UG BA S6-02 (DSC)

Indian Financial Systems
(Finance Specialisation)

SEMESTER- VI

BUSINESS ADMINISTRATION

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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BACHELOR OF BUSINESS ADMINISTRATION

INDIAN FINANCIAL SYSTEMS

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COURSE INTRODUCTION

This course "**Indian Financial System**" has been structured to give the learners of BBA 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.

This course consists of 14 units and it deals with concept of Financial System,Indian Financial System,Financial Market,Money market in India,Capital Market in India,Primary Markets on India,Secondary Markets in India deals with financial institutions, Mutual fund, Derivative Markets, Foregin Exchange Market in India, credit rating, Depository Services and Regulation of Financial markets in India.

Each unit of these blocks includes some along-side boxes to help you know some of the difficult, unseen terms. Some "EXERCISES" have been included to help you apply your own thoughts. You may find some boxes marked with: "LET US KNOW". These boxes will provide you with some additional interesting and relevant information. Again, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study. It will be helpful for you 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. you in making your learning more active and efficient. And, at the end of each section, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study.

COURSE INTRODUCTION

This is the course “Indian Financial System”. Consisting 14 units.

The structure of the course is as follows :

UNIT 1 **:** The Financial System

UNIT 2 **:** Indian Financial System

UNIT 3 **:** Financial Market

UNIT 4 **:** Money Market in India

UNIT 5 **:** Capital Market in India

UNIT 6 **:** Primary Markets in India

UNIT 7 **:** Secondary Markets in India

UNIT 8 **:** Financial Institutions

UNIT 9 **:** Mutual Fund

UNIT 10 **:** Derivative Markets

UNIT 11 : Foreign Exchange Market

UNIT 12 **:** Credit Rating

UNIT 13 **:** Depository Services

UNIT 14 **:** Regulation of Financial Markets in India

UNIT 1: THE FINANCIAL SYSTEM

UNIT STRUCTURE

1.1 Learning Objectives
1.2 Introduction
1.3 Meaning and Components of Financial System
1.4 Functions of Financial System
1.5 Services provided by the Financial System
1.6 Macro economic framework analysis for exploring the role of the financial system
1.7 Relationship between the financial system and economic development
1.8 Let Us sum Up
1.9 Further Reading
1.10 Answers To Check Your Progress
1.11 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- explain the financial system and its importance
- explain the components and the functions of a financial system
- dicuss the role of the financial systems in the economic development

1.2 INTRODUCTION

In this unit we are going to learn the concept of financial system.To understand the concept of financial system, one should know some of the tools which will be discussed in various sections of this unit.

Financial system is a system, which facilitates the process of capital accumulation by transferring financial resources from savers to the investors. With financial resources, the investors create physical assets, viz. land, buildings, plants and machineries.

Let us now discuss the various aspects of financial system in the following sections.

1.3 MEANING AND COMPONENTS OF FINANCIAL SYSTEM

The word ‘System’ is a set of inter-related components working together to achieve some purpose. Human body, computer, TV, car, bank, and educational institutes are the

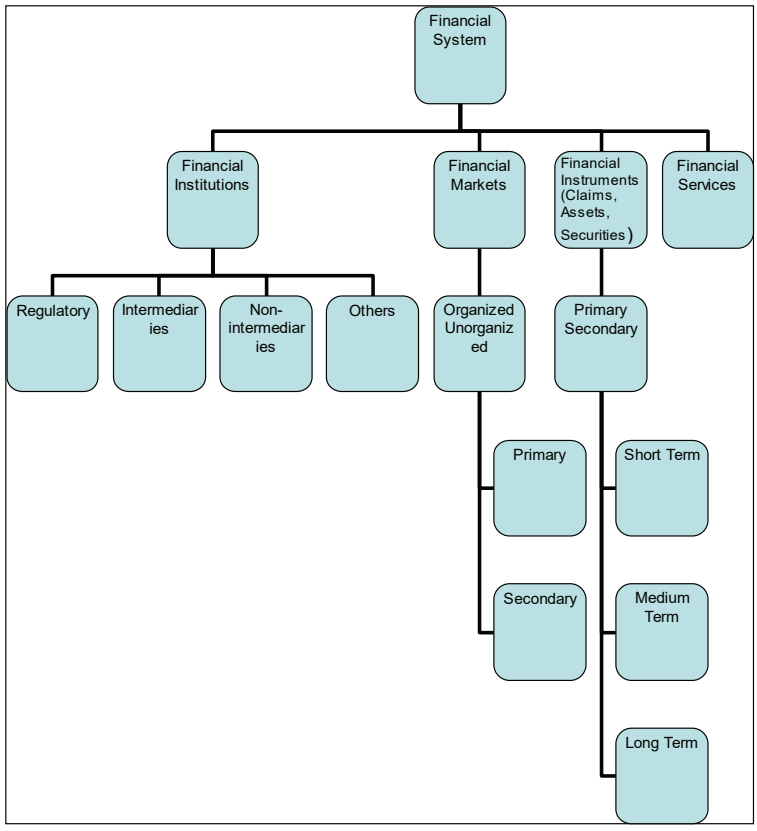
examples of system. Financial system is a set of inter-related institutions, instruments and markets, which raise (savings) funds and channels them to their efficient use. In other words, financial system comprises of individuals (savers), intermediaries (financial institutions), markets (money and capital markets), and users (borrowers of money). Hence, financial system acts as an intermediary between the savers and users (investors). It provides the principal means by which savings are transformed into investments. It helps produce goods and services, which in turn improves standard of living. There are areas or people with surplus funds and there are those with a deficit. Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy has opined that the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with
individual desires."

According to Robinson, the function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth."

From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

A financial system functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. In fact developed financial system is an indication of economic development of a country. Given its role in the allocation of resources, the efficient functioning of the financial system is of critical importance. Figure 1.1 shows the components of the financial system.

While an understanding of the financial system is useful to all informed citizens, it is particularly useful to the financial manager.The financial manager’s task is to provide sufficient funds to meet the business needs. Therefore, a clear understanding of the financial system is of utmost importance. In other words, knowledge about the financial institutions that provide finance; the financial markets from which to raise funds and the different instrument available to raise the finance is required.



Let us now try to understand the various functions of the financial system in the following sections

CHECK YOUR PROGRESS

Q1: Define Financial System

.....

.....

Q2: Write the components of the financial system.

.....

.....

1.4 FUNCTIONS OF THE FINANCIAL SYSTEM

The financial system facilitates the transformation of savings into investment and consumption. The financial system performs the following interrelated functions that are essential to modern economy:

- It provides a payment system for the exchange of goods and services.
- It enables the pooling of funds for undertaking large scale enterprises.
- It provides a mechanism for transfer of resources.
- It provides a way for managing uncertainty and controlling risk.
- It generates information that helps in coordinating decentralized decision-making.
- It helps in dealing with the incentive problem when one party has an informational advantage.

We elaborate on these points in the paragraphs that follows.

(i) Payment System : Financial system helps for payment of goods and services. It provides a payment system for the exchange of goods and services. We find that majority of buyers and sellers of products or services prefer to pay or receive money through banks to avoid the risk of carrying cash in large amount.

(ii) Pooling of funds : Modern business organizations require large investments which are often beyond the means of an individual or groups of individuals. Financial markets and financial intermediaries which are an integral part of the financial system facilitate the pooling of household savings for financing business. Hence, we can also say that the financial system enables households to participate in large enterprises. Small savings are pooled together and transformed into large amounts which promoters of businesses can avail to meet their financial needs.

(iii) Maturity Transformation: The financial system offers alternative forms of deposits to savers with different maturity and provides these funds to borrowers for different maturity periods. Thus, it facilitates the transfer of financial resources across time and space.

(iv) Risk Management: The financial system helps to reduce the risk of savers. Financial institutions like banks and mutual funds mobilizes fund from savers and lend them to borrowers and thereby bears the risk of borrowing.

(v) Provision of Liquidity: The financial system provides a mechanism for an investor to sale securities whenever there is the need for cash.

(vi) Price Information: Financial markets provide information that helps in coordinating decentralized decision making. Price information such as interest rates and security prices are used by households or their agents in making their consumption-saving decisions and in deciding their wealth allocation portfolio.

(vii) Financial (services) Advice: Now-a-days financial services have occupied much

important place in financial system. Under this the financial system provides advices and services to both savers and investors.

1.5 SERVICES PROVIDED BY THE FINANCIAL SYSTEM

- **Risk Sharing:** Financial system provides risk sharing by allowing savers to hold many assets. It also means financial system enables individuals to transfer risk. Financial markets can create instruments to transfer risk from savers to borrowers who do not like uncertainty in returns or payments to savers or investors who are willing to bear risk. The ability of the financial system to provide risk sharing makes savers more willing to buy borrowers' IOUs. This willingness, in turn, increases borrowers' ability to raise funds in the financial system.
- **Liquidity:** The second service that financial system provides for savers and borrowers is liquidity, which is the ease with which an asset can be exchanges for money to purchase other assets or exchanges for goods and services. Most of the savers view the liquidity as a benefit. If an individual need their assets for their own consumption and investment, they can just exchange it. Liquid assets allow an individual or firm to respond quickly to new opportunities or unexpected events. Bonds, stocks, or checking accounts are created by financial assets, which have more liquid than cars, machinery and real estate.
- **Information:** The third service of financial system is collection and communication of information or we can say that it is the facts about borrowers an expectations about returns on financial assets. The first informational role the financial system plays is to gather information. That includes finding out about prospective borrowers and what they will do with borrowed funds. Another problem that exists in most transactions is asymmetric information. This means that borrowers posses information about their opportunities or activities that they don't disclose to lenders pr creditors and can take advantage of this information. The second informational role that financial system plays is communication of information. Financial markets do that job by incorporating information into the prices of stocks, bonds, and other financial assets. Savers and borrowers receive the benefits of information from the financial system by looking at asset returns. As long as financial market participants are informed, the information works its way into asset returns and prices.

1.6 MACRO ECONOMIC FRAMEWORK ANALYSIS FOR EXPLORING THE ROLE OF THE FINANCIAL SYSTEM

To understand the role of financial system in the economy, the following concepts and tools should be considered:

1. **National Income accounts:** National income accounts extend the accounting concept to the economy as a whole. National income accounts of the sector–of-origin reveal the contribution made by the different sectors of the economy to the national income and the portion of the national income they consume.
2. **Flow of Funds Accounts:** The national income accounts do not tell anything about monetary or financial transactions whereby one sector places its savings at the disposal of the other sectors of the economy by means of loans, capital transfers, etc. In fact, the national income accounts do not take into consideration the financial dimensions of economic activity and they describe product accounts as if they are operated through barter. The flow of funds accounts are meant to supplement national income and product accounts. The flow of funds accounts list the sources of all funds received and the uses to which they are put within the economy. They show the financial transactions among different sectors of the economy and the link between saving and investment aggregates with lending and borrowing by them.
3. **Saving and Investment:** One of the basic influences of financial development on growth is the saving and investment rate. Among the many roles of the financial system is the augmenting and channelising of savings into productive avenues for economic growth. A study of trends in saving and investment is necessary to evaluate the role of financial system in the economy.

CHECK YOUR PROGRESS

Q3: Write any two functions of Financial System

.....

.....

Q4: What is meant by National Income accounts:

.....

.....

1.7 RELATIONSHIP BETWEEN THE FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

The development of any country depends on the economic growth the country achieves over a period of time. Economic growth deals about investment and production and also the extent of Gross Domestic Product in a country. Only when this grows, the people will experience growth in the form of improved standard of living, namely economic development.

The 'financial system' is concerned with the mobilization of the savings of the public and providing of necessary funds to the needy persons and institutions for enabling the production of goods and/or for provision of services and allows the exchange of funds between lenders, investors, and borrowers.

The financial system that facilitates the movement of finance from the persons who have surplus funds to the persons who need it is called as financial system.

The following are the role of financial system in economic development of a country.

1. **Savings-investment relationship:** To attain economic development, a country needs more investment and production. This can happen only when there is a facility for savings. As, such savings are channelized to productive resources in the form of investment. Here, the role of financial institutions is important, since they induce the public to save by offering attractive interest rates.
2. **Financial systems help in growth of capital market:** Every business requires two types of capital namely, fixed capital and working capital. Fixed Capital is raised through capital market by the issue of debentures and shares. Public and other financial institutions invest in them in order to get a good return with minimized risks. For working capital, we have money market, where short-term loans could be raised by the businessmen through the issue of various credit instruments such as bills, promissory notes, etc.
3. **Foreign Exchange Market:** Foreign Exchange Market enables exporters and importers to receive and raise funds for settling transactions. It also enables banks to borrow from and lend to different types of customers in various foreign currencies.
4. **Government securities market:** Financial system enables the state and central governments to raise both short-term and long-term funds through the issue of bills and bonds which carry attractive rates of interest along with tax concessions.

5. **Financial system helps in Infrastructure and Growth:** The financial system play a crucial role by providing funds for the growth of infrastructure industries. As we know that, economic development of any country depends on the infrastructure facility available in the country. In the absence of key industries like coal, power and oil, development of other industries will be hampered.
6. **Financial system helps in development of Trade:** The financial system helps in the promotion of both domestic and foreign trade. The financial system not only helps the traders but also various financial institutions. Some of the capital goods are sold through hire purchase and installment system, both in the domestic and foreign trade. As a result of all these, the growth of the country takes place.
7. **Employment Growth is boosted by financial system:** The presence of financial system will generate more employment opportunities in the country. The money market which is a part of financial system provides working capital to the businessmen and manufacturers due to which production increases, resulting in generating more employment opportunities.
8. **Financial system ensures balanced growth:** Economic development requires a balanced growth which means growth in all the sectors simultaneously.
9. **Role of financial system in attracting foreign capital:** Financial system promotes capital market. A dynamic capital market (we will discuss this concept in unit 5 of this course) is capable of attracting funds both from domestic and abroad.
10. **Financial system role in Electronic development:** Due to the development of technology and the introduction of computers in the financial system, the transactions have increased diversely which brought the changes for the all round development of the country.

1.8 LET US SUM UP

In this unit we have discussed the following:

- Financial system is a set of inter-related institutions, instruments and markets, which raise (savings) funds and channels them to their efficient use. It comprises of individuals (savers), intermediaries (financial institutions), markets (money and capital markets), and users (borrowers of money).
- A clear understanding of the financial system is of utmost importance to the financial manager whose task is to provide sufficient funds to meet the business needs.
- The financial system facilitates the transformation of savings into investment and consumption. The financial system (i) provides a payment system for the exchange

of goods and services, (ii) enables the pooling of funds, (iii) provides a mechanism for transfer of resources, (iv) provides a way for managing uncertainty and risk, (v) generates information.

- The financial system facilitates the transformation of savings into investment and consumption. The financial system performs the following interrelated functions that are essential to modern economy:Payment System, Pooling of funds,Maturity Transformation,Risk Management,Provision of Liquidity, Price Information
- Services Provided by the Financial System are:Risk Sharing,Liquidity and Information
- The role of financial system in the economic development are Savings-investment relationship, Financial systems help in growth of capital market, Foreign Exchange Market, Government securities market, Financial system helps in Infrastructure and Growth, Financial system helps in development of Trade, Employment Growth is boosted by financial system, Financial system ensures balanced growth, Role of financial system in attracting foreign capital, Financial system role in Electronic development.

1.9 FURTHER READING

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1.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to QNo.1: According to Robinson, the function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

Ans to QNo.2: The components of the financial system. are:Financial Intermediaries,

financial Markets and Financial Instruments.

Ans to QNo.3: The functions of financial system are: 1. It provides a payment system for the exchange of goods and services.2. It enables the pooling of funds for undertaking large scale enterprises.

Ans to QNo. 4: National income accounts of the sector–of-origin reveal the contribution made by the different sectors of the economy to the national income and the portion of the national income they consume.

⑦1.11 MODEL QUESTIONS

Q 1. Discuss in detail the functions performed by the financial system.

Q 2. Why is it necessary to study the financial system?

Q 3. Discuss the functions of the Financial System.

Q 4. What are the Services Provided by the Financial System

Q 5. Write short notes on:

a. National Income accounts

b. Flow of Funds Accounts

c. Saving and Investment

Q 6. Dusccuss how financial system helps in the economic development of a country.

*** **** ***

UNIT 2 : INDIAN FINANCIAL SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Structure of the Financial System in India

2.4 Financial System and Its Components

- 2.4.1 Financial Intermediaries or Institutions
- 2.4.2 Financial Markets
- 2.4.3 Financial Instruments
- 2.4.4 Financial Services

2.5 Let Us Sum Up

2.6 Further Reading

2.7 Answers to Check Your Progress

2.8 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- discuss the structure of the financial system in India
- discuss the different financial intermediaries
- describe various functions of financial market and instruments

2.2 INTRODUCTION

In the previous unit we have discussed in detail the concept of financial system. In this unit we will discuss about the 'Indian Financial System'.

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.

2.3 THE STRUCTURTE OF THE FINANCIAL SYSTEM IN INDIA

As we have already discussed that, the financial system of a country is an important tool for economic development of the country, as it helps in creation of wealth by linking savings with investments. It facilitates the flow of funds from the households(savers) to business firms (investors) to aid in wealth creation and development of both the parties.

The financial system of a country is concerned with:

- Allocation and mobilization of savings
- Provision of funds
- Facilitating the financial transactions
- Developing financial markets
- Provision of legal financial framework
- Provision of financial and advisory services

The Indian financial system is broadly classified into two broad groups:

i) Organised sector and *(ii)* unorganised sector.

The financial system is also divided into users of financial services and providers. Financial institutions sell their services to households, businesses and government. They are the users of the financial services. The boundaries between these sectors are not always clear cut.

In the case of *providers* of *financial services,* although financial systems differ from country to country, there are many similarities.

(i) Central bank

(ii) Banks

(iii) Financial institutions

(iv) Money and capital markets and

(v) Informal financial enterprises.

i) Organised Indian Financial System

The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are mainly provided by the commercial and cooperative banking structure. Nine-tenth of such banking business is managed by twenty-eight leading banks which are in the public sector. In addition to commercial banks, there is the network of cooperative banks and land development banks at

state, district and block levels. With around two-third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas such as merchant banking, mutual funds, leasing and factoring.

The organised financial system comprises the following sub-systems:

1. Banking system
2. Cooperative system
3. Development Banking system

(i) Public sector

(ii) Private sector

4. Money markets and
5. Financial companies/institutions.

Over the years, the structure of financial institutions in India has developed and become broad based. The system has developed in three areas - state, cooperative and private. Rural and urban areas are well served by the cooperative sector as well as by corporate bodies with national status. There are more than 4,58,782 institutions channellising credit into the various areas of the economy.

ii) Unorganised Financial System :

On the other hand, the unorganised financial system comprises of relatively less controlled moneylenders, indigenous bankers, lending pawn brokers, landlords, traders etc. This part of the financial system is not directly amenable to control by the Reserve Bank of India (RBI). There are a host of financial companies, investment companies, chit funds etc., which are also not regulated by the RBI or the government in a systematic manner.

However, they are also governed by rules and regulations and are, therefore within the orbit of the monetary authorities.

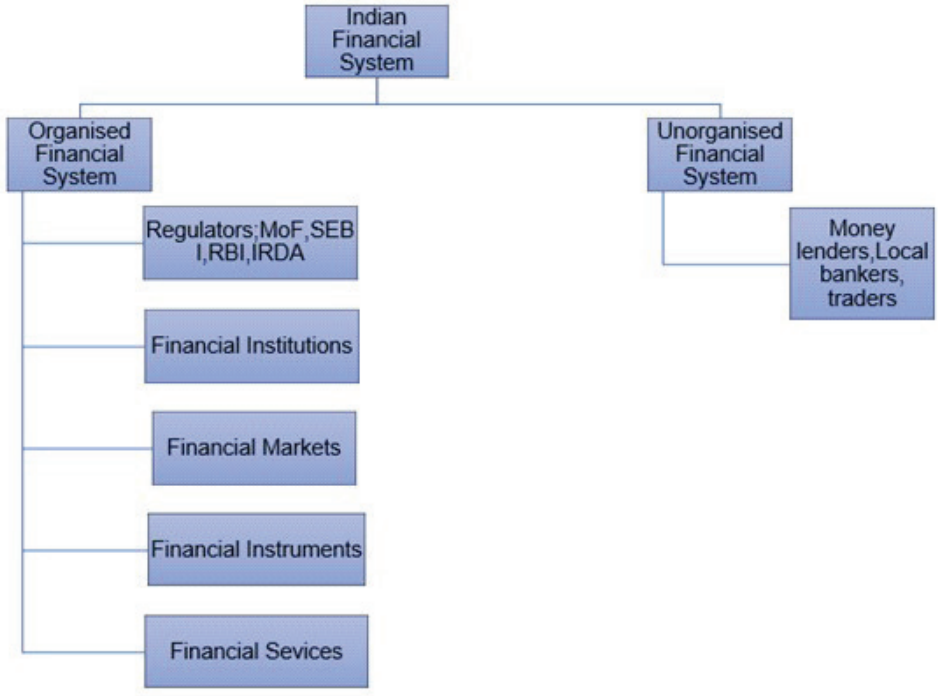


Fig 2.1 : Indian Financial System

2.4 FINANCIAL SYSTEM AND ITS COMPONENTS

In the previous unit, i.e. in unit 1 we oulined the components of financial system, now let us describe the financial system and its components in detail. There are 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.

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

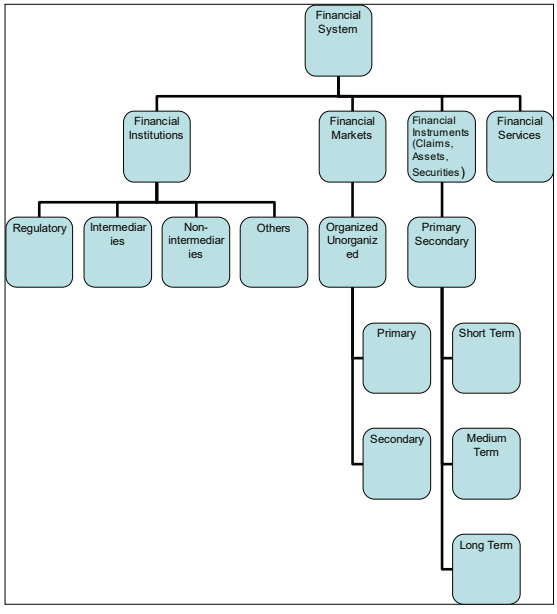


Fig 2.1 : Financial System

2.4.1 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.

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.

2.4.2 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 1: What is meant by Financial Market?

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Q2: 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 2.1

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

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2.4.3 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.

2.4.4 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.

ACTIVITY 2.2

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

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2.5 LET US SUM UP

In this unit we have discussed the following points:-

- 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.

2.6 FURTHER READING

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✓ 2.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Financial markets are markets which cater to the financial needs of individuals, firms and institutions required for short as well as for long period.

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

? 2.8 MODEL QUESTIONS

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

Q 2: What are the instruments traded in the money market?

Q 3: Distinguish between money market and capital market.

Q 4: State the salient features of money market instruments.

Q 5: Disuss the various components of financial system

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UNIT 3: FINANCIAL MARKETS

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Financial Markets-An Introduction

3.4 Advantages and disadvantages of the financial markets

3.5 Classification of Financial Markets

3.6 Functions of Financial Markets

3.7 Structure of Financial Markets

3.8 Let Us sum Up

3.9 Further Reading

3.10 Answers To Check Your Progress

3.11 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- discuss the meaning of financial markets and its advantages and disadvantages.
- outline the functions and classifications of the financial market
- describe the functions of the regulatory institutions in the financial system

3.2 INTRODUCTION

In this unit we are going to learn the concept of financial markets. Under financial market, we will come to know about classification of financial market, functions of financial market and differences between money market and capital market.

At the end of this unit we will get a fair idea on financial intermediaries and its structure, we will also discuss the concept of financial instruments.

3.5 FINANCIAL MARKETS-AN INTRODUCTION

A financial market is a market for creation and exchange of financial assets. Financial market exists wherever financial transactions take place. A financial transaction is said to have taken place when a financial asset is created or transferred. For instance, issue of equity shares by a company, deposit of money in a bank and so on.

A financial market is a market in which people and entities can trade financial securities, commodities and other fungible assets at prices that are determined by pure supply and demand principles. Markets work by placing the two counterparts, buyers and sellers, at one place so they can find each other easily, thus facilitating the deal between them. Financial Market refers to a marketplace, where creation and trading of financial assets, such as shares, debentures, bonds, derivatives, currencies, etc. take place. It plays a crucial role in allocating limited resources, in the country's economy. It acts as an intermediary between the savers and investors by mobilising funds between them.

3.4 ADVANTAGES AND DISADVANTAGES FINANCIAL MARKETS

Some of the advantages and disadvantages of the financial markets are as follows:

ADVANTAGES OF FINANCIAL MARKETS

1. It gives a platform to buyers and the sellers, to meet in order to trade in the assets. The prices for trading which are determined by the market forces i.e., demand and supply in the market. So It helps in the determination of the prices of securities.
2. It helps in the mobilization of the savings of the investors as the investor can put his money in most productive uses.
3. For the traders, the financial market platform provides the potential buyer and seller of their securities, which help them in saving their time and money in finding the potential buyer and seller.
4. In the financial market, investors can sell their securities readily and convert them into cash, thereby providing liquidity to the tradable assets.

DISADVANTAGES OF FINANCIAL MARKETS

1. Prices in the financial market may not indicate stock's true intrinsic value because of some macroeconomic forces like the taxes etc.
2. There are certain factors that change the prices of the securities suddenly. So there is a risk involved when trading in the financial market.

3.5 CLASSIFICATION OF FINANCIAL MARKETS

There are different ways of classifying financial markets. Financial markets may be classified under five heads, viz., Maturity of Securities (claim), Seasoning of Claim, Timing of delivery, Type of claim and Organization structure.

(i) Maturity of Securities: One way of classifying financial markets is by the maturity of claims. The market for short-term financial claims is called **money market** and the market for long-term financial claims is called the **capital market**. The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions. Since short-term financial claims are invariably debt-claims, the money market is the market for short-term debt instruments. On the other hand, the capital market is designed to finance the long-term investments. It deals with long-term securities such as debentures, loans and shares.

(ii) Seasoning of Claim: A second way of classifying financial markets is based on whether the claims represent new issues or outstanding issues. The market where the issuers of securities sell new claims to the initial buyers is referred to as the **primary market** and the market where issuers trade securities previously issued is called the **secondary market**. For example, Mr. X had bought 100 shares of ONGC from a public offer (primary market) and now he sells them to Mr Y. Mr. Y has thus purchased securities in the secondary market.

(iii) Timing of Delivery: A third way to classify financial markets is by the timing of delivery. A cash or spot market is one where the delivery occurs immediately and a forward or futures market is one where the delivery occurs at a predetermined time in the future.

(iv) Type of claim: Another way to classify financial markets is into debt market and equity market. The debt market is the financial market for fixed claims (debt instruments) and the equity market is the financial market for residual claims (equity instruments).

(v) Organization Structure: A fifth way of classifying financial markets is by the nature of its organizational structure. These are Exchange market and Over the Counter market. An exchange-traded market is characterized by a centralized organization structure with standardized procedures. An over-the-counter market is a decentralized market with customized procedures.

CHECK YOUR PROGRESS

Q1: Define financial markets

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Q2: On what basis the fiancial markets are classified

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3.6 FUNCTIONS OF FINANCIAL MARKETS

From the earlier sections, we find that financial markets play a key role in allocating resources in an economy by performing the following functions.

- **Facilitates Price Discovery**: The interaction that takes place between numerous buyers and sellers in the financial market helps in determining the price of financial assets. Thus, it facilitates price information.
- **Provides Liquidity**: Financial markets provide liquidity to investors. It enables investors to sell their financial assets whenever they wish to. The liquidity provided by financial markets acts as a motivator for investors to hold financial assets.
- **Reduces the Cost of Transaction**: The cost incurred in the sale and purchase of financial assets is the cost of transaction. The two major costs associated with transactions are search cost and information cost. Search cost includes the monetary expenses incurred on advertising and non-monetary expenses in the form of effort and time spent in identifying a seller or a buyer. Information cost includes the cost incurred in evaluating the investment merits of financial assets. All these costs are reduced because financial markets provide convenience and relatively inexpensive services in linking small savers to large borrowers.
- **Promotes Savings and Investments**: Financial markets encourage savings and investments by providing price information, liquidity and reduced transaction cost.

3.7 STRUCTURE OF FINANCIAL MARKET

There are different types of financial markets and their characterization depends on the properties of the financial claims being traded and the needs of the different market participants. We recognize several types of markets, which vary based on the

type of the instruments traded and their maturity. A common breakdown is the following:

a. **Money Market:** The money market enables economic units to manage their liquidity positions through lending and borrowing short-term loans, generally under 1 year. It facilitates the interaction between individuals and institutions with temporary surpluses of funds and their counterparts who are experiencing a temporary shortage of funds.One can borrow money within a quite short period of time via a standard instrument, the so-called “call money”. Apart from the “call money” market, banks and other financial institutions use the so-called “Interbank market” to borrow funds within a longer period of time, from overnight to several weeks and up to one year. Retail investors and smaller trading parties do not participate on the Interbank market. While some of the trading is performed by banks on account of their clients, most transactions occur in case a bank experiences extra liquidity, a surplus of funds, while another has a shortage of liquidity.

b. **Capital market:** The capital market aids raising of capital on a long-term basis, generally over 1 year. It consists of a primary and a secondary market and can be divided into two main subgroups – Bond market and Stock market.The Bond market provides financing by accumulating debt through bond issuance and bond trading. The Stock market provides financing by sharing the ownership of a company through stocks issuing and trading

   Financial markets are classified as (i) primary markets and (ii) secondary markets. Primary market is also known as a direct market, whereas as secondary market is called an indirect market. The primary market deals in the new financial claims or new securities deals in the new financial claims or new securities and, therefore, they are also known as the new issues markets.

   On the other hand, secondary markets deal in securities already issued or existing or outstanding. The primary markets mobilise savings and they supply fresh or additional capital to business units. Although secondary markets do not contribute directly to the supply of additional capital, they do so indirectly by rendering securities issues on the primary markets liquid. Stock markets have both the primary and secondary market segments. The institutional structure of the primary markets differs form that of the secondary markets. We will get a detailed understanding of primary and secondary markets in unit 5 and 6 respectively of this cousre.

c. **Derivatives Market:** The derivatives market is the financial market that trades in the

securities that derive its value from some specified underlying asset. Derivatives do not have a physical existence but emerge out of the contracts between two parties. These underlying assets may be debentures, shares, currencies, etc. The derivative contracts' value is determined by the market price of an underlying item. This market trades in the derivatives which include futures and forward contracts, swaps, options, etc.

d. Forex Market: The forex market is not a physical entity but is a network of communication among banks, brokers and forex dealers. This is the market where all kinds of currencies are traded. It is the highest liquid market as cash is liquid. It includes market dealings like spot market, forward market, etc.

CHECK YOUR PROGRESS

Q3: Define Derivatives market

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Q4: Define Money market and Capital market

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3.8 LET US SUM UP

In this unit we have discussed the following:

- A financial market is a market for creation and exchange of financial assets. Financial market exists wherever financial transactions take place. Financial markets may be classified under four heads, viz., maturity of securities (claim), seasoning of claim, timing of delivery, type of claim and organization structure.
- Financial markets facilitates price discovery, provides liquidity, reduces the cost of transaction and, promotes savings and investments.
- Money market deals in short-term financial assets and capital market deals in long-term financial assets.
- Financial Markets is the market where the traders are involved in the buying and selling of the financial assets like shares, bonds, derivatives, commodities, currencies, etc.

3. 9 FURTHER READING

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3.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to QNo. 1. A financial market is a market in which people and entities can trade financial securities, commodities and other fungible assets at prices that are determined by pure supply and demand principles.

Ans to QNo. 2. Financial markets may be classified under five heads, viz., Maturity of Securities (claim), Seasoning of Claim, Timing of delivery, Type of claim and Organization structure.

Ans to QNo. 3. The derivatives market is the financial market that trades in the securities that derive its value from some specified underlying asset.

Ans to QNo. 4. The money market enables economic units to manage their liquidity positions through lending and borrowing short-term loans, generally under 1 year. The capital market aids raising of capital on a long-term basis, generally over 1 year.

3.11 MODEL QUESTIONS

Q 1: What is a financial market? How do you classify them?

Q 2: Define money market

Q 3: Define capital market

Q 4: Discuss the functions of Financial markets.

Q 5: Write the advantages and disadvantages of the financial markets

Q 6: Explain the structure of Financial Markets

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UNIT 4 : MONEY MARKET IN INDIA

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Meaning and features of Money Market

4.4 Functions of Money Market

4.5 Structure of Indian Money Market

4.6 Money Market Instruments/Constituents

4.7 Defects of Indian Money Market

4.8 Reforms in Indian Money Market

4.9 Let Us Sum Up

4.10 Further Reading

4.11 Answers To Check Your Progress

4.12 Model Questions

4.1 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 reforms in Indian Money Market

4.2 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.

4.3 MEANING AND FEATURES OF MONEY MARKET

Meaning of the Indian 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.

The money market is a market for short-term funds, which deals in financial assets whose period of maturity is upto one year. It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. The Indian money market consists

of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialised financial institutions. The Reserve Bank of India is the leader of the money market in India.Some Non-Banking Financial Companies (NBFCs) and financial institutions like LIC,GIC, UTI, etc. also operate in the Indian money market.

Features of the Indian money market:

The following are the important features of the money market in India –

1) The money market is purely for short-term funds or assets called near money.
2) All the instruments of the money market deal only with financial assets that are financial in nature. Also, such instruments have maturity period up to one year.
3) It deals assets that can convert into cash readily without much loss and with minimum transaction cost.Generally, transactions take place through oral communication (for eg. phone or mobile).
4) The exchange of relevant documents and written communications take place subsequently. There is no formal place for the trading (like a stock exchange).
5) The components of a money market are the Central Bank, ommercial Banks, Non-banking financial companies, discount houses,and acceptance house. Commercial banks are dominant player of this market.

4.4 FUNCTIONS OF MONEY MARKET

The following are some of the functions of money market:

1. To cater to the short-term financial needs of the economy.
2. 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.

4.5 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.

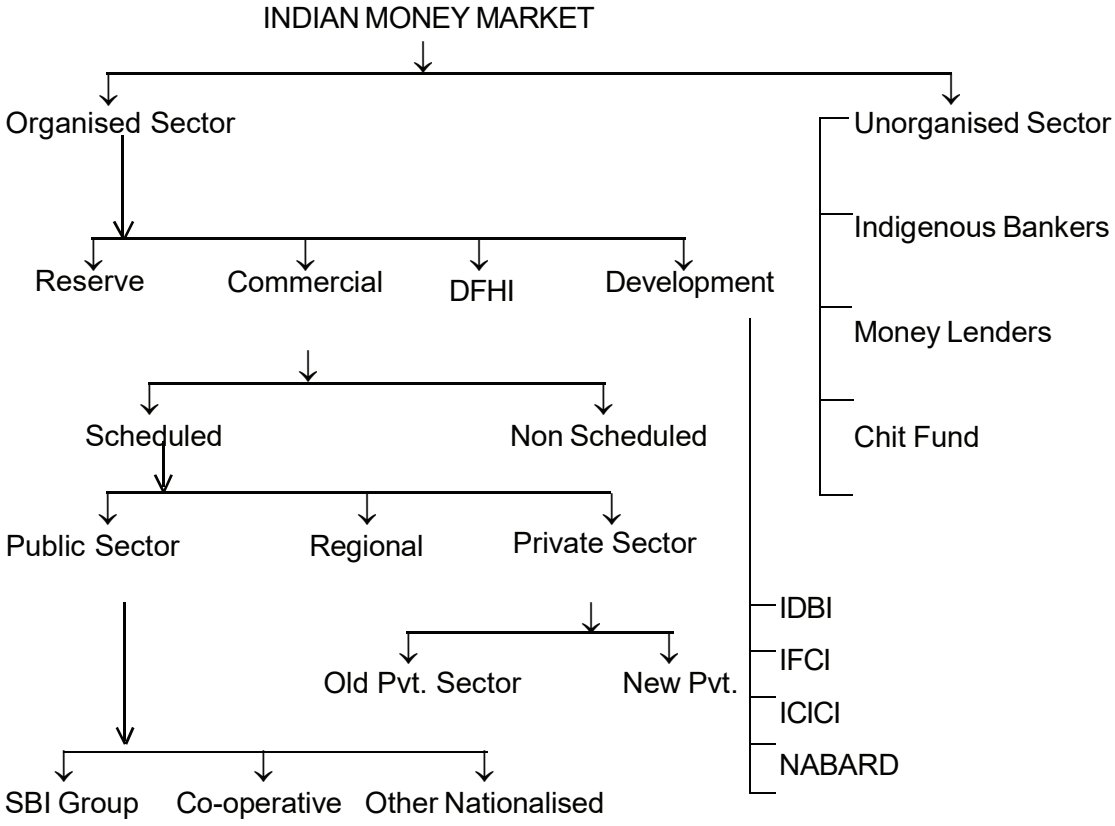


Fig 4.1 : Indian Money Market

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.

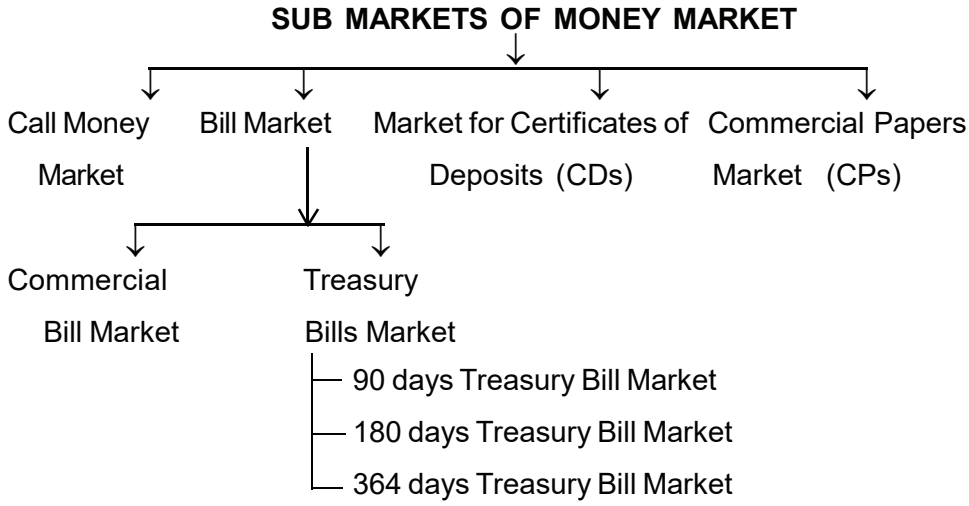


Fig 4.2 : Sub Markets of Money Market

CHECK YOUR PROGRESS

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

i).....

ii) .....

4.6 MONEY MARKET INSTRUMENTS/CONSTITUENTS

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 -

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.

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/-.

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 2: Mention three types of Government Securities.

i) .....

ii) .....

iii) .....

Q 3: Mention four types of Treasury Bills.

i) .....

ii) .....

iii) .....

iv) .....

4.7 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) .....

4.8 REFORMS IN 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) .....

4.9 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.
- Under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.

4.10 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deep and Deep Publication Pvt. Ltd.
2) Mishkin,Frederic S. (2007) *Financial Markets and Institutions*. New Delhi, Pearson Education Ltd.
3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.
4) Khan, M. Y. (2007). *Indian Financial System.* New Delhi. Tata McGraw Hill.

4.11 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

? 4.12 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 5: CAPITAL MARKET IN INDIA

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Meaning and Structure of Indian Capital Market

- 5.3.1 Industrial Securities Market
- 5.3.2 Government Securities Market
- 5.3.3 Long term Loan Market

5.4 Capital Market Instruments

5.5 Capital Market Intermediaries

5.6 Let Us Sum Up

5.7 Further Reading

5.8 Answers to Check Your Progress

5.9 Model Questions

5.1 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

5.2 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.

5.3 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:

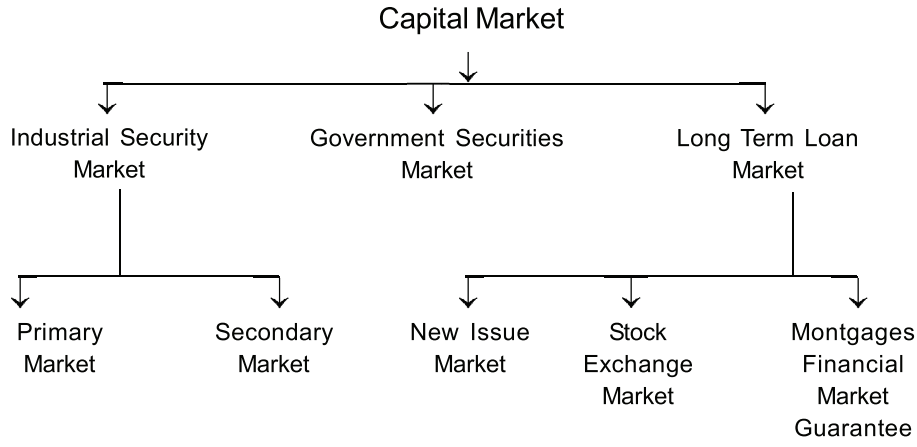


Fig 5.1 Capital Market

5.3.1 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.

5.3.3 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.

5.4 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.

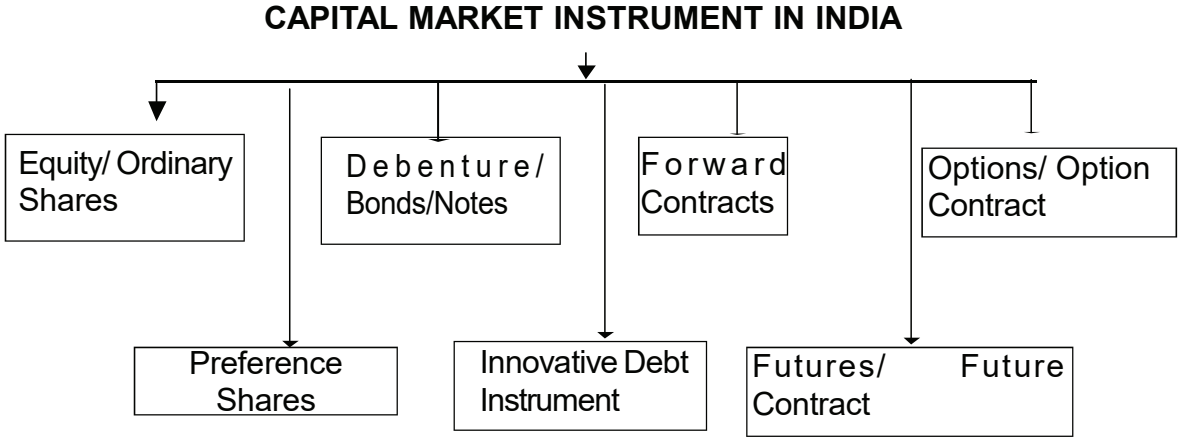


Fig 5.2 Capital Market Instrument in India

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.

5.5 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. Refund 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 refund, 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 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) .....

5.6 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.

5.7 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deep and Deep Publication Pvt. Ltd.
2) Mishkin,Frederic S. (2007) *Financial Markets and Institutions.* New Delhi, Pearson Education Ltd.
3) Khan, M. Y. (2007). I*ndian Financial System.* New Delhi. Tata McGraw Hill.
4) Pathak, Bharati V (2006). *The Indian Financial System : Markets, institutions and services.* New Delhi, Pearson Education Ltd.
5) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.

5.8 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

5.9 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 6: PRIMARY MARKETS IN INDIA

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning of Primary Market

6.4 Functions of Primary Market

6.5 Issue Mechanism in Primary Market

6.6 Role of SEBI in Primary Market

6.7 Factors leading the growth of Primary Market Investment

6.8 Let Us Sum Up

6.9 Further Reading

6.10 Answers To Check Your Progress

6.11Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- explain the meaning of Primary Market
- discuss the functions of Primary Market
- discuss issue mechanism in Primary Market
- describe the role of SEBI in Primary market

6.2 INTRODUCTION

In this unit we are going to discuss the concept of primary market and its different functions. From the previous units we came to know that financial markets are broadly categorized into money market and capital market. Securities market is divided into primary market and secondary market.In this unit we will discuss on priamry market in India.

A system that aims at establishing and providing a regular, smooth, efficient and cost effective linkage between depositors and investors is known as Financial System. Financial Markets perform a crucial role in the financial system as facilitating organizations. Financial markets provide the link between suppliers of funds and demanders of loans. There are different ways of classifying the financial markets. One such classification

consists of dividing the financial market into (i) Primary market (ii) Secondary market.

The primary market facilitates the transfer of investible funds of the savers to the corporates, which need them for productive purposes. The Primary Market, also called the New Issues Market, is of vital importance in the economv of a country, as it leads to better utilisation of otherwise inactive or dormant monetary resources in the economy.

6.3 MEANING OF PRIMARY MARKET

Primary market is the market of new issue .Shares available for the first time is offered through new issue market. The issuer may be a new company or an existing company. These issues may be public issue of new shares or existing shares. Primary market comprises of a market where investors apply directly to the issuer/company for allotment and pay application money to the issuer's/company's account. Primary market is where an issuer/company makes its contact directly with the public at large while raising fund. The primary market provides a direct link between the prospective investors and the company.

In simple words, the primary market creates new securities and offers them for sale to the public.

So, Primary market can be defined as the part of capital market where the issuance of new securities is done. The securities are offered to public and are sold for the first time. Also, sellers and buyers can negotiate without any intermediary. This market is also known as new issues market.

This market normally features long term equity capital. Companies and government bodies buy these securities from investment banks and also from security dealers. When the primary issue is done the securities are issued directly by the company to the investors. The companies which receive the primary issues use them for setting up new businesses and also modernizing or expanding the current business.

6.4 FUNCTIONS OF PRIMARY MARKET

The main function of primary market is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish new ventures or to expand or diversify existing ones. The primary market is a complex of institutions consisting of issuing companies, investment bankers and brokers.

The general functions of primary market can be grouped into three services: (i) Origination, (ii) Underwriting and (iii) Distribution.



Origination: The term origination refers to the work of investigation, analysis and processing of new issues for raising funds. The proposal is analyzed in terms of the nature of the security, the size of the issue, and timing of the issue and floatation method of the issue. This function is mainly carried by the lead managers of the issue.

Underwriting: Underwriting is a contract by means of which a person gives an assurance to the issuer to the effect that the former would subscribe to the securities offered in the event of non-subscription by the person to whom they were offered. In other words, the underwriter takes up an agreed portion of the unsubscribed part of the public issue . The person who assures is called an underwriter. The underwriters directly do not buy and sell securities; they stand as back-up supporters and underwriting is done for a commission. However, at present underwriting is not mandatory.

Distribution: The success of an issue depends on the issues being acquired by the investing public. The sale of securities to the ultimate investors is referred to as distribution. This function is mainly performed by brokers and dealers in securities, who maintain regular and direct contact with the investors.

CHECK YOUR PROGRESS

Q1: What do you mean by Primary Market?

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Q2: What are the functions of Primary Market?

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6.5 ISSUE MECHANISM IN PRIMARY MARKET

The success of an issue depends mainly on its issue mechanism. The methods by which new issues are made are given below:

(i) Public issue through prospectus: A common method followed by companies to raise capital through the issue of securities is by means of a prospectus inviting subscription from the investing public. Under this method, the issuing companies themselves offer directly to the general public a fixed number of shares at a stated price. This method has the advantage that the transaction is carried through publicity to reach the entire public. It ensures that the share ownership is widely-diffused, thereby contributing to the prevention of concentration of wealth and economic power. The main disadvantage of this method is that it is highly expensive as the floatation cost is very high.

(ii) Book Building Method: The essence of the book building method is that the pricing of the issues is left to the investors. The issuing company incorporates all the details of the issue proposal in the offer document on the lines of the public issue method including the minimum price. The investors are required to quote the number of securities and the price at which they wish to acquire.It is a pricing mechanism wherein new issues are priced on the basis of demand feedback. Under this system, the price of the new issue is based on real time feedback from the investors. The mechanism adopted under the Book Building is as follows:

- A draft prospectus containing all information, except the price and the number of securities, is filed by the Company with SEBI.
- A lead merchant banker to the issue is appointed as Book Runner.
- The Book Runner will circulate copies of the prospectus amongst the institutional investors and underwriters inviting offeres for subscription to the security.
- The Book Runner maintains a record of the offers received from the institutional investors and underwriters mentioning the price they are ready to pay and the number of securities

they intend to buy.

- On the basis of these offers, the Company and the book runner will determine the price of the security. The price so determined, will be the same for both placement position and the public issue.
- Thereafter, the Underwriting Agreement is entered into and prospectus is filed with the Registrar of Companies.
- One-day prior to the public issue, institutional investors are required to submit application forms along with money to the extent the securities are proposed to be allotted to them.

Initially, the book-building process was optional to the companies, but gradually, an element of compulsion has been introduced.

(iii) Placement Method: Under this method, a company offers shares privately only to a few investors, namely, financial institutions, corporate bodies and high net worth individuals that is, less than 50 in number. This is referred to as private placement of securities. The issue is placed through letter of offer, giving information regarding the issue. Private placement has become the most significant method of mobilizing funds by Indian companies. The advantages of this method are (i) private placement of securities is subject to much less compliance than the public issue;(ii) it is cost effective as compared to public issue and (iii) it is time effective as deals can easily and directly negotiated with a few investors. The main disadvantage is that as securities are offered to a select group , it may lead to the concentration of shares into a few hands .Hence this method lacks transparency.

6.6 ROLE OF SEBI IN THE PRIMARY MARKET

Since SEBI (Securities and Exchange Board of India) became a statutory body in 1992, the Government initiated a series of measures to strengthen the role of SEBI as the regulatory authority of the Capital Market. Most of the powers which were earlier the Government had under the various securities were delegated to SEBI. The following are some of the measures taken by SEBI for the development of primary market:

i. SEBI has been entrusted with the responsibilities to look after the interest of investors for providing them with adequate and full disclosures in the prospectus used for raising equity capital.

ii. SEBI has made it mandatory that all companies issuing equity capital must furnish all the risk factors associated with the issue. These risk factors may cover aspects

such as management/ promoters' track record, specific economic aspect affecting the industry in which the issuer company operates, supply of raw materials, the state of statutory approvals, and financial data.

iii. One of the most important changes in the primary market introduced by SEBI is related to fixing the basis of allotment of shares on oversubscription The new method introduced popularly is known as the 'proportional method of share allotment'. This means that the allotment of shares to each category (classified by number of shares applied for) are in same proportion as the aggregate of shares applied for from such category, to the aggregate number of shares applied in the whole issue.

iv. SEBI removed the earlier condition of compulsory underwriting for all public issues. Underwriting has become a voluntary work. It has become the promoters'/issue managers option on whether or not to get the proposed public issue underwritten partly or fully.

6.7 FACTORS LEADING THE GROWTH OF PRIMARY MARKET INVESTMENT

The following are some of the factors that leads to the growth of primary market investement:

- I*ndustrial Growth:* The industrial growth and exhausting production capacities in the industry has necessitated further expansion of industrial capacities. It induced the companies to mobilize resources for further investment in future.
- *Buoyancy of the secondary market:* Buoyancy of the secondary market led all-round rise in prices of shares. This factor induced the investors put higher amount of their savings in investment in the primary market.
- *Fiscal incentives:* The fiscal incentives given to investors in schemes of mutual funds and reduction in capital gain tax attracted investors in the primary market.
- *Tightening of norms:* On-going process of improving the quality of issues and tightening of norms relating to merchant bankers and credit rate agencies probably created more confidence among investors.

CHECK YOUR PROGRESS

Q3: What is Book Building Method?

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.....

Q4: Write the factors that accelerate the primary market investment.

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.....

6.8 LET US SUM UP

- In the primary market , shares are offered for the first time. The primary market provides a direct link between the prospective investors and the company.
- The general functions of Primary market can be grouped into three services: (i) Origination, (ii) Underwriting and (iii) Distribution.
- The methods by which new issues are made are : (i) Public issue through prospectus, (ii) Book Building Method, (iii) Placement Method.
- Book Building has been adopted by SEBI to determine the amount of premium to be charged by a company.
- SEBI ataken some measures for the development of primary market.SEBI has brought several reforms in the new issues market during recent years.
- The factors that leads to the growth of primary market investement:Industrial Growth, Buoyancy of the secondary market, Fiscal incentives and Tightening of norms.

6.9 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deepand Deep Publication Pvt. Ltd.
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5) Pathak, Bharati V (2006). *The Indian Financial System : Markets, institutions and services.* New Delhi, Pearson Education Ltd.

6.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: Primary market is where an issuer/company makes its contact directly with the public at large while raising fund.

Ans to Q No.2: (i) Origination, (ii) Underwriting and (iii) Distribution.

Ans to Q No.3: In book building method the pricing of the issues is left to the investors. The issuing company incorporates all the details of the issue proposal in the offer document on the lines of the public issue method including the minimum price.

Ans to Q No.4: The factors that leads to the growth of primary market investement:Industrial Growth, Buoyancy of the secondary market, Fiscal incentives and Tightening of norms

? 6.11 MODEL QUESTIONS

Q 1: What do you mean by primary market.

Q 2: Write main functions of the primary market.

Q 3: Write two major reforms that SEBI has brought for the primary market.

Q 4: Discuss the issue mechanism in primary market.

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UNIT 7: SECONDARY MARKETS IN INDIA

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Meaning of Secondary Market

7.4 Functions of Secondary Market

7.5 Relationship Between Primary market and Secondary Market

7.6 Differences between primary market and secondary market

7.7 Stock Exchanges of India

7.8 Bombay Stock Exchange (BSE)

7.9 Over the Counter Exchange of India (OTCEI)

7.10 National Stock Exchange (NSE)

7.11 Rules of SEBI regarding Stock exchange

7.12 Let Us Sum Up

7.13 Further Reading

7.14 Answers To Check Your Progress

7.15 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit you will be able to :

- explain the meaning and functions of Secondary Market
- explain the history of Stock Exchanges
- explain the historical background of Bombay Stock Exchange
- analyse the functioning of Counter Exchange of India
- describe about National Stock Exchange of India

7.2 INTRODUCTION

In the previous unit we discussed about the primary market. In this unit we are going to discuss the concept secondary market and its different functions. You will also get a fair idea on the concept of Stock Exchange of India, Bombay Stock Exchange, and National Stock Exchange. At the end of this unit we will discuss on rules of SEBI regarding stock exchange.Also we will discuss the relationship between Relationship

Between Primary market and Secondary Market.

The secondary market of securities is an important component of the capital market. It is the market where shares, bonds, debentures and other securities are traded.Once these securities are floated, subscribed to and issued to the public, they are traded in the secondary market, which is called **'Stock Market'.**

Let us now discuss about the secondary markets in the following sections.

7.3 MEANING OF SECONDARY MARKET

The secondary market is the market of existing shares, bonds and preference shares. It is the market where investors can buy and sell securities. This process takes place in the stock exchanges through the help of brokers. This secondary market is often referred as the stock market. Secondary market comprises of the buyers and sellers of shares and debentures subsequent to the original issue. For example, having subscribed to the share or debenture of the company, if one wishes to sell the same, it will be done in the secondary market. Similarly one can also buy the share or debenture of a company from the secondary market (if the company is listed on the stock exchange) without having to wait for that company to come out with a new public issue.

7.4 FUNCTIONS OF SECONDARY MARKET

The following are some of the functions of secondary market:

i. **Maintains active trading:** Shares traded on the stock exchanges, enable the investors to buy and sell securities. The stock exchanges provide liquidity to the existing shares. By and large, at the stock exchange , a seller has a ready purchaser and a purchaser has a ready seller at a price determined at the exchange.

ii. **Ensures safe and fair dealing:** The rules and regulations of the stock exchanges provide measures of safety to the investors. Transactions are conducted under competitive conditions enabling investors to get a fair deal.

iii. **Continuous price formation:** The stock exchanges help in the process of continuous price formation. Price is determined by the transactions that flow from investors' demand and suppliers' preferences. The traded prices are made known to public.

iv. **Performance inducer:** The prices of stocks reflect the performance of the traded companies. This makes the corporate more concerned with its public image and

tries to maintain good performance.

v. **Self-regulating organization**: The stock exchanges monitor the integrity of the members, brokers, listed companies and clients. Continuous internal audit safeguards the investors against unfair trade practices.

vi. **Economic Barometer**: The secondary market, through the help of the stock exchange play the role of a barometer, namely, an indicator of the state of health of the nation's economy as a whole. The trend of price movements in the market is indicated by calculating stock market indices. Their movements and levels are indicative of the economic health of the nation to a great extent because movements of prices of shares are influenced by macro economic factors such as growth of GDP, financial and monetary policies, tax changes, political environment, etc.

7.5 RELATIONSHIP BETWEEN PRIMARY MARKET AND SECONDARY MARKET

The following are the relationship between primary and secondary market:

i. The primary market or new issue market cannot function without the secondary market. The secondary market provides liquidity for the issued securities. The issued securities are traded in the secondary market offering liquidity to the stocks at a fair price.

ii. The stock exchanges through their listing requirements, exercise control over the primary market. The company seeking for listing on the respective stock exchange has to comply with all the rules and regulations given by the stock exchange.

iii. The primary market provides a direct link between the potential investors and the company. By providing liquidity and safety, the stock markets encourage the public to subscribe to the new issues.

7.6 DIFFERENCES BETWEEN THE PRIMARY MARKET AND SECONDARY MARKET

The following table shows the differences between primary and secondary market.

Points of Differences	Primary Market	Secondary market
Issues of securities	Primary market deals with new issues of new or existing companies	Deals in existing securities
Location	No fixed geographical location needed	Needs a fixed place to house the secondary market activities , viz. trading
Transfer of securities	Securities are created and transferred from corporate to investors for the first time.	Securities are transferred from one investor to another through the stock exchange mechanism.
Feature	**Primary Market**	**Secondary market**
Administration	Has no tangible form of administrative set-up.	Has a definite administrative set-up that facilitates trading in securities.
Regulation	Subject to regulations from outside the company- SEBI, Stock Exchanges etc	Subject to regulation both from within and outside the stock exchange framework.
Price movement	Stock price movement in secondary market influences pricing of new issues	Both macro and micro factors influence the stock price movement.

7.7 STOCK EXCHANGES OF INDIA

The stock exchanges are the most perfect type of market for securities whether of government and semi-government bodies or other public bodies as also for shares and debentures issued by the joint stock companies. In the stock exchanges, the purchases and sales of shares are made in conditions of free competition. The bargains that are struck in the trading system by the members of the stock exchanges are the fairest prices determined by the basic laws of supply and demand.

Definition of stock exchange:

Stock exchange means any body or individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. It is an association of member brokers for the purpose of self – regulation and protecting the interests of its members. It can operate only if it

is recognized by the Government under the Securities Contract (Regulation) Act, 1956. The recognition is granted under Section 3 of the Act by the Ministry of Finance, Central Government. The Securities Contract (Regulation) Act, 1956 is the basis for operation of the stock exchanges in India.

LET US KNOW

The Indian stock market is one of the oldest in Asia. The origin of the stock market in India goes back to the end of the eighteenth century when long-term negotiable securities were first issued. However, the real beginning occurred in the middle of the nineteenth century after the enactment of the Companies Act in 1850, which introduced the features of limited liability and generated investor interest in corporate securities. A significant event in the development of the stock market in India was the formation of the 'Native Shares and Stock Brokers' Association at Bombay in 1875, which is today the Bombay Stock Exchange. Then the second stock exchange 'Ahmedabad Stock Exchange' was set up in 1894. Both the Exchanges were organized as voluntary non-profit making associations of brokers to regulate and protect their interests. The Bombay Securities Contracts Act of 1925 used to regulate trading in securities. Under this Act, the Bombay Stock Exchange was recognized in 1927 and Ahmedabad in 1937. During the war boom, a number of stock exchanges were organized even in Bombay, Ahmedabad and other centres, but they were not recognized. Soon after, it became a Central subject and The Securities Contract (Regulation) Act, became law in 1956, which is the basis for operation of the stock exchanges in India.

Subsequently, 25 stock exchanges were set up and recognized by the central government, the most important development being the establishment of the National Stock Exchange (NSE) in 1994.Within a short period, it emerged as the largest stock exchange in the country, and even surpassed the Bombay Stock Exchange which was historically the leading stock exchange in India.

TRADING ON EXCHANGES

Investors can carry out their operations i.e. buying and selling of securities through brokers and sub-brokers. A broker is an enrolled member of stock exchange who is authorized to the stock exchange trade. He has to be registered with SEBI. A sub-broker

is affiliated to the members (brokers) of the stock exchange and registered with SEBI as sub-brokers.

Buying and selling of shares is an agreement between the broker/sub-broker and the investor. The broker charges a fee , which is between 0.50 per cent and 1per cent of the value of transaction, for executing the transaction in the stock exchanges.

Every stock exchange has certain listed securities which are traded on it. Investors who wish to purchase or sell these securities need to place their orders with the members/ brokers of the exchange. There are two ways of organizing the trading activity: the open outcry system and the screen-based system.

- **Open Outcry System**: This system involves shouting and using of signals by traders on the trading floor of the exchange which has several trading posts for different securities.
- **Screen-based System**: In this system, the trading ring is replaced by the computer screen whereby, a large number of participants, geographically spread can trade simultaneously at high speeds.

SETTLEMENT

The process of fulfillment of the obligations of the trade by the parties to the transactions is known as 'settlement'. This implies payment of funds to the seller and delivery of securities to the buyer. Though trading in shares takes place on all stock exchange working days, all settlements need not take place automatically. Settlement may be on a cash basis or by a forward contract.

- **Cash settlement** means that the sale and purchase of shares noted down by the brokers will be finalized through the act of receiving cash by the seller and the receipt of share documents by the buyer. Thus, the delivery of assets takes place on the settlement day.
- **In forward contracts of settlement**, the transactions recorded are renewed by a carry forward contract. Payment for sale and delivery of share certificate do not take place.

CHECK YOUR PROGRESS

Q1: What do you mean by Secondary Market

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Q2: What are the functions of Secondary Market?

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Q3: What do you mean by Stock Exchange?

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7.8 BOMBAY STOCK EXCHANGE (BSE)

The origin of the Bombay Stock Exchange dates back to 1875. It was organized under the name of "The Native Stock and Share Brokers Association" as a voluntary and non-profit making organization. It was recognized on a permanent basis in 1957. This premier stock exchange is the oldest stock exchange in Asia. The Bombay Stock Exchange Limited has the greatest number of listed companies in the world, with 4700 listed as of August 2007 .On 31 December 2007, the equity market capitalization of the companies listed on the BSE was US$ 1.79 trillion, making it the largest stock exchange in South Asia and the 12th largest in the world.

The main objectives of the organization are (i) to safeguard the interest of investing public; (ii) to promote, develop and maintain well-regulated market for dealing in securities; and (iii) to establish and promote just practices in securities transactions.

In March 1995, the Bombay Stock Exchange introduced screen based trading called BOLT (BSE on-line trading).The BOLT is designed to get best bids and offers from brokers as well as the best but and sell orders from the order book. There is a separate surveillance department in the stock exchange. The surveillance department aims at providing free and fair market price. The surveillance can be classified into price surveillance and pre-monitoring. BSE places a great deal of emphasis on Information Technology for its operations and performance. The 'Operations & Trading Department' at BSE continuously upgrades the hardware, software and networking systems, thus enabling BSE to enhance the quality and standards of service provided to its members, investors and other market intermediaries. The capacity of the BOLT platform stands presently enhanced to 80 lakh orders per day.

The securities traded in the BSE are classified into three groups, namely, specified shares or 'A' group and non-specified securities. The latter is divided into 'B1' and 'B'

groups. Group 'A' contains the companies with large outstanding shares, good track record and large volume of business in the secondary market. Relatively liquid securities come under the 'B1' group and the remaining shares are placed under the 'B' group.

7.9 OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

OTCEI (OTC exchange of India) is a different kind of stock exchange. The acronym OTC stands for 'Over The Counter', a phrase coined to describe the situation , many years ago, when investors could buy and sell securities over the counters of their local banks. Today the OTC market refers to a way of trading, securities through a network of broker-dealers spread over different locations and linked to each other by telephones, telexes, faxes and computers.

The Over the Counter Exchange of India (OTCEI) was started in India in 1992. Its operations had been fully computerized. It has a network of counters linked by an electronic communication system. The minimum capital requirement for a company to be listed on the OTCEI is Rs 3 crores and the maximum is Rs 50 crores.

The main objectives of the exchange are the followings:

i. To provide a market for the smaller companies that can not afford the listing fees of the larger exchanges.
ii. To create a fully decentralized and transparent market.

Players in the OTCEI Market:

There are the following players in the OTCEI market:

- Companies whose securities are traded on the OTCEI.
- Investors who deal through the OTCEI counters.
- Members and dealers: Instead of the brokers who function on the traditional stock exchanges, OTCEI will have two players, namely, members and dealers.

OTCEI was started with facilities very new to the Indian market, like screen based trading, nation wide coverage etc. Even though, the OTCEI was established to help small companies to raise capital later it started listing large capitalization companies. In spite of its initial glamour, it needed lot of improvement in upgradation of infrastructure and technology. This paved the way for the starting of the National Stock Exchange.

7.10 NATIONAL STOCK EXCHANGE (NSE)

The National Stock Exchange came much after the Bombay Stock Exchange but

within a short period, it emerged as the largest stock exchange in the country, and even surpassed the Bombay Stock Exchange which was historically the leading stock exchange in India.

After the formation of the Securities Market regulator, the Securities and Exchange Board of India (SEBI), attention were drawn towards the inefficiencies of the bourses and the need was felt for better regulation, discipline and accountability.

A Committee recommended the creation of a second stock exchange in Mumbai called the **"National Stock Exchange**". The Committee suggested the formation of an exchange which would provide investors across the country a single, screen based trading platform, operated through a VSAT network. It was on this recommendation that setting up of NSE as a technology driven exchange was conceptualized. NSE has set up its trading system as a nation-wide, fully automated screen based trading system. It has written for itself the mandate to create a world-class exchange and use it as an instrument of change for the industry as a whole through competitive pressure. NSE was incorporated in 1992 and was given recognition as a stock exchange in April 1993. It started operations in June 1994, with trading on the Wholesale Debt Market Segment. Subsequently it launched the Capital Market Segment in November 1994 as a trading platform for equities and the Futures and Options Segment in June 2000 for various derivative instruments.

NSE was set up with the objectives of:

(a) Establishing a nationwide trading facility for all types of securities;

(b) Ensuring equal access to investors all over the country through an appropriate communication network;

(c) Providing a fair, efficient and transparent securities market using electronic trading system;

(d) Enabling shorter settlement cycles and book entry settlements; and

(e) Meeting international benchmarks and standards.

Ownership and Management

The NSE is owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries. It is managed by a team of professional managers and the trading rights are with trading members who offer their services to the investors.The Board of NSE comprises of senior executives from promoter institutions and eminent professionals, without having any representation from trading members.

Market Segments and Products

NSE provides an electronic trading platform for of all types of securities for investors under one roof - Equity, Corporate Debt, Central and State Government Securities, Treasury Bills, Commercial Paper (CPs), Certificate of Deposits (CDs), Warrants, Mutual Funds (MFs) units, Exchange Traded Funds (ETFs), Derivatives like Index Futures, Index Options, Stock Futures, Stock Options, Futures on Interest Rates etc., which makes it one of the few exchanges in the world providing trading facility for all types of securities on a single exchange. The Exchange provides trading in 3 different segments viz., Wholesale Debt Market (WDM) segment, Capital Market (CM) segment and the Futures & Options (F&O) segment.

The following are the achievements of NSE:

i. **NSE as a trend setter:** The anonymous order matching system adopted by NSE is one of the best in the world. In terms of geographical reach of the real time trading facilities to the nooks and corners of the country, the Indian capital market is way ahead of most of the global capitals. Investors can trade from close to 400 cities/ towns across the country.

ii. **The Concept of a Demutualised Exchange:** The NSE happens to be the first truly demutualised stock exchange of the world. It means separation of exchange ownership and management from the trading rights of members.

iii. **Settlement Guarantee:** The concept of a settlement as it is prevalent today was almost unknown in India until 1995. NSE had set up National Securities Clearing Corporation Ltd. (NSCCL) for this purpose. This has helped NSE in providing a seamless integration of two important functions, that is , trading and settlement with full guarantee.

iv. **Depository with dematerialization:** NSE is the first in the country to set up a depository where ownership records would be maintained in the dematerialized form. The Indian depository is unique in the world as it has full data on investor holdings.

7.11 RULES OF SEBI REGARDING STOCK EXCHANGES

Under Section 11 (1) of the SEBI Act, following are the powers of SEBI to protect and promote the interests of investors in securities:

- **Stock Exchange Regulation**: SEBI is empowered to regulate the regulate the business in stock exchanges and any other securities market. It works to prohibit

fraudulent and unfair trade practices in securities market. SEBI performs functions like calling for information, undertaking inspection, conducting enquiries and audits of the stock exchanges, intermediaries, and self-regulatory organizations in these securities market.

- **Stock Brokers Regulation:** SEBI is empowered to register and regulate the working of stockbrokers, sub-brokers, share transfer agents underwriters etc. who may be associated with securities market in any manner.
- **Investor Protection:** SEBI is empowered to initiate all the steps for promoting investor education and training of intermediaries in securities market. For this purpose it would work towards prohibiting insider trading in securities, besides regulating substantial acquisition of shares and take-over of companies.

CHECK YOUR PROGRESS

Q4: Pick the correct alternative from the following :

i. Primary and secondary markets
   (a) compete with each other
   (b) complement each other
   (c) function independently

ii. In private placement
   (a) shares are offered through letter of offer
   (b) shares are offered through prospectus
   (c) shares are offered through brokers

iii. The underwriter has to take up
   (a) the fixed portion of the issue capital
   (b) the agreed portion of the unsubscribed part
   (c) the agreed portion or can refuse it

iv. Under screen –based system
   (a) this system involves shouting and using of signals by traders on the trading floor
   (b) this involves selling of shares by banks (c) the tradingring is replaced by the computer screen .

v. The Bombay Stock Exchange was recognized on a permanent

basis in

(a) 1957 (b) 1956 (c) 1950

vi. To be listed on the OTCEI, the minimum capital requirement for a company is

(a) Rs 5 crores (b) Rs 3 crores (c) Rs 1 crores

7.12 LET US SUM UP

- The secondary market is the market of existing shares, bonds and preference shares. It is the market where investors can buy and sell securities.
- In the stock exchanges, the purchases and sales of shares are made in conditions of free competition.
- A significant event in the development of the stock market in India was the formation of the 'Native Shares and Stock Brokers' Association at Bombay in 1875, which is today the Bombay Stock Exchange.
- The OTCEI was established with the purpose of providing a fair trade platform for the shares of small capitalization companies.
- National Stock Exchange is an exchange which provides investors across the country a single, screen based trading platform, operated through a VSAT network.

7.13 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deepand Deep Publication Pvt. Ltd.
2) Mishkin,Frederic S. (2007) *Financial Markets and Institutions.* New Delhi, Pearson Education Ltd.
3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.
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.

7.14 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: The secondary market is the market of existing shares, bonds and

preference shares. It is the market where investors can buy and sell securities.

Ans to Q No.2: i. Maintains active trading, ii. Ensures safe and fair dealing, iii. Continuous price formationm, iv. Performance inducer, v.Self-regulating organization, vi. Economic Barometer.

Ans to Q No.3: The stock exchanges are the most perfect type of market for securities whether of government and semi-government bodies or other public bodies as also for shares and debentures issued by the joint stock companies.

Ans to Q No.3: i. (b) ii. (a) iii (b) iv. (c) v.(a) vi. (b)

⑦7.15 Model QUESTIONS

Q 1: What is meant by secondary market.

Q 2: Write four main functions of the secondary market.

Q 3: Is there any relationship between the primary and secondary market? Explain.

Q 4: Give a brief account of the history of stock exchanges in India .

Q 5: Explain the trading process on stock exchanges.

Q 6: Is there any difference between the Bombay Stock Exchange and National Stock Exchange.

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UNIT 8: FINANCIAL INSTITUTIONS

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Financial Institutions: An Introduction

8.4 Assistance of Financial Institutions

8.5 Types of financial institutions

- 8.5.1 Banking Institutions
- 8.5.2 Non-Banking Institutions

8.6 Merchants Banks

- 8.6.1 Importance of Merchant Banking in India
- 8.6.2 Role of a Merchant Banker

8.7 Money Market Institutions

8.8 Insurance Companies

- 8.8.1 Importance or need of Insurance Organisations

8.9 Foreign Institutional Investors (FIIs)

8.10 Let Us Sum Up

8.11 Further Reading

8.12 Answer to Check Your Progress

8.13 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- learn the meaning of Financial Institution
- know the assistance provided by the financial institutions
- understand the concept of Merchant banking
- discuss the role of Flinancial Institutional Investors
- know the need of insurance companies.

8.2 INTRODUCTION

In this unit we are going to discuss about Financial Institutions. Financial Institutions

are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet.

In this unit we will discuss about meaning of Financial Institution, the assistance provided by the financial institutions,concept of Merchant banking.

At the end of the unit we will get a fair idea about the role of Financial Institutional Investors and the need of insurance companies

8.3 FINANCIAL INSTITUTIONS: AN INTRODUCTION

Financial institutions also provide services to entities (individual, business, government) seeking advice on various issues ranging from restructuring to diversification plans.

These institutions are also termed as financial intermediaries because they act as middlemen between the savers and borrowers. Financial intermediaries mobilize the savings of the surplus units and lend them to the borrowers in the form of loans and advances (i.e. by creating a financial asset). They also meet the short term and long term needs of the borrowers and provide the liquidity to the savers. Deposits are payable on demand by the customers. Banks are in a position to avoid the situation of illiquidity while borrowing for short periods and lending for long term by mobilizing savings from diversified set of depositors. RBI also has made it mandatory for the banks to keep a certain percentage of deposits as cash reserves with itself to avoid the situation of ill-liquidity.

There is a need of financial institutions not only for providing financial assistance to the industrial undertakings but also help in creating infrastructural facilities. Basically, financial institutions are required for the economic development of a country.

Financial institutions provide means and mechanism of transferring resources form those who have an excess of income over expenditure to those who can make productive use of the same. For the economic development of a country it needs resources, adequate infrastructural facilities and persons who can take the initiative of setting up units for providing goods and services.

8.4 ASSISTANCE OF FINANCIAL INSTITUTIONS

Financial institutions provide all types of assistance required for development. They help in the following ways:

a. **Providing funds:** These institutions help large number of people for taking up some industrial activity. Due to low incomes, people are not able to save sufficient funds which are needed for setting up new units and also for expansion, diversification, and modernization of existing units. These people approach financial institutions for help. And these financial institutions have large investible funds which are used for productive purposes.

b. **Infrastructural facilities:** For economic development of a country there is a need for roads, water, sewerage, communication facilities, electricity etc. Financial Institutions prepare their investment policies by keeping national priorities in mind. The institutions invest in those areas which can help in increasing the development of the country. All India institutions are giving priority to invest funds in projects generating electricity in areas facing these problems. Financial institutions are developing industrial estates and provide shed at state level at easy instalments. So financial Institutions are helping in the creation of all those facilities which are required.

c. **Promotional Activities:** for setting up a new unit an entrepreneur faces many problems like undertaking a feasibility report, complete registration formalities seeking approval from agencies etc, which require a lot of money, time and energy. Financial institutions have the expertise and manpower resources for undertaking the exercise of starting a unit. These institutions take this work on behalf of the entrepreneurs. Some units are set up jointly with the financial institutions were the formalities are completed collectively. This role of financial institution is very helpful for the development of the country.

d. **Development of Backward areas:** Some areas remain neglected because facilities needed for setting up new units are not available. In order to help the backward areas, financial institutions, provide special assistance to entrepreneurs for setting up new units in these areas. IDBI, IFCI, ICICI give priority in giving assistance to units set up in backward areas and even charge lower interest rates on lending. These units also improve basic amenities and create employment opportunities. And these measures will help in increasing the economic development of backward areas.

e. **Planned development:** Financial institutions help in planned development of the economy. Different institutions earmark their spheres of activities so that every business activity is helped. Some institutions like SIDBI, etc help especially small scale sector while IFCI and SIDC's Finance large scale sector. The institutions also follow the developments priorities set by central and state governments. They give preference to those activity which are

specifies in industrial policy statements and in five year plans.

f. Accelerating Industrialization: The setting up of more and more industries will generate direct or indirect employment, making available goods and services in the country. These institutions provide required financial, managerial, technical, help for setting up new units. Since 1947, financial institutions have played a significant role in accelerating the pace of industrialization. The country has progressed in almost all areas of economic development.

g. Employment generation: These institutions not only generate direct or indirect employment but also they need the services of experts which help them in finalizing leading proposals. They help in creating employment opportunities in the backward areas by encouraging the setting up of units in those areas. It also creates new and better job opportunities.

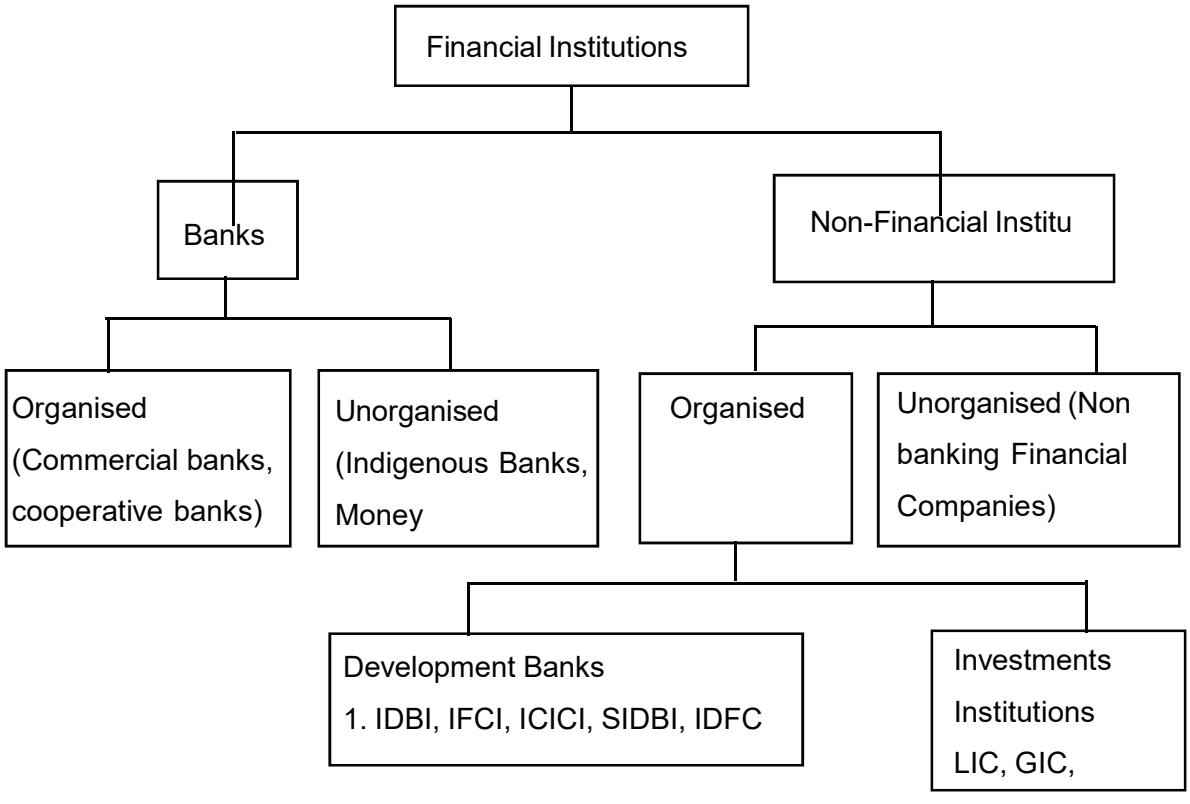
8.5 TYPES OF FINANCIAL INSTITUTIONS

Financial Institutions are of two types. They are:

a. Banking Institutions.

b. Non-Banking Financial Institutions.

Let us now discuss the types of Financial Institutions in the following ways:



8.5.1 Banking Institutions

The RBI as the apex institution organizes runs, supervises, regulates and develops the monetary system and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulations Act 1949. The Indian Banking Institutions can be broadly classified into two categories:

Organized Sector:

a. **Commercial banks:** The commercial banks may be scheduled banks or unscheduled banks. At present only one bank is a non – scheduled bank. All other banks are scheduled banks. The commercial banks consist of 27 public sector banks, private sector banks and foreign banks. Prior to 1969, all major banks with the exception of State bank of India were in the private sector. An important step towards public sector banking was taken in July, 1969, when 14 major private banks with the deposit base of Rs 50 crores or more were nationalized. Later in 1980, another 6 were nationalized bringing up the total number of banks nationalized to 20. Commercial banking system in India consisted of 297 scheduled banks, including foreign banks and one non scheduled bank at the end of December 2000. Traditionally, commercial banks accept deposits and met the short and medium term funding needs of the industry. But now, since 1990, banks are also funding the long term needs of the industry, particularly the infrastructure sector.

   A major development in the Indian Banking system was the entry of major banks in merchant banking. The merchant bankers are financial intermediaries providing a range of financial services to the corporate and investors. Some of the merchant banker activities include issue management and underwriting, project counselling and finance, mergers and acquisition advice, portfolio management services etc.

b. Co-operative banks: An important segment of the organized sector of Indian banking is the co-operating banking. The segment is represented by a group of societies registered under the acts of the states relating to co-operating societies. In fact, co-operative societies may be credit societies or non credit societies.

   Different types of co-operating credit societies are operating in the Indian economy. These institutions can be classified into two broad categories: a. rural credit societies which are primarily agricultural. b. Urban credit societies which

are primarily non-agricultural. For the purpose of agricultural credit there are different co-operative credit institutions to meet different kinds of needs. For example, short and medium term credit is provided through three-tier federal structure. At top is the apex body, i.e. state co-operative bank, in the middle there are district co-operative banks or central co-operative banks, at the grass root level i.e. village level there are primary agricultural credit societies. For medium to long term loans to agriculture, specialised co-operatives societies have been formed. These are called "Land Development Banks". The Land Development Banks movement started in 1929.

c. Regional Rural Banks (RRBs): *R*egional Rural Banks were set up by the state government and the sponsoring commercial banks with the objective of developing the rural economy. Regional Rural Banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas. The RRB was set up with the view to provide credit facilities to weaker sections. They constituted an important part of the rural financial architecture in India. There were 196 RRBs at the end of June 2002, as compare to 107 in 1981 and 6 in 1975. IDBI, NABARD and SIDBI are also required to provide managerial and financial assistance to RRBs under the Regional Rural Bank Act.

   The State Bank of India took several measures of managerial and financial restructuring including enhancement of issued capital and placements of officers of proven ability to head the RRBs. NABARD took several policy measures such as quarterly/ half yearly review of RRBs by the sponsor banks, framing of appointment and Promotional Rules 1998 for the staff of RRBs, introduction of Kisan Credit Cards, introduction of self help groups etc. for improving the overall performance of RRBs.

d. Foreign Banks: Foreign banks have been in India from British Days. ANZ Grindlays Bank has its presence in number of places with 56 branches. The Standard and Chartered Bank has 24 branches and Honkong Bank 21. All other foreign banks have branches less than 10. Obviously, these banks have concentrated on corporate clients and have been specializing in areas relating to international banking.

Unorganized Sector:

a. Indigenous Bankers: Indigenous bankers are the forefathers of modern

commercial banks. These are the individuals or partnership forms performing the banking functions. They also act as financial intermediaries. As the term indigenous indicates, they are the local bankers. The geographical area covered by the indigenous bankers is much larger than the area covered by the commercial banks. They can be found in all parts of the country although their names, styles, of functioning may differ. In West India they may be known as Gujarati shroffs or Marwari, in south India they may be called Chettiars, in the north India they may be called sahukars etc.

The dominance of indigenous bankers can be seen from the fact that they not only provide credit to trade and commerce but at times to the government of the day also.

According, to the Indian Central Banking Enquiry Committee (1931), an indigenous banker is any individual or private firm receiving deposits and dealing in hundies or lending money. Although deposit side is emphasized, these banks do not necessarily depend upon this source entirely, like modern commercial banks. Many among them also use large funds of their own. As against this, money lenders are those whose primary business is money lending, such essential banking functions as receiving of deposits or /and dealing in hundies are outside their operation.

Indigenous bankers provide finance for productive purposes directly to trade and industries and indirectly, through money-lenders and traders to agriculturists with whom they find it difficult to establish direct relations. They keep in touch with traders and small industrialists and finance marketing on a sizeable scale.

b. Money Lenders: Money lenders depend entirely on their own funds for the working capital. Money lenders may be rural or urban, professional or non-professional. They include large farmer's merchants, traders, goldsmiths village shopkeepers, sardars of labourer etc. The methods and areas of operation differ from the money lender to money lender. The main characteristics of money lender are as follows:

a. Their funds are own funds.
b. Their clients are mainly the weaker section of society.
c. Their loans are highly exploitative. They charge very high rates of interest.
d. Their operations are entirely unregulated.
e. The credit is prompt and flexible.

Money lenders can exploit the weaker sections as they are fully dependant on them. They enjoy monopoly in their area of operation.

CHECK YOUR PROGRESS

Q 1: Define Financial Institutions.

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Q 2: Mention two types of assistance provided by the financial Institutions.

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8.5.2 Non-banking Institutions

The non banking Institutions may be categorized broadly into two groups:

a. Organised Financial Institutions
b. Unorganised Financial Institutions

Organized Financial Institutions: The organized Non banking Institutions include:

A. Development Finance Institutions: Which include the institutions like IDBI, IFCI, IIBI, IRDC at all India Level, State Finance Corporations (SFCs), State Industrial Development Corporations at the state level, Agricultural Development Finance Institutions as NABARD, etc.

Development banks provide medium and long term finance to the corporate sector and industrial sector also takes up promotional activities for economic development of the country.

B. Investment Institutions: It includes those financial institutions which mobilize savings of the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC, UTI and mutual funds.

Unorganised Financial Institutions: The unorganized non-banking financial institutions include number of non-banking financial companies (NBFCs) providing whole range of financial services. These include hire purchase and consumer finance companies, leasing companies, housing finance companies, factoring companies, merchant banking companies etc. NBFCs mobilize public funds and provide loan

able funds.

8.6 MERCHANT BANKS

Merchant banking is a service-oriented industry specializing in investment and financial decision making. It also assists in making corporate strategies, assessing capital needs and helping in procuring equity and debt funds for corporate sectors and ultimately helping in establishing a favourable economic environment. Moreover, merchant bankers perform capital issue management activities-as Lead Managers/ Book Running Lead Managers in intermediary, consultant and liaison services- in India.

A merchant banker, according to the Securities and Exchange Board of India (Merchant Bankers) Regulations 1992, "is a person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management".

A merchant banker also plays the role of a rehabilitator at the time of acquisition, merger, take over, amalgamation, etc. Many merchant banks also acts as agents for their clients companies for maintaining registers of shareholders and debentures holders and to act as transfer agents and paying agents for interests and dividend, etc.

Merchant bankers' role extends to such a services as company formation, syndication of projects finance, workings capital management, FERA activities, global loans, international finance, feasibility explorations, mergers, capital restructuring, corporate tax planning, leasing finance, venture capital, etc. But to provide this large variety of services, the merchant bank has to possess a number of qualities. He should be an expert in the financial market and well versed with the activities involved in the promotion of an enterprise. Merchant banker should possess high integrity to inspire trust and confidence.

8.6.1 Importance of Merchant Banking in India

In fact, merchant bankers are regarded as specialized banks with expertise in areas like: (i) corporate counseling; (ii) project counseling and pre-investment study; (iii) credit syndication and project finance; (iv) corporate re-structuring; (v) capital issue management; (vi) underwriting; (vii) portfolio management; and (viii) venture capital financing. These institutions also render exclusive services to clients in procuring

and managing funds from the public. Merchant bankers in India play a major role in the capital issue management of corporate securities.

The following are the importance of Merchant Banking in India is:

- ***Incapability of Managing Agency House:*** In India, during the pre-Independence period, managing agency houses also functioned as issue houses in: managing securities; planning long-term investments; and contributing risk capital in project development. Managing new issues of corporate securities was performed by a few prominent houses and, as a consequence, investment practices of common investors were not so encouraging;
- ***Demand for Economic Development:*** The post- Independence era was faced with an under-developed capital market and economy because of a static economic environment and a monopolistic managing agency system. The services- rendered by these managing agency houses- were found to be inadequate and their performance was subjected to rigorous criticism resulting in the abolition of the system in 1956 when the Indian Companies Act was drastically amended.
- ***Growing Industrialization:*** Developmental activities, in the late sixties, carried on by Indian trade and industries led to excess demand for fund for expansion, modernization and for diversification of corporate entities. However, this requirement could not be met by the financial institutions including banks, which ultimately prompted those entities to enter into the capital market for generating long-term funds.
- ***Developing Technologically Advanced Industries:*** With the process of economic as well as technological development in India, the absence of specialized institutions was seriously felt at every stage and the Government of India started to make a search for the like institutions and subsequently the outcome was the emergence of such institutions rendering financial services to the corporate sectors.
- ***Recommendation for Specialized services****:* The Banking Commission, in its report in 1972, recommended the necessity of merchant banking services in financial institutions. The recommendation opened up new vistas for commercial banks and financial institutions to enter into merchant banking activities with specialized skills, expertise and updated knowledge.
- ***Gap between Managing Agency System & Specialized Services:*** The gap- in

the area of the managing agency system- was filled up by merchant bankers.

- ***Economic Reforms:*** The capital market in India has been in a state of transformation and growth since the early 1990s. The process of economic liberalization was also accompanied by a corresponding and parallel growth of financial institutions including that of merchant bankers.
- ***Positive initiative from the Government:*** The boost from the Government and the initiation of the de-bureaucratization process allowed merchant banking institutions to help industries in undertaking financial engineering effectively.
- ***Inadequacy of Entrepreneurs and Promoters:*** Entrepreneurs and promoters failed to arrange finance from the general public. They then approached the merchant bankers who took this opportunity to assist corporate sectors in rendering multifarious financial advisory services.
- ***Initiative from Regulatory Authority:*** The concept of merchant banking assumed a serious concern only after the Securities and Exchange Board of India (SEBI) felt it was an important intermediary in the functioning of capital market.
- ***Speedy Mobilization of Funds:*** With the growth of this specialized profession, corporate sector were able to raise the required finance, from capital markets, to meet the growing requirements for funds. Other core areas of work included expansion, modernization and diversification programmes to deal with increasing competition.
- ***Need for Encouragement of Small and Medium Industrialists:*** Merchant banks help industries and trade – including small and medium industries- to rise. They also help investors to invest saved money in sound and healthy concerns with confidence, safety and the expectation for higher yields. Merchant bankers make available finance for business enterprises acting as intermediaries.
- ***Promoting the Role of New Issues Markets in Mobilizing Savings:*** The need for merchant banking was felt in the wake of huge public savings lying untapped. Merchant banking can play a highly significant role in mobilizing the funds of savers to invisible channels assuring promising returns on investment. They also assist in meeting the widening demand for invisible funds for economic activities.

8.6.2 Role of a Merchant Banker

From the above mentioned services rendered by a merchant banker, it can be observed

that he is the most critical link between a company raising funds and the investors. He plays the role of a promoter, advisor, rehabilitator and an agent or intermediary for corporate enterprises. He translates the ideas into ventures by providing a number of promotional services such as identification of projects, preparing feasibility reports, obtaining Government approvals, raising funds for the project, etc.

After the project is promoted, a merchant banker acts as a **corporate advisor** and renders a number of services for the successful running of the enterprise. His expert advice on certain issues such as financial planning, tax planning, issues management, credit syndication, investment management, etc is of immense help to the entrepreneurs.

As a **managerial economist,** he guides the client on the aspects of organizational goals, location factors, organisation's size and operational scale, choice of a product and market survey, forecasting of products, cost reduction and cost analysis, allocation of resources, investment decision, capital management and expenditure control, pricing methods and marketing strategy, etc.

As a **financial and investment expert, a** merchant banker has to guide the corporate clients in areas covering financial reporting, projects measurement, working capital management, financial requirements and the sources of finance, evaluating financial alternatives, rate of return and cost of capital besides basic corporate changes of financial rearrangements, reorganizational, mergers and acquisitions, etc.

Merchant banker, acting as **' Manager' to the issue** settles the fee for advocate/solicitors' advice, accountants certification, broker's and bank's charges, underwriters' commission, printers' charges and advertising & publicity expenses and coordinates with syndicated merchant bankers and principal brokers, stock exchanges, etc. The responsibility for all this rests upon the merchant banker. If proper coordination is not done, the success of the issue may be rendered unassured.

8.7 MONEY MARKET INSTITUTIONS

The Institutions of money market are those which deal in lending and borrowing of short term funds. The Institutions of Money market are not the same in all the countries of the world; rather they differ from country to country. The commercial banks, central banks, acceptance houses, non-banking financial intermediaries (NBFI), brokers etc. are the major

institutions of money market.

These are discussed as under:

a. ***Commercial Banks:*** These are the back bone of the money market. They form one of the major constituents of money market. These banks use their short term deposits for financing trade and commerce for short periods. The commercial banks lend against promissory notes and through advances and overdrafts. The call money loans are also provided by these banks to the bill brokers and dealers in the stock exchange market. The commercial banks put their excess reserves in different forms or channels of investments which satisfy their conflicting principles of liquidity and profitability.

b. ***Central Banks:*** It plays a vital role in the money market. It is the monetary authority and is regarded as an apex institution. No money market can exist without the central bank. The central bank is the lender of the last resort and controller and guardian of the money market. The member banks may approach the central bank for loans and advances during emergency. It controls and guides the institutions working s in the money market. It helps in averting the possibilities of inflation and deflation. The central banks controls the money market through changes in the bank rate and open market operations, it does not enter into direct transactions.

c. ***Acceptance Houses:*** The institutions of acceptance houses developed in England where merchant bankers transferred their headquarters to London Money Market in the late 19th and the early 20th century. They function as intermediaries between importers and exporters and between lenders and borrowers in the short period. The acceptance houses performed a very useful role as merchant bankers. These houses specialized in the acceptance of trade bills/ commercial bills. A noteworthy point is that by accepting a trade bill they guaranteed the payment of the bill on maturity.

d. ***Non-Banking Financial Intermediaries:*** These also resort to lending and borrowing of short term funds in the money market. In Non-banking Financial intermediaries we include savings banks, Investment houses, insurance companies, building societies. Provident funds and other business corporation like chit funds.

e. ***Bill Brokers:*** In the developed money markets like the London Money Market and the New York Money Market, private companies act as discount houses. The main function of these companies is to discount bills on behalf of others. Besides these companies, there are bill-brokers who work as intermediaries between the borrowers and lenders by discounting bills of exchange at a small commission.

CHECK YOUR PROGRESS

Q 3: Give the definition of merchant banker.

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Q 4: Mention two institutions of money market.

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8.8 INSURANCE COMPANIES

Risk and uncertainties also prevail in the activities and professions of the individuals. Naturally, the people always try to stay secured against these risks and uncertainties. This requirement of individuals and entrepreneurs generates the need of the insurance. There exist numerous insurance companies who undertake the responsibility of covering the risk and uncertainties associated with human life and activities against a normal premium. These insurance companies company provide compensation to the individual or business concerns or theirs nominees in case of any accident. Thus, insurance is a contract of indemnity between insurer and insured. It can be treated as a contract that provides protection against a possible eventuality.

As per the oxford dictionary, insurance can be termed as 'an arrangement by which a company or the state undertakes to provide a guarantee of compensation for specified loss, damage, illness, or death in return for payment of a specified premium'.

Investopedia thinks, 'insurance is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from an insurance company.'According to 'The Economic Times', the insurance is 'a financial risk management tool in which the insured transfers a risk of potential financial loss to the insurance company that mitigates it in exchange for monetary compensation knows as the premium'.

To sum up, the concept of insurance can be better explained through the following information:

(i) Insurance is a contract of indemnity between insurer and insured.

(ii) It comprises two parties- insurer and insured.

(iii) It ensures compensation for the insured in case of any losses due to illness and accident within a specific time period against a specified premium.

In India, the insurance sector is colossal and growing at a speedy rate of 15-20 per cent. Along with banking services, insurance services add approximately 7 percent to the colony's GDP. A well- developed and evolved insurance sector acts as unmixed blessings for economic development as it provides long-term finance for infrastructure development.

8.8.1 Importance or need of Insurance organizations

The importance of insurance is felt in every aspects of the modern life. We have already mentioned that insurance refers to a contract by which an individual by which he can minimize the risk associated with his life. Similarly, an entrepreneur can ensure smooth running of his business by availing the facilities of insurance.

Now, we will discuss the importance of insurance in the following way:

1. **Minimization of risk:** An individual as well as a business person always has the experience of risk associated with his life or business. Different types of risk are involved in a person's life or business. A person can suffer from accident and illness. An entrepreneur can suffer from losses due to fire, labour unrest, theft, government policy etc. Insurance provide compensation to the individual or an entrepreneur against payment of premium. An individual can opt for life insurance policies to cover the risk of death or a general insurance policy to cover the possibilities of losses due to illness. Thus, insurance minimizes the risk associated with a person's life and business.
2. **Supply of finance:** The industrial concerns require a huge amount for smooth functioning. The premium collected by the insurance company is a great source of capital for the industries. In fact, the insurance companies are profit-making organizations who invest the accumulated premium of the insured into profitable sectors for good returns.
3. **Encouragement for saving:** Apart from banking institutions, the savers can easily put their savings into various insurance policies introduced by the companies. People with different income level can opt for policies specially designed for them. Thus, people are encouraged to save more. The investment in different policies not only creates the possibilities of higher return but also covers the risk associated with a person's life.
4. **Social security:** The insurance companies introduce various policies that comprise social security measures. The people in society are not free from risks such as loss of life and loss of body parts especially for the labourers of the factories. The different insurance

schemes of the companies ensure social security and, thus, improve the quality of life of the insured.

5. **Scope of the employment:** Since the insurance business is expanding, the requirement of qualified staff increases. The spread of insurance business is possible through the agents and sub-agents who work in the company on the commission basis. Apart from this, numerous branches of all reputed insurance companies, including the foreign insurance companies, are established in recent times, which require experienced and highly qualified professionals. Thus, there are huge opportunities of new employment generating from the insurance sector.
6. **Provisions of loan:** The insurance companies are not only selling insurance policies to the individuals or entrepreneurs to protect them from the risk associated with their life and business but also provide loans to the individuals and business corners. This makes the insurance companies more relevant in the financial market.
7. **Assistance to the government:** The insurance companies accumulate the premiums paid by the insured and invest it in various sectors for higher returns. With this huge fund, they also purchase government securities that will give assured returns. On the other hand, the purchase of government bonds improves the financial status of the government.
8. **Acting as a financial intermediary:** The insurance organizations act as a fianancial intermediary in the financial system. They accumulate the premiums paid by the insured and provide this fund as loans to the industries. This transfer of funds from savers to investors is essential for the growth of the financial system.
9. **Industrial development:** The insurances organizations collect the premiums for the insured and, with this accumulated fund, provide finance to the industries. We know, without finance, the industries cannot perform. The insurance organizations provide necessary finance to the industries, which leads to industrial development.
10. **Tax benefits:** As per Income Tax Act, 1961, there will be an income tax benefits for the premium paid for the life insurance. This tax rebate encourages the people to invest more in the insurance sector, and this contributes in the development of the insurance sector.
11. **Assistance in the foreign trade:** Sometimes, the traders in the foreign exchange market suffer from exchange risk and finally end up with huge amount of losses. Thus, a huge risk is involved in the foreign exchange market, which affects the exports and importers. Thus, foreign trade of a nation is adversely affected. In this context, various insurance

policies provide the opportunities to the foreign traders to reduce the risk. This acts as a boost to the expansion of the foreign trade.

12. **Tension-free life:** Being insured, the risk associated with life and business can be minimized or mitigated. In recent times, the changing lifestyle of the individuals increases the risks of lifestyle –related diseases and even death from this. The job-oriented tension and work-stress are responsible for these diseases. The insurance policies sold by the insurance companies reduce the risk, which include the policy-holders to enjoy a stress-free life. Thus, the quality of the life of the individuals improves with insurance.
13. **Maintenance of normal profit:** Without insurance, the business corners may suffer from huge losses and may not cover the average variable cost. Then, they have no option other than closing down.
14. However, **proper insurance policies** protect them from possible losses and ensure the compensation ion case of losses, so that they can be able to maintain their normal profit position.
15. **Economic development**: The insurance policies not only motivate the individuals to perform better but also act as an encouragement to the entrepreneurs. The individual can raise their productivity and the entrepreneurs can expand their business. This will definitely improve and develop the industrial base of the country. All these act as preconditions for the economic development.

Thus, from the aforementioned analysis, we can realize the importance of insurance business and the insurance organizations in the modern financial and economic systems.

8.9 FOREIGN INSTITUTIONAL INVESTORS (FIIs)

A number of measures were taken by the SEBI to increase liquidity in the stock market. The stock market was opened to **foreign institutional investors** (FIIs) for investment and this was one of the important characteristic too. FIIs were allowed to participate in the Indian capital market in September 1992. Earlier FIIs could investment in Indian securities only through the purchase of GDR, foreign currency convertible bonds (FCCBs) and foreign currency bonds issued by Indian issuers.

The SEBI Regulations, 1995, define *foreign institutional investor*, “as an institution established or incorporated outside India, which proposes to make investment in India in securities. They are eligible to purchase shares and convertible debentures issued by Indian

Companies under the Portfolio Investment Scheme (PIS)."

FIIs commenced their operations in the Indian Stock markets with a token investment of Rs 0.6 crores in January 1993. They have become active investors since 1993. FIIs such as mutual funds, pension funds and country funds are operating in Indian Capital Market.

Routes for Investment in Indian Stock Markets

There are three routes through which FIIs can invest in the Indian stock market. They are as follows:

a. Direct route
b. Participatory notes
c. FII sub-account

In the direct route, the foreign entity applies to the SEBI for registration as FII.

Participatory notes are overseas derivative instruments issued by SEBI registered FII to foreign investors for trading in the Indian stock market. These derivative instruments derive value from underlying securities such as equity and equity linked instruments. These foreign investors do not get registered with SEBI out of choice or regulatory issues. And as they are not registered with SEBI, the identity of the actual investor and source of funds remain disguised. The notes are generally issued by the India-based foreign brokerage houses. Citigroup, Morgan Stanley etc are some of the issuers of participatory notes. From February 2004, these notes against underlying Indian Securities can be issued only to regulated entities and further transfers can be made to other regulated entities only subject to compliance with 'know your client requirements.' In other words the participatory notes cannot be issued to unregulated entities like overseas corporate bodies and non-residents by FIIs.

Thirdly, FII sub-account means any person resident outside India, on whose behalf investment are proposed to be made in India by a foreign institutional investor and who is registered as a sub-account under SEBI (FII) regulations. The names of the sub-accounts on whose behalf the FII is investing are to be disclosed to SEBI by the foreign institutional investor. An institution or fund or portfolio established or incorporated outside India, A broad based fund can register as sub-accounts.

Again, FIIS must clearly segregate their account with that of sub-accounts. SEBI has also made in mandatory for FIIS to disclose all information relating to sub-accounts through joint undertakings. This also includes a submission in writing that the sub-account is not a NRI and the source of income is from known and legitimate means. FIIS can set up sub-account in Mauritius to enter India. While these account have a little administrative cost

which is less expensive than the participatory notes. Finally, India has a double taxation avoidance agreement (DTAA) with Mauritius which makes it an attractive platform for flow of investment to India.

Role of FIIs in the Indian Stock Market: The face of Indian stock market has changed due to the influence of FIIs. It was FIIs who eased the pressure on the rupee from the balance of payments position and lowered the cost of capital to Indian business. In the Indian companies the concept of corporate governance in adopted increasingly due to FIIs, which is benefiting domestic investors also. The FIIs were the first ones to identify the potential of the Indian technology stocks. FIIs have become the driving force behind the movements of stock indices in the Indian stock markets.

Rolling settlement was introduced at the insistence of FIIs, as they were uncomfortable with the badla system. The major beneficiaries of the rolling-settlement system are FIIs, as short-settlement cycles offer them a quick exit from the market.

Today, financial institutions and mutual funds including UTI can do little to help the stock markets at a time of crisis. FIIs inflows create a bull run which encourages participation of small investors. FIIs caused the bull run of 2003 which enabled the government to carry out its disinvestment programmes.

CHECK YOUR PROGRESS

Q 5: Define Foreign Institutional Investors.

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Q 6: What are the different routes of investment in the stock market?

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8.10 LET US SUM UP

After going through the unit we have come through the following:

- The various definitions of financial institutions, merchant banker etc.
- Also the importance of Insurance organizations.
- The role of FII in the Indian Stock Market.

- The various assistance of the financial institution for the development of the economy.
- Also about banking and non banking financial institutions.

8.11 FURTHER READING

1) Bharati V. Pathak (2018); I*ndian Financial System*; Pearson Education;Fifth edition.
2) Sujatra Bhattacharya(2017); *Indian Financial System* ;Oxford University Press.
3) M.Y.Khan(2017); *Indian Financial System*;McGraw Hill Education; Tenth edition.
4) Shashi. K. Gupta & Nisha Aggarwal (2014);*Indian Financial System;* Kalyani Publishers; 6 edition.

8.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Financial Institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet.

Ans to Q No 2: (1) Promotional Activities (2) Planned development.

Ans to Q No 3: A merchant banker, according to the Securities and Exchange Board of India (Merchant Bankers) Regulations 1992, "is a person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management".

Ans to Q No 4: (1) Commercial Banks and (2) Central Banks.

Ans to Q No 5: The SEBI Regulations, 1995, define *foreign institutional investor*, "as an institution established or incorporated outside India, which proposes to make investment in India in securities. They are eligible to purchase shares and convertible debentures issued by Indian Companies under the Portfolio Investment Scheme (PIS)."

Ans to Q No 6: The different routes are: a) Direct route

b) Participatory notes and c) FII sub-account.

8.13 MODEL QUESTIONS

Q 1: Explain the meaning of Money market.

Q 2: Explain the term Financial Institutions.

Q 3: Explain the importance of Insurance Organization.

Q 4: What are the different institutions of money market? Elaborate.

Q 5: Define the following:

a. FII

b. Commercial Banks

c. Money lenders

d. Insurance

Q 6: Write a note on Non-Banking Institutions.

Q 7: Write a detailed note on Banking Institution.

Q 8: What are the different types of assistance provided by financial institutions?

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UNIT 9: MUTUAL FUND

UNIT STRUCTURE

9.1 Learning objectives

9.2 Introduction

9.3 Meaning and Definition of Mutual Funds

9.4 Objectives of Mutual Funds

9.5 Features of Mutual Fund Investment

9.6 Importance of mutual funds

9.7 Types of mutual funds

9.8 Constituents of mutual funds

9.9 Systematic Investment plan (SIP)

9.10 SEBI (Mutual Funds) Regulation, 1996

9.11 Growth of Mutual Funds in India

9.12 Challenges faced by the mutual funds in India

9.13 Let us Sum Up

9.14 Further Reading

9.15 Answer to Check your progress

9.16 Model Questions

9.1 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

9.2 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.

9.3 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.

9.4 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.

9.5 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.

9.6 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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9.7 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.

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:

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.

9.8 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

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.	v) The main objective of close-ended fund is capital application.

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.

9.9 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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9.10 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.

9.11 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.

9.12 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.

9.13 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.

9.14 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets*. New Delhi, Deepand Deep Publication Pvt. Ltd.
2) Mishkin,Frederic S. (2007); *Financial Markets and Institutions*. New Delhi, Pearson Education Ltd.
3) Srivastava, R.M. (2009). *Management of Indian financial institutions.* New Delhi, Himalaya Publishing House.
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9.15 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.

9.16 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 10: DERIVATIVE

UNIT STRUCTURE

10.1 Learning objectives

10.2 Introduction

10.3 Meaning of Derivatives

10.4 Types of Derivatives

10.5 Traders in Derivatives Market

10.6 Foreign Exchange Market: Meaning and Scope

10.7 Dealers in Foreign Exchange Market

10.8 Exchange Rate

10.9 Let us Sum Up

10.10 Further Reading

10.11 Answer to Check your progress

10.12 Model Questions

10.1 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.

10.2 INTRODUCTION

In this unit we are going to discuss the various concepts related to derivatives.Derivatives are securities that derive their value from an underlying asset or benchmark. A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset.

At the end of this unit you we will get some idea about the advantages and disadvantages of derivatives, the different types of derivatives.Also we will discuss the current scenario of derivatives market in India.We will get some idea about forex market and the

structure of foreign exchange market.

Let us now discuss the meaning and its concepts in the following sections.

10.3 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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10.4 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 at and agreed rate in future.	A contract in which the parties agree to exchange the asset for cash at a fixed price and 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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10.5 TRADERS IN 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.

10.6 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.

10.7 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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10.8 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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10.9 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.

10.10 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets.* New Delhi, Deepand Deep Publication Pvt. Ltd.
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10.11 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.

10.12 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 11: FOREIGN EXCHANGE MARKET

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Meaning of Foreign exchange market

11.4 Evolution of foreign exchange market in India

11.5 Components of foreign exchange market

11.6 Importance of Foreign exchange market

11.7 Functions of Foreign exchange market

11.8 Structure of Foreign exchange Market in India

11.9 Measures initiated to develop foreign exchange market in India

11.10 Let us Sum up

11.11 Further Reading

11.12 Answers to Check Your Progress

11.13 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the meaning of foreign exchange market
- know the evolution of foreign exchange market in India
- discuss the importance of foreign exchange market
- learn the structure of foreign exchange market
- outline the functions of the foreign exchange market.

11.2 INTRODUCTION

The foreign exchange market is one of the important components of the international financial system. Especially, for the developing economy, the foreign exchange market is necessary for the conversion of currencies for short term capital flows or long- term investments in the financial physical assets of another country. The services of the foreign exchange markets are necessary not only for trade transactions but also for other financial receipts or payments between countries involving a foreign exchange transaction.

Globally, operations in the foreign exchange market started in a major 'way after the breakdown of the Bretton woods system in 1971, which also marked the beginning of floating exchange rate regimes in several countries. Over the years, the foreign exchange market has emerged as the largest market in the world. The decade of the 1990s witnessed a perceptible policy shift in many emerging markets towards reorientation of their financial markets in terms of new products and instruments, development of institutional and market infrastructure and realignment of regulatory structure consistent with the liberalised operational framework. The changing contours were mirrored in a rapid expansion of foreign exchange market in terms of participants, transactions volumes, decline in transaction costs and more efficient mechanisms of risk transfer.

11.3 MEANING OF FOREIGN EXCHANGE MARKET

The term foreign exchange refers to the process of converting home currencies into foreign currencies and vice versa. According to Dr. Paul Elinzing, "foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another".

The market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a market place in the physical sense of the term. In fact, it consists of a number a dealers banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central banks of each country and the treasury authorities who enter into his market as controlling authorities. Those engaged in the foreign exchange business are controlled by the Foreign Exchange Maintenance Act (FEMA)

CHECK YOUR PROGRESS

Q 1: Define foreign exchange market.

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Q 2: Why foreign exchange market is necessary for the developing economy?

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.....

11.4 EVOLUTION OF FOREIGN EXCHANGE MARKET

The origin of the foreign exchange market in India could be traced to the year 1978 when banks in India were permitted to undertake intra-day trade in foreign exchange. However, it was in the 1990s, that the Indian foreign exchange market witnessed far reaching changes along with the shifts in the currency regimes in India.

The exchange rate of the rupee that was pegged earlier was floated partially in March 1992 and fully in March 1993, following the recommendations of the Report of the High Level Committee on balance of payments (Chairman: Dr. C. Rangarajan). The unification of the exchange rate was instrumental in developing a market determined exchange rate of the rupee and an important step in the progress towards current account convertibility, which was achieved in August 1994.

A further impetus to the development of the foreign exchange market in India was provided with the setting up of an Expert Group on Foreign Exchange Market in India (Chairman: Shri O.P. Sodhani), which submitted its report in June 1995. The Group made several recommendations for deepening and widening of the Indian foreign exchange market. Consequently, beginning from January 1996, wide-ranging reforms have been undertaken in the foreign exchange market. After almost a decade, an internal technical group on the Foreign Exchange Market (2005) was constituted to undertake a comprehensive review of the measures initiated by the reserve bank and identify areas for further liberalisation or relaxation of restrictions in a medium-term framework.

The momentous developments over the past few years are reflected in the enhanced risk-bearing capacity of banks along with rising foreign exchange trading volumes and finer margins. The foreign exchange market has acquired depth (Reddy, 2005). The conditions in the foreign exchange market have also generally remained orderly. While it is not possible for any country to remain completely unaffected by developments in international markets, India was able to keep the spillover effect of the Asian crisis to a minimum through constant monitoring and timely action, including recourse to strong monetary measures, when necessary to prevent emergence of self-fulfilling speculative activities.

11.5 COMPONENTS OF FOREIGN EXCHANGE MARKET

There are three major components in this market, depending upon the transaction:

(i) Transactions between the public and the banks at the base level;

(ii) Transactions between the banks dealing in foreign exchange involving conversion of currencies; and

(iii) Transactions between banks and the central bank involving purchase and sale of foreign currencies.

11.6 IMPORTANCE OF FOREIGN EXCHANGE MARKET

India's foreign exchange market is one of the fastest growing across countries-a likely consequence of strong economic growth and the increasing depth and openness of domestic financial markets in the economy.

The Indian foreign exchange market has witnessed far reaching changes since the early 1990s, following the phased transition from a pegged exchange rate regime to a market determined exchange rate regime in 1993 and the subsequent adoption of current account convertibility in 1994. Market participants are provided with greater flexibility to undertake foreign exchange operation and manage their risks. There has been significant improvement in market infrastructure in terms of trading platform and settlement mechanisms. As a result the depth and liquidity of the market have improved significantly over the years.

Empirical evidence shows that foreign exchange markets in India are efficient, in the sense that while over the medium term, forward premier and interest differentials move together; in the short run deviations from uncovered interest pacify indicate that sterilised foreign exchange market intervention and monetary tightening can be effective in ensuring orderly conditions.

With the economy moving towards fuller capital account convertibility in a calibrated manner, focused regulation and monitoring of the foreign exchange market assumes added importance. In this context, there is a need to strengthen infrastructure, transparency and disclosure and product range in the forex derivatives segment. Strengthening the trading infrastructure, market conduct, transparency of OTC derivatives in the forex market, accounting and disclosure in line with international practices, including disclosures by non-bank corporate, needs to be done on a priority basis.

In the years to come, the foreign exchange market is likely to play a pivotal role in strengthening the Indian financial system and accelerate the process of economic development.

11.7 FUNCTIONS OF FOREIGN EXCHANGE MARKET

The most important functions of this market are:

(i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

(iii) To cover foreign exchange risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorized brokers.

(iii) Trading with banks abroad.

CHECK YOUR PROGRESS

Q 3: Give two importance of foreign exchange market?

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Q 4: Mention the functions of foreign exchange market.

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11.8 STRUCTURE OF FOREIGN EXCHANGE MARKET IN INDIA

The foreign exchange market in India is a three-tier structure comprising (a) the Reserve Bank at the apex, (b) Authorised Dealers (ADs) Licensed by the Reserve bank, and (c) customers such as exporters and importers, corporates and other foreign exchange earners. Apart from these main market players, there are foreign exchange money chargers who bring buyers and sellers together but are not permitted to deal in foreign exchange on their own account. The ADs are governed by the guidelines framed by the Foreign Exchange Dealers Association of India (FEAI). Dealings in the foreign exchange market include transactions between transactions between ADs and the exporters, importers and others customers, transactions among ADs themselves, transactions with overseas banks and transaction between ADs and the exporters, importers and other customers, transactions among ADs themselves, transactions with overseas banks and transactions between ADs

and the Reserve Bank.

As on March 31, 2008 there are 83 (category 1) Authorised dealers (ADs) operating in india-27 public sector banks 15 old private sector banks, 7 new private loans, 5 cooperative banks and 29 foreign banks. All Ads are required to become members of the FEDAI. All merchant transactions in the foreign exchange market have to be necessarily undertaken directly through Ads. However, to provide depth and liquidity to the inter-bank segment, ADs have been permitted to utilise the services of foreign exchange brokers who acts as intermediaries. All upgraded fully fledged money changers (FFMCs) and select regional rural banks (RRBs) and cooperative banks belongs to category 11 of ADs. Select financial institutions belong to category 111 of ADs.

Foreign Exchange Dealers Association of India (FEDAI) sets ground rules for fixation of commercial and other charges and involves itself in matters of mutual interest of ADs. The market trades freely in spot and forward exchange contracts, and to a limited extent in derivatives. The efficiency/ liquidity of the market is often gauged in terms of bid/offer spreads.

The total turnover in the foreign exchange market has been showing an increasing trend over the years.

CHECK YOUR PROGRESS

Q 5: Write some lines on the structure of Foreign exchange market.

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Q 6: Write two components of foreign exchange market.

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11.9 MEASURES INITIATED TO DEVELOP THE FOREIGN EXCHANGE MARKET IN INDIA

Institutional framework

- The Foreign Exchange Regulatory Act (FERA), 1973 was replaced by the market friendly Foreign Exchange Management Act (FEEMA), 1999. The reserve Bank delegated powers to authorised dealers (ADs) to release foreign exchange for a variety o9f purposes. Capital account transactions were also liberalised in a calibrated manner.

- In purchases of the Sodhani committee recommendations, the clearing corporation of India limited (CCIL) was set up in 2001.
- To further the participatory process in a more holistic manner by taking into account all segments of the financial markets, the ambit of the technical advisory committee (TAC) on money and Securities Markets set up by the Reserve Bank in 1999 was expanded in 2004 to include foreign exchange markets and the Committee was rechristened as TAC on Money, Government Securities and Foreign Exchange Markets.

Increase in Instruments in the Foreign Exchange Market

- The rupee-foreign currency swap market was allowed.
- Additional hedging instruments such as foreign currency-rupee options, cross currency options, interest rate swaps (IRS) and currency Swaps, caps/collars and forward rate agreements (FRAs) were introduced.

Liberalisation Measures

- Authorised dealers were permitted to initiate trading positions, borrow and invest in overseas market, subject to certain specifications and ratification by respective bank's Boards. Banks were also permitted to (i) fix net overnight position limits and gap limits (with the Reserve Bank formally approving the limits); (ii) determine the interest rates (subject to a ceiling) and maturity period of FCNR (B) deposits with exemption of inter-bank borrowings from statutory pre exemptions; and (iii) use derivatives products for asset- liability management.
- Participants in the foreign exchange market, including exporters, Indians investing abroad, and FIIs were permitted to avail forward cover and enter into swap transactions without any limit, subject to genuine underlying exposure.
- FIIs and NRIs permitted to trade in exchange-traded derivative contracts, subjects to certain conditions.

11.10 LET US SUM UP

After going through the unit we have come through the following:

- The meaning of foreign exchange market in detail.
- Also the functions of foreign exchange market.
- The importance of foreign exchange market.
- The various components of foreign exchange market.

- The structure of foreign exchange market in India.
- Various measures initiated to develop foreign exchange market in India.

11.11 FURTHER READING

1) Bharati V. Pathak (2018); I*ndian Financial System*; Pearson Education;Fifth edition.
2) Sujatra Bhattacharya(2017); *Indian Financial System* ;Oxford University Press.
3) M.Y.Khan(2017); *Indian Financial System*;McGraw Hill Education; Tenth edition.
4) Shashi. K. Gupta & Nisha Aggarwal (2014);*Indian Financial System;* Kalyani Publishers; 6 edition.

11.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another.

Ans to Q No 2: The foreign exchange market is necessary for the conversion of currencies for short term capital flows or long-term investments in the financial physical assets of another country.

Ans to Q No 3: (1) There has been significant improvement in market infrastructure in terms of trading platform and settlement mechanisms.

2. Market participants are provided with greater flexibility to undertake foreign exchange operation and manage their risks.

Ans to Q No 4: (i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

Ans to Q No 5: The foreign exchange market in India is a three-tier structure comprising (a) the Reserve Bank at the apex, (b) Authorised Dealers (ADs) Licensed by the Reserve bank, and (c) customers such as exporters and importers, corporates and other foreign exchange earners.

Ans to Q No 6: (i) Transactions between the public and the banks at the base level;

(ii) Transactions between the banks dealing in foreign exchange involving conversion of currencies

11.13 MODEL QUESTIONS

Q 1: Explain the meaning of foreign exchange market.

Q 2: What are the components of foreign exchange market?

Q 3: Explain the evolution of foreign exchange market.

Q 4: Write the functions of foreign exchange market.

Q 5: What is the importance's of foreign exchange market?

Q 6: Describe in detail the structure of foreign exchange market.

Q 7: What are the various measures taken to develop foreign exchange market in India?

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UNIT 12 : CREDIT RATING SERVICES

UNIT STRUCTURE

12.1 Learning objectives

12.2 Introduction

12.3 Meaning of Credit Rating

12.4 Types of Rating

12.5 Benefits of Credit Rating

12.6 Benefits of Credit Rating to the Company

12.7 Disadvantages of Credit Rating

12.8 Users of Credit Rating

12.9 Credit Rating Methodology

12.9.1 Business Risk Analysis

12.9.2 Financial Risk Analysis

12.9.3 Management Evolution

12.9.4 Fundamental Analysis

12.10 Steps involved in Credit Rating

12.11 Credit Rating in India

12.11.1 Credit Rating Information Services of India Limited (CRISIL)

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

12.11.3 Credit Analysis & Research Ltd. (CARE)

12.11.4 Fitch India Limited

12.11.5 ONICRA Credit Rating Agency of India Limited

12.11.6 Brickwork Ratings India Pvt. Limited (BWR)

12.11.7 SME Rating Agency of India Limited (SMERA)

12.12 SEBI Regulations of Credit Rating Agencies

12.13 SEBI Code of Conduct

12.14 Let us Sum Up

12.15 Further Reading

12.16 Answer to check your progress

12.17 Model Questions

12.1 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

12.2 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.

12.3 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.

12.4 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.

12.5 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.

12.6 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.

12.7 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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12.8 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 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.

12.9 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.

12.9.1 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.

12.9.2 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.

12.9.3 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.

12.9.4 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.

12.10 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.

12.11 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.

12.11.1 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.

12.11.2 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 instructions, 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.

12.11.3 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.

12.11.4 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.

12.11.5 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.

12.11.6 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.

12.11.7 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.

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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12.12 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

12.13 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.

12.14 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.

12.15 FURTHER READING

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.

✓ 12.16 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.

? 12.17 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 13: DEPOSITORY SERVICES

UNIT STRUCTURE

13.1 Learning objectives

13.2 Introduction

13.3 Meaning of Depository

13.4 Benefits of Depository

13.5 Depository Participant

13.6 International Securities Identification Number

13.7 Depository Process

13.8 Depositories in India

13.9 Let us Sum Up

13.10 Further Reading

13.11 Answers to Check your progress

13.12 Model Questions

13.1 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.

13.2 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.

13.3 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.

13.4 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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13.5 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.

13.6 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.

13.7 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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13.8 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.

13.9 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)

13.10 FURTHER READING

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.
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.

✓13.11 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.

?13.12 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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UNIT 14: REGULATION OF FINANCIAL MARKETS IN INDIA

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Concept of Regulation of Financial Market

10.4 Objective of financial market regulation

14.5 Regulators of Indian Financial Market

14.6 Reserve Bank Of India (RBI)

14.6.1 Regulatory Functions of RBI

14.7 Securities and Exchange Board of India

14.7.1 Objectives of SEBI

14.7.2 Functions of SEBI

14.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act,1956

14.7.4 SEBI and Regulation of Securities Market

14.8 Insurance Regulatory and Development Authority (IRDA)

14.8.1 Powers/Functions of IRDA

14.9 Pension Fund Regulatory and Development Authority (PFRDA)

14.9.1 Functions and Powers of PFRDA

14.10 Let Us Sum Up

14.11 Further Readings

14.12 Answer to Check Your Progress

14.13 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- define the concept of regulation of financial markets
- know the objectives of financial regulation
- identify the importance of Indian financial markets
- describe the various regulators of financial system
- outline the regulatory role of various regulatory bodies in the financial System
- describe the various initiatives for Regulation of financial market.

14.2 INTRODUCTION

A significant development of the 20th century, particularly in its later part, is expansion of financial market world over which mostly was driven by globalization, technology, innovations and increasing trade volume. India has not been an exception with probably largest number of listed companies with a very large investor population and ever increasing volumes of trades. Since the economic development of an economy is directly linked with the development of financial market, the effectiveness of monetary policies largely depend on the performance of financial market. A well-regulated financial market increases the level of confidence among the investors and insures them against the potential risk.

The regulation and supervision of the financial markets in India is carried out by different regulatory authorities. The Reserve Bank of India (RBI) regulates and supervises the major part of the financial system. The supervisory role of the RBI covers commercial banks, urban cooperative banks (UCBs), and nonbanking finance companies (NBFCs). Some of the financial institutions, in turn, regulate or supervise other institutions in the financial sector, for instance, Regional Rural Banks and the Co-operative banks are supervised by National Bank for Agriculture and Rural Development (NABARD); and housing finance companies by National Housing Bank (NHB). Department of Company Affairs (DCA), Government of India regulates deposit taking activities of corporate, other than NBFCS registered under companies Act, but not those which are under separate statutes. The Registrar of Cooperatives of different states in the case of single state cooperatives and the Central Government in the case of multi-state cooperatives are joint regulators, the RBI for UCBs, and NABARD for rural cooperatives. Whereas RBI and NABARD are concerned with the banking functions of the cooperatives, management control rests with the State/ Central Government. This “dual control” impacts the supervision and regulation of the cooperative banks. The capital market, mutual funds, and other capital market intermediaries are regulated by Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector; and the Pension Funds Regulatory and Development Authority (PFRDA) regulates the pension funds.

India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, IRDA and PFRDA – was not designed; it has evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time. Each regulator has their own rules on registration, code of conduct, commissions and fees

to monitor the product providers and distributors. RBI, SEBI and IRDA have grievance redress procedures through sector financial Ombudsmen services. The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act, 1992, in order to protect the interests of the investors in securities as well as promote the development of the capital market. It involves regulating the business in stock exchanges; supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc; as well as prohibiting unfair trade practices in the securities market.

14.3 CONCEPT OF REGULATION OF FINANCIAL MARKET

The functioning of financial markets is regulated by several legislations that include Acts, Rules, Regulations, Guidelines, Circulars, etc. Understanding the legislations governing the financial markets in India will give the reader a fair idea of how the financial markets in India are regulated. The regulators of the financial market lay down specific rules of behaviour for participants in the financial system and provide for the monitoring of the observance of the rules and regulation. Such regulations became more important in the situations of far reaching technological progress, liberalization and greater integration in the financial system.

14.4 OBJECTIVES OF FINANCIAL MARKET REGULATION

Following are the objectives of financial market regulation :-

(A) To protect the interest of the investor and consumer of the financial services.

(B) To maintain stability in the financial system.

(C) To reduce the fraudulent activities in the financial system.

(D) To provide confidence to the small investors to invest in the financial market

(E) To provide easy and flexible financial transaction.

14.5 REGULATORS OF INDIAN FINANCIAL MARKET

In Indian financial system each financial services is regulated by the individual regulators.The following table will give us an India about who regulate what.

Regulator	Financial Services and Schemes
RBI (Reserve Bank of India)	Fixed deposits and other banking products and services
SEBI (Securities and capital Exchange Board of India)	Services in the capital market and market intermediaries
Insurance Regulatory and Development Authority (IRDA)	Insurance Sector
Pension Fund Regulatory and Development Authority	New Pension Scheme

14.6 RESERVE BANK OF INDIA (RBI)

The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system. In exercise of the powers under these Acts, the RBI regulates the entry into banking business by licensing, exercise controls over shareholding and voting powers of shareholders, exercises control over managerial persons, and regulates the business of the bank by permitting and prohibiting certain business. RBI also supervises the functioning of the banks operating in the country by inspecting and issuing directions from time to time in public interest and in the interest of the banking system as a whole. It also gives directions to the bank to adhere the norms laid down by it or by the Bank for International Settlement for maintaining an international standard in the operations of banks relating to capital adequacy, asset classification, income recognition, management quality, efficiency, liquidity and surveillance. The bank also regulates the functions of other banks by giving directions in respect of interest rates, lending limits, investment limit and other matter. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. Under the Reserve Bank of India (Board of Financial Supervision) Regulations 1994, a separate Board for Financial Supervision (BFS) was set up within the Bank. The objective of this Board is to strengthen supervision and surveillance over the financial system and to provide a sharper focus to supervisory policy and skills. This Board covers banks, non-banking financial institutions and other para-banking institutions.

14.6.1 Regulatory functions of RBI

The regulatory and supervisory functions of the RBI may be summed up as follows:

1. **Power to issue license:** The RBI grants license to banks for carrying out banking business. License is given to the new banks as well as to the existing banks for branch expansion and for opening extension counters, new branches, even to close down existing branches.
2. **Power of appointment and removal of banking board/personnel:** An amendment Act passed in 1963, which became effective February 1, 1964, gave further powers to the Reserve Bank, particularly to restrain the control exercised by particular groups of persons over the affairs of banks and to restrict loans and advances as well as guarantees given by banks. It also enlarged the Reserve Bank's powers of control in the appointment and removal of banks' executive personnel. Further, The RBI is empowered to supersede, after consultation with the central government, the Board of Directors of banking companies and to appoint an Administrator. On recommendation of RBI, the central government may supersede the Board of Directors of nationalized banks, SBI and subsidiary banks of SBI under certain circumstances and appoint Administrator.
3. **Powers to regulate the business of banking:** The Reserve Bank of India Act, 1934 (RBI Act) empowers the Reserve Bank of India (RBI) to issue rules, regulations, directions and guidelines on a wide range of issues relating to banking and the financial sector.
4. **Power to give directions to banks:** The RBI is empowered to give directions from time to time to other banks operating in India regarding various banking and other activities. Section 21 (3) of RBI act further lays down that every bank shall be "bound to comply with any direction given by Reserve Bank".
5. **Power to inspect and supervise banks:** The Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts; and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.
6. **Power to conduct audit of the banks:** Where the Reserve Bank is of opinion that it is necessary in the public interest or in the interest of the banking company

or its depositors to do so, may at any time by order direct that a special audit of the banking company's accounts, for any such transaction or class of transactions or for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order either appoint a person duly qualified under any law for the time being in force to be an auditor of companies or direct the auditor of the banking company himself to conduct such special audit and the auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company.

7. **Powers relating to moratorium, amalgamation and winding up:** The RBI can make an application to the High Court for the winding up of the banking company, in respect of which an Order of Moratorium has been issued by the High Court.
8. **Power to impose norms of practice and maintenance of accounts:** The RBI can impose norms of practice and maintenance of accounts to other banks operating in India from time to time in accordance to the changing scenario of accounting practices prevailing in India.
9. **Power to collect and furnish credit information:** The RBI may at any time direct any banking company to submit to it such statements relating to such credit information and in such form and within such time as may be specified by the Bank from time to time
10. **Power to impose penalty:** The RBI can impose penalty on any banking company if it violates norms and practices as defined under banking law prevailing in India.

Recently a provision was incorporated by the Information Technology Act, 2000 which enabled the RBI to make regulations for regulating payment systems of banks and financial institutions.

CHECK YOUR PROGRESS

Q 1: Mention two objectives of financial regulation.

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Q 2: Mention two regulatory functions of RBI.

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14.7 SECURITIES AND EXCHANGE BOARD OF INDIA

The Securities and Exchange Board of India was established on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.

The reason the SEBI was constituted was because before the SEBI law relating to the securities market in India was contained in different enactments like Companies Act, 1956, Securities Contract (Regulation) Act, 1956, and the Capital Issues (Control) Act, 1947. The capital market witnessed a tremendous growth during 1980's, characterised particularly by the increasing participation of the public. This ever expanding investor's population and market capitalisation led to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants and others involved in the securities market. The glaring examples of these malpractices include existence of self –styled merchant bankers, unofficial private placements, rigging of prices, unofficial premium on new issues, non adherence of provisions of the Companies Act, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. These malpractices and unfair trading practices have eroded investor confidence and multiplied investor grievances. The Government and the stock exchanges were rather helpless in redressing the investor's problems because of lack of proper penal provisions in the existing legislation. In view of the above, the Government of India decided to set-up a separate regulatory body known as Securities and Exchange Board of India.

14.7.1 Objectives of SEBI

The overall objective of SEBI is to protect the interests of investors and to promote the development of, and regulate the securities market. This may be elaborated as follows:

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.
2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.
3. To prevent trading malpractices and achieve a balance between self regulation by the securities industry and its statutory regulation.

4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

14.7.2 Functions of SEBI

Keeping in mind the emerging nature of the securities market in India, SEBI was entrusted with the twin task of both regulation and development of the securities market. It also has certain protective functions, Which are mention bellow :-

Regulatory Functions

1. Registration of brokers and sub brokers and other players in the market.
2. Registration of collective investment schemes and Mutual Funds.
3. Regulation of stock brokers, portfolio managers, underwriters and merchant bankers and the business in stock exchanges and any other securities market.
4. Regulation of takeover bids by companies.
5. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.
6. Levying fee or other charges for carrying out the purposes of the Act.
7. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

Development Functions

1. Training of intermediaries of the securities market.
2. Conducting research and publishing information useful to all market participants.
3. Undertaking measures to develop the capital markets by adapting a flexible approach.

Protective Functions

1. Prohibition of fraudulent and unfair trade practices like making misleading statements, manipulations, price rigging etc.
2. Controlling insider trading and imposing penalties for such practices.
3. Undertaking steps for investor protection.
4. Promotion of fair practices and code of conduct in securities market.

14.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act,1956

The Securities Contracts (Regulation) Act, 1956 (SCRA) which was enacted to prevent undesirable transactions in securities and to regulate the business of securities had given certain powers to the Central Government, under the provisions of that Act. The functions of the Central Government under that Act have been granted to SEBI. These Functions are:

(a) Power to call for periodical returns or direct enquires to be made (Section 6): SEBI will receive from every recognized Stock Exchange such periodical returns relating to its affairs as may be prescribed by SCRA rules.

(b) Power to approve the bye-laws of stock exchanges: Section 9 of SCRA provides that any stock exchange may make bye-laws for the regulation ad control of contracts with the previous approval of SEBI.

(c) Power of SEBI to make or amend bye-laws of recognized stock exchanges (Section 10, SCRA): SEBI may either on a request in writing received by it in this behalf from the governing body of a recognized stock exchange or in its own motion make bye-laws on matters specified in Section 9 of SCRA or amend any bye laws made by stock exchange.

(d) Licensing of dealers in securities in certain areas (Section 17 SCRA): SEBI has been empowered to grant a license to any person for the business of dealing in securities in any State or area to which Section 13 of SCRA has not been declared to apply.

(e) Power to delegate: Section 29A of SCRA provides that the Central Government may, by order published in the Official Gazette, direct that the powers exercisable by it under any provision of the SCRA shall, in relation to such matters and subject to such conditions, if any as may be specified in the order, be exercisable also by SEBI or the Reserve Bank of India.

More Powers for SEBI: Certain additional powers with regard to certain provisions under the Companies Act, 2013, related to issue and transfer of securities and non-payment of dividend, in the case of listed public companies intending to get their securities listed on any recognized stock exchange, shall be administered by SEBI.

CHECK YOUR PROGRESS

Q 3: Mention two powers of SEBI.

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14.7.4 SEBI and Regulation of Securities Market

SEBI prescribes the conditions for issuer companies to raise capital from the public so as to protect the interest of the suppliers of capital (investors). The extensive disclosures prescribed for issuers facilitate informed investment decision making by investors while simultaneously ensuring quality of the issuer. Further, it has prescribed norms for such corporates on 'on going' basis and also during their restructuring (like substantial acquisition, buy back and delisting of shares) to safeguard the interest of investors. To ensure fair and high standards of service to investors, SEBI allows only fit and proper entities to operate in the capital markets as intermediaries. In this regard, it has prescribed detailed and uniform norms of their registration. Further, to ensure market integrity, it has prescribed norms for fair market practices including prohibiting fraudulent and unfair trade practices and insider trading. Detailed norms for safeguarding the interest of investors in secondary markets have also been prescribed. SEBI also prescribes conditions for operation of collective investor schemes, including Mutual Funds. SEBI tries to create favourable situation for the entry of investors with confidence in the market with a purpose to expand capital market particularly security market. SEBI's intervention has resulted into improvements in proper methods of transaction and to minimize defects and manipulations in them. But infrequently large improper transactions are taking place. For example, in 1992 Harshad Mehta used money from banks to make personal gains via investment in shares; in 1996 C R Bhansali raised public money through FDs, MFs and debentures via nonexistent firms and invested them in stocks for personal gains; in 2001 Ketan Parekh made Circular trading in selected stocks via borrowed money from banks to manipulate share prices; and in 2010 Sahara Chief Subrata Roy issued Sahara Housing Bonds to 29.6 million investors without following Sebi regulations and investor protection measures mentioned therein.

Activities of SEBI

The focus area of SEBI's activities are as follows:

- Increasing market transparency through further improvement of disclosure

standards

- Improving the standards of corporate governance
- Improving market efficiency by speeding up the process of dematerialization and introducing rolling settlement in a phased manner.
- Reducing transaction costs by refining the margin system
- Enhancing the market safety through an efficient margin system and stepping up surveillance.

SEBI has identified the following areas for focusing its attention for the overall growth and the development of the stock market in India:

- Registration of the stock brokers
- Authorization of Merchant Banker
- Monitoring and controlling of the mutual funds business.
- Issue of portfolio managers regulations.
- Issue of guidelines for disclosure and investor protection.

14.8 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY(IRDA)

The government in order to provide better insurance cover to citizens and also to augment the flow of long term sources of financing infrastructure, initiated reforms in the insurance sector by setting up of committee under chairmanship of R. N. Malhotra, former Governor of RBI. The Committee on reforms of the insurance sector recommended for the creation of a more efficient and competitive financial system in tune with global trends. It recommended amendments to regulate the insurance sector to adjust with the economic policies of privatization. The government in pursuance of the recommendation of the committee, decided to establish a Provisional Insurance Regulatory and Development Authority in 1996, to replace the erstwhile authority called the Controller of Insurance constituted under the Insurance Act, 1938, which initially worked under the Ministry of Commerce and later transferred to the Ministry of Finance. Finally, the decision to establish the Insurance Regulatory and Development Authority was implemented by the passing of the Insurance Regulatory and Development Authority Act, 1999. In India, presently after the opening up of the insurance sector, the regulator for the monitoring of the operations of the insurance companies is the IRDA, having its head office in Hyderabad. The regulatory framework mainly aims to focus on

three areas, viz.,

- The protection of the interest of the consumers
- To ensure the financial soundness of the insurance industry
- To pave the way to help a healthy growth of the insurance market where both the government and the private players play simultaneously.

Need of IRDA in Regulation of Insurance Businesses

Any industry wherein the stakes of the public are high would come within the purview of a Regulation – reason being that failure of such companies could result in serious implications on the economy of the country at large. Insurance business involves collection of money from various Policyholders, investing them properly, honouring the obligations of the Policyholders and providing an efficient service. It is important to ensure that the entities providing these services stick to their commitments. Failure to honour commitments by such entities could have major repercussions on the financial services industry. After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.

14.8.1 Powers/Functions of IRDA

Under Section 14 of the IRDA Act, IRDA has the following powers:

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

(c) Specification of requisite qualifications, practical training and code of conduct for insurance agents and intermediaries.

(d) Specification of code of conduct for surveyors and loss assessors.

(e) Promoting efficiency in the conduct of insurance business.

(f) Promoting and regulating professional organizations connected with insurance and reinsurance business.

(g) Levying fees and other charges for carrying out the purposes of the Act.

(h) Calling for information from or undertaking inspection of insurance companies, intermediaries and other oganisations connected with insurance business.

(i) Control and regulation of rates, terms and conditions that may be offered by general insurance companies.

(j) Specifying the form and manner in which books of account shall be maintained by insurance companies and intermediaries.

(k) Regulation of investments of funds by insurance companies.

(l) Regulation of maintenance of margin of solvency.

(m) Adjudication of disputes between insurers and insurance intermediaries.

(n) Supervising the functioning of Tariff Advisory Committee.

(o) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations.

(p) Specifying the percentage of insurance business to be undertaken by insurers in rural or social sectors.

(q) Such other powers as may be prescribed.

14.9 Pension Fund Regulatory Development Authority (PFRDA)

Pension Fund Regulatory and Development Authority (PFRDA) was established by the Government of India on 10th October 2003 to promote old age income security and to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental there to. The Central Government has introduced the National Pension System (NPS) with effect from 1st January 2004. The NPS covers, at present, new entrants to Central Government services (excluding Armed Forces), some State Government services and autonomous bodies at their discretion and all citizens of India on a voluntary basis with effect from 1st May 2009. PFRDA has since been constituted under the provisions of the PFRDA Act 2013 w.e.f. 1st February 2014. PFRDA is responsible for appointment of various intermediate agencies such as Central Record Keeping Agency (CRA), Pension Fund Managers, Custodian, NPS Trustee Bank, etc. Currently, PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

14.9.1 Functions and Powers of PFRDA

- Regulate and ensure orderly growth of NPS and other pension schemes.

- Registering and regulating intermediaries.
- Protecting interest of subscribers by ensuring safety of contribution and by ensuring that intermediation and operational costs under NPS are economical and reasonable.
- Promoting professional organisations connected with pension system, research and projects.
- Adjudicating of disputes between intermediaries and between intermediaries and subscribers.
- Residuary powers like inspection, conducting inquiries, investigation, audit.
- Powers of Civil Court for the purpose of examining persons, inspection of books, register etc.
- Powers of restrain, impounding and retaining proceeds etc.

CHECK YOUR PROGRESS

Q 4: Mention two powers of IRDA.

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Q 5: Mention two powers of PFRDA.

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14.10 LET US SUM UP

The main aspects covered in this unit are -

- The major aim of financial regulation is to maintain integrity of the financial market.
- The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system.
- The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.
- After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.

- PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

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14.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two Objectives of financial market regulation are:

(a) To protect the interest of the investor and consumer of the financial services.

(b) To maintain stability in the financial system.

Ans to Q No 2: Two powers of RBI are-Power to issue license and Powers to regulate the business of banking.

Ans to Q No 3: Following are the two powers of SEBI:

(a) To regulate stock exchanges and the securities industry to promote their orderly functioning.

(b) To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

Ans to Q No 4: Following are the two powers of IRDA

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

Ans to Q No 5: Following are the two powers of PFRDA

(a) Regulate and ensure orderly growth of NPS and other pension schemes.

(b) Registering and regulating intermediaries.

14.13 MODEL QUESTIONS

Q 1: Discuss the functions of SEBI.

Q 2: Discuss the regulatory powers of RBI.

Q 3: Discuss the powers and functions of IRDA and PFRDA.

Q 4: Explain the regulatory environment of financial markets in India.

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