly by markets. They can be

divided into securities, which are readily transferable, and other *cash* instruments such as loans and deposits, where both borrower and lender have to agree on a transfer.

- Derivative instruments are financial instruments which derive their value from some other financial instrument or variable. They can be divided into exchange-traded derivatives and over-the-counter (OTC) derivatives.

Alternatively, financial instruments can be categorized by "asset class". They are -

- Equity based (reflecting ownership of the issuing entity) or
- Debt based (reflecting a loan the investor has made to the issuing entity). If it is debt, it can be further categorized into short term (less than one year) or long term.

Foreign Exchange instruments and transactions are neither debt nor equity based and belong in their own category.

Further, instruments can be categorized into two types by its "market class". They are-

a) **Money Market Instruments**-instruments traded in the money market. Important instruments in this market are-

- **Call money /Notice money**-call money or call deposits are those moneys which are lent on condition to repay on call. Notice money refers to the money lent and repaid on a certain day's notice from the lenders. The period of these transactions varies between overnight and to a maximum of fourteen days.
- **Term money**-Transactions between inter-bank participants for a period of more then 14 days are called term money.
- **Certificates of Deposits**- Certificate of deposit is a money market instrument issued in dematerialized form or as a usance promissory note, against funds deposited at a bank or other eligible financial institution for a specified period. These are issued by scheduled commercial banks (excluding regional rural banks and local area banks) and all India financial institutions that have been permitted by RBI. The maturity

period of certificates of deposits issued by the banks should not be less than 7 days and more then one year while for certificates of deposits issued by the financial institutions is not less then one year and more than three years.

- **Commercial Paper-** Commercial paper (CP) is an instrument issued by corporates, primary dealers and all India financial institutions to raise short-term resources .CPs are issued in the form of promissory note for maturities between minimum of 7days and a maximum up to one year from the date of issue. These can also be issued in dematerialized form through any of the depositories approved by and registered with SEBI. Issuer of the CPs has to obtain prior permission from the RBI for the issue. CP may be issued to individuals, banks, other corporate bodies, Non-resident Indians and foreign institutional Investors. CPs are issued at a discount to the face value as determined by the issuer.
- **Bill Re-discounting Schemes (BRDS) -** This is a money market scheme where by banks may raise funds by issue of Usance promissory notes in convenient lots and maturities matching the genuine trade bills discounted by them. This instrument promotes liquidity in the money market. BRDS transaction can be done for a minimum period of 15 days and maximum period of 90days. The bank borrowing under this scheme issues a Usance promissory note to the lender as well as a certificate to the effect that the bank holds genuine bills equal to the amount of the transactions on its book.
- **Inter-Bank Participation Certificates (IBPCs)-** IBPCs are instruments issued by scheduled commercial banks only to raise funds or to deploy short –term surplus. IBPCs are of two types- with risk sharing and without risk sharing. The minimum period shall be 91days and maximum period 180 days in case of IBPCs on risk sharing basis and in the case of IBPCs under non-risk sharing basis the total period is limited to 90 days.

IBPCs are not transferable and cannot be redeemed before due date. Interest rates are determined between the issuing bank and participatory bank.

- **Collateralized Borrowing and Lending (CBLO) -** CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to 90 days against securities which are placed with the Clearing Corporation of India either as margin or otherwise.. This is an instrument for those entities who have either been phased out from inter-bank call money market or have been given restricted participation in terms of ceiling on call borrowing and lending transactions and who do not have access to the call money. Banks, financial institutions, NBFCs (Non- Bank Financial Corpotrations), insurance companies, mutual funds, primary dealers, non-government provident funds, corporates etc. are eligible to deal in CBLO.
- **Treasury Bills** (T-bills) - Treasury bill is a very common short term money market instrument issued by the Government of India through the RBI. T-bill is issued at a maturity period of 14 days, 28 days, 91 days, 182 days and 364 days. It is issued at a discount to its face value which is usually Rs.100/-.The discount rate is determined by the RBI on the basis of the bid submitted by the participants in the auction. Auctions are normally conducted every week. T-bills are used by the RBI as credit control tool.

b) Capital market Instruments- Instrument issued to raise long term funds is called capital market instruments. They are-

Bonds- Bonds are debt instruments issued by corporate bodies, governments or development financial institutions to raise long term finance. These are fixed interest bearing instruments. They can be issued with or without security. Bonds are negotiable instruments governed by the law of contract and are generally transferable by endorsement.

Debentures- A debenture is also a debt instrument issued by a

company for raising funds from the public and institutions and offers to pay interest on the funds borrowed by the company. The maturity of these instruments ranges between one to ten years. Debentures are governed by provisions of the company law and are transferable only by registration. On the basis of security, debentures can classified as secured (secured by a charge on the fixed assets of the company) and Unsecured (not secured by any charge on assets). On the basis of convertibility, they can be classified as Non-convertible, Partly convertible, Fully Convertible, and Optionally Convertible.

Equity Shares- According to the Companies Act, 1956, equity share is a part of the total capital of the company. Equity shareholders entitled for a share of profit (Dividend) of the company and the voting right. However, they also bear the risk of corporate performance. Shares are ownership instruments but transferable. Shares are issued by the companies to raise funds required for long term in the primary capital market while the secondhand shares are traded in the secondary market through stock exchanges.

Preference Shares- Preference shares are the shareholders who assume only limited risks and entitled to a predetermined dividend .They have no voting rights. Holders of preference shares enjoy the preference to receive their capital over the equity shareholders. These instruments are issued when there is a need for long term funds and at the same time shareholders do not want to dilute the ownership in the company. Though these types of shares are marketable, they are not widely traded on account of a fixed dividend.

Global Depository Receipts (GDR) - Global Depository Receipts, also known as GDRs, are internationally traded equity instruments issued against equity shares .They represent a fixed ratio of Indian shares quoted on BSE (Bombay Stock Exchange). GDRs are issued by international depository and denominated in US Dollars. They are negotiable certificates and they are freely traded in the overseas financial markets including Europe and USA.

American Depository Receipts (ADR)- American Depository Receipts, popularly called ADRs are similar kind of instrument like GDR. However, ADRs are traded in US markets mostly. They are denominated in US Dollars. These instruments are issued in accordance with the scheme for issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Central Government there under from time to time.

1.7.4 Financial Services

The industry that has grown up to encourage people to put their money into investment and which provides the facilities for doing so is called the “Finacial Services Sector”. Simply put, all types of activities involved in the transformation of surplus in to investments, transfer of financial resources, financial innovation are called financial services. The scope of the financial services is very wide, unlimited and dynamic. However, banking services are not covered under financial services because of their independent legal interpretation. The main distinction between banking and financial services is bank offers current account, cheque facility and credit creation which can not be offered other than a banking company. Financial Services may be divided into two groups - Fund based activities and Non-fund-based activities.

Fund-based activities

- Leasing
- Hire Purchase
- Venture Capital
- Consumer Financing
- Underwriting or investment in securities
- Dealing in money market
- Dealing in Forex market
- Real Estate Financing
- Housing finance

- Insurance
- Mutual funds etc.

Non-fund based activities

These financial services do not directly involve funds –

- Merchant banking(issue management, placement of securities)
- Portfolio Management
- Industrial investment Consultancy and Project Advisory Services
- Broking and Portfolio Investment Services
- Risk management
- Bill Discounting,
- Factoring
- Depository and Custodian services
- Credit rating etc.



CHECK YOUR PROGRESS

Q 4: State whether following statements are true or false-

a) Treasury Bills are issued by corporate bodies.

b) The market where the first issue of a company is sold is called primary market.

c) GDRs are denominated in US Dollars.



LET US KNOW

The basic elements of Indian Financial System were laid down during British rule. After independence, the government adapted the banking system for the economic development of the country. Moreover, the government formed a number of specialized institutions to meet the credit needs of industry, agriculture, small business etc. The government nationalised fourteen major commercial banks in 1969 and six more in 1980 with the objective of providing credit to the weaker section of the society.

1.8 ELECTRONIC BANKING – MEANING AND FEATURES

This section highlights modern technology in banks. With the advent of technology in the banking sector and introduction of computers in Indian banks, services are provided to the customers across the country giving ease the difficulties for example, going to the bank branch, sticking to the time and working days etc. Now a days customers need not necessarily visit the bank to do banking transaction because the transactions can be done through phone, internet etc. Doing banking transaction through electronic mode is called electronic banking, popularly known as E-banking. E-banking is a recent concept and is gaining popularity among the individual as well as corporate customers. Many new concepts like anywhere banking, anytime banking, online banking, phone banking, tele-banking, personal banking, internet banking, mobile banking etc have been emerging with the use of technology and electronic programmes in the banking sector. Many financial products have also launched by the banks like ATMs, Debit cards, Credit cards, multiple pins, electronic cheques, electronic cash etc which bringing great advantages to the customers.

FEATURES OF E-BANKING

- On line bill payments.
- Transfer of funds between account within community bank.
- Transfer funds to account at other financial institution.
- Make loan payment.
- 24 hours service.
- View and print loan account histayes.
- Real times account access.
- Time saving.

1.9 AUTOMATIC TELLER MACHINE (ATM)

An Automated Teller Machine (ATM) is a computerized telecommunications device that provides the customers of a financial institution with access to financial transactions in a public space without the

need for a human clerk or bank teller. On most modern ATMs, the customer is identified by inserting a plastic ATM card with a magnetic stripe or a plastic smartcard with a chip that contains a unique card number and some security information, such as an expiration date or CVC (CVV). Security is provided by the customer entering a personal identification number (PIN). By using an ATM, customers can access their bank accounts in order to make cash withdrawals (or credit card cash advances) and check their account balances. ATMs are known by various casual terms including *automated banking machine*, *money machine*, *cash machine*, *hole-in-the-wall*, *cashpoint* or *Bancomat* (in Europe and Russia).

The ATM was invented by Scot John Shepherd-Barron. The world's first ATM was installed in a branch of Barclays in the northern London borough of Enfield, Middlesex, in 1967. Inspiration had struck Mr Shepherd-Barron while he was in the bath.

ATMs are placed not only near or inside the premises of banks, but also in locations such as shopping centers/malls, airports, grocery stores, petrol/gas stations, restaurants, or any place large numbers of people may gather. These represent two types of ATM installations: on and off premise. On premise ATMs are typically more advanced, multi-function machines that complement an actual bank branch's capabilities and thus more expensive. Off premise machines are deployed by financial institutions and also ISOs (or Independent Sales Organizations) where there is usually just a straight need for cash, so they typically are the cheaper mono-function devices. An ATM is typically made up of the following devices:

- CPU (to control the user interface and transaction devices)
- Magnetic and/or Chip card reader (to identify the customer)
- PIN Pad (similar in layout to a Touch tone or Calculator keypad), often manufactured as part of a secure enclosure.
- Secure cryptoprocessor, generally within a secure enclosure.
- Display (used by the customer for performing the transaction)
- Function key buttons (usually close to the display) or a Touchscreen (used to select the various aspects of the transaction)
- Record Printer (to provide the customer with a record of their

transaction)

- Vault (to store the parts of the machinery requiring restricted access)
- Housing (for aesthetics and to attach signage to)

Recently, due to heavier computing demands and the falling price of computer-like architectures, ATMs have moved away from custom hardware architectures using microcontrollers and/or application-specific integrated circuits to adopting a hardware architecture that is very similar to a personal computer. Many ATMs are now able to use operating systems such as Microsoft Windows and Linux. Although it is undoubtedly cheaper to use commercial off-the-shelf hardware, it does make ATMs vulnerable to the same sort of problems exhibited by conventional computers.



CHECK YOUR PROGRESS

Q 5: Choose the correct answer from the following alternatives-

ATM means-

(a) Any Time Machine (b) Automated Teller Machine

(c) Any Where Machine (d) Any Time Machine

Q 6: State two features of E- banking.



ACTIVITY 1.2

Go to a leading bank and collect the booklets of their services and products and find out the electronic services it offers and list them below

.....

.....

.....

.....



1.10 LET US SUM UP

In this unit we have discussed the following points:-

- Finance is the life-blood for every economic activity. It has the equal significance both at the micro level and the macro level of an economy.
- Finance consists of money and the near money financial assets.
- Financial system through its components provides the solutions for each need and requirements of the surplus holders and the ultimate users.
- The financing process allows prospective users of funds to compete for them and creates the incentive for funds to be supplied.
- The globalization process and the technology upgradation has given the dynamism to the financial system due to which many new financial services, financial products and financial solutions have made their place in the financial system in recent decades.



1.11 FURTHER READINGS

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4) Khan, M. Y. (2007). Indian Financial System. New Delhi. Tata McGraw Hill.

5) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.



1.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (i) Finance is an important aspect of business management.

(ii) Finance is used by individuals, governments, businesses as well as by non-profit organizations

Ans to Q No 2: (d) Stock Exchange

Ans to Q No 3: (b) Equity Share

Ans to Q No 4: (a) False (b) True (c) True

Ans to Q No 5: (b) Automated Teller Machine

Ans to Q No 6: 1. Electronic bill presentment and payment

2. Investment purchase or sale.



1.13 MODEL QUESTIONS

Q 1: What do mean by financial system? Briefly discuss the component of Indian financial system.

Q 2: Point out the advantages of E-banking.

Q 3: What are the instruments traded in the money market?

Q 4: Distinguish between money market and capital market.

Q 5: State the salient features of money market instruments.

*** ***** ***

UNIT 2 : INDIAN MONEY MARKET

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Meaning of Money Market

2.4 Structure of Indian Money Market

2.5 Money Market Instruments

2.6 Defects of Indian Money Market

2.7 Measures to Improve the Indian Money Market

2.8 Bill Market

2.9 Let Us Sum Up

2.10 Further Readings

2.11 Answers To Check Your Progress

2.12 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- discuss the structure of Indian Money Market
- explain the instrument of Indian Money Market
- explain the defect of Indian Money Market
- discuss the Bill Market

2.2 INTRODUCTION

The Money Market is a very important segment of the Indian financial system. It is the market where short term monetary assets are dealt in to raise short term requirements of funds and/ or to park short term surpluses. The main characteristic of the Money Market is the liquid nature. The money market transactions may range from overnight to one year. It has minimum transaction cost. This unit encompass the structure of the Money Market that has undergone vast changes in the last decade. In this unit, we are going to discuss the different instruments and the defect of Indian Money

Market. The unit also discuss the bill market. Thus, you will be able to understand through this unit the structure, instrument as well as the defect of the Indian money market.

2.3 MEANING OF MONEY MARKET

The money market is the market which deals with short term funds in the economy. It refers to the institutional arrangements facilitating borrowings and lending of short term funds.

Participants of money market:

Following are the institutions which can take part in money market:

a. Reserve Bank of India
b. Commercial banks
c. Central and State Government
d. Public sector undertaking
e. Private sector companies
f. Non-banking financial institutions
g. Mutual funds
h. Insurance companies

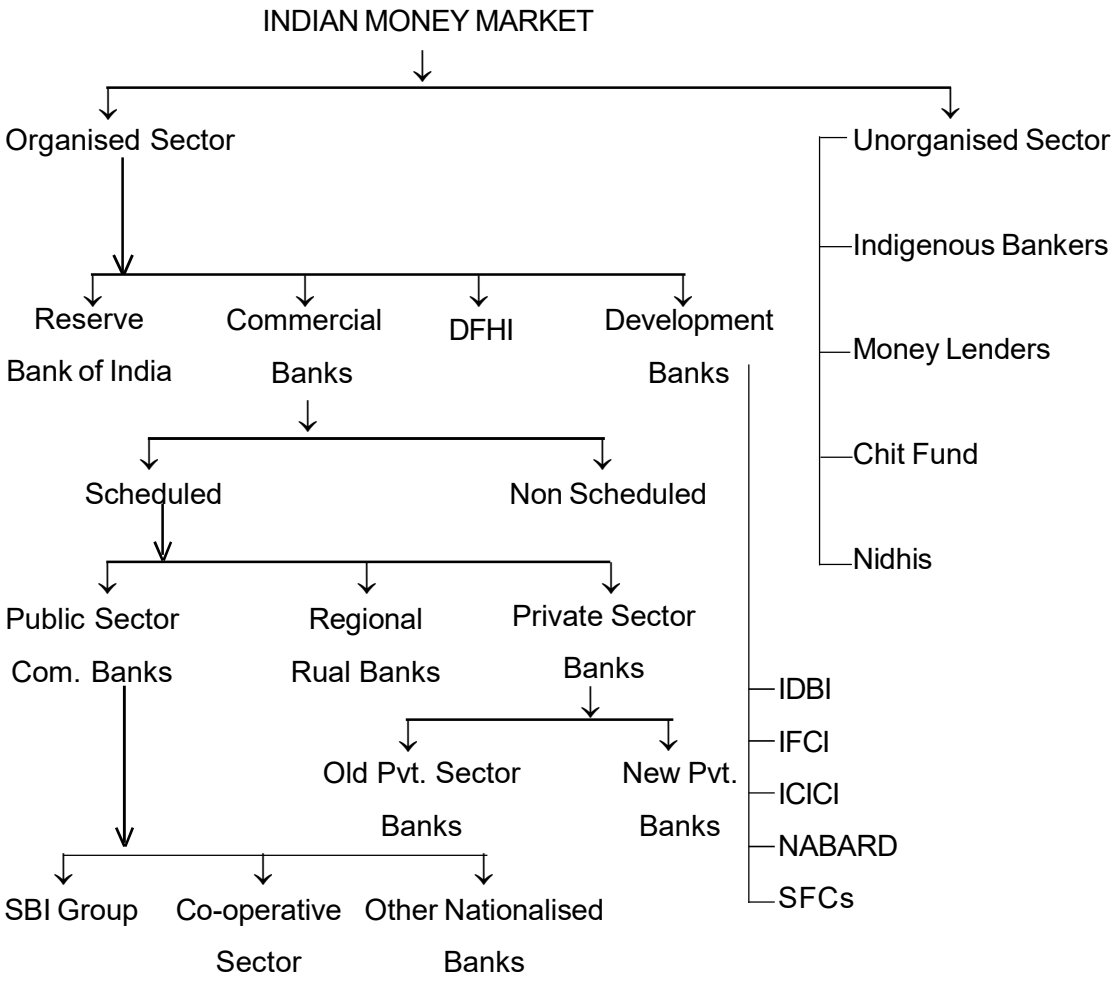
BASIC FUNCTIONS OF MONEY MARKET:

1. To provide efficient mechanism of liquidating for commercial banks, non-banking financial institutions, business firms and other investors.
2. To bridge between short term surpluses and deficits.
3. To provide a realistic price for short term money.
4. To provide a platform for the Central bank of the country to control and manage the money supply.

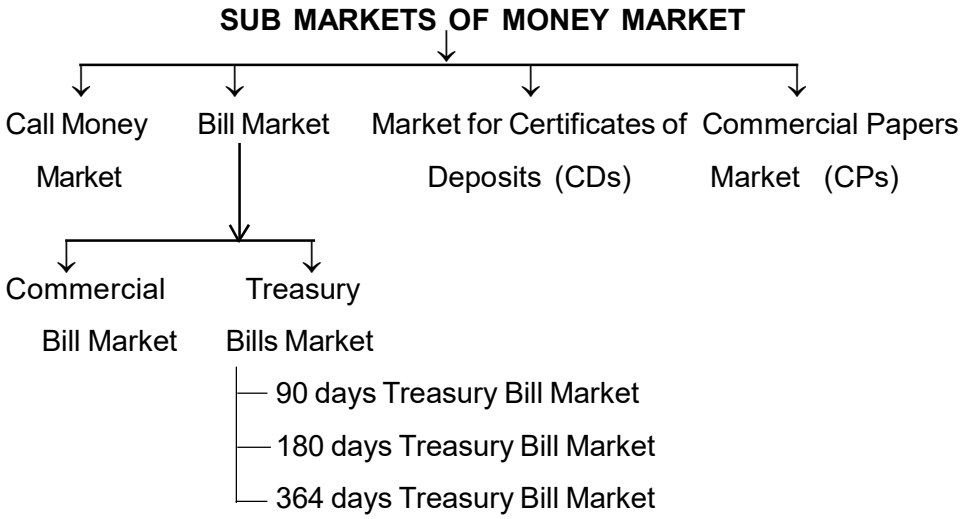
2.4 STRUCTURE OF INDIAN MONEY MARKET

The Money Market is the close substitutes for money with the short term time span from overnight to year. The Indian Money Market consists of both organised and unorganised segment. The organised segment includes the Reserve Bank of India, State Bank of India, Public Sector as well as Private Sector Banks, Regional Rural Bank, Commercial Banks including

Foreign Banks, Non-Scheduled Commercial Banks and other Non-Bank Financial Intermediaries such as LIC, GIC, and UTI etc. On the other hand, the unorganised segment consists of indigenous bankers, money lenders and other non-bank financial intermediaries.



Indian money market can be divided into various sub-markets depending on their nature and scope of the transactions and the features of the instruments.





CHECK YOUR PROGRESS

Q 1: Mention two unorganised sectors of Indian Money Market.

i) .....

ii) .....

2.5 MONEY MARKET INSTRUMENTS

Money Market instruments mainly include Government securities, securities issued by private sector and banking institutions—

1. Government Securities
2. Money at Call and Short Notice
3. Inter-Bank Participation certificate
4. Treasury Bills
5. Certificates of Deposits
6. Commercial Bills
7. Commercial Paper
8. Repo

1. Government Securities: The Reserve Bank of India issues securities on behalf of the Government. The term Government Securities includes Central Government Securities, State Government Securities and Treasury Bills. The different types of Government Securities are—

The Government dated securities can be purchased for a minimum

amount of Rs. 10,000/- and the Treasury bills of Rs. 25,000/- and in multiple thereof. The State Government Securities can be purchased for a minimum amount of Rs.1,000/-.

Dated Securities	**Zero Coupon Bonds**	**Partly Paid Stock**	**Floating Rate Bonds**	**Bonds with Call/ Put Option**	**Capital Indexed Bonds**
Issued at face value	Issued at discount to the face value	Issued at face value, but paid in installments over a period	Issued at face value	Abond issued at call and put option	Issued at face value
Interest or coupon rate is fixed at the time of issuance, and remains constant till redemption of the security	Do not carry any interest rate	Interest or coupon rate is fixed at the time of issuance, and remains constant till redemption of the security	Interest rate is fixed as a percentage over a predefined benchmark rate which may be Treasury bill, bank rate etc at the time of issuance	This bond is due for redemption in 2012 and carries a coupon of 6.72%	Interest rate is fixed as a percentage over the wholesale price index at the time of issuance.
The tenure of security is fixed	The tenure of security is fixed	The tenure of security is fixed	The tenure of security is fixed	This bond has been priced in line with 5 year bonds	The tenure of security is fixed
The security is redeemed at par (face value) on its maturity date	The security is redeemed at par (face value) on its maturity date	The security is redeemed at par (face value) on its maturity date	The security is redeemed at par (face value) on its maturity date	This bond has been priced in line with 5 year bonds	The principal redemption is linked to the Wholesale Price Index.



CHECK YOUR PROGRESS

Q 2: Mention three types of Government Securities.

i) .....

ii) .....

iii) .....

2. ***Money at Call and Short Notice:*** Call money or call deposits are that money which is lent on condition to repay on call. Notice money refers to the money lent and repaid on a certain day's notice from the lenders. Banks borrow for a variety of reasons to maintain their cash reserve ratio, heavy payments, to maturity mismatch etc. Money at short notice is for a maturity upto 14 days. The main participants are banks and all India financial institutions as permitted by RBI.

   A minimum size of Rs. 20 crores for each transaction was permitting the participation of the corporate in the call money market. The Discount and Finance House of India (DFHI) enhanced the activity of Call Money Market and Short-term Deposit Market. It allows lending and borrowing of funds. The borrowers are essentially the banks. It can operate outside the purview of the provision of the ceiling rates fixed by the Indian Banks Association. The different participants that lend fund in the market are like GIC, IDBI, NABARD etc. The private Mutual funds were also participating in the market. The DFHI ascertains the settlement between the lender and the borrower about the availability of fund and the amount needed and the exchanges. It also provides advice regarding the interest rates applicable to them.

   Here, the call rates are more volatile as they are determined by the interaction of demand and supply of funds in the market which is based on the maintenance of Cash Reserve Ratio by the banks. There are two call rates maintained in India i.e. Inter-bank call rate and the lending rate of DFHI.

3. ***Inter-Bank Participation Certificate:*** Inter-Bank Participation Certificates are instruments issued by scheduled commercial banks only to raise funds or to deploy short term surplus. This instrument is issued as per RBI guidelines for two purposes:

   a. on risk sharing basis

   b. without risk sharing

   Inter-Bank Participation without risk sharing can have tenure of 90 days only where, the issuing bank as borrowing and the participating bank advances to the banks. In case of risk sharing basis, the lender

bank shares losses with the borrowing banks by mutually determining the interest rate. The tenure may be for 90 to 180 days.

4. ***Treasury Bills:*** Treasury Bills are discounted securities issued at a discount face value as per the short term requirement of the Government of India. RBI issues Treasury Bills on a prefixed day and at a fixed amount. There are four types of Treasury Bills:

   a. 14-day Tbill maturity is in 14 days.

   b. 91-day Tbill maturity is in 91 days.

   c. 182-day Tbill maturity is in 182 days.

   d. 364-day Tbill maturity is in 364 days.

   These are highly liquid money market instruments. It is a zero default risk bearing paper. It helps in deployment of idle funds for very shorts periods as well.

5. ***Certificates of Deposits:*** These are issued according to the guidelines of the Reserve Bank of India in dematerialized form or Usance Promissory Note for the fund deposited at a bank or other financial institution. It is a negotiable money market instrument whose minimum deposit should be Rs.1 lakh and the multiples of Rs. 1 lakh thereafter. The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year. But, it should not be less than 1 year and exceed 3 years for financial institution.

6. ***Commercial Bills:*** These are the bills accepted by the buyer for goods and services on credit from the seller and which may be kept upto the due date and encased by the seller or may be endorsed to a third party. The bills being bills of exchange may be discounted with the banks or financial institutions. These bills may again be the rediscounted at the bank.

7. ***Commercial Papers (CP):*** It is an additional unsecured money market instrument to the investors as a source of short term borrowing. This instrument is issued in the form of a promissory note or dematerialized form. Every issuer has to appoint an Issuing and Paying Agent (IPA) for the issue of commercial papers and only a scheduled bank can act as an IPA for issuance of CP. The investor are given the Issuing

and Paying Agent (IPA) certificate as well as issued physical certificates or arrangement is made for crediting the CP to the investor's account with a depository. The CP issued for a maturity period between a minimum of 7 days and a maximum up to one year from the date of issue in the denomination of Rs. 5 lakh or multiples thereof. The main purposes of introducing CP are—

a. To enable the high level corporate borrowers such as leasing and financing of companies, manufacturing and financial institutions etc.

b. To diversify the sources of short term borrowing

c. To provide instrument for bank and financial institution in the money market.

8. ***Repo:*** This money market instrument helps in collateralised short-term borrowing and lending through sale or purchase operation in debt instruments. Here the securities are sold by the holders to the investors with an agreement to repurchase them at a predetermined rate and date.

On the other hand, under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.



CHECK YOUR PROGRESS

Q 3: Mention four types of Treasury Bills.

i) .....

ii) .....

iii) .....

iv) .....



Indigenous Bankers: These are individuals or private firms who receive deposits and give loans and there by operate as banks.

2.6 DEFECTS OF INDIAN MONEY MARKET

Money market is the market for lending and borrowing of short term funds. A well developed money market denotes an implementation of effective monetary policy. But the Indian money market suffers from many weaknesses.

1. ***Lack of integration:*** The Indian Money Market is divided into two sectors viz, the organised and unorganised money market. But both the markets are completely separate from each other. They are working independently and have little effect on each other. RBI is fully effective in controlling the organised sector. But, it has very less control on the unorganised sector.
2. ***Lack of rational interest rates structure:*** The Indian Money Market exist too many interest rates. For example, the deposit and lending rates of commercial banks, the borrowing rate of Government etc. In the past these created excess demand for credit and the RBI had to rely often on cash reserve ratio. Though the RBI has tried to bring rationality in the interest rates, the situation in the Indian money market is still not effective.
3. ***Existence of Unorganised Money Market:*** The existence of the unorganised sector in money market still prevails in Indian Money Market. The indigenous banker does not make any distinction between short term and long-term finance. They have no coordination with each other and have no link with other banking sectors. They do not follow any sound banking regulations. The RBI has no control over these bankers.
4. ***Absence of an organised bill market:*** In Indian Money Market, there is an absence of adequate bill market. There is an absence of commercial bill market or a discount for short term commercial bills. There are many factors responsible for the underdeveloped bill market such as (i) relying more on cash transaction, (ii) cash credit of commercial bank, (iii)seller's limited use of bills, (iv) imposition of heavy stamp duty, (v) absence of acceptance houses etc.
5. ***Shortage of funds in the Money Market:*** The lack of banking habit, inadequate banking facility, less saving habit, etc created have shortage of fund in the money market. On the other hand, the increasing demand for loanable funds in the money market far exceeds its supply.
6. ***Inadequate banking facility***: Now-a-days, the commercial banks have opened many new branches of banking facilities. But, it still leaves

much scope for further development. In a developing country like India, people live below poverty line and have less saving habit. Their savings are very small and they do not have much access to banking facilities till now.

7. **Seasonal Stringency of Money:** During the part of the year the interest rates become high due to the increasing demand for funds in the money market for the operation in the agricultural sector. Basically, it is seen in the period from October to June.

CHECK YOUR PROGRESS

Q 4: Mention four defects of Indian Money Market.

i) .....

ii) .....

iii) .....

iv) .....

2.7 MEASURES TO IMPROVE INDIAN MONEY MARKET

The major drawback of India Money Market is its high volatility. Gradually the money market transaction is increasing. But, on the recommendation of the Sukhmoy Chakravarty Committee (on the review of the working of the Monetary System) and the Narasimham committee (on the Report on the working of the financial system in India, 1991), RBI initiated a series of reform in Indian Money Market. The following are some of the measures undertaken,

1. **Introducing new money market instrument:** Many new money market instruments are introduced like Commercial Papers, Certificates of Deposits, 182-day Treasury, 364-day Treasury etc. The Discount and Finance House have also developed. These facilitate different short term borrowings to the different borrowers to collect fund as and when required to maintain their financial position.
2. **Relaxation of interest rate regulations:** The all types of interest rates like lending as well as deposit rates of the banks and financial institution

are controlled and regulated by RBI. But, gradually the interest rates of the bank loans are controlled by the market forces which result decontrolled of it.

3. ***Remitting the stamp duties:*** In August 1989, Government remitted the stamp duty. But, it is not effective till it discourages the cash credit system in favour of using the bill system.
4. ***Sector specific refinance:*** Export credit refinance and general refinance are two refinance schemes that are in operation in the current financial system. The refinance is used by the central bank to control credit conditions and the liquidity positions in the system. But if the excessive funds supplies into the system do not result any the development then it could be highly distorted one.
5. ***Introduction of repo:*** This is used by the banks for short term liquidity through sale or purchase of debt instruments. It is an agreement to repurchase them at a predetermined rate and date between the RBI and commercial banks.
6. ***Introducing Money market Mutual Funds:*** The Money Market Mutual Funds were introduced in April 1991. The collection of the small savings invested generate short term avenues to the different investors.
7. ***Setting the Discount and Finance House in India:*** The DFHI equilibrated the surplus of fund and the deficit amounts of the banks. The DFHI helps in lending and borrowing of funds to the different banks as well as financial institutions.



CHECK YOUR PROGRESS

Q 5: Mention five measures to improve the Indian Money Market.

i)

.....

ii) .....

iii) .....

iv) .....

v) .....

2.8 Bill Market

A bill is nothing but a promise by the borrower to the creditor to pay. These bills should be drawn on and accepted by the purchaser's bank. The date of repayment of bank's loan is fixed. It is of three types: i.) promissory notes, ii.) bills of exchange, and iii.) treasury bills. This is a market of short term bill to meet short term financial needs of individual, companies etc. The commercial banks use these bills to maintain their financial positions of the bank by disposing or rediscounting it in the Reserve Bank of India. The Reserve bank of India has been making efforts to develop the bill market. These are of self- liquidating nature. Now-a-days, all commercial banks as well as the public sector banks are eligible for to offer the bill of exchange for rediscounting to the Reserve Bank of India.



2.9 LET US SUM UP

In this unit we have discussed the following -

- Money Market is a market for short term funds. Money is raised and deployed for short term in this market.
- The Money Market is the close substitutes for money with the short term upto one year.
- A minimum size of Rs. 20 crores for each transaction was permitted in the participation of the corporate in the call money market.
- The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year.
- On the recommendation of the Sukhmoy Chakravarty Committee and the Narasimham committee, RBI initiated a series of reform in Indian Money Market.
- To provide safety, liquidity and return, MMMFs are formed which collect the small savings of a large number of savers and invest them in the capital market.
- Gilt-edged (Government) Securities security have great demand for

the banks to maintain the Net Demand and Time Liquidities (NDTL) position of the bank through its buying and selling.

- Under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.



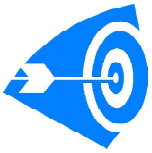
2.10 FURTHER READINGS

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4) Khan, M. Y. (2007). Indian Financial System. New Delhi. Tata McGraw Hill.



2.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two unorganised sectors of Indian Money Market are:

i. Indigenous Bankers

ii. Money Lenders

Ans to Q No 2: Three types of Government Securities are:

i. Dated Securities

ii. Zero Coupon Bonds

iii. Partly Paid Stock

Ans to Q No 3: Four types of Treasury Bills are:

i. 14-day Tbill maturity is in 14 days.

ii. 91-day Tbill maturity is in 91 days.

iii. 182-day Tbill maturity is in 182 days.

iv. 364-day Tbill maturity is in 354 days.

Ans to Q No 4: Four defects of Indian Money Market are:

i. Lack of integration
ii. Lack of rational interest rates structure
iii. Existence of Unorganised Money Market
iv. Inadequate banking facility

Ans to Q No 5: Five measures to improve the Indian Money Market are:

i. Introducing new money market instrument
ii. Relaxation of interest rate regulations
iii. Remitting the stamp duties
iv. Sector specific refinance
v. Introduction of repo



2.12 MODEL QUESTIONS

Q 1: What do you understand by Money Market? What are the constituents of the Indian Money Market?

Q 2: Discuss the different Money Market instruments?

Q 3: Discuss the defects of Indian Money Market?

Q 4: What are the measures to improve the Indian Money Market?

Q 5: Write short notes on:

a. Government Securities
b. Bills Rediscounting
c. Money Market Mutual Funds
d. Treasury Bills
e. Certificates of Deposits
f. Commercial Paper
g. Gilt-edged (Government) Securities
h. Bill Market.

*** ***** ***

UNIT 3 : INDIAN CAPITAL MARKET

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Meaning and Structure of Indian Capital Market

- 3.3.1 Industrial Securities Market
- 3.3.2 Government Securities Market
- 3.3.3 Long term Loan Market

3.4 Capital Market Instruments

3.5 Capital Market Intermediaries

3.6 Let Us Sum Up

3.7 Further Readings

3.8 Answers to Check Your Progress

3.9 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

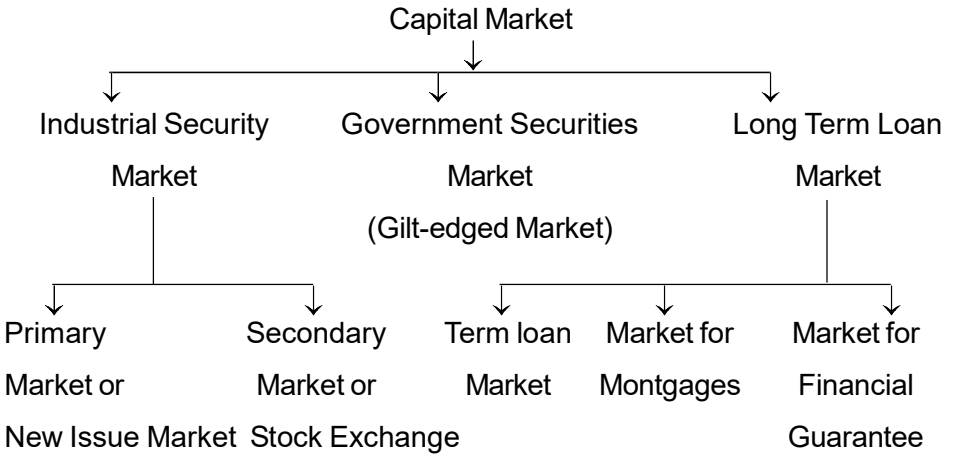
- discuss the meaning of Capital Market
- explain the structure of capital market
- explain the instrument and intermediaries of Capital Market

3.2 INTRODUCTION

The corporate bodies require funds for different projects in different times. They raise their funds depending on the preference of the investors and the regulatory framework. The business need two types of finance viz short term finance and long term finance. The capital market meets the long term requirements of fund. Through this unit, you will be able to know about the meaning of capital market and its instrument. The unit also, discusses about the capital market intermediaries. Thus, you will able to understand through this unit, the meaning, instrument and capital market intermediaries.

3.3 MEANING AND STRUCTURE OF INDIAN CAPITAL MARKET

Capital market is the market where long-term funds are traded. Capital market deals with securities with long term maturity. Instruments like shares, debentures, bond etc. are issued in the capital market for raising long term capital. The Indian capital market has the following structure:



3.3.1 Industrial Securities Market

Industrial securities market deals with the securities such as equity shares, preference shares etc., issued by the corporate houses. This market can further be classified in to: a) New Issue Market or Primary Market and b) Secondary Market or Stock Exchanges.

New issue market is the market where the securities which are issued for the first time or come to the market for the first time are bought and sold. The players in the new issue market are merchant bankers, underwriters, registrars to the issue collecting and coordinating bankers etc.

Secondary market or stock exchanges is the place where buying and selling of existing or second hand securities (securities which are once sold in the new issue market) takes place. This market provides liquidity and transferability to the securities. At present there are 25 stock exchanges working throughout the country.

3.3.2 Government Securities Market

Government Securities Market also called Gilt-Edged securities market. In this market long term securities issued by the government are traded. These securities are issued by the central government, state government; semi-government authorities like city corporation, port trust etc. electricity board, all India and state level financial institution and public sector enterprises are traded.

3.3.3 Long term Loan Market

This is the market where development banks and commercial banks supply long term loan to the corporate houses. This market can further be classified in to :

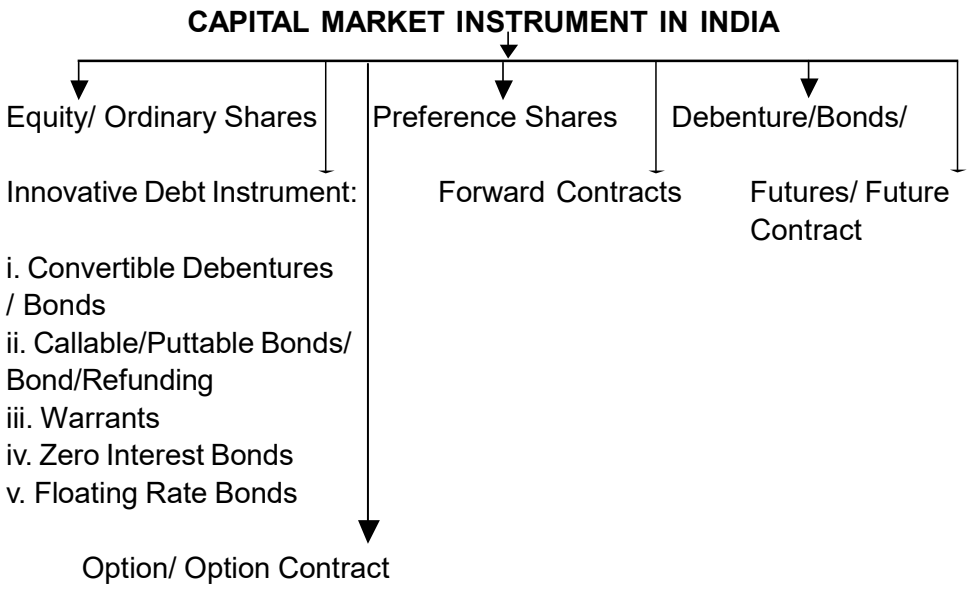
a) Term loan market

b) Mortgage market

c) Financial guarantee market.

3.4 CAPITAL MARKET INSTRUMENTS

The capital market instrument can be classified into three categories as pure, hybrid and derivatives. The pure instrument means equity shares, preference shares and debentures or bonds without mixing features. The hybrid instrument means combining of equity with bond, preference share and equity. Derivatives are nothing but contract which derive their values from the value of one or more of other assets i.e. financial instrument. Futures and options belong to the categories of derivatives.



a) **Equity or Ordinary Shares**: It represents the ownership capital. It is of several types:

Authorized equity share capital: The maximum amount of share capital that a company can raise is its authorized share capital.

Issued capital: It is that portion of the capital which is offered by the company to the investors.

Subscribed capital: It is the part of issued capital which is subscribed by the investors.

Paid-up capital: It is the capital that is paid by the shareholders.

The main features include limited liability, residual claim to income, right to control, pre-emptive rights.

b) **Preference Shares:** It has certain characters of equity share and debentures. It carries a fixed rate of interest. It has preferential right to get dividend in comparison to equity share. The preference shareholders can get cumulative dividends i.e. all unpaid dividend are payable. It does not carry any voting right. But, if the preference shares are not paid for more than two years with respect of cumulative shares, the preference shareholders entitled to vote.

c) **Debentures or Bonds or Notes**: The debenture holders are long term creditors. The debenture holders get fixed rate of interest and the principal amount repay at stipulated time. Three types of debentures

are found presently in India as:

i. Convertible debenture after 36 months,

ii. Optionally convertible debenture within 36 months,

iii. Compulsorily convertible with 18 months

d) Innovative Debt or Instrument: The debenture may be compulsory, optional or convertible. Call option gives the opportunity to the company to redeem the bonds prematurely. The firms issue such bonds and in favorable condition, they refund it.

A warrant gives the right to subscribe the equity shares at a certain period.

The zero coupon bonds do not carry any coupon rate and sold at discount from their maturity value.

The deep discount bond issued at discount over its face value far less than the yield to maturity.

Floating rate bonds are bonds whose interest rate are not fixed and it is the percentage point more than the benchmark rate. The benchmark rate is interest rate on treasury bills, bank rate, and maximum rate on term deposit.

e) Forward Contracts: It is the contract based on specified price to buy or sale at a specified future date of an asset. The buyer assumes a long position and agrees to buy at a specified future date at a specified price to buy and the other party gets short position to sell the asset on the same date at specified price. These are traded outside the stock exchange.

f) Futures or Future Contracts: It is an agreement between two parties to buy or sale an asset at a certain time in the future, at a certain price. It solves the different problems associated with the forward market. It reduces the counter party risk as seen in forward contract.

The future contracts are traded on an organized stock market whereas forward contract are traded on Over the Counter in nature. The future contracts are standardized contract which follow daily settlement. The forward contracts are customized contract terms and settlement done at the end of the period.

g) **Options or Option Contracts:** In forward contract and future contract, the parties committed themselves to do something whereas in case of option contract the parties get option the right to do something. The forward contract and future contract does involve any charge any cost. But the option contract requires an up front payment. The option contracts are of two types, call option and put option. In case of call option the holder get the right not obligation to buy an asset by a certain date for a certain price. In case of put option the holder gets the right not obligation to sell an asset by a certain date for a certain price.

3.5 CAPITAL MARKET INTERMEDIARIES

The financial markets have two components, the money market and the capital market. The capital market consists of two components, the securities market and other forms of lending and borrowing. The securities market which is divided again into two parts as primary market and secondary market.

The primary market deals with the sale of new securities. The following are the primary market intermediaries:

a. Merchant Banker or Lead Managers
b. Underwriter
c. Debenture Trustees
d. Registrars and Share Transfer Agents
e. Bankers to issue

The capital market intermediaries are vital link between investor, issuer and the regulator. Securities and Exchange Board of India Act, 1992 was made to protect, secure and promote the interest of the investors. It is responsible in constant monitoring for good government practices of the intermediaries.

The secondary market deals with the trading of securities initially offered. The following are the secondary market intermediaries:

a. Portfolio manager
b. Stock brokers
c. Sub-Brokers
d. Custodian

PRIMARY MARKET INTERMEDIARIES:

A. MERCHANT BANKER OR LEAD MANAGERS:

Merchant bankers are body corporate who are engaged in issue of securities. It acts as manager or advisor or consultant to issuing company. A merchant banker requires compulsory registration under the regulation 3 of SEBI (Merchant Bankers) Regulations, 1992. These activities mainly includes determining the composition of capital structure, compliance with procedural formalities, appointment of registration, listing of securities, arrangement of underwriting, selection of brokers and bankers, publicity and advertisement agent , private placement of securities, advisory services, etc. The merchant bankers are responsible to make all efforts to protect the interest of investors. The merchant bankers has to exercise due diligence, high standards of integrity, dignity. The merchant bankers are also responsible in providing adequate information without misleading about the applicable regulations and guidelines. It is now mandatory for all public issues to be managed by merchant bankers functioning as the lead managers.

B. UNDERWRITER:

An underwriter may be an individual, broker, merchant banker, financial institution or banks. The underwriting is an agreement between the issuing company and the assuring party through an agreement to take up shares or debentures or other securities to a specified extent in case public subscription does not amount to the expected level. Thus, in case any short-fall, it has to be made good by underwriting arrangements by the underwriter as per the agreement.

The underwriter shall not derive any benefit from underwriting the issue other than commission as specified in the agreement. If an underwriter is being called upon to subscribe the shares of a company has to subscribe such securities within 45 days of receipt of such intimation as per to the agreement. The underwriter has to appoint a compliance officer who is responsible for compliance of the Act. The compliance officer is required to report to SEBI and is responsible for complying the notification, guidelines, instruction issued by SEBI.

C. DEBENTURE TRUSTEES:

The issuing company has to make proper arrangements and comply with the legal requirements for the investor. The company renders these services to the investors for a fee under an agreement executing as trust deed with the trustee who are generally banks and financial institution and file the same with the Registrar of Companies. The main duties of debenture trustees are mainly possession of trust property in accordance with the trust deed, taking periodical report from the body corporate, enforce security of interest, protection of the debenture holders, inspect books of account, inform SEBI if any breach of trust deed etc.

Every debenture trustees is required to appoint a compliance officer. He is responsible for monitoring the compliance of the Act, rules and regulations. He is responsible for redressal of investor grievances.

D. REGISTRARS AND SHARE TRANSFER AGENTS:

The Registrars and Share Transfer Agents are very important intermediaries in mobilizing new capital, maintaining records, deciding the basis of allotment etc for the investors. They are very useful in case of share transfer, sale, as it helps in liquidity to the investors of their investment. They also provide this service to the existing companies. But this responsibility decreases as depository system comes into play. But unless and until the old system is completely eliminated and the shareholding totally switch over to dematerialized system, the share transfer agents will have to play their role.

The 'Registrar to an issue 'means, any person that appointed by the company or group of individuals carry out such activities on its behalf i.e. collecting applications, maintain records, determine the basic for allotment of securities, finalizing the list from the same, process and dispatch of allotment letters etc.

The 'Share Transfer Agents' means, any person who maintain records of holder of securities on behalf of any body corporate. They deal all matters connected with it, like redemption, transfer of securities etc. It may be the department of a body corporate performing the activities at any time the total number of holders of its securities issued exceed one lakh.

The Registrars and Share Transfer Agents shall have to maintain high standards of integrity, due diligence, adequate care, in the conduct of its business. They have to make reasonable effort to avoid misrepresentation, conflict and disclosure of its interest. They are also responsible in maintaining the continuity the data and records.

E. BANKERS TO ISSUE:

The Chapter I of SEBI (Bankers to an Issue) Regulations, 1994, deals with Banker to an issue. The Banker to an issue means a schedule bank carrying on all or any of the following activities:

A. Acceptance of application and application monies.

B. Acceptance of allotment or call monies.

C. Return of application monies.

D. Payment of dividend or interest warrant.

The banks may render different function like, mobilizing of capital, issuing of securities, collection of application for securities etc. The banks are responsible in maintaining the records and furnish prompt information. But the company has to an agreement with the banks. Under Regulation 12, the banker to an issue has to maintain the date, name amount of monies return, dividend and interest warrant paid; time, number of application received to the investor.

CHECK YOUR PROGRESS

Q 1: Mention three primary market intermediaries.

i) .....

ii) .....

iii) .....

SECONDARY MARKET INTERMEDIARIES:

A. PORTFOLIO MANAGER:

The word 'portfolio' means the total holdings of securities belonging to any person and the portfolio manager is the person who under an arrangement with the client, advises or directs the management and administration of



Networth: It means the aggregate value of paid-up equity capital plus free reserved which is aggregate value of loose and differed expenditure not written off.

such portfolio of securities. The portfolio manager has to enter into an agreement on behalf of a client and it contains:

1. The investment objectives,
2. Area of investment,
3. Type of instrument,
4. Custody of securities,
5. Procedure of client's account etc.

Registration of portfolio manager:

a) The applicant is a body corporate and have infrastructure like adequate office space,

b) The principal officer of the applicant has professional qualification like law, finance, accountancy, management from a recognized university.

c) It has the capital requirement. The portfolio manager must have capital requirement of not less than networth of fifty lakhs rupees.

d) The grant of certificate to the applicant is in the interest of investors.

e) The applicant has minimum of two persons having at least five years of experience as portfolio manager or stock broker etc.

The portfolio manager act in a fiduciary capacity with regard to the clients funds under the provision of Reserve Bank of India, 1934. He shall pledge or give loan on securities on behalf of the client depending on the written permission of the client. He can not earn any direct or indirect benefits out of the clients fund or securities. The portfolio manager has to maintain high standard of integrity, fairness, due diligence. But he should not make any statement to any act, practice, unfair competition. The portfolio manager is responsible to appoint a compliance officer responsible for monitoring the compliance of the Act.

B. STOCK BROKERS AND SUB-BROKERS:

Stock brokers are members of recognized stock exchanges who buy and sell or otherwise deal in securities. For a broker to deal in securities on a recognized stock exchange, it is obligatory that he should be registered as a stock broker with SEBI. The stock broker facilitates transaction of securities in the secondary market. The stock broker has to enter into an agreement with his client before buying and selling of securities. One must

have a client account with a registered broker or sub- broker to buy or sell of securities and has to do the transaction through such broker or sub-broker. Broker or sub-broker charges brokerage commission for facilitating transaction.

The sub-brokers act as agent on behalf of the stock broker. The sub-brokers assist the investor in buying and selling the securities. Both broker and the sub-brokers hold a certificate of registration granted by SEBI. Both broker and the sub-brokers has to follow disciplinary proceedings under the rules, bye-laws etc. The SEBI observe before granting the certificate of Registration, about the applicant's eligibility to be admitted as a member of a stock exchange or not. The SEBI also take into account the availability of necessary infrastructure like adequate office space etc. Where an application does not fulfill the requirement may be rejected by SEBI and communicated within 30 days to the concerned stock exchange and to the applicant stating the grounds of refusals. But, SEBI can also reconsider an application.

The sub-broker has to forward an application in Form-B accompanied with letter in Form-C from a stock broker to a recognized stock exchange with whom he is to be affiliated as a member. But the applicant is eligible for registration like:

A) Incase of an individual, he should not less than 21 years of age, has not convicted of any offence and fit and proper. He should pass at least 12th standard or equivalent examination.

B) In case of body corporate or partnership firm, the directors or partners may comply with the requirements as stated by SEBI.

The sub-broker has the maintain different obligations like payment of fees as per Schedule III, agreement with the stock broker, abode the code of Conduct of Schedule II, all rules and regulation of stock exchange etc. Under Regulation 17 and 18, the sub-broker has to maintain the books of account.

Every broker has to appoint compliance officer who shall be responsible for monitoring the compliance of the act, rules, regulation etc issued by SEBI.

C. CUSTODIAN:

Custodian of securities means any person who provides custodial

services in relation to securities of a client or safe keeping of gold or gold related instrument. They operate their function through opining custodial account. It is an account of a client maintained by a custodian of securities in respect of securities. Any person proposes to carry such business as custodian of securities has to make an application to SEBI for grant of a certificate for registration. The applicant fulfils the capital requirement specified under regulation 7(1), a net worth of a minimum of rupees fifty cores. The applicant must have necessary infrastructures and follow all rules and regulation approved under any law for the time being in force relating to securities, gold or gold related instrument. The applicant should be competent person and the grant of certificate is in the interest of investor. Custodian has the duty to inspected their affairs through the inspecting officer such as books, securities etc.



CHECK YOUR PROGRESS

Q 2: Mention three secondary market intermediaries.

i) .....

ii) .....

iii) .....



3.6 LET US SUM UP

In this unit we have discussed the following aspects -

- The word 'portfolio' means the total holdings of securities belonging to any person and the portfolio manager is the person who under an arrangement with the client, advises or directs the management and administration of such portfolio of securities.
- The capital market instrument can be classified into three categories as pure, hybrid and derivatives.

- Three types of debentures are found presently in India as convertible debenture after 36 months, optionally convertible debenture within 36 months and compulsorily convertible with 18 months
- The capital market consists of two components, the securities market and other forms of lending and borrowing.
- Merchant bankers are person who engaged in issue of securities. It acts as manager or advisor or consultant to issuing company.
- The underwriting is an agreement between the issuing company and the assuring party through an agreement to take up shares or debentures or other securities to a specified extent in case public subscription does not amount to the expected level.
- The stock broker has to enter into an agreement with his client before buying and selling of securities
- Security Exchange Board of India is the regulator of capital Market in India.



3.7 FURTHER READINGS

1))) Batra G.S. (2002). Financial services and markets. New Delhi, Deep and Deep Publication Pvt. Ltd.

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5)) Srivastava, R.M. (2009). Management of Indian financial institutions. New Delhi, Himalaya Publishing House.



3.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The three primary market intermediaries are-

i. Merchant Banker or Lead Managers

ii. Underwriter

iii. Debenture Trustees

Ans to Q No 2: The three secondary market intermediaries are-

i. Portfolio manager

ii. Stock brokers and Sub-Brokers

iii. Custodian



3.9 MODEL QUESTIONS

Q 1: Discuss the role and obligation of portfolio manager.

Q 2: What is meant by merchant banker? Discuss its role as a primary market intermediary.

Q 3: What is meant by capital market? What are different primary market intermediary.

Q 4: Write short notes:

a. Custodian

b. Underwriter

c. Debenture Trustees

d. Registrars and Share Transfer Agents

e. Bankers to issue

f. Stock brokers and Sub-Brokers.

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UNIT 4 : INTEREST RATES

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Meaning and Importance of Interest Rate

4.4 Various Types of Interest Rates

4.5 Meaning and Features of Administered Interest Rates

4.6 Meaning and Features of Deregulated Interest Rates

4.7 Interest Rate Structure in India

4.8 Bill Rates

4.9 Deposit Rates

4.10 Bond Rates

4.11 Let Us Sum Up

4.12 Further Readings

4.13 Answers to Check Your Progress

4.14 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning and importance of Interest rates
- describe different types of interest rates
- explain the features of administered interest rates
- analyze the rationale of deregulation of interest rates
- explain the concepts of Bill rates, Bond rates and Deposit rates etc.

4.2 INTRODUCTION

You may have noticed that everybody who lend or invest or hold securities expects a return out of it. When this return is of a fixed nature and expressed in percentage term per annum, it is known as rate of interest. There are varieties of interest rates in financial markets of any economy. The structure of the interest rates is also different from country to country.

In this unit we will discuss the meaning, importance and various types of interest rates with their features.

4.3 MEANING AND IMPORTANCE OF INTEREST RATE

When you borrow money you will pay interest. What is this 'interest'? It is the difference between 'the total amount you pay to the lender' and 'the amount you have borrowed'. In other words, it is the price the borrowers must pay to lenders to obtain the use of money for a period of time. When bank lends, the borrower is required to pay a price for the use of that money he has received from the bank. Similarly, when a company raises its funds by selling securities to investors, it has to pay interest to the investors. This is because the company uses investors' money for a fixed period. This price is called interest. On the other hand, when bank accepts deposits from the public, the bank's position becomes a borrower and the depositors' position become of a lender. In this case, bank has to pay a price for the funds it gathered from the public. This is also called interest. Hence, interest means the consideration paid by one party to other for using money. The rate of interest as per Keynes is the reward offered to people to induce to hold securities instead of cash. This means that people generally tend to hold cash because holding cash entails no risk of deterioration or capital loss while holding securities have the risk of fluctuation in the value. Interest is the reward given to the holder of securities for holding them instead of holding liquid cash. As we know that all the prices are determined in different markets, the equilibrium rate of interest is also determined by the market forces (supply and demand) in the financial market.

As per classical theory offered by Ricardo, Hume, Fishar, interest rate is reward for sacrifice or abstinence or waiting involved in the act of supplying savings. It means it is a price for preference of future over present.

Importance of interest rate

Interest rates are very significant to the economy of the country. The following points will help you to understand the significance in a better way:

- Interest rate has a close relationship with the general price level. They are positively co-related. Hence, adjustment and re-adjustment of interest rates is very significant for the economy as a whole.
- There is positive relationship between interest rate and money supply too. Keynes opined that an increase in money stock may tend to lower the interest rates and vice verse. Open market purchase by the monetary authority tends to raise security price and lower their yields.
- In countries like India there are a number of interest rates apart from the general level of interest rates which are conversional known as "differential interest rates". These interest differentials policies are adopted by the authority with a view to achieve the goal of social welfare. Hence, the interest rates are very significant for the large chunk of the economy like small industries, exports, agriculture, small borrowers, backward areas, food procurements and other priority sectors.
- Interest rate is also a tool for controlling inflation and low interest rate policy can favorable conditions for further inflation.
- The rate and composition of savings is affected by the interest rate. High interest rates in deposits encourage savings which is desirable is a capital scoring economy like India whereas low interest will work as a disincentive to save. Hence, there is a significant relationship between interest rates and total savings, financial savings, household savings, and corporate savings.
- Interest rates influence the level of investment in an economy. Low interest rates encourage investment, help fight recession, revive the economy and accelerate the rate economy growth. However, some time low interest rates also cause distortion effects in terms of a) siphoning off resources into uneconomic projects, b) increasing speculative activities in foreign exchange market, money and stock markets and c) increasing volatility in interest rates.
- Interest rates structure influence the degree of social and mass welfare of an economy. A reduction interest rates on bank deposits, small savings, provided fund and other debt instruments harm the interests

of low income group, old, weak, poor, disadvantaged who are in need of social help.



CHECK YOUR PROGRESS

Q 1: What is interest rate?

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Q 2: State two importance of interest rate.

(i) .....

(ii) .....



ACTIVITY 1

Visit two branches of commercial banks and list out the rates of interest they charge from the borrowers.

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4.4 VARIOUS TYPES OF INTEREST RATES

A variety of short term, medium term and long term interest rates exists in the financial markets. There are also various concepts like the ceiling rate of interest, coupon rate, yields.

Ceiling rate: The ceiling rate refers to the maximum rate of interest fixed by the authorities on different financial claims. In India, the government and the RBI fixes ceilings on a number of interest rates.

Coupon rate: The coupon rate, also known as the 'bond rate' is the rate of interest stated and paid on the face value (i.e. per value) of the bond or debenture.

Yield: The term 'yield' represents the rate of interest which equals the present value of the future cash flows generated by an investment. Running yield on bond (also known as income yield, market yield, current yield) is an annual interest payment as a proportion of the market price of the bond.

'Yield to maturity or redemption yield is the annual interest payment plus average appreciation or depreciation as a proportion of the redemption value of the bond. Dividend yield and earnings yield are concepts usually in evaluating investment in ordinary share.

4.5 MEANING AND FEATURES OF ADMINISTERED INTEREST RATES

When the interest rates are determined and controlled by the government, is called administered interest rates. Many times governments of developing countries administer the interest rates and keep them low because low interest rates had been regarded desirable in order to induce a higher rate of fixed capital formation. Controlling interest rates helps government to improve the distribution of finance, income and availability.

Deposit and lending rates of banks are controlled by the government for following reasons:-

a) To avoid unhealthy competition for borrowing and deposits
b) To maintain uniformity of interest rates on deposit accounts of all the banks.
c) To keep deposit rates in alignment with the lending rates of banks and with other rates of interest.
d) To aid deposit mobilization
e) To lengthen the maturity structure of deposits.
f) To enable the authorities to avoid frequent changes in the bank rate

Administered rates enable the government to direct the monetary transactions to desired directions and ensuring effectiveness in monetary measured.

Features of Administered Interest Rate

From the following Indian case you will be able to understand the regime of administered interest rate.

- The deposit and lending rates of commercial and cooperative banks were fixed by the authorities. Deposit rates first came to be regulated in 1966 through inter-bank agreements. Since 1969 they were fixed by the Reserve bank of India (RBI). It had also been fixing the maximum

and minimum lending rates of commercial banks since 1964 and 1969, respectively. The RBI fixed different deposit rates and lending rates for different types of banks, viz. large banks, smaller banks, cooperative banks, and regional banks.

- The Indian Banks Association had been fixing the ceiling on call rates since 1973 until October 1988 when the call rate was freed from the ceiling.
- The Government fixed the rates on treasury bills and long-term government securities.
- The Government had a great say in the fixation of interest rates on long term loans of term financing institutions.
- The RBI fixed different interest rates on loans to different categories of borrowers and on loans for different purposes.
- It fixed interest rates on different financial instruments such as commercial bills.
- Cooperative societies were required to accept deposits at higher rates and to lend at lower rates than the rates of commercial banks.



LET US KNOW

The Controller of Capital Issues (CCI) administered control over capital issues according to the Capital Issues (Control) Act, 1947. The Act aimed at healthy growth of capital market and for this purpose empowered the CCI to control the capital issues of companies. Companies had to obtain approval from the CCI for any change in their capital structure. In 1992, the Capital Issues (Control) Act was repealed and CCI was replaced by Securities and Exchange Board of India.



CHECK YOUR PROGRESS

Q 3: What is cupon rate?

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Q 4: State whether following statements are true or false.

a. The deregulated system of interest rates involves greater uncertainty, risk and variability of interest rates.

b. Treasury bill rate is an example of deregulated interest rate.

c. The administered system of interest rates had been adopted with a view to maintain interest rate stable and at low level.

4.6 MEANING AND FEATURES OF DEREGULATED INTEREST RATES

Deregulated interest rates means the interest rates determined by the market force i.e. demand and supply. These rates are market-determined, market-related and flexible. The control of government is absent in this types of interest rates system. The process of interest rates liberation began in the middle of 1980s. However, freeing, deregulation, flexibility of interest rates has differed from instruments to instrument such as bank credit, bank deposit, government securities, small savings, and so on.

Features of the Deregulated System

- The interest rates are fixed by the respective banks as Financial Institutions individually in view of the demand for and supply of money.
- There is no government interference in fixing the interest rates.
- Interest rates may differ from banks to banks and instrument to instrument and will be fixed on competitive market condition.
- Interest rates in deregulated market changes frequently because of change of money supply and demand and competition among the institutions.
- The deregulated system of interest rates involves greater uncertainty, risk and variability of interest rates.

  The deregulated system of interest rates is expected to ensure better promotion of savings, efficiency of financial system, efficiency of investment, efficiency of monetary policy and efficiency and equity in government finance.

ACTIVITY 2

Distinguish between administered interest rates and deregulated interest rates.

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4.7 INTEREST RATE STRUCTURE IN INDIA

- Till 1985 India was having the administered system of interest rates.
- During late years of 1980s the interest rates system has undergone a change and at present it is a mixed system. Both the deregulated and administered system is applicable for instruments and institutions.
- Certain important interest rates in the economy like interest rates on small savings, provident Fund and Non-Resident Indians (NRIs) deposits are controlled by the government. These interest rates are, therefore, called administered interest-rates. Similarly, interest rates on savings accounts with commercial and co-operative banks also continue to be persevered by the RBI. The RBI also governs the lending interest rates for bank advances to the priority sectors.
- The RBI has introduced the following measures to bring in deregulation to the interest rates and to impart greater flexibility to level and structure of interest rates in the country-
  - To encourage banks to introduce a flexible interest rates option for depositors.
  - To urge banks to review and announce the maximum speed over their PLR and
  - To ask banks to provide information a deposits rate for various maturities, the effective annualized return to depositors, and the maximum and minimum interest rates charged to their borrowers.

Phases of Interest Rates Policy

The period since 1951 can be divided into the following five phases of interest rates policy (system) in India:

(i) 1951-52 to 1960-61: Flexible interest rates system

(ii) 1961-62 to 1985-86: The system of administered, regulated, and repressed or suppressed (low) interest rates.

(iii) 1986-87 to 1990-97: The beginning of liberalization or the system with inclination or intent towards liberalization and flexibility, or a semi-administered system with the inching up of interest rates.

(iv) 1991-92 to 1996-97: The system of progressive deregulation and flexibility, and a significant increase in and unprecedentally high interest rates, or the phase of deregulation and dear money.

(v) 1997-98 to 2003-2004: The system of managed flexibility with nearly complete deregulation, and one of the lowest levels of interest rates in India, or the phase of deregulation and cheap money.

CHECK YOUR PROGRESS

Q 5: What is deregulated interest rate?

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Q 6: Mention two features of deregulated interest rate.

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4.8 BILL RATES

Interest rates in bills can be discussed categorizing them in to two types – Government bills (Treasury bills) and Commercial bills. A treasury bill is a finance bill or a promissory note issued by the government. The basic features of these bills are that the interest rate of these instruments

are fixed and administered by the government. However, during recent past an auction system of trading of these bills introduced a long-standing practice of fixed yield was replaced by a flexible yield system. This was done with a view to move towards market-related interest rates on Government securities. The rate of interest at which treasury bills are sold by the RBI is called as Treasury bill rate. The effective return on treasury bills is the discount at which they are sold and is based on the difference between the price at which they are sold and their redemption value. It used to be an administered rate till 1993 and has become market determined with effect from January 1 1993.

Commercial bills, popularly known as bill of exchange is a credit instrument or re-discounting facilities. Bill rates are the cost of bills finance. Various bill rates are determined by the- A) Bank Rate b) SBI *hundi* rate c) *bazaar* bill rate d) Commercial banks bill finance rate and e) SEBI discount rate the bank rate is the rate at which the RBI rediscounts eligible bills from commercial banks. The SBI *hundi* rate is the rate at which the SBI used to discount *hundies* of indigenous bankers. The *bazaar* bill rate was the rate at which *shroffs* used to discount bills of small traders. The commercial banks bill finance rate is the minimum rate fixed by the RBI at which commercial banks can discount bills. The discount rate is the rate which SBI discount first class commercial usance bills.

The rates which can be used to indicate the cost of bill finance in India are the SBI discount rate and Discounting and Finance House of India (DHFI)'s discount rate for commercial bills. In addition to these rates, the RBI from time to time, prescribe a ceiling on the rate of discount at which bills could be discounted by banks with other commercial banks. However, this ceiling has been withdrawn by now.



LET US KNOW

DFHI was set up in March, 1988 by the Reserve Bank of India jointly with public sector banks and all India financial institutions. It deals in money market instruments like; call money, commercial bills, treasury bills etc. It mobilizes funds from commercial banks, co- operative banks, other financial institutions, companies etc. and lent in the money market

4.9 DEPOSIT RATES

The interest rates offered on deposits to the public is called deposit rates. The rates of interest on public deposits with different companies vary on the basis of maturity, over a wide range. Generally, interest rates offered by the companies to the public on deposits used to be higher than the rates on loan from the banks. Interests on deposits on government securities, deposits on post office savings bank account and other small savings schemes are administered. Governments deliberately decide to offer relatively more attractive rates on these assets in order to canalize household savings to the exchequer. On the other hand, public deposits of companies are deregulated and determined by market forces. Interest rates on bank deposits have been deregularised but due to understanding or agreement among the banks the interest rates are almost stable. Public deposit interest rates offered by the companies are well above the bank deposits because of risk factor associated with thereon. However, governments fix ceilings on the maximum interest rates offered on public deposits to ensure safety to the funds.

4.10 BOND RATES

Rates of consideration paid for the deposits made in bonds called bond rates. Government issue, from time to time, bonds generally long term for mobilization of funds for development activities. On the other hand, for short and medium term, government issue treasury bills to control money supply or to direct money as per the monetary policy. However, during 1990s, the interest rates on Treasury bills and Government bonds have been brought in alignment with market rates of interest.



Bond: A debt security whereby the issuer owes a debt and compelled to repay the principal and interest to its holder.

Apart from Government, institutional and corporate houses also issue bonds with a fixed rate of interest for fixed maturity period secured by tangible physical assets of the company. Although bonds are usually issued with a fixed coupon rate of interest, a number of modification have emerged in recent time. Bonds may be issued without specifying periodic interest payments but issued at discounted price. Such bonds are called 'zero-

coupon bond' or 'deep discount bonds'. There are certain types of bonds where interest rates are not fixed and vary with the market interest rates. Such rates are called floating interest rates. In addition to the private sector corporate bonds and Govt. bonds, the public sector bonds became popular since 1985. These bonds are redeemable not before of seven years and carry fixed interest rates determined by the Union Financed Ministry.



CHECK YOUR PROGRESS

Q 7: State whether following statements are true or false.

a. Interest rates on treasury bills are not administered by government.

b. Commercial bills are credit instruments.

c. Treasury bills are issued by government to control money supply.



4.11 LET US SUM UP

The following points have been discussed in this unit -

- Interest is the price the borrowers must pay to the lenders for the use of money for a period of time. In general market phenomenon the rate of interest is determined by the majority of developing country the rate of interest is determined by the Government; while is called administered interest rates.
- A variety of short term, medium term and long term interest rates exists in the financial market any economy. The general structure of interest rates of an economy is influenced by factors like default risk, call risk, marketability or liquidity and tax status.
- Administered or regulated interest rates are predominantly existed in India like US, UK, Japan and Australia. During last couple of decades, deregulated interest rates has exercised; however majority of interest rates are still controlled by the government.

- Treasury bill rate, deposit rates of post office savings bank public provident fund and other government securities like National Savings Certificate (NSC), Kishan Vikash Patra (KVP) etc. are classic examples of administered interest rates. Commercial bank term deposit rates are the examples of deregulated interest rate in India.
- Indian structure of interest rate may be named as 'soft interest rate policy' as because even after deregulation, the interest rate structure is titled towards the socio-economic-political dimensions.



4.12 FURTHER READINGS

1) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.

2) Batra G.S. (2002). Financial services and markets. New Delhi, Deep and Deep Publication Pvt. Ltd.



4.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: It is the price paid by the borrower for using money to the lender for a fixed period of time.

Ans to Q No 2: i) It helps in controlling inflation.
ii) It influences the level of investment in an economy.

Ans to Q No 3: It is the rate of interest paid on the face value of the bond.

Ans to Q No 4: i) True ii) False iii) True

Ans to Q No 5: The interest rate which is determined by market forces of demand and supply is called deregulated interest rate.

Ans to Q No 6: i) There is no government interference in fixing interest rates.

ii) It differs from bank to bank and instrument to instrument.

Ans to Q No 7: a. False b. True c. True



4.14 MODEL QUESTIONS

Q 1: Explain the meaning and important characteristics of administered interest rates.

Q 2: What is interest rate? Explain briefly different interest rates of India in practice.

Q 3: Write short notes on-

a) Bank rate

b) Features of deregulated interest rates

c) Bill rate

d) Process of deregulation of interest rates in India

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UNIT 5: MUTUAL FUND

UNIT STRUCTURE

5.1 Learning objectives

5.2 Introduction

5.3 Meaning and Definition of Mutual Funds

5.4 Objectives of Mutual Funds

5.5 Features of Mutual Fund Investment

5.6 Importance of mutual funds

5.7 Types of mutual funds

5.8 Constituents of mutual funds

5.9 Systematic Investment plan (SIP)

5.10 SEBI (Mutual Funds) Regulation, 1996

5.11 Growth of Mutual Funds in India

5.12 Challenges faced by the mutual funds in India

5.13 Let us Sum Up

5.14 Further Readings

5.15 Answer to Check your progress

5.16 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of mutual fund
- discuss the objectives and features of mutual fund
- discuss the types of mutual fund
- describe the provisions of SEBI (Mutual Funds) Regulation

5.2 INTRODUCTION

Investing money in securities market is risky for the common people. It requires special knowledge and expertise to deal in securities market. To invest in the securities of big corporate houses the investor also must have a huge amount of investable fund. In such situations, investment in the

securities market becomes difficult for the common people. Here, the mutual fund plays an important role by giving the opportunity of investment in securities market to the small investors. It works on the principle of 'small drops of water make a big ocean'. Hence, a mutual fund is a form of collective investment.

In this unit we will discuss the concept of mutual fund, features and importance of mutual fund, different types of mutual funds, constituent and regulation of mutual fund.

5.3 MEANING AND DEFINITION OF MUTUAL FUNDS

Mutual fund is special types of investment institutions which pools the savings of investors for collective investment in a diversified portfolio of securities. It acts as financial intermediaries who collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. It serves as a links between the investors and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns.

The Securities and Exchange Board of India (Mutual Funds) Regulation, 1996 defines mutual fund as 'a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instrument or real estate assets'

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be set up in the form of a trust under the Indian trust Act.

5.4 OBJECTIVES OF MUTUAL FUNDS

Mutual funds have specific investment objectives, which are stated in their prospectus. Growth funds strive for large capital gains, while growth-income funds seek both dividend income and capital gains from the common stocks. The balanced fund generally holds a portfolio of diversified common

stocks, preferred stocks and bonds with the hope of realising capital gains, dividend and interest income, while at the same time, conserving the principal. Income funds concentrate heavily on high interest and high dividend yielding securities. The industry specific mutual funds, obviously specialise in selected industries such as chemicals, petroleum or power stocks.

The main advantages of investing in mutual fund are:

1. **Professional management:** The investor can avail the service from dedicated investment research team. They analyze the performance of the companies and select the suitable investment to the investor.
2. **Diversification:** Diversification reduces the risk. The mutual fund helps in investing a number of companies across a broad cross-section of industries and sectors.
3. **Convenient Administration:** It reduces many problems like less paper work, delay payments, bad delivery etc.
4. **Return Potential:** It provide higher return as mutual fund invests in diversified securities.
5. **Low costs:** Mutual fund is relatively low expensive as it directly invests and does not require paying brokerage and other fees.
6. **Transparency:** The investment in mutual fund is more transparent as the investor can get regular information on the value of their investment, the proportion of investment in each class of assets etc.

   The mutual fund may face the following risks:

   1. The fund manager may not be accountable for poor result.
   2. Faulty planning of investment may result in minimum return.
   3. The different risks associated with the scheme may not be clearly identified.
   4. The Fund may be unable to focus on the securities of the key segments due to excessive diversification of portfolio.

5.5 FEATURES OF MUTUAL FUND INVESTMENT

The following features have made the mutual fund an attractive investment avenue -

(a) Funds for all reasons and seasons that include variety of products as per the suitability of investors.

(b) Aggressive investing that emphasizes on high profits with moderate risks.

(c) Focus on dividend yield with the help of equity income fund.

(d) Mobilization of savings from small investors to profitable avenues.

(e) Protection of investor's interest.

5.6 IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. The following are some of the important advantages of mutual funds industry:

a) Channelizing savings for investment: A number of schemes are being offered by mutual funds so as to meet the varied requirement of the investors and thus saving are directed towards capital investments directly. In the absence of mutual funds, these savings would have remained idle.

b) Offering wide portfolio investment: The investors can enjoy the wider portfolio of the investment held in the mutual fund. The fund diversified its risks by investing on large variety of shares and bonds which cannot be done by small and medium investors.

c) Rendering expertise investment service at low cost: The management of the fund is generally assigned to professionals who were well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus the investors are always assured of quality services in their best interest.

d) Offering tax benefit: Certain fund offer tax benefits to its customers. Under Section 80 c of the Income Tax Act, investment in equity mutual fund up to Rs. 1,50,000 is tax exempted. No tax is to be paid by the investors on the dividend that is received from such mutual fund.

e) Providing greater affordability and liquidity: Even a very small investor can afford to invest in mutual funds. They provide an attractive

and cost effective alternative to direct purchase of shares. In absence of mutual funds, small investors cannot think of participating in securities market.



CHECK YOUR PROGRESS

Q 1: What is meant by mutual fund?

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Q 2: Mention two features of mutual fund investment.

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5.7 TYPES OF MUTUAL FUNDS

1. According to ownership:

a) **Public sector mutual fund**: Mutual funds which are established by the Government of India or by public sector undertaking are known as public sector mutual fund.

b) **Private sector mutual fund**: Mutual fund set up by private sector companies are termed as private sector mutual fund. For example, Reliance Mutual Fund, Kotak Mahindra mutual fund, Escorts India Mutual Fund, etc.

2. According to location:

a) **Domestic fund**: Domestic mutual fund operates within the boundary of a country. This fund mobiles savings of the nationals within the country and invest only in the securities which are issued and traded in domestic financial markets. For example, in India, UTI Mutual Fund, SBI Mutual Fund, Can Bank mutual fund, etc.

b) **Offshore fund**: Offshore mutual fund facilitates cross border fund flow. This fund attracts foreign capital for investment in the market of a specific country or countries. Offshore Mutual Fund opens up domestic markets to the international investment and

global portfolio investments. This fund is regulated by the provisions of foreign countries where it is registered. India Investment Fund sponsored by Standard Chartered Bank, Common Wealth Equity fund sponsored by Canara Bank, etc. are examples of offshore fund.

3. **According to portfolio:**

   a) **Income fund**: Income fund aims at maximising the current income of the investor from investment. There are two aspects of income fund, low risk with constant income and high risk with maximum income.

   b) **Growth fund**: Growth fund invests major parts of its corpus in equities with the objective of capital appreciation over medium to long term period. It is a high risk investment fund with high capital gains potential and low current income assistance. This fund is best suited to young salaried and business people who have high risk bearing capacity and ability to defer liquidity of investment.

   c) **Balanced fund**: This is income-cum-growth fund and its uses its corpus to invest in equities as well as fixed income securities in proportion indicated in the offer documents. The aim of balance fund is to provide regular income as well as capital appreciation. The fund's exposure to risk is moderate and it offers a reasonable rate of return.

   d) **Bond fund**: Bond fund invests in various kinds of bonds so as to ensure regular and fixed income to investors. The main thrust of this fund is earning regular income rather than capital appreciation.

   e) **Equity fund**: Equity fund invests in equity shares of companies. Such funds are for those investors who are willing to take risk in the hope of very high returns.

4. **According to operation:**

   a) **Open - ended mutual fund**: An open - ended mutual fund is available for subscription and repurchase on a continuous basis.

Under this scheme, the size of the fund or the period of the fund is not pre-determined. The investors are free to buy and sell units at Net asset Value (NAV) related price at any point of time. Open- ended schemes enable investors to switch over from one scheme to another. The main objective of this fund is income generation for investors.



Net Asset Value: NAV is value per share of a mutual fund.

b) **Close - ended mutual fund**: A close - ended mutual fund has a fixed corpus and a definite maturity period. The fund is open for subscription only during a specified period. The investor can subscribe directly to the scheme only at the time of initial issue and subsequently a person can buy or sell the units in the stock market where they are listed. The main objective of this fund is capital appreciation. After the expiry of the stipulated period the entire corpus is disinvested and the proceeds are distributed to the unit holders in proportion to the number of units held by them.

c) **Internal fund**: Internal fund is one that has features of both open-ended and close-ended funds. The fund remains open for sale or redemption for a specific interval at NAV related prices and subsequently it operates as a close-ended fund and the units are traded in the stock markets.



CHECK YOUR PROGRESS

Q 3: What is income fund?

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Q 4: What is domestic fund?

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Distinguish between open-ended and close-ended fund

The difference between open-ended and close-ended fund is as follows:

Open-ended fund	Close-ended fund
i) Open-ended fund do not have a fixed corpus.	i) In Close-ended fund corpus is fixed.
ii) Open-ended fund are open for public subscription on a continuing basis. The investors can join and come out from the fund as and when they desire.	ii) Close-ended fund are open for public subscription only during a specific period at the time of launch of the fund.
iii) The units of open-ended funds are not publicly traded. The units are repurchases by the fund at NAV related prices.	iii)The unit of close-ended fund is traded at the stock market.
iv) Open-ended fund do not have a definite maturity period.	iv) Close-ended fund have a definite maturity period.
v) The main objectives of open-ended fund are income generation. application.	v) The main objective of close-ended fund is capital

5. Miscellaneous Mutual funds:

a) **Gilt fund**: It is a fund that exclusively deals with government securities. It is usually risk free because government securities have no default risk.

b) **Sectoral fund**: The Sectoral fund invest in specific sectors like power, telecommunications, information technology, natural resources, entertainment, etc.

c) **Index fund**: It is a mutual fund which invests in securities that represent a specific index, e.g., Bombay Stock Exchange, Sensex, etc.

d) **Leveraged fund**: Leveraged fund is common stock fund which aims at maximising capital appreciation of the unit holders by the use of borrowed funds.

e) **Taxation funds**: Taxation fund is designed to provide tax exemption benefits to the investor. The investor in such a fund gets some concession in income tax. These funds are growth oriented and invest predominantly in equities and are suitable for salaried people who wish to avail of tax rebates.

f) **Money market mutual fund**: Money market mutual fund is set up to invest exclusively in short term money markets instruments like treasury bills, commercial paper, certificate of deposits, etc. The main objective of this fund is generation of income and provides easy liquidity. A money market fund invests in a pool of short-term, interest-bearing securities. Money market funds are most appropriate in situations where you seek to preserve the value of your investment while still earning income. After the remarkable success of mutual funds set up by the banks and financial institutions in India, the Reserve Bank of India (RBI) permitted the establishment of the Money Market Mutual Funds (MMMF) in the year 1992. The basic idea is the deployment of mutual funds' surplus funds in the money market. MMMF ensures high liquidity, adequate surety and high returns. What distinguishes the money market mutual funds from the existing mutual funds is the difference in their investment portfolios. A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments, whereas, a mutual fund largely invests in capital market securities and "parks" its surplus funds in money market instruments for short period.

5.8 CONSTITUENTS OF MUTUAL FUNDS

Mutual funds in India are governed under the Securities and Exchange Board of India (Mutual Fund) Regulation, 1996. The four tier system of managing mutual funds as designed by the SEBI is discussed below:

(a) The Sponsor: Any corporate body which initiates the launching of

mutual fund is referred to as the “sponsor”. According to SEBI norms, the sponsor should have professional competence, financial soundness and a general reputation for fairness and integrity in business transactions. The sponsor appoints trustee, an asset management company and custodian in compliance with the regulations.

(b) **The trustees**: Persons who hold the property of mutual fund in trust for benefit of the unit holders are called “trustees”. Trustees look after the mutual fund, which is constituted as a trust under the provision of the Indian Trust Act, a company is appointed as a trustee to manage the mutual fund with prior approval from SEBI.

(c) **Asset Management Company (AMC):** The investment manager of mutual fund is technically known as the “Asset Management Company” and is appointed by the sponsor or trustees. The AMC is a company formed and registered under the Companies Act, 1956, the AMC is responsible for operating all the schemes of the fund, one company can act as the AMC of only one mutual fund. An Investment Company Management Agreement is executed between the trustee and the asset management company to manage the mutual fund. It charges a fee for the services it renders to the Mutual fund trust. It acts as the investment manager to the trust under the supervision and direction of the trustees.

(d) **Custodians**: An agency that keeps custody of the securities that are brought by the mutual fund managers under the various schemes is called the custodian. The custodian should in no way be associated with the AMC and cannot act as sponsor or trustee to any mutual fund. A custodian is supposed to act only for a single mutual fund unless otherwise approved by SEBI.

5.9 SYSTEMATIC INVESTMENT PLAN (SIP)

An investor may invest a lump sum in a particular scheme of mutual fund. But he needs to correctly predict the movement of market, which is difficult even for professionals. If the investment is done when the market is at high level, his risk increase on account of volatility of markets. There is an

alternative mode of investment available known as “systematic investment plan” (SIP).In SIP, Instead of making one lump sum investment, a fixed sum of money is invested periodically in equality and equity oriented mutual fund schemes. This plan avoids the problem of market timing and usually gives high returns if the investor has a long term investment horizon. Systematic investment plan is, thereby, a popular investment strategy employed by a large number of investors.

CHECK YOUR PROGRESS



Q 5: Who is a trustee?

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Q 6: What is meant by SIP?

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.....

5.10 SEBI (MUTUAL FUNDS) REGULATION, 1996

SEBI announced the amended mutual fund regulations on Dec 9, 1996 covering registration of mutual funds, constitution and management of mutual funds and operation of trustees, constitution and management of Assets Management Committees (AMCs) and custodian schemes of MF’s, investment objectives and valuation policies, general obligations, inspection and audit. The revision has been carried out with the objective of improving investor protection, imparting a greater degree of flexibility and promoting innovation.

The increase in the number of MFs and the types of schemes offered by them necessitated uniform norms for valuation of investments and accounting practices in order to enable the investors to judge their performance on a comparable basis. The mutual fund regulations issued in Dec, 1996 provide for a scheme – wise report and justification of performance, disclosure of large investments which constitute a significant portion of the portfolio and disclosure of the movements in the unit capital.

The existing assets management companies are required to increase their net worth from Rs. 5 Crores to Rs. 10 Crores within one year from the date of notification of the amended guidelines. AMCs are also allowed to do other fund based business such as providing investment management services to offshore funds, other mutual funds, venture capital funds and insurance companies. The amended guidelines retained the former fee structure of the AMCs weekly average NAV up to Rs. 100 crores and 1% of NAV.

The consent of the investors has to be obtained for bringing about any changes in fundamental attributes of the scheme on the basis of which the unit holders had made initial investments. The amended guidelines require portfolio disclosure, standardization of accounting policies, valuation norms for NAV and pricing. The regulations also sought to address the areas of misuse of funds by introducing prohibitions and restrictions on affiliate transactions and investment exposure to companies belonging to the group of sponsors of mutual funds. The payment of early bird incentive for various schemes has been allowed provided they are viewed as interest payments for early investment with full disclosure.

The various mutual funds are allowed to mention an indicative return of schemes for fixed income securities. In 1998-99 the Mutual Funds Regulations were amended to permit mutual funds to trade in derivatives for the purpose of hedging and portfolio balancing. SEBI registered mutual funds and fund managers are permitted to invest in overseas markets, initially within an overall limit of US $ 500 million and a ceiling for an individual fund at US $ 50 million.

In October, 1999 SEBI made investment guidelines for MFs more stringent. The new guidelines restrict MFs to invest not more than than 10% of NAV of a scheme in share or share related instruments of a single company. MFs investment in rated debt instruments of a single issuer is restricted to 15% of NAV of the scheme (up to 20% with prior approval of Board of Trustees or AMC). The new norms also specify a maximum limit of 25% of NAV of any scheme for investment in listed group companies as against an umbrella limit of 25% of NAV for all schemes taken together earlier. SEBI increased (June 7, 2000) the maximum investment limit for

MFs in listed companies from 5% to 10% of NAV in respect of open – ended funds. Changes in fundamental attributes of a scheme was also allowed without the consent of three fourths of unit holders provided the unit holders are given the exit option at NAV without any exit load. MFs are also not to make assurance or claim that is likely to mislead investors. They are also banned from making claims in advertisement based on past performance.

ASSET MANAGEMENT COMPANY (AMC)

A mutual fund is managed by an Asset Management Company that is appointed by the sponsored company or by the trustees. The asset management company has to be registered under the Companies Act and has to be approved by the SEBI. The AMC manages the affairs of the mutual funds and its schemes. AMCs are registered by the Registrar of Companies only after a draft memorandum and articles of association are cleared by the SEBI. An AMC has to follow a number of obligations. They are as follows:

- The AMC shall take all the steps and exercise due diligence to ensure that any scheme is not contrary to the provisions of the trust deed and provisions of investment of fund pertaining to any scheme is not contrary to the provisions of resolution and trust deed.
- The AMC shall exercise due diligence and care in all its investment decision. The AMC shall be responsible for the acts of commission or omissions by its employees or the person whose services have been procured.
- An AMC shall submit reports to the trustees quarterly.
- The trustees at the request of an AMC can terminate the assignments of the AMC.
- An AMC shall not deal in securities through any broker associated with a sponsor or a firm which is an associated of sponsor beyond 5 per cent of the daily gross business of the mutual fund.
- No AMC shall utilise services of the sponsor of any or any of its associates, employees, or their relatives for the purpose of any securities transaction and distribution and sale of securities, unless disclosure is made to unit holders and brokerage/ commission paid is

disclosed in half-yearly account of the mutual fund.

- No person, who has been found guilty of any economic offence or involved in violation of securities law, should be appointed as key personal.
- The AMC shall abide by the code of conduct specified in fifth schedule.
- The asset management company shall not carry out its operations including trading desk, unit holder servicing and investment operations outside the territory of India, Provided that the asset management company having any of its operations outside India shall wind up and bring them within the territory of India within a period of one year from the date of notification of Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2011.
- The AMC has to make a continuous effort to remind the investor thought letters to take unclaimed amounts. The information on amount unclaimed and number of such investors for each scheme is required to be disclosed in the annual reports of mutual funds. The unclaimed redemption and dividend amounts can be deployed by the mutual funds in call money market or money market instruments and the investors who claim this amount during a period of three years from the due date shall be paid at the prevailing net assets value. After a period of three years, the amount can be transferred to a pool account and the investors can claim the amount at NAV prevailing at the end of the three year. The income earned on such funds can be used for the purpose of investor education.

5.11 GROWTH OF MUTUAL FUNDS IN INDIA

The Indian mutual fund industry has evolved over distinct stages. The growth of the mutual fund industry in India can be divided into four phases: phase I (1964-87), phase II (1987-92), Phase III (1992-97) and Phase IV (beyond 1997).

- **Phase I** - The mutual fund concept was introduced in India with the setting up of UTI in 1963. The Unit Trust of India (UTI) was the first mutual fund set up under the UTI Act, 1963, a Special act of the

parliament. It became operational in 1964 with a major objective of mobilising savings through the sale of units and investing them in corporate securities for maximising yield and capital appreciation. This phase commenced with the launch of the unit scheme 1964 (US-64), the first open-ended and the most popular scheme. Master share, the equity growth fund launched in 1986, proved to be a grand marketing success. Master share was the first real close-ended scheme floated by UTI. It launched the India Fund in 1986- the first Indian off shore fund for overseas investors, which was listed on the London Stock Exchange (LSE). UTI maintained its monopoly and experienced a consistent growth till 1987.

- **Phase II**: The second phase witnessed the entry of mutual fund companies sponsored by nationalised banks and insurance companies. In 1987, SBI Mutual Fund and Can bank Mutual Fund were set up as trusts under the Indian Trust Act, 1882. In 1988, UTI floated another off shore fund, namely, The India Growth Fund which was listed on the New York Stock Exchange (NYSE). By 1990, the two nationalised insurance giants, LIC and GIC, and nationalised banks, namely, Indian Bank, Bank of India and Punjab National Bank had started operations of wholly-owned mutual fund subsidiaries. The assured return type of schemes floated by the mutual funds during this phase was perceived to be another banking product offered by the arms of sponsor banks. Subsequently the Government of India issued comprehensive guidelines in June 1990 covering all mutual funds. These guidelines emphasised compulsory registration with the SEBI and a close relationship be maintained between the sponsor and asset management company (AMC). With the entry of public sector funds, there was a tremendous growth in the size of the mutual fund industry.
- **Phase III**: The year 1993 marked a turning point in the history of mutual funds in India. The Securities and Exchange Board of India (SEBI) issued the Mutual Fund Regulations in January 1993. The SEBI notified regulations bringing all mutual funds except UTI under a common regulatory frame work. Private domestic and foreign players were

allowed entry in the mutual fund industry. The Kothari group of companies, in joint venture with pioneer, a US fund company, set up the first private mutual fund, the Kothari pioneer Mutual Fund, in 1993. Kothari Pioneer introduced the first open-ended fund Prima in 1993. Several other private sector mutual funds were set up during this phase. UTI launched a new scheme, Master-gain, in May 1992, which was phenomenal success with a subscription of Rs.4, 700 crore from 63 lakh applicants. The industry's investible funds at market value increased to Rs. 78,655 crore and the number of investor accounts increased to 50 million. However, the year 1995 was the beginning of the sluggish phase of the mutual fund industry. During 1995 and 1996, unit holders saw erosion in the value of their investments due to a decline in the NAVs of the equity funds. Moreover, the service quality of mutual funds declined due to a rapid growth in the number of investor accounts and the inadequacy of service infrastructure. A lack of performance of the public sector funds and miserable failure funds like Morgan Stanley eroded the confidence of investors in fund managers. Investor's perception about mutual funds gradually turned negative. Mutual funds found it increasingly difficult to raise money. The average annual sales declined from about Rs. 13,000 crore in 1991-94 to about Rs. 9,000 crore in 1995 and 1996.

- **Phase IV** : During this phase, the flow of funds into the kitty of mutual funds sharply increased. This significant growth was aided by a more positive sentiment in the capital market, significant tax benefits, and improvement in the quality of investor service. Investible funds, at market value, of the industry rose by June 2000 to over Rs. 1, 10,000 crore with UTI having a 68 percent of the market share. During 1999-2000 sales mobilisations reached a record level of Rs. 73,000 crore as against Rs. 31,420 crore in the preceding year. The effect of these problems was felt strong in India also. Pioneer ITI, JP Morgan and Newton Investment Management pulled out from the Indian market. The Bank of India MF liquidated all its schemes in 2002.

5.12 CHALLENGES FACED BY THE MUTUAL FUNDS IN INDIA

Mutual funds in India have not been able to perform up to the desired level and in many cases have expressed their financial inability to repay the invested capital along with promised rate of returns. The following are some of the main problems that are being faced by the Indian mutual funds.

(a) **Lack of innovation**: Mutual funds in India have not been able to provide innovative schemes in terms of risk, liquidity and choice of the investors.

(b) **Conventional pattern of investment**: Mutual funds in India have been following conservative pattern of investment. They have not been able to diversify the risk to a large extent, which has caused low return in investment.

(c) **Poor risk management**: As per the recent survey, about 50% of mutual funds are not managing the risk properly and another 50% do not have documented risk procedures or dedicated risk managers.

(d) **Liquidity crises**: Mutual funds in India face liquidity problems. Investors are not able to draw back some of the scheme, there is no easy exit route.

(e) **Lack of transparency**: Mutual funds in India are not providing adequate information and materials to the investors. Unfortunately, most of the funds are not able to send even quarterly report to their members. For the success of mutual funds it is very essential that they should create a good rapport with the investors by declaring their holdings to them.

(f) **Delay in service**: Mutual funds in India have not been able to provide quick and adequate services to the investors. Mutual funds have failed to build up investor- confidence by rendering poor services.



5.13 LET US SUM UP

In this unit we have discussed the following points:

- Mutual fund is special types of investment institutions which pools the savings of investors for collective investment.

- A number of schemes are being offered by mutual funds so as to meet the varied requirement of the investors and thus saving are directed towards capital investments directly.
- A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments
- A mutual fund is managed by an Asset Management Company that is appointed by the sponsored company or by the trustees.



5.14 FURTHER READINGS

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3) Srivastava, R.M. (2009). Management of Indian financial institutions. New Delhi, Himalaya Publishing House.

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5.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Mutual fund is special types of investment institutions which pools the savings of investors for collective investment in a diversified portfolio of securities.

Ans to Q No 2: Two features of mutual fund are -

(a) Funds for all reasons and seasons that include variety of products as per the suitability of investors.

(b) Aggressive investing that emphasizes on high profits with moderate risks.

Ans to Q No 3: Funds which aims at maximising the current income of the investor from investment are called income fund.

Ans to Q No 4: Mutual fund operates within the boundary of a country are called domestic fund.

Ans to Q No 5: Persons who hold the property of mutual fund in trust for benefit of the unit holders are called “trustees”.

Ans to Q No 6: In SIP, Instead of making one lump sum investment, an investor may put in a fixed sum of money, over a period of time regardless of the mutual fund’s unit price.



5.16 MODEL QUESTIONS

Q 1: Define mutual fund.

Q 2: What is SIP?

Q 3: Discuss the different types of mutual fund.

Q 4: Discuss the constituent of mutual fund.

Q 5: Discuss the obligations of Asset Management Company.

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UNIT 6 : LEASE FINANCING AND HIRE-PURCHASE

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Concept of Leasing

6.4 Features of Lease

6.5 Classification of Lease

- 6.5.1 Financial Lease
- 6.5.2 Operating Lease
- 6.5.3 Sale and Lease Back Lease
- 6.5.4 Leverage Lease

6.6 Advantages and Limitations of Lease

6.7 Legal Aspect of Leasing

6.8 Hire Purchase: Meaning and Features

6.9 Differences between Leasing and Hire-Purchase

6.10 Installment Purchase: Meaning and Features

6.11 Differences between Hire-Purchase and Installment Purchase

6.12 Legal Aspect of Hire Purchase

6.13 Let Us Sum Up

6.14 Further Readings

6.15 Answers to Check Your Progress

6.16 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the concept of lease financing, hire purchase and installment purchase
- discuss types of lease financing
- describe the essential features of lease financing, hire purchase and installment purchase
- explain the legal aspects of lease financing and hire purchase.

6.2 INTRODUCTION

In this unit we will get inputs on major asset financing service prevalent in industrial sector i.e. leasing.

Suppose, we are going to establish a tea factory .First of all we require land, building and machinery which involves investment of huge funds. We do not have the entire fund required for setting up the factory. Now, what we can do is that we can go to a leasing company, get the machinery on lease without buying them. For that we need to pay an amount monthly to the leasing company which is called rental. This system is called lease. The same is done for the existing company also which go for expansion of their business. In case of existing companies, they may have the required fund but if they pay the entire amount from their earning, it will put a pressure on the current year's earning resulting in reducing profit. Hence, companies go for alternative financing of assets like leasing. Let us discuss the concept of "lease".

6.3 CONCEPT OF LEASING

A lease may be defined as a contractual arrangement or transaction in which a party (lessor) owing an asset or equipment provides the asset for use to another or transfer the right to use the equipment to the user (lessee) over a certain or for an agreed period of time for consideration in the form of a periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset or equipment reverts back to the lessor unless there is a provision for the renewal of the contract. The above definition reveals that leasing essentially involves the divorce of ownership from the economic use of an asset or equipment. It is a device of financing the cost of an asset. Lease financing is thus a device of financing or money lending. Lease financing is available for land, buildings, industrial equipments etc.

As we have already discussed that in leasing, the user company does not own the machinery or the equipment leased; yet for all practical purposes the user has virtually all rights over the machinery. The main difference

between leasing and term loan are: a finance company called the leasing company arranges to buy a piece of machinery or equipment (usually in consultation with and prior approval of the lessee) and the leases the machinery on long term to the lessee.

The lessee pays the lease rental whereas in a term loan the borrower is expected to pay the interest as well as the repayment of the loan amount. The lessee does not own the equipment and hence cannot claim the depreciation and investment allowances on the relative machines. However, the lease rental would normally include repayments towards principal and interest and the entire rental may be written off as eligible expenditure from profits for income tax purpose.



LET US KNOW

Lease has been in practice since time immemorial in various forms. Evidence trace the evolution of leasing during the Sumerian and Greek civilization where leasing of land, agricultural tools, animals and ships took place. Equipment leasing is found to be used in large scale during the post second world war era by the European rail companies. Since then the leasing gained popularity and during late 19th century, the leasing practice was rapidly used in USA especially among the rail road operators who took rail cars and locomotives in lease. Leasing in India is of recent practice. It is in 80's when the leasing practice was started in India. Today leasing has become a very common and popular means of assets financing for large scale manufacturing facilities, power and infrastructural equipments and construction equipments. Other common equipment leasing includes plant and machinery, office equipment automobiles ships and aircrafts. Leases are used to finance such items as computers, commercial aircrafts, construction equipment machine tools and medical equipment.

Although it started late in India, leasing witnessed a very rapid growth during last few decades. Industrialization and the advent of multinationals in India have augmented the growth further. The

financial sector reform has paved the path for the financial innovation resulting in these types of services. Leasing is expanding both in public and private sectors. The major private sector leasing companies operating in India are Sundaram Finance Ltd, Ashok Leyland Finance Ltd, Kotak Mahindra Finance Ltd and Tata Finance Ltd. Apart from these; many public sector banks have floated their finance and leasing arms. Some of them are Infrastructure Leasing and Financial Services Ltd promoted jointly by Central bank of India, HDFC and UTI, PNB Financial Services, Industrial Reconstruction Bank of India etc.

6.4 FEATURES OF LEASE

The basic features of a lease are-

- There are essentially two parties associated in the leasing; the Lessor (owner of the asset) and the Lessee (user of the asset).However, in some cases a third party called Lender or financer is involved when the Lessor thinks it to be necessary.
- The asset- a vehicle, an aircraft, a machine, a computer, a building, etc can be a subject of leasing.
- Lease contract is done for a specified period; may be for long term(called finance lease) or for short term(called operating lease)
- Lessee has to pay a consideration to the lessor for using the asset. This is called rentals.
- At the end of the lease period, the contract may be renewed or the asset may be sold to the lessee or the asset may be reverted to the owner.



CHECK YOUR PROGRESS

Q 1: Who are the parties involved in lease agreement?

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Q 2: State two features of lease agreement.

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ACTIVITY 1

Visit two Finance companies of your choice and identify various items for which they provide lease financing.

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Now, we have a fair idea about the concept of leasing .Let us now proceed to discuss a little more about it.

6.5 CLASSIFICATION OF LEASE

An equipment lease transaction can differ on the basis of (i) the extent to which the risks and rewards of ownership are transferred. (ii) number of parties to the transactions (iii) domicile of the equipment manufacturer, the lessor and the lessee and so on.

Leasing can be classified in to the following types: (i) Financial lease, (ii) operating lease, (iii) sale and lease back arrangement (iv) Leverage Lease

6.5.1 Financial Lease

Finance lease or Financial lease sometimes called the capital lease means a long term lease which transfers the ownership of an asset to the lessee by the lessor with a substantial part of risks and rewards of ownership .As per Financial Accounting Standards Board (FASB) of the USA, the lease can be classified as financial lease , if the term of lease exceeds 75 percent of the useful life of the asset or if the present value of the minimum lease payments exceeds 90

percent of the fair market value of the asset, at the inception of the lease.

The basic features of the financial lease are –

(a) The lessor does not provide for the repair and maintenance service, insurance of the asset and these have to be borne by the lessee;

(b) These contracts are not cancelable;

(c) They are fully amortised (i.e., the lessor receives rental payments which are equal to the full price of the lease equipment plus return on the investment);

(d) Lessee has the obligation to pay the rental irrespective of the suitability of the asset once agreed to take it on lease;

(e) The lessee enjoys the option to purchase the asset at a price which is lower than the fair market value at the end of the lease period.

Now, let us go through the steps of a lease finance transaction. They are –

- The lessee (the intending buyer) selects the equipment according to his requirement, from its manufacturer or distributor.
- The lessee negotiates and settles with the manufacturer or the distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment etc.
- The lessor purchases the equipment either directly from the manufacturer or distributor (under straight forward leasing) or from the lessee after the equipment is delivered (under sale and lease back).
- The lessor leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment. A finance lease may provide a right or option to the lessee to purchase the equipment at a future date, however this practice is rarely found in India.

6.5.2 Operating Lease

Operating lease is defined as a short-term cancelable lease which transfers the ownership of the asset to the lessee without transferring risk and reward of the ownership unlike the finance lease. Operating leases, sometimes called service leases, provide for both financing and maintenance. An important feature of operating leases is that the frequently contain a cancellation clause, which gives the lessee the right to cancel the lease before the expiration of the basic agreement. Let us discuss the features of an operating lease

- An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases, it may be even on hourly, daily, weekly or monthly basis.
- Since the lease periods are shorter than the expected life of the assets , the lease rental are not sufficient to totally amortise the cost of the asset
- Operating lease normally include maintenance clause requiring the lessor to maintain the lease asset and provide services such as insurance, support staff, fuel etc.

6.5.3 Sale and Leaseback Lease

Under this type of lease, the owner of an equipment/ asset sells it to a leasing company (lessor) which leases back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits vaults by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The lease company in turn offers these lockers on a long-term basis to the bank. The bank sub-leases the locker to its customers. The lease back arrangement in sale and lease back type can be in the form of finance lease or operating lease. This type of lease enables the lessee to use the sales proceeds in productive projects and meet the rental of the lease using them.

6.5.4 Leverage Lease

Leverage lease is a form of lease where lessor acquires the asset/ equipment by borrowing funds from a third party. The lender to this leased asset is called the loan participant. Loan participant gets an assignment of the lease which gives the right to the rentals to be paid by the lessee. Further a first mortgage on the leased assets is also entitled to the loan participant. Another party called trustee is also associated with this type of lease to look after the interest of the lessor and the loan participant. The rental payments of the lease are routed through the trustee. On receipt of the lease rental, the trustee remits the debt service component to the lender (loan participant) and the balance to the lessor. Leverage lease is applied in case of those assets which require a huge amount of funds, i.e., aircrafts, ships etc.

6.6 ADVANTAGES AND LIMITATIONS OF LEASE

Now, let us discuss about the advantages of leasing. Advantages of leasing may be discussed from the lessee's point of view and from the lessor's points of view.

Lease financing has following advantages to the lessee:

- **Financing of capital goods:** Lease financing enables the lessee to have finance for huge investments in land, building, plant, machinery, heavy equipment etc. up to 100 percent without requiring any immediate down payment. Thus , the lessee is able to commence his business virtually without making any initial investment (of course he may have to invest the minimal some of working capital needs)
- **Additional source of finance:** Leasing facilitates the acquisition of equipment, plant and machinery without the necessary capital investment, and thus has a competitive advantage of mobilizing the scare financial resources of business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

- **Less costly:** Leasing as a method of financing is less costly than the other alternatives available.
- **Ownership preserved:** Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long term finances, for example, equity or debentures normally dilute the ownership of the promoters.
- **Avoids conditionality:** Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionality, such as representation on the board, conversions of debt into equity, payment of dividend etc which usually accompany institutional finance and term loans from bank.
- **Simplicity:** Lease finance is simple to negotiate and free from cumbersome procedure with faster and simple documentation. As against it, institutional finance and term loans require compliance of covenants and formalities and bulk of documentation causing procedural delays.

Lease financing has following advantages to the lessor-

- **Full security:** The lessor's interest is fully secured since he is always the owners of the leased assets and can take repossession of the asset if the lessee fails to pay rentals. As against it , releasing an asset secured against a loan is more difficult and cumbersome
- **Tax benefit:** The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor in high tax bracket he can lease out assets with high depreciation rates and reduce his tax liability substantially. Besides, the rentals can be suitably structured, to pass on some tax benefit to the assessee.
- **High profitability:** The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowing. Also the rate of return is more than in case of lending finance directly.
- **Trading on equity:** Lessor usually carries out the operations with greater financial leverage i.e., they have a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the

ultimate return on equity is very high.

Limitations of leasing

Lease financing suffers from certain limitations which may be discussed as under-

- **Restrictions on use of equipment:** A lease arrangement may impose certain restriction on use of the equipment, or requires compulsory insurance etc. Besides, the lessee is not free to make additions or alteration to the lease assets to suit his requirement.
- **Limitation of financial lease:** A financial lease may entail a higher payout obligation, if the equipment is found not useful and the lessee opts for premature termination of leased agreement. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.
- **Loss of residual value:** The Lessee never becomes the owner of the lease asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessee or caused by inflation or otherwise, such as appreciation in value of leasehold land.
- **Double sales-tax:** with the amendment of sale tax law of various states a lease financing transaction may be charged to sale tax twice, once when the lessor purchases the equipment and again when it is leased to the lessee.



CHECK YOUR PROGRESS

Q 3: State two advantages and two disadvantages of lease.

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Q 4: Mention two features of finance lease.

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6.7 LEGAL ASPECT OF LEASING

There is no legislation which is exclusively meant for leasing transactions. However, various provisions of a number of laws/ Acts / directions are applicable to lease. In the following paragraphs, we will the main provisions of different Acts/ laws which are very common.

Indian Contract Act, 1872

The provisions relating to bailment in the Indian Contract Act cover equipment leasing agreement. Since an equipment lease transaction is regarded as a contract of bailment, the obligation of the lessor and the lessee are similar to those of the bailor and the bailee as defined by the provisions of the Indian Contract Act. The special provisions of Indian Contract Act relating to leasing are:

- The lessor is required to deliver the asset to the lessee with all legal documents enabling him to use the asset.
- The lessor must ensure the peaceful possession of the lessee during the tenure of the agreement.
- The lessor must disclose to the lessee about the faults, defects and risks (if any) of the assets leased failing which the lessor has to compensate the loss arising out of that.
- The lessor (Bailor) must ensure that the asset leased is fit and usefull for the lesee(bailee).
- The lessee has the obligation to pay the lease rentals as specified in the lease agreement, to project the lessor's title,
- Take reasonable care of the asset, and the lesse must not use the asset for unauthosied purpose.
- The lessee has to return the leased asset on the expiry of the lease, or when the agreement is terminated.

Competition Act

The lease contract also comes under the purview of Restrictive Trade Practices Act, now Competition Act. According to this Act, the following practices considered to be restrictive-

- Use of leased assets in certain purposes

- Binds the lessee to use a certain types of machinery manufactured by the Lessor
- Binds the lessee to buy the accessories and spare parts from the lessor only.

Foreign Exchange Management Act

Certain provisions pertaining to holding of assets in India by NRIs, restriction of payment on imported assets, restrictions in sending assets to outside on lease or hire purchase etc are appended in the FEMA which cover lease transactions involving foreign party or currency.

Motor Vehicle Act

Under Motor Vehicle Act the lessor of a lease contract is considered as the dealer and the lessee is considered as the owner for the purpose of registration, even if the legal ownership remains with the lessor.In this the lessor is treated as financier of the assets.

Indian Stamp Act

The leasing contracts are subject to the provisions of Indian Stamp Act for the payment of stamp duty creating a right or liability in monetary terms.

Income Tax Act, 1961

Income Tax Act 1961 provides for implications and offers tax benefits both to the lessor and the lessee the provisions are:-

- Lessor can deduct the amount of depreciation of the leased assets from his taxable income.
- Where leasing constitutes the business or main activity of the assessee (lessor), income from the lease is taxable under the head Profits and Gains from business and profession. In other cases, the income from lease is taxed as income from other sources.
- While computing the income of lessor from leasing, certain expenses are allowed as deductible expenses to determine the taxable income. These include-
  – Depreciation
  – Rent, taxes, repairs and insurance
  – Preliminary expenses

– Interest on borrowed capital

– Bad debts

– Expenses incurred in the furtherance of trade/business

– Entertainment expenses

– Travel expenses

- Lease rentals are considered as a normal business expenditure of lessee as per the Income Tax Act.
- Income Tax Act allows the lessee to deduct the expenses associated with the leased assets such as repairs and maintenance, insurance, finance charge and so on.

Sales Tax Act

Leased transactions are also covered by certain provisions of Sales Tax Act. These provisions are following.

- While purchasing equipment by the lessor, the normal sales tax is applicable.
- Sale tax is payable on the annual taxable turnover (aggregate lease rentals) of the lessor.
- Lessor with an annual taxable turnover beyond the specified limits must seek registration as 'dealer' under the local sales tax law.
- Surcharge, additional surcharge, additional sales tax is levied on turnover exceeding a specified limit or turnover.



ACTIVITY 2

Which type of lease would be suitable for acquisition of the following assets or equipments? Justify.

Computer .....

Aircraft .....

Truck .....

Car .....

6.8 HIRE PURCHASE: MEANING AND FEATURES

Now let us discuss another asset financing service of similar kind, called hire-purchase. A hire purchase can be defined as a contractual arrangement under which the owner lets his goods on hire to the hirer and offers an option to the hirer for purchasing the goods in accordance with the terms of the contract.

Features of Hire Purchase system

The following are the important features of hire- purchase system:

- Hire- purchase agreements are agreements to sell goods. It is not a contract of sale although it resembles a sale. The sale takes place at a future date on the fulfillment of certain conditions.
- Possession of goods under hire- purchase system is transferred from the seller to the buyer on signing the agreement.
- Although the possession of goods under the hire- purchase system remains with the buyer, the ownership of such goods remain with the hire seller till the payment of the last installment.
- The hire- purchaser agrees to pay cash price of the goods along with interest in periodical installments which may be monthly, quarterly, half- yearly or yearly.
- Installments paid by the hire- purchaser are treated as the hire charges till the payment of the last installment.
- The hire- vendor has the right to repossess the goods if the hire-purchaser makes default in the payment of any installment.
- The hire- purchaser has a right to terminate the agreement, after giving at least fourteen day's notice in writing, and thereby return the goods bought under hire- purchase system.

6.9 DISTINCTION BETWEEN LEASING AND HIRE-PURCHASE

Many a times people confuses between the leasing and hire purchase contract. Both leasing and hire-purchase provide a source of financing fixed assets. However, the two are not similar on many accounts. Let us discuss

the following points of distinction between leasing and hire purchase -

Point of Difference	Leasing	Hire-Purchase
1. Ownership	Ownership is not transferred to the lessee	Ownership is transferred to the hirer on payment of last installment.
2. Tax Deductibility	Entire lease rentals are tax-deductible expenses	Only the interest component and not the entire installment is deductible.
3. Depreciation and other allowances	Cannot be claimed by the lessee	Can be claimed by the hirer.
4. Salvage Value	Lessee cannot realize salvage value of the asset on the expiry of the lease of life of the asset.	Hirer can realize salvage value of the asset after payment of last installment.

6.10 INSTALLMENT PURCHASE: MEANING AND FEATURES

Installment purchase indicates the type of purchase under which the price of the goods and the interest on the price are paid by the buyer by periodical installments. Under this system the buyer acquires the title of the goods and the possession thereof as soon as the transaction is completed. This system hardly differs from a contract of sale except that payment of the price of the goods is spread over a number of installments and that each installment includes interest.

Features

The main features of an Installment purchase arrangement are as follows:

- **Credit sale**: It is a credit sale where payment is made in installments.
- **Transfer of ownership**: The title in the goods passes from the seller to the buyer when the transaction is completed.
- **Payment of interest**: Every installment includes interest on unpaid balance.

- **Non-return of goods**: The buyer has no option to return the goods once they are purchased.
- **No right of possession**: the seller has no right to repossess the goods if the buyer fails to pay the installments. However, he can sue the buyer for the unpaid balance.

6.11 DIFFERENCES BETWEEN HIRE-PURCHASE AND INSTALLMENT PURCHASE

Installment system differs from hire purchase system in many respects as shown below:

Points	Hire Purchase	Installment
1. Nature of contract	It is only an agreement to sale but the actual sale takes place in future	It is a contract of sale of goods and is completed when the parties enter into an agreement
2. Ownership of goods	The title in the goods passes from the seller to the buyer after the last installment is paid	The title in the goods passes from the seller to the buyer when the contract for sale is completed.
3. Right of lien on goods	The seller has a lien on the goods until he receives full payment	The seller has no lien on the goods as it is a contract of sale.
4. Disposal of goods	The buyer is not the owner; hence he cannot dispose off the goods till he pays the last installment	Since the buyer is the owner, he can dispose off the goods before the last installment is paid.
5. Controlling Act	It is controlled by the Indian Contract Act of 1872	There is no such Act to control these transactions.



CHECK YOUR PROGRESS

Q 5: State two differences between leasing and hire- purchase system.

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Q 6: State two differences between hire- purchase and installment purchase system.

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6.12 LEGAL ASPECT OF HIRE PURCHASE

Like leasing, there is no legislation exclusively for the governance of hire-purchase transactions. An effort was made to this direction by passing an Act named The Hire-purchase Act in 1972. However, the act has not been implemented so far. Now, in absence of any specific law, the hire-purchase transactions are governed by the provisions of the Indian Contract Act and the Sales of Goods Act. Other laws which provides for governance of hire-purchase transactions are Income Tax Act and Sales Tax Act.



ACTIVITY 3

Which among the Lease, hire-purchase and installment purchase will you chose for financing your asset and why? Justify.

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6.13 LET US SUM UP

In this unit we have discussed the following points:

- Lease is a contractual arrangement in which the owner of an asset (lessor) provides the asset for use to another the right to use the asset to the user (lessee) for an agreed period of time in return for periodic payments (rental).
- At the end of the lease period the asset reverts back to the owner.
- The major players in leasing in India are independent leasing companies, other finance and investment companies, manufacturer-lessor, development finance institutions, in–house lessors and banks.
- Hire Purchase is the agreement whereby the hirer will pay to the owner of the goods an equal periodic installments spread over a period of time for using the goods.
- In case of Installment Purchase system, the buyer pays periodically the price of the goods along with interest to acquire the title and possession of goods.
- Both leasing and hire-purchase have emerged as a supplementary source of finance.



6.14 FURTHER READINGS

1) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.

2) Khan, M. Y. (2007). Indian Financial System. New Delhi. Tata McGraw Hill.

6.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) Lessor- owner of the asset

ii) Lessee- user of the asset

Ans to Q No 2: i) Lease contract is done for a specified period.

ii) Lease contract separates the owner from the user of the asset.

Ans to Q No 3: Advantages:

i) Full security

ii) Tax benefit

Disadvantages:

i) Restriction on use of equipment

ii) Loss of residual value

Ans to Q No 4: i) The lessor does not provide for the repair, maintenance and insurance of the asset.

ii) The lessee enjoys the benefit of purchasing the asset at a lower price than the market value at the end of the market value.

Ans to Q No 5: i) In case of lease, ownership is not transferred from the lessor to the lessee.

In case of hire- purchase, ownership is transferred from the owner to the hirer of the asset after the last installment is paid.

ii) In lease, the lessee cannot claim depreciation and other allowances. In hire- purchase, the hirer can claim depreciation and other allowances

Ans to Q No 6: i) Hire purchase is an agreement to sale but the actual sale takes place in future. Installment is an agreement of sale and is completed as soon as the parties enter into the agreement.

ii) In hire- purchase system, ownership is transferred after the last installment is paid. In installment system, ownership is transferred when the contract for sale is completed.



6.16 MODEL QUESTIONS

Q 1: Explain the concept of leasing and hire-purchase

Q 2: Why companies go for leasing rather than purchasing the equipment? Discuss.

Q 3: Differentiate between Hire purchase and leasing.

Q 4: Differentiate between Hire-purchase and Installment purchase.

Q 5: Classify lease financing and explain their specific features.

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UNIT 7: DERIVATIVE

UNIT STRUCTURE

7.1 Learning objectives

7.2 Meaning of Derivatives

7.3 Types of Derivatives

7.4 Traders in Derivatives Market

7.5 Foreign Exchange Market: Meaning and Scope

7.6 Dealers in Foreign Exchange Market

7.7 Exchange Rate

7.8 Let us Sum Up

7.9 Further Readings

7.10 Answer to Check your progress

7.11 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit you will be able to

- explain the meaning of derivative, advantages and disadvantages
- explain the different types of derivatives
- discuss the current scenario of derivatives market in India
- explain about forex market
- discuss the structure of foreign exchange market.

7.2 MEANING OF DERIVATIVES

The word 'derivative' originates from mathematics and refers to a variable, which means derived from another variable. A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset. The variables underlying derivatives are the prices of traded assets. For e.g. price of a stock (share), price of commodities like wheat, rice, pulses, interest rates, currency prices etc. Derivatives do not have value of their own. In finance the word derivative is used to mean a contract between dealers of financial assets where value is derived from the value of

the underlying assets that is any financial assets.

The financial assets are dealt in financial market. The prices of financial assets like shares, stock, bonds, foreign currency, interest rate of loans etc. are always keeps on changing. It creates uncertainty regarding future prices of financial assets and parties involved are also exposed to market risk. To avoid such risk/ uncertainty from fluctuation in prices of financial assets parties in financial market entered into a contract which is known as derivative. For example investor may purchase shares with the intention of increasing the share prices but in reality share prices may decline. Uncertainty is involved in future price of shares which exposed investors towards risk. Again Importer and exporter also face similar kind of risk. An importer while importing goods from other country may face problem in the time of payment of foreign currency when payment is due. As foreign currency exchange rates keeps on fluctuating the importer may have to pay more Indian rupee for purchase of necessary foreign currency if the value of that particular foreign currency appreciates. Similarly the exporter is also exposed to similar kind of risk and may receive less Indian rupee after due time if the value of foreign currency depreciates. The importer and exporter would like to protect the risk that arises due to fluctuation in foreign currency which can be avoided through derivatives.

Financial derivative is a contract between dealers of financial assets. Here the value is derived from the value of the underlying assets i,e; assets dealt in the financial market like share or foreign currency. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Dealers entered into a contract to protect themselves or hedge the risk that may arise from the changes in the value of the financial assets. It is one kind of instrument for the management of the risk that arise due to uncertainity prevailing in the financial market. The importance of derivative is increasing day by day because of high volatility in market.

Financial derivative are designed to protect dealers of financial market from the adverse movement of prices of financial assets in future. With the help of financial derivative dealers can easily deal in financial assets in future

at predetermined agreed rate. Financial derivative 'lock in' the price of a particular financial asset for a future date. It effectively protects them from future uncertainities.

The main advantages of derivatives are:

- Risk Management: It is a risk management tool for the dealers of financial market. They can protect the future uncertainties that arise in the financial market due to fluctuation in market.
- High Profit: The ability and chances to make huge and extreme profits is high in derivatives than primary securities or mutual funds.

Disadvantages of derivatives

A disadvantage of financial derivative is the possibility of loss of money. While financial derivatives help increase profits and reduces risks it may also lead to lose out a lot of money or other assets. For example a cotton farmer enters into a contract with a weaver. Both the parties need the cotton as a resource to continue in their business. Thus, they can enter into a contract for the benefit of both of them. The cotton producer may agree on a fixed price to sell the cotton to the weaver on harvest time. This ensures a fixed income and a sure customer for the cotton farmer. On the other hand, the weaver is also ensured of a supply of cotton. This agreement could be a disadvantage when the price of cotton fluctuates. If the price of cotton goes up, the farmer would still have to sell the cotton at the earlier agreed cost. This makes the farmer lose out on the profit. Price fluctuations on the cotton could affect the weaver too. If the price of cotton goes down, he still has to pay the high cost that was agreed in the contract, regardless of the decrease in cotton's price or value.

Features of Derivative Market

a. Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.

b. Derivative contract have a specific lifespan or fixed expiry date.

c. A derivative requires little or no initial investment because it is an investment in a change in value rather than an investment in the actual asset or liability.

d. Derivatives enable price discovery, improve the liquidity of the underlying asset, serve as effective hedge instruments and offer better

ways of raising money.

e. Generally the parties to the contract, the counterparties, are not required to actually deliver an asset that is associated with the underlying.



CHECK YOUR PROGRESS

Q 1: What is derivative?

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7.3 TYPES OF DERIVATIVES

The most commonly used derivatives contracts are forwards, futures, options and swap. Here we take a brief look at various derivatives contracts that have come to be used.

Forward: It is the simple and most old form of derivative. Here a contract is made between parties to sell something in future at today's rate. Here price is agreed at present rate but actual deal takes place at future. On the day of the contract time of delivery of the asset, quality and quantity of the asset is fixed. Simply it can be said that here contract is initiated in one time but actual execution takes place at a later date.

Forward contracts are informal and it is not traded in exchange thus it is also known as Over – the- counter derivative (OTC). These types of contracts are actually some commitment between two parties. The assets which are traded in forward contracts include commodities like grain, precious metals, electricity, vehicle etc. For example: A farmer is growing 500 tons of wheat . Now, he could sell his wheat next year at that time rate or he could fix the price now by selling it through forward contract. Forward contract binds farmer to sell 500 tons of wheat after the harvest for a fixed price. By locking the price, the farmer eliminates the risk of falling wheat prices in the future. But on the other hand, if prices rise later, the farmer will get that price only what contract fixes.

Future: A future contract is very similar to a forward contract. The main similarity is that in both of the contract actual deal is executed at a

future date but the rate is pre determined. However, futures contracts are listed on the exchange. Exchange act as intermediary between dealers. Hence, future contracts are of standard nature and the agreement cannot be modified in any way. Exchange contracts come in a pre-decided format, pre-decided sizes and have pre-decided expirations. Also, since these contracts are traded on the exchange they have to follow a daily settlement procedure. An important point that needs to be mentioned is that in case of a future contract, the buyer and seller do not enter into an agreement with one another. Rather both of them enter into an agreement with the exchange.

Forwards and futures are similar type of financial contracts but there exist some differences. The main difference between futures and forward contracts is that futures are standardized contracts which are traded on an exchange. While forwards are some private transactions which are traded over - the - counter.

Differences between future and forward contract

Following are the main point of differences between future and forward contracts :

	Forward	Future
1	Forward Contract is an agreement between parties to buy and sell the underlying asset at a specified date and agreed rate in future.	A contract in which the parties agree to exchange the asset for cash at a fixed price and at a future specified date, is known as future contract
2	It is a tailor made contract.	It is a standardized contract.
3	It is an over the counter contract, i.e. there is no secondary market.	It is an exchange traded contract.
4	In forward contract Risk is high.	In future contract Risk is low.
5	It is a Self regulated Contract exchange	It is regulated by stock
6	Contracts are settled on maturity date	Contracts are settled on daily basis.

Option: An Option contract provides choices to the parties to buy/ sell the assets at a predetermined price before predetermined time. But

unlike forward and future, parties are not under obligation to buy or sell the assets. Parties can exercise their right or may not, thus it is known as option contract. For exercising right the purchasing party must have to bear a cost which is known as premium. Options can be traded in both OTC market and exchange traded markets.

Options can be of two types - call and put. Call option provides a right to buy the asset at a given price within a pre determined date. The seller is under obligation to sell the asset to the buyer if the buyer wants to exercise the right. A put option gives the right to sell the asset at a given price by a specified date. The buyer is under obligation to buy the asset from the seller at the price specified in the contract. The price listed in the contract is called the “strike price”. If the parties do not exercise their rights within the specified time period then remain ‘unexercised’

Options contracts are often used in securities, commodities and real estate transactions. Options help to make profit from changes in share prices without putting down the full price of the share. It can also be used to protect from fluctuations in the price of a share by enabling parties to buy or sell the shares at a pre-determined price for a specified period of time. Though it has advantages but trading in options is not so easy like trading in regular shares.

Swap: Swaps are financial agreements to exchange a series of cash flows between two parties. Here one party agrees to pay fixed interest payments on a predetermined date and the other party agrees to return interest payments that float with the underlying assets. Swaps are used in interest rates, stock indices, foreign currency exchange rates and even commodities prices.

The mechanism of swap is different from other form of derivative contract like forward , future and option. Forward, future and option will have one trade at the end of the contract but the swap will have multiple exchanges during the life of the contract. Unlike future and option this swap contracts are not traded on exchanges thus not regulated. So it involve a higher default risk then exchange traded contract.

One of the party will make a fixed series of payments based on the

swap agreement, but the other party will make payment on floating rate on the basis of the underlying assets like foreign currency exchange rate etc.

Types of Swap:

Swaps are generally of the following types:

- An interest rate swap is an agreement between two parties where floating interest rate is exchanged for fixed interest rate. This type of contract allow two parties to exchange fixed and floating cash flows on an interest-bearing investment or loan. One party makes payment on fixed rate which is pre determined at the time of the contract and the other party makes payment on future rate that is floating rate. Simply it is an agreement to exchange a series of cash flows.
- A currency swap is an agreement to make a currency exchange between two parties. Here cash flows in one currency are exchanged for cash flows in another currency.

  Interest rate swaps and currency swaps are the most popular swap contracts, which are traded over the counters between financial institutions.



CHECK YOUR PROGRESS

Q 2: What are the different forms of derivatives?

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Q 3: Define option contract.

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Q 4: What is swap?

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7.4 TRADERS IN THE DERIVATIVE MARKET

Following three types of traders operates in derivative market:

Hedgers: Hedger is someone who faces risk associated with price movement of an asset and who uses derivatives as a means of reducing

that risk. Hedgers enter into a derivative contract to cover risk associated with the business deal. For example farmer growing paddy is not sure about the price he would get during harvest season. Similarly a rice mill is not sure about the price at which it may have to procure the rice in future. Both the farmer and the rice meal owner would enter into a forward contract where the farmer agrees to sell his paddy to the rice mill at a predetermined price. The farmer is expecting a price fall during harvest season and the rice meal is expecting a price rise. Hence both the parties face price risk. The forward contract in which they have entered into would eliminate the price risk for both the parties. This is called as hedging and the participants are called as hedgers.

Speculators: While hedgers enter in to derivative contract for reducing risk, Speculators enter into a derivative contract to make profits. The speculators have an independent view of future price behavior of the underlined asset and take appropriate position in derivatives with the intention of making profit later. Speculators render liquidity to the market and make markets competitive and expand the market size.

Arbitrageurs : Arbitrageurs are persons who simultaneously enter into transactions in two or more markets to take advantage of price discrepancy between both the markets. The markets could be physical market and the commodity exchange. Arbitrageurs constantly monitor the prices of different assets in different markets and identify opportunities to make profit that emanate from mispricing of products in the different markets. For example if the share price of Tata is Rs. 1550/- in National Stock Exchange and Rs. 1570/- in Bombay Stock Exchange the arbitrageurs will buy at NSE and sell at BSE simultaneously and pocket the difference of Rs. 20/- per share.

7.5 FOREIGN EXCHANGE MARKET: MEANING AND SCOPE

The foreign exchange market is a market in which currencies are bought and sold against each other. In other words, foreign exchange market is the market where the currency of one country is exchanged for the

currency of another country. The market is an over the counter market. There is no single market place or an organized exchange (like a stock exchange) where traders meet and exchange currencies. According to Kindelberger, “Foreign exchange market is a place where foreign money are bought and sold.”

Foreign exchange market is the largest financial market. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt. The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

There are two foreign exchange markets. Viz. the retail market and the wholesale market

In the retail foreign exchange market, Retail traders buy or sell currency for their genuine business/personal requirements. Individuals like tourists, foreign students, patients traveling to other countries for medical treatment; small companies, small exporters and importers operate in the retail foreign exchange market. Money transfer companies are also major players in the retail market. The wholesale foreign exchange market is also called the inter-bank market. In the wholesale market Commercial banks are the market makers. This market serves to smoothen the excessive purchases or sales made by individual banks.

Functions of Foreign Exchange Market

The foreign exchange market performs the following three functions:

a) Transfer function: The foreign exchange market transfer purchasing power between two countries. It is the primary function of this market. Various instruments such as telegraphic transfers, bank drafts and foreign bills are used for transferring the purchasing power.

b) Credit function: Another function of foreign exchange market is provide

credit for promotion of foreign trade. Foreign exchange market provide credit by discounting bills of exchange arising out of foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

c) Hedging function: The third function of foreign exchange market is to hedge foreign exchange risk. The exchange rates (price of one currency expressed in another currency) under free market situation can go up and down. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign currency. Through hedging, the foreign exchange market tries to protect the interest of the persons dealing in the market from any such unforeseen changes in the exchange rate.

7.6 DEALERS IN FOREIGN EXCHANGE MARKET

Following are the important dealers of foreign exchange market in India:

1. **Banks:** Commercial banks operate in the foreign exchange market either at retail level for individual exporters and corporations or at wholesale level in the interbank market. The banks dealing in foreign exchange maintain substantial foreign currency balances to serve the need of the customers. These banks discount and sell foreign bills of exchange, issue bank draft, make transfer etc.
2. **Central Bank:** Central banks of the country intervene in the foreign exchange market in order to maintain the exchange rate within a certain range. The central banks also execute the policies of the government.
3. **Brokers:** In the foreign exchange market banks do not deal directly with each other. The brokers bring together the buyers and sellers of foreign exchange. If a bank wants to buy or sell foreign exchange, it informs the broker the amount. If the broker succeeds in carrying out the transaction, he receives a commission from the selling bank.
4. **Acceptance Houses:** Acceptance houses also operate in foreign

exchange market. They accept bills on behalf of their customers and helps in foreign remittance.



CHECK YOUR PROGRESS

Q 5: Mention two functions of foreign exchange market.

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Q 6: Name the dealers of foreign exchange market.

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7.7 EXCHANGE RATE

The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another. The rate of exchange expresses the external purchasing power of a home currency. E.g.- If one US dollar can be exchange for 60 Indian Rupees, than the rate of exchange is 1US $ = Rs.60 or Rs.1=1/60 US $=0.017 $. In a foreign exchange market, there exist different types of exchange rates. Following are the some major exchange rates:

1. **Spot Rate:** A spot foreign exchange rate is the rate of a foreign exchange contract (buying and selling of foreign exchange) for immediate delivery. This rate is also known as cable rate or telegraphic transfer rate. The spot rate is quoted differently for buyers and sellers. For example, $1=60.31 for buyers and $1=Rs60.15 for the seller. This difference arises because of transportation charges, dealer's commission, insurance etc. These costs are to be borne by the buyers.
2. **Forward Rate:** Forward rates are exchange rates for currency exchanges that will occur at a future date. The forward exchange rate is settled now but the actual exchange of foreign exchange take place in the future. Forward dates are typically 30, 90, 180 or 360 days in the future.
3. **Long Rate:** Long rate of exchange is the rate at which the banks

purchase or sells foreign currency bills which are payable at a specific future date.

Exchange Rate Regime

There are two types of exchange rate systems; namely- Fixed exchange rate system and flexible exchange rate system.

Fixed exchange rate: Under fixed exchange rate system the rate of exchange between two or more countries does not vary or varies only within narrow limits. Under this system, the government or the Central Bank intervenes in the foreign exchange market so as to maintain the exchange rate stays close to an 'exchange rate target'. By intervening in the foreign exchange market, through the process of buying and selling foreign assets and currencies, Central Banks keep the exchange rate at the "target fixed level".

Advantages of Fixed Exchange Rate

- Exchange-rate stability promotes globalization –more trade and investment by making prices of goods involved in trade more predictable.
- Since there is no fear of currency fluctuations, fixed exchange rate creates confidence in the strength of the domestic currency and there is no fear of adverse effect of speculation on the exchange rate.
- Since uncertainty and risk of exchange rates volatility is rare in case of fixed exchange rate, hence it promote long-term capital flows.
- Fixed exchange rate serve as an anchor and imposes a discipline on monetary authorities

to follow responsible financial policies within countries.

Disadvantages of Fixed Exchange Rate

- Fixed exchange rate may achieve exchange rate stability but at the expense of domestic economic stability.
- In fixed exchange rate system, country needs to have significant foreign exchange reserves and this imposes heavy burden on the monetary authorities for managing foreign exchange reserves.
- Monetary authorities lose the independence of monetary policy formulation to maintain exchange rate stability.

Flexible exchange rate: In flexible exchange rate system value, of one currency in terms of another is determined through the forces of demand and supply. Under the flexible exchange rate system, the rate of exchange is allowed to vary to suit the economic policies of the government. There are no restrictions on buying and selling of foreign exchange and the exchange rates are free to change according to the change in the demand and supply of foreign exchange. A currency that uses a floating exchange rate is known as a floating currency.

Advantages of Flexible Exchange Rate

- The fundamental argument in favour floating exchange rate system is that it allows country's autonomy with respect to their use of monetary, fiscal and other policy instruments and at the same time external equilibrium is ensured because of flexible exchange rate.
- Floating exchange rates gives the government and monetary authorities' flexibility in determining interest rates. This is because interest rates do not have to be set to keep the value of the exchange rate within pre-determined bands.
- Balance of Payments on current account disequilibrium can automatically be restored to equilibrium floating exchange rate regime and the scarcity or surplus of any currency is eliminated under floating exchange rate regime.



CHECK YOUR PROGRESS

Q 7: What is meant by exchange rate?

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7.8 LET US SUM UP

In this unit we have discussed the following points:

- A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset. The variables underlying

derivatives are the prices of traded assets. For e.g. price of a stock.

- The most commonly used derivatives contracts are forwards, futures, options and swap.
- Forward contracts are informal and it is not traded in exchange thus it is also known as Over – the- counter derivative (OTC).
- Options can be of two types - call and put. Call option provides a right to buy the asset at a given price within a pre determined date. A put option gives the right to sell the asset at a given price by a specified date.
- Foreign exchange market is the market where the currency of one country is exchanged for the currency of another country. The market is an over the counter market.
- The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another.



7.9 FURTHER READINGS

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5) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.



7.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset.

Ans to Q No 2: The most commonly used derivatives contracts are forwards, futures, options and swap.

Ans to Q No 3: An Option contract provides choices to the parties to buy/ sell the assets at a predetermined price before predetermined time.

Ans to Q No 4: Swaps are financial agreements to exchange a series of cash flows between two parties.

Ans to Q No 5: Two functions performed by foreign exchange market are transfer purchasing power between two countries and to provide credit for promotion of foreign trade.

Ans to Q No 6: Important dealers of foreign exchange market are banks, central bank, brokers and acceptance houses.

Ans to Q No 7: The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another.



7.11 MODEL QUESTIONS

Q 1: What is derivative? Discuss the different types of derivative.

Q 2: Mention the features of derivative market.

Q 3: What is foreign exchange market? Discuss the participants of foreign exchange market.

Q 4: What is meant by exchange rate? Discuss the different types of exchange rates.

Q 5: Discuss the fixed exchange rate system.

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UNIT 8 : CREDIT RATING SERVICES

UNIT STRUCTURE

8.1 Learning objectives

8.2 Introduction

8.3 Meaning of Credit Rating

8.4 Types of Rating

8.5 Benefits of Credit Rating

8.6 Benefits of Credit Rating to the Company

8.7 Disadvantages of Credit Rating

8.8 Users of Credit Rating

8.9 Credit Rating Methodology

- 8.9.1 Business Risk Analysis
- 8.9.2 Financial Risk Analysis
- 8.9.3 Management Evolution
- 8.9.4 Fundamental Analysis

8.10 Steps involved in Credit Rating

8.11 Credit Rating in India

- 8.11.1 Credit Rating Information Services of India Limited (CRISIL)
- 8.11.2 Investment Information and Credit Rating Agency of India Limited (ICRA)
- 8.11.3 Credit Analysis and & Research Ltd. (CARE)
- 8.11.4 Fitch India Limited
- 8.11.5 ONICRA Credit Rating Agency of India Limited (ONICRA)
- 8.11.6 Brickwork Ratings India Pvt. Limited (BWR)
- 8.11.7 SME Rating Agency of India Limited (SMERA)

8.12 SEBI Code of Conduct

8.13 SEBI Regulations of Credit Rating Agencies

8.14 Let us Sum Up

8.15 Further Readings

8.16 Answer to check your progress

8.17 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of credit rating
- discuss the benefits and disadvantages of credit rating
- describe the types of credit rating
- discuss the methodology of credit rating
- discuss with different credit rating agencies
- analyse the provisions of SEBI regarding credit rating.

8.2 INTRODUCTION

It is very difficult for a general investor to know the authenticity, creditworthiness and profitability of an instrument or institution. To take an efficient investment decision, investors perceive the need of an independent and credible agency, which judges impartially and in a professional manner, the credit quality of different companies and assist investors in making their investment decisions. Credit Rating Agencies, by providing a simple system of gradation of corporate securities, assist the investors/lenders to form an opinion on -the relative capacities of the borrowers to meet their obligations. Credit rating is used' extensively for evaluating debt instruments. With the passes of time rating agencies have diversified their area of works. Besides rating bond issues they have diversified into rating of asset-backed securities, commercial papers, bank loans, etc. Credit rating agencies also rate financial institutions like-banks, insurance companies, mutual funds and sovereign government.

The concept of credit rating originated in the United States of America in 1909 AD when John Moody, the founder of Moody's Investor Service rated the US Rail Road Bond. However, importance of the concept was realized after the great depression of 1929 to 1939. After that the concept of credit rating gets popularity. Moody's Investor Service, Standards and Poor's (S&P), Fitch Investor Service are the leading credit rating agencies of the world.

In this unit, we will discuss the meaning, types, benefits, disadvantages, methods and regulatory aspects of credit rating. We will also have an idea

about some credit rating agencies operating in India.

8.3 MEANING OF CREDIT RATING

A credit rating is an opinion on the relative degree of risk associated with timely payment of interest and principal on a debt instrument. The credit worthiness of an individual, company or even country is assessed through credit rating. It is an evaluation made by a credit rating agency about the debtor's ability to pay back the debt and likelihood of default. It tells an investor, whether the debt instrument is safe or risky. It tells whether the issuer will be able to pay the interest and repay the principal amount in time.

The rating is expressed in alphabetical or alphanumeric symbols. For example, CRISIL has prescribed the following symbols for debenture issues:

AAA indicates highest safety of timely payment of interest and principal.

AA indicates high safety of timely payment of interest and principal.

A indicates adequate safety of timely payment of interest and principal.

BBB offers sufficient safety of payment of interest and principal for the present.

BB offers inadequate safety of timely payment of interest and principal.

B indicates great propensity to default.

C indicates vulnerability to default.

D indicates that the debenture is in default in payment of arrears of interest or principal

Before issuing the instrument, the issuing company asks the credit rating agency to rate its instrument. Credit rating is not permanent, it is reviewed periodically.

8.4 TYPES OF RATING

Following are the different types of rating:

i. **Sovereign credit rating**: Sovereign credit rating is the credit rating of a sovereign entity like a national government. A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors. A number of factors such as

growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating.

ii. **Short term credit rating**: Short term rating is a probability factor of an individual going in to default within a year. Now a day's short term rating is very common.

iii. **Corporate credit rating**: Corporate credit rating is the rating of financial instruments issued by corporate entities. The credit rating of a corporation is a financial indicator to potential investors of debt securities such as bonds. Investor looks at the credit rating of instrument and issuer before investing.

8.5 BENEFITS OF CREDIT RATING

Credit rating is beneficial for both investors and issuing company. Following are the benefits of credit rating to the investor.

i. **Helps in investment decision**: Credit rating gives an idea of creditworthiness of the issuing company and the risk associated with a particular security. Depending upon the credit rating investor can decide whether to invest in such company or not.

ii. **Freedom of investment decisions**: For common people it is very difficult to take investment decision. Before taking investment decisions they seek advice from the stock brokers, merchant bankers or the portfolio managers. Credit rating service makes the task easy by attaching rating symbols to a particular security. Rating symbol assigned to a particular instrument suggests the creditworthiness of the instrument and indicates the degree of risk involved in it.

iii. **Assurance of safety**: A high rating assures the investor about the safety of the instrument. Companies having high ratings of their instruments maintain healthy financial discipline.

iv. **Choice of instruments**: By rating the securities, credit rating agencies enables an investor to select a particular instrument from many alternatives available.

v. **Dependency on rating**: The ratings assigned to the instruments are authentic and reliable. The rating firms are independent of issuing company and have no business connection with. Hence, they give a fair rating to the instruments. This brings confidence among the investors.

vi. **Continuous monitoring**: Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols depending upon performance and position of the company.

8.6 BENEFITS OF CREDIT RATING TO THE COMPANY

A company who has got its credit instrument or security rated is benefited in the following ways:

i. **Easy to raise fund**: It become very easy for a company to raise fund from the market if the instruments issued by the company are highly rated. A high rating gives confidence to the investors. Many investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return.

ii. **Good corporate image:** High credit rating of securities helps in improving the corporate image of a company. A high credit rating increases the level of confidence among the investors. This helps in creating a good corporate image of the company.

iii. **Lower the cost of public issue**: A company with highly rated instruments has to make least efforts in raising funds through public issue. A good credit rating gives good publicity to the company. Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

iv. **Easy and Lowers Cost of Borrowing:** A company with highly rated debt instruments has to make least efforts in raising funds from the

market. A high rating indicates low risk. High rated instrument will enable the company to offer low rate of interest. The investors will accept low interest because of low risk involvement. High credit rating gives the company wider spectators for borrowing. It can easily approach financial institutions, banks, investing companies, public etc. for borrowings.

v. **Help Non-popular Companies:** Good credit rating gives exposure to the company. If the instruments issued by a company get publicity, the company with low publicity gets popularity. It will now become easy for the company to raise fund from the market.

vi. **Rating facilitates growth:** Rating motivates the management of the company to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future.

8.7 DISADVANTAGES OF CREDIT RATING

i. **Non-disclosure of important information**: The firm being rated may not furnish all material or important information to the credit rating agency. Any decision taken in absence of such important information may put investors at a loss.

ii. **Possibility of biasness**: The rating given by credit rating agency is based on the information collected from the company. The information collected by the rating agency may be subject to personal bias of the rating team.

iii. **Problems for new company**: Rating agencies give ratings on the basis of information supplied by the company. But, a new company may not be able to provide sufficient information to prove its financial soundness. Therefore, it may get lower credit rating. A low credit rating may create problem in raising funds from the market.

iv. **Static in Nature**: Rating is done on the basis of a static study of present and past data of the company at one particular point of time. There are numbers of political, economical, social and environmental factors which have direct bearings over the affairs of the company. Any changes after the rating may defeat the very purpose of rating.

v. **Rating is not 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 financial soundness or quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company.

vi. **Difference in rating grades:** Same instrument may be rated differently by different rating agencies because of many factors. This may create confusion among the investors.



CHECK YOUR PROGRESS

Q 1: What is meant by credit rating?

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Q 2: Mention different types of credit rating.

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8.8 USERS OF CREDIT RATING

The users of credit rating include the following:

Investors

Investors are the prime users of credit rating. They often use credit ratings to assess credit risk and to compare different issuers and debt issues when making investment decisions. Individual investors, for example, may use credit ratings in evaluating the purchase of a municipal or corporate bond from a risk tolerance perspective.

Institutional investors, including mutual funds, pension funds, banks, and insurance companies often use credit ratings to supplement their own credit analysis of specific debt issues.

Intermediaries

Intermediaries like Investment bankers help to facilitate the flow of



Counterparty risk also known as default risk is the risk to each party of a contract that the counterparty will not live up to its contractual obligations. Counterparty risk is a risk to both parties and should be considered when evaluating a contract.

capital from investors to issuers. They may use credit ratings to benchmark the relative credit risk of different debt issues, as well as to set the initial pricing for individual debt issues and to help determine the interest rate these issues will pay. Intermediaries that structure special types of debt issues may look to a rating agency's criteria when making their own decisions about how to configure different debt issues, or different tiers of debt

Issuers

Issuers use credit ratings to provide independent views of their creditworthiness and the credit quality of their debt issues. Issuers may also use credit ratings to help communicate the relative credit quality of debt issues, thereby expanding the universe of investors. In addition, credit ratings may help them anticipate the interest rate to be offered on their new debt issues. As a general rule, if creditworthiness is more the issuer need to pay lower interest rate to attract investors and issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors.

Businesses and financial institutions

Businesses and financial institutions may use credit ratings to assess counterparty risk, which is the potential risk that a party to a credit agreement may not fulfill its obligations. For example, in deciding whether to lend money to a particular organization or in selecting a company that will guarantee the repayment of a debt issue in the event of default, a business may wish to consider the counterparty risk. A credit rating agency's opinion of counterparty risk can therefore help businesses analyze their credit exposure to financial firms that have agreed to assume certain financial obligations and to evaluate the viability of potential partnerships and other business relationships.

8.9 CREDIT RATING METHODOLOGY

Credit rating requires throughout analysis and investigation of relevant factors that affect creditworthiness of the issuer or borrower. Rating methodology of each rating agency usually includes business risk analysis, financial risk analysis, management evolution and fundamental analysis.

8.9.1 Business Risk Analysis

To ascertain the business risk the rating agency makes an assessment of the company's environment focusing on the strength of the industry prospects, business cycle as well as competitive factors affecting the industry. The vulnerability of the industry to country risk is also assessed by evaluating political factors, economic factors, industry specific factors and foreign exchange risk. If a company is involved in more than one business, each segment is analyzed separately. The main factors include company position such as - market position, size, diversification, management, operating efficiency and legal position etc; Industry factor such as– industry trend, industry structure, market size, growth potential, competition, technological changes, regulatory environment etc.

8.9.2 Financial Risk Analysis

To assess the financial risk the rating agency takes in to consideration various aspects of the financial management. Financial risk analysis includes accounting quality, earnings protection, adequacy of cash flow and financial flexibility.

Accounting quality is evaluated by analyzing accounting regime, reporting and discloser norms, methods of income recognition, depreciation policy etc. Earnings protection is examined with the help of ratios. Adequacy of cash flow is determined by study of future cash flow, working capital need and capital budgeting. Financial flexibility is measured in terms of whether alternative financial plans have been developed or not.

8.9.3 Management Evolution

This involves a study of the track record of the management, evaluation of management goal, strategies and philosophies, planning and control system, evaluation of capacity to overcome adverse situations.

8.9.4 Fundamental Analysis

This includes analysis of liquidity management, asset quality, profitability and interest and tax sensitivity. Liquidity management of a business organization can be known through a study of capital structure, liquid assets, matching of assets and liabilities etc. Asset quality analysis includes study of credit management policies, credit monitoring policies and composition of assets. Profitability is examined through profitability ratio, reserve and non-business incomes. Interest and tax sensitivity is measured in terms of exposure to interest rate change, tax provisions and changes in tax laws.

8.10 STEPS INVOLVED IN CREDIT RATING

- Information is collected and then analysed by a team of professionals in an agency.
- If necessary, meetings with top management suppliers and dealers and a visit to the plant of proposed sites are arranged to collect additional data. This team of professionals submits their recommendations to the rating committee.
- Committee discusses this report and then assigns rating.
- Rating assigned is then notified to the issuer and only on his acceptance, rating is published.
- Assures confidentiality of information.
- Once the issuer decides to use and publish the rating, agency has to continuously monitor it over the entire life of instrument, called surveillance.

8.11 CREDIT RATING IN INDIA

The history of credit rating agency (CRA) in India is not very old. India was first among the developing world to set up a credit rating agency. Credit Rating Information Services of India Limited (CRISIL) is the first credit rating

agency established in India in the year 1988. Second is Investment Information and Credit Rating Agency of India (ICRA) established in the year 1990. During this short span of time, the major rating agencies have instilled confidence in the minds of the Investors and Regulatory bodies. The Indian Rating Agencies are providing training and technical assistance in setting up rating agencies in many other countries. In India, credit rating service gets more importance and become popular after 1990 when the Reserve Bank of India and Securities Exchange Board of India made credit rating mandatory for the issue of Commercial Paper and some kinds of debentures and debt instruments. In the following paragraph we will discuss some credit rating agencies of India.

8.11.1 Credit Rating Information Services of India Limited (CRISIL)

CRISIL is the largest and first credit rating agency of India and a global leader in research, ratings and risk & policy advisory services. It was established in the year 1987 and commences operations in the year 1988. CRISIL has been promoted by ICICI and UTI as a public limited company with its head quarters at Mumbai. It is one of the top credit rating agencies in India. CRISIL had assessed more than 61000 entities and more than Rs. 47 trillion of debt. It Rates two-thirds of bonds outstanding in India and highest number of outstanding Small and Medium Enterprises in India.

CRISIL's services include credit ratings and risk assessment; research on India's economy, industries and companies; financial research and outsourcing; fund services; risk management and infrastructure advisory services. CRISIL provides rating and risk assessment services to manufacturing companies, banks, non banking financial companies, and financial institutions, housing finance companies, municipal bodies and companies in the infrastructure sector. It rates long term instruments such as debentures, bonds, preference shares, structured obligations, fixed deposits, commercial paper and short term deposits. It makes credit

assessments of various entities including state governments and subsidiaries and joint ventures of multinationals. It also assigns ratings of financial strength to insurance companies.

8.11.2 Investment Information and Credit Rating Agency of India Limited (ICRA)

ICRA was incorporated on January 16, 1991 and launched its services on August 31, 1991. ICRA was promoted by Industrial Finance Corporation of India jointly with other leading financial/ investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency. ICRA is a Public Limited Company, with its shares listed in the Bombay Stock Exchange and National Stock Exchange. International Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The primary objective of ICRA is to provide information and guidance to the investors and creditors for determining the credit risk associated with a debt instrument and credit obligation.

ICRA undertakes credit assessment for small scale industries, rating of collective investment schemes and claim paying ability of insurance companies. ICRA rates rupee-denominated debt instruments, such as bond and debentures, fixed deposit, commercial paper, certificates of deposit and sector specific debt obligations issued by infrastructure companies. Since 1995, ICRA has been rating equity instruments.

ICRA offers rating services to a wide range of issuers which includes banks and other financial institutions, service company, insurance company, non-banking financial companies, telecom companies, manufacturing companies, power companies etc. ICRA has developed highly specialized rating methodologies for grading of different entities.

8.11.3 Credit Analysis & Research Ltd. (CARE)

CARE was incorporated in April 1993 as a credit rating information and advisory services company. CARE Ratings' registered office and head office is located at Mumbai. In addition, CARE Ratings has regional offices at Ahmedabad, Bengaluru, Chandigarh, Chennai, Coimbatore, Hyderabad, Jaipur, Kolkata, New Delhi, Pune and Mauritius. It is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI) jointly with financial institutions, public \ private sector banks and private finance companies. It is offering a wide range of services such as rating services, advisory services, information services and equity research services. CARE ratings are recognized by Government of India, Reserve Bank of India and Securities Exchange Board of India. CARE provides rating to industrial companies, public utilities, financial institutions, infrastructure projects, state government and municipal bodies. CARE rates all types of instruments like commercial papers, fixed deposits, bonds, debentures and structures obligations. Apart from rating services, CARE provides advisory services such as project advisory services and financial restructuring services. CARE also prepares confidential reports for companies, which may be useful in taking decisions with regard to financial options, joint ventures, acquisitions and collaborations.

8.11.4 Fitch India Limited

With the acquisition of Duff and Phelps Credit Company in April 2000 by Fitch Ratings, Duff and Phelps Rating India Private Limited became Fitch India Limited. Duff and Phelps Credit Rating India Private Ltd was the first joint venture rating company promoted by JM Financials, Alliance Group and the international rating agency Duff and Phelps. At present Fitch Group is comprised of: Fitch Ratings - a global leader in credit ratings and research; Fitch Solutions - a leading provider of credit market data, analytical tools and risk services; BMI Research - an independent provider of country risk

and industry analysis specializing in emerging and frontier markets; and Fitch Learning - a preeminent training and professional development firm. It has dual headquarters in London and New York. Majority of Fitch Group is owned by Hearst.

Fitch introduced a rating scale to meet the growing demand for independent analysis of financial securities. Fitch was one of the three rating agencies that were first declared as nationally recognized statistical rating organizations by the Securities and Exchange Commission in 1975. Fitch Group is a global leader in financial information services with operations in more than 30 countries. Fitch has 49 offices worldwide with the coverage of more than 3,000 financial institutions, more than 1,200 corporate issuers. The company has over 8,600 structured finance transactions and also maintains surveillance of more than 1,200 European structured finance transactions and 200 Asian structured finance transactions. Fitch India analysis have access to Fitch internationals large global information network. The credit rating of Fitch apply to a variety of entities and issues which includes Financial Institutions, Insurance, Sovereigns and Supranational, Corporate Finance, Public Finance, Structured Finance, Islamic Finance, Global Infrastructure and Project Finance.

8.11.5 ONICRA Credit Rating Agency of India Limited

ONICRA Credit Rating Agency is one of the leading Credit and Performance Rating agencies in India. The company is based in Gurgaon and founded in 1993. It provides ratings, risk assessment and analytical solutions to Individuals, MSMEs and Corporates. Third party credit and performance rating and assessment help to create “trust” between players in markets that underpins transactions. ONICRA has pioneered individual credit rating services in India. ONICRA plays a central and critical role in collecting and analyzing a variety of financial, operational, industry and market information, synthesizing that information, and providing autonomous, reliable

assessments of the entity, thereby providing stakeholders with an important input into their decision making process. It has developed over the years the methodology to assess the financial risks in respect of various types of transactions related to individuals and small and medium enterprises. ONICRA is presently operating at commercial scale. It provides pre and post disbursement and activation solutions so as to bridge the gap between the principals and their customer. It also serves clients in auto finance, consumer finance, credit card issues and cellular phones service provider.

8.11.6 Brickwork Ratings India Pvt. Limited (BWR)

Brickwork Rating India Pvt. Ltd. was founded in 2007 by group of professionals to provide rating of public issues and others to help investors take information decisions. BWR has its corporate office in Bangaluru and a countrywide presence with its offices in New Delhi, Chandigarh, Chennai, Guwahati, Hyderabad, Kolkata, Mumbai and Ahmedabad along with representatives in more than 150 locations. Brickwork Ratings (BWR) is registered with SEBI accredited by RBI and empanelled by National Small Industries Corporation. It offers bank loan, Commercial papers, MSME rating and grading services. NABARD has empanelled Brickwork for MFI and NGO grading.

Brickwork assigns two types of credit ratings- one to the issuers and the other to specific debt issues or other financial obligations. The rating of issuer, which is called “Brickwork counterparty credit rating”, reflects the current opinion about an issuer’s overall capacity to fulfill its financial obligations. The other type of rating is the rating of issues, mainly the debt issues. Four types of analysis were made on debt issues namely business analysis, industry analysis, financial analysis and management analysis.

BWR has rated debt instrument such as bands, bank loans, securitized paper of over Rs.9, 30,000 Crore. BWR has also rated

about 5000 MSMEs, Fixed Deposit and Commercial Papers of over 19,700 crore.

8.11.7 SME Rating Agency of India Limited (SMERA)

SMERA commenced its operations in 2005 as a full service Credit Rating Agency, registered with the Securities and Exchange Board of India (SEBI), and accredited by Reserve Bank of India (RBI) as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms. SMERA is a joint venture started by Small Industrial Development Bank of India (SIDBI), Dun & Brand Street Information Services India Private Limited (D& B) and several leading banks in India. SMERA is the country's first rating agency that focuses primarily on small and medium enterprises (SME) in India. The main objective of rating SMEs is to facilitate greater and easier flow of credit to SMEs from the banking sector. SMERA is empanelled with National Small Industries Corporation (NSIC), the nodal agency of the Ministry of MSME, Government of India to provide SMERA-D&B-NSIC Micro & Small Enterprises Rating for MSEs in India. SMERA makes two types of analysis- business risk analysis and financial analysis. SMERA has assigned more than 44,000 ratings since inception.



Basel II is a set of international banking regulations put forth by the Basel Committee on Bank Supervision, which leveled the international regulation field with uniform rules and guidelines.

SMERA has achieved the reputation of providing comprehensive, transparent and reliable ratings, thus providing comfort and confidence to lenders and investors alike in decision making. SMERA ratings have gained wide acceptability and are now an integral part of the risk assessment process within the lending and investing community.

SMERA has its Registered and Head Office in Mumbai, branches at 9 cities and representatives in more than 50 clusters across India.



CHECK YOUR PROGRESS

Q 3: Name two credit rating agencies in India.

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Q 4: Name two users of credit rating service.

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8.12 SEBI REGULATIONS OF CREDIT RATING AGENCIES

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. Following are the some regulatory provisions related to Credit Rating Agencies in India:

Registration of Credit Rating Agencies: Registration with SEBI is mandatory for carrying on the rating business in India. The application for the certificate of registration should be made to the SEBI in Form A of first schedule of Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 and shall be accompanied by a nonrefundable fee of Rs.25000.

Promoter of Credit Rating Agency: A credit rating agency can be promoted by a:

(i) Public financial institutions as defined in section 4-A of the companies Act.

(ii) Scheduled Bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934.

(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 continuous net worth of a minimum of Rs.100 crores as per its audited annual accounts for the previous five years prior to filling of

the application with the SEBI for registration.

Grant of Certificate of Registration: The SEBI will grant a certificate of registration to eligible applicants on the payment of a fee of Rs.5, 00,000, subject to the following conditions:

(A) The CRA would comply with the provisions of the SEBI Act/ regulations and guidelines/ directions/circulars and instructions issued by the SEBI, from time to time, on the subject of credit rating.

(B) (i) where any information/particulars furnished to the SEBI by a CRA is found to be false/misleading in any material particular or has undergone changes subsequent to its furnishing at the time of application, it would immediately inform SEBI in writing and

(ii) The certificate of registration is valid for a period of three years, renewable for subsequent three years.

Renewable of Certificate: An application for renewal of certificate of registration shall be made not less than three months before expiry of the period of validity of the certificate. The application shall be accompanied by a renewal fee of Rs. 3, 00,000.

Restrictions on Rating of Securities: Credit Rating Agencies are Restricted from rating of securities issued by (i) promoters and (ii) certain other entities such as a borrower of its promoter; or a subsidiary of its promoter; or an associate of its promoter and the associate or subsidiary of the Credit Rating Agency.

General Obligations: Following are the some of the general obligations specified in the SEBI (Credit Rating Agencies) Regulations which need to be followed by the credit rating agencies.

- Code of Conduct stipulated by SEBI
- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating
- Internal procedures to be framed by the CRA
- Disclosure of rating definitions and rationale by the CRA
- Submission of information to the board
- Compliance with circulars etc., issued by the board

- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Confidentiality
- Rating process

8.13 SEBI Code of Conduct

SEBI's code of conduct for CRAs is designed to ensure transparent and independent functioning of CRAs. Some of the provisions of the Code of Conduct are:

1. A credit rating agency shall make all efforts to protect the interests of investors.
2. A credit rating agency, in the conduct of its business, shall observe high standards of integrity, dignity and fairness in the conduct of its business.
3. A credit rating agency shall fulfill its obligations in a prompt, ethical and professional manner.
4. A credit rating agency shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
5. A credit rating agency shall have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in depth rating researches. It shall also maintain records to support its decisions.
6. A credit rating agency shall have in place a rating process that reflects consistent and international rating standards.
7. A credit rating agency shall not indulge in any unfair competition nor shall it wean away the clients of any other rating agency on assurance of higher rating.
8. A credit rating agency shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further a credit rating agency shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.

9. A credit rating agency shall disclose its rating methodology to clients, users and the public.
10. A credit rating agency shall, wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further it shall ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.
11. A credit rating agency shall not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
12. A credit rating agency shall not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to the board, stock exchange or public at large.
13. A credit rating agency shall ensure that the Board is promptly informed about any action, legal proceedings etc., initiated against it alleging any material breach or non-compliance by it, of any law, rules, regulations and directions of the Board or of any other regulatory body.
14. A credit rating agency shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations and circulars, which may be applicable and relevant to the activities carried on by the credit rating agency. The credit rating agency shall also comply with award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
15. A credit rating agency shall ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
16. (a) A credit rating agency or any of his employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media.

(b) A credit rating agency shall not offer fee-based services to the rated entities, beyond credit ratings and research.

17. A credit rating agency shall ensure that any change in registration status/any penal action taken by board or any material change in financials 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.
18. A credit rating agency shall maintain an arm's length relationship between its credit rating activity and any other activity.
19. A credit rating agency shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.
20. A credit rating agency shall provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
21. A credit rating agency shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
22. A credit rating agency shall ensure that good corporate policies and corporate governance are in place.
23. A credit rating agency shall not, generally and particularly in respect of issue of securities rated by it, be party to or instrumental for—(a) creation of false market; (b) price rigging or manipulation; or (c) dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded.



8.14 LET US SUM UP

In this unit we have discuss the following points:

- Credit rating is an opinion on the relative degree of risk associated with timely payment of interest and principal on a debt instrument.
- The rating is expressed in alphabetical or alphanumeric symbols.
- Credit rating is beneficial for the issuing company, investors and lenders.
- Investors, intermediaries, issuer, Businesses and financial institutions are the users of credit rating.
- Rating methodology of each rating agency usually includes business risk analysis, financial risk analysis, management evolution and fundamental analysis.
- Credit Rating Information Services of India Limited (CRISIL) is the first credit rating agency established in India in the year 1988.
- The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India.



8.15 FURTHER READINGS

1) Arora, M. (2003) “Credit Rating in India –Institutions, Methods and Evaluation”, New Century Publications, Delhi.

2) Verma, J.C. (2000) “Credit Rating Concepts: Practices and Procedures”, Bharat Publishing House, New Delhi.



8.16 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Credit rating is an opinion on the relative degree of risk associated with timely payment of interest and principal

on a debt instrument.

Ans to Q No 2: Different types of credit rating are Sovereign credit rating, short term credit rating, and corporate credit rating.

Ans to Q No 3: Two credit rating agencies in India are Credit Analysis and & Research Ltd. and SME Rating Agency of India Limited.

Ans to Q No 4: Investors and issuers are the two users of credit rating service.



8.17 MODEL QUESTIONS

Q 1: What are the benefits of Credit Rating for both investors and issuing company?

Q 2: Discuss the Credit Rating Methodology.

Q 3: Discuss the SEBI regulations issued to regulate the Credit Rating Agencies in India.

Q 4: Write a brief note on CRISIL.

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UNIT 9: DEPOSITORY

UNIT STRUCTURE

9.1 Learning objectives

9.2 Introduction

9.3 Meaning of Depository

9.4 Benefits of Depository

9.5 Depository Participant

9.6 International Securities Identification Number

9.7 Depository Process

9.8 Depositories in India

9.9 Let us Sum Up

9.10 Further Readings

9.11 Answers to Check your progress

9.12 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of depository
- explain the benefits of depository
- discuss the process of depository
- describe about NSDL and CDSL.

9.2 INTRODUCTION

In earlier days securities were in the form of physical certificates, due to which trading and settlement system of Indian stock exchanges was very slow and inefficient. Speedy and quick transfer of security was very difficult. Besides delay in settlement, there were some other problems like, theft, forgery, mutilation, bad deliveries of securities etc. To overcome the problems associated with physical securities, the Depositories Act, 1996 was passed. It was formed with the purpose of ensuring free transferability of securities with speed, accuracy & security. The first depository set up in

India is National Securities Depository Limited (NSDL) and is promoted by IDBI, UTI and NSE.

In this unit, we will discuss the concept, benefits and functioning of depositories, demat account and other areas associated with depositories.

9.3 MEANING OF DEPOSITORY

Depository is an organisation which holds securities of an investor in electronic form, in the same manner as a bank holds our money. Depository hold securities in book entry form in the account of the investor. Besides holding securities, a depository also provides services related to transactions in securities. A depository interfaces with its investors through its agents called Depository Participants (DPs). If an investor wants to utilize the services offered by a depository, the investor has to open an account with a DP.

According to Section 2 (e) of Depositories Act, 1996, "depository" means a company formed and registered under the Companies Act, 1956, and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992.

Depositories can be in two forms- dematerialized or immobilized. In dematerialized form paper certificates are completely eliminated after verification by the custodians. In immobilized form initial paper certificates are preserved in safe vaults by custodians and further movement of papers are discontinued.

9.4 BENEFITS OF DEPOSITORY

Following are the benefits of participating in depository system:

- Depository system enables immediate allotment, transfer and registration of securities.
- In depository system no stump duty is required on transfer of securities.
- Depository system eliminate the risks associated with physical certificates such as bad deliveries, fake securities etc.
- Depository system makes considerable reduction in the handling of large volumes of paper.

- Reduction in transaction cost.
- Faster disbursement of corporate benefits like rights and bonus shares.
- Periodic status reports to investors on their holdings and transactions, leading to better controls.



CHECK YOUR PROGRESS

Q 1: Define depository.

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Q 2: Name the first depository of India.

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9.5 DEPOSITORY PARTICIPANT

A depository participant (DP) is an agent of the depository through which it interfaces with the investor and provides depository services. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations / clearing houses, NBFCs and registrar to an issue or share transfer agent complying with the requirements prescribed by SEBI can be registered as DP.

9.6 INTERNATIONAL SECURITIES IDENTIFICATION NUMBER

The International Securities Identification Number (ISIN) standard is used worldwide to identify specific securities such as debt securities, equities, options, derivatives and futures. Each security issued bears a unique ISIN issued by the International Organization for Standardisation (ISO). ISIN is a twelve-character long identification mark. An ISIN consists of three parts: Generally, a two letter country code, a nine character alpha-numeric national security identifier, and a single check digit. For example, ISIN for Indian securities is like INE009A01021. In India, the task of issuing ISIN of various

securities has been assigned to SEBI. For Government securities, allotment of ISIN is done by Reserve Bank of India.

9.7 DEPOSITORY PROCESS

The depository process consists of the following steps-

Opening an Account: It is mandatory to open an account with the depository to avail the services of a depository. The account is to be open through depository participant. At the time of opening an account, the DP will sign a standard agreement with the investor, which details the rights and duties of both investor and DP. A client account number or client ID number is issued to the investor which is to be quoted in all future correspondences. With effect from 1st April, 2006, SEBI has made PAN Card compulsory for all categories of investors for opening a Demat Account.

There are no restrictions on the number of depository participants, one investor can open account with. Depository accounts are similar to bank accounts. Just as you can have accounts with more than one bank, you can open accounts with more than one DP. In case of joint holdings, the investor needs to open accounts in the same order of names in which they hold the securities.

Dematerialization

Dematerialization is the process of converting physical securities into electronic form. An investor can dematerialise only those certificates that are already registered in his name and belong to the list of securities admitted for dematerialization in the depository. For converting physical securities into electronic form, the following process is followed:

First step, The Investor submits the Demat Request Form(DRF) and physical certificates to the DP. DP checks whether the securities are available for demat. The DP, upon receipt of the shares and the DRF, will issue the client an acknowledgement and will send an electronic request to the Company.

Second step, DP enters the demat request in his system to be sent to the depository electronically and dispatches the physical certificates along

with the DRF to the respective issuer or its registrar and transfer Agent.

Third step, Registrar and transfer agent, on receiving the physical documents and the electronic request, verify and check them. Once the registrar and transfer agent is satisfied, dematerialization of the concerned securities is electronically confirmed to the depository.

Fourth Step, the depository credits the dematerialized securities to the demat account of the investor and intimates the DP electronically.

Fifth Step, The DP issues a statement of transaction to the client.

Demat Account

A demat account is that account where the investor (holder of securities) can hold his securities in electronic or dematerialize form. Like the bank account, a demat account holds the securities like shares, bonds, government securities, mutual funds and exchange traded funds. One cannot trade in the stock market without a demat account.

Benefits of demat account

Following are the some benefits of demat account:

- It is a safe and convenient way to hold securities compared to holding securities in physical form.
- No stamp duty is required to pay for transfer of securities in the electronic form.
- Risks associated with physical certificates such as delays, loss, in transit, theft, mutilation, bad deliveries, etc. are eliminated.
- Dematerialized securities are most preferred by the financiers for providing credit against securities.
- Shares bought or sold are transferred in the name of the investor on the very next day of pay out.
- Change of address, registration of Power of Attorney –can be effected across companies by one single instruction to the DP.
- Eliminate the postal cost for sending share certificates and transfer deeds.

Rematerialization

The process of converting electronic form of security to physical form is known as rematerialization. If one investor want to withdraw his security

in physical form balance with the depository, in such a case the investor makes an application to the depository in rematerialization request form (RRF) through the depositor participant. The DP will forward the request to the depository after verifying that the investor has the necessary balances. The depository in turn will intimate the registrar who will print the certificates and dispatch the same to the investor.

Distributing Dividend

The registrar or share transfer agent shall inform the depository about the corporate actions such as dates for book closer, redemption or maturity of securities etc. The depository will then electronically provide a list of the holdings of the investors. The company can then distribute dividend, interest and other monetary benefits directly to the investors on the basis of the list.

Closing an account

If a client wants to close an account, he shall make an application in the specified format. The client can close his account if no balance is outstanding to his credit. If any balance exists in the account, he may close the account in the following manner:

a. By rematerialization of all its existing balance in the account,

b. By transferring his security balances to his other account held either with the same DP or with other DP.



CHECK YOUR PROGRESS

Q 3: What is demat account?

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Q 4: What is meant by rematerialization?

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9.8 DEPOSITORIES IN INDIA

To wipeout these problems associated with physical certificates, the Depositories Act 1996 was passed in India. The Act was passed with the

purpose of ensuring free transferability of securities with speed, accuracy and security by-

a) Making securities of public limited companies freely transferable, subject to certain exceptions;

b) Dematerializing the securities in the depository mode; and

c) Providing for maintenance of ownership records in a book entry form. For performing the above tasks, two depositories viz, National Securities Depository Ltd. (NSDL) and Central Depository Services (India) Ltd. (CDSL) have come up.

National Securities Depository Ltd. (NSDL)

The NSDL is the first depository of India set up in the year 1996. It is the largest depository of the country promoted by Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and National Stock Exchange (NSE). As on July, NSDL has eliminated 2764 crore certificates and more than 75% shares of 7678 companies are dematted. NSDL open 3713 accounts per day on an average. The NSDL interacts with investors through Depository Participants. It has 266 DP as on August, 2017 with 27539 DP service centre. NSDL provides a wide range of security related services to its clients (the investors) through the DPs. These services are can be classified into two categories: Basic services and value added services.

Basic services

Following are the basic services offered by NSDL:

- **Account Opening**: To avail the services provided by NSDL an investor/ a broker/ an approved intermediary has to open a NSDL depository account with any of its DPs. There are three types of accounts.
  - i) Beneficiary Account: An investor who wants to hold securities in dematerialized form and receive or deliver securities by inter-account transfers must have a depository account called beneficiary account with a DP of his choice.
  - ii) Clearing Member Account: Member brokers of those stock exchanges which have established electronic connectivity with NSDL need to open a clearing member account, with a DP of his choice, to clear and settle trades in the demat form. This

account is popularly known as Settlement account or "Pool account". This account is meant only to transfer securities to and receive securities from the clearing corporation/ house and hence, the member broker does not have any ownership rights over the shares held in such an account.

iii) Intermediary account: Any person who wants to act as an approved 'intermediary' for stock lending and borrowing needs to open an intermediary account with any DP of his choice. An intermediary account may be opened with the DP only after the intermediary has obtained registration from the Securities & Exchange Board of India and with the prior approval of NSDL. This account is meant only to deposit the securities received from the lender and lend them to the borrower under stock lending and borrowing scheme. The intermediary does not have any ownership rights over the shares held in such an account.

- **Dematerialisation:** Dematerialisation is the process by which a client can get physical certificates converted into electronic balances. This we had already discussed in the earlier section.
- **Rematerialization:** The process of converting electronic form of security to physical form is known as rematerialization. This we had already discussed in the earlier section.
- **Market Transfers:** Trading in dematerialised securities is quite similar to trading in physical securities. The major difference is that at the time of settlement, instead of delivery/receipt of securities in the physical form, the same is affected through account transfers. Delivery of securities to or from a clearing member is called "Market Trades". If, either source or target in a transfer instrument is a Clearing Member Account; such a transfer is a "Market Trade".
- **Off Market Transfer:** Trades which are not settled through the Clearing Corporation/ Clearing House of an exchange are classified as "Off Market Trades". Delivery of securities to or from sub brokers, delivery for trade-for-trade transactions, by this definition are off-market trades.

- **Inter-Depository Transfers:** Transfer of securities from an account in one depository to an account of another depository is termed as an inter-depository transfer. It can be done only for securities that are available for dematerialisation on both the depositories. Government securities cannot be transferred from one depository to another using this facility.
- **Transmission:** The Companies Act distinguishes transmission of shares from transfer of shares. While transfer of shares relates to a voluntary act of the shareholder, transmission is brought about by operation of law. The word 'transmission' means devolution of title to shares otherwise than by transfer, for example, devolution by death, succession, inheritance, bankruptcy, marriage, etc. While transfer of shares is brought about by delivery of a proper instrument of transfer duly stamped and executed, transmission of shares is done by forwarding the necessary to the company.

In case the deceased was one of the joint holders, then the surviving holders have to request the DP vide a form called the transmission form along with a copy of notarised death certificate to transmit the securities lying in the account of the deceased to the account of the surviving holders. For this purpose, the surviving clients must have a depository account, which can be with the same DP or with a different DP.

In case of death of the sole holder, the legal heir(s) or legal representative(s) of the deceased must request the DP to transmit the balances lying in the Client account of the deceased to the account of the legal heir(s) or legal representative(s). For this, the legal heir (s) or the legal representative(s) of such securities must submit an instruction called the transmission form to the DP along with the following documents:

1. A copy of the death certificate duly notarised
2. A copy of the Succession certificate duly notarised or an order of a court of competent jurisdiction where the deceased has not left a Will; or
3. A copy of the Probate or Letter of Administration duly notarised.

- **Corporate Actions:** Corporate actions are benefits given by a

company to its investors. These may be either monetary benefits like dividend, interest or non-monetary benefits like bonus, rights, etc. NSDL facilitates distribution of corporate benefits.

Central Depository Service (India) Ltd. (CDSL)

The second depository Central Depository Services Limited (CDSL), has been promoted by Bombay Stock Exchange and Bank of India. It was formed in February 1999. CDSL was set up with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants. CDSL has a wide network of DPs, operating from over 17,000 sites, across the country. The DPs are directly connected to CDSL thereby providing on-line and efficient depository service to investors. The services offered by CDSL is same with the NSDL.



9.9 LET US SUM UP

In this unit we have discussed the following points:

- Depository is an organisation which holds securities of an investor in electronic form, in the same manner as a bank holds our money in accounts.
- A depository participant (DP) is an agent of the depository through which it interfaces with the investor and provides depository services.
- Dematerialization is the process of converting physical securities into electronic form.
- A demat account is that account where the investor (holder of securities) can hold his securities in electronic or dematerialized form.
- The process of converting electronic form of security to physical form is known as rematerialization.
- In India there are two depositories viz, National Securities Depository Ltd. (NSDL) and Central Depository Service (India) Ltd. (CDSL)



9.10 FURTHER READINGS

1) Batra G.S. (2002). Financial services and markets. New Delhi, Deepand Deep Publication Pvt. Ltd.

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3) Srivastava, R.M. (2009). Management of Indian financial institutions. New Delhi, Himalaya Publishing House.

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5) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.



9.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Depository is an organisation which holds securities of an investor in electronic form, in the same manner as a bank holds our money.

Ans to Q No 2: National Securities Depository Ltd. (NSDL)

Ans to Q No 3: A demat account is that account where the investor (holder of securities) can hold his securities in electronic or dematerialize form.

Ans to Q No 4: The process of converting electronic form of security to physical form is known as rematerialization.



9.12 MODEL QUESTIONS

Q 1: State the meaning and benefits of depository.

Q 2: Define depository participant.

Q 3: Discuss the depository process.

Q 4: Discuss the services provided by NSDL.

Q 5: What are the benefits of demat account?

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