PG EC S3-03 (DSC)

TWO YEAR MASTER'S DEGREE COURSE

(CBCS in Accordance with NEP 2020)

SEMESTER - III

Financial Systems

ECONOMICS

Surya Kumar Bhuyan School of Social Sciences

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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September, 2024

ISBN: 978-93-91026-16-5

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Printed and published by Registrar on behalf of the Krishna Kanta Handiqui State Open University

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The University acknowledges with thanks the financial support provided by the **Distance Education Bureau, UGC** for preparation of this material.

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COURSE INTRODUCTION

Financial System is one of the course of third semester of the M.A. in Economics programme of this University. The financial system refers to a set of institutional arrangement through which financial resources of the economy are mobilized from surplus to deficient units, channelizes the funds raised in productive activities, creating assets for people and contributes to the development of the economy. Financial system is a complex, well integrated set of subsystems, which comprises financial assets, financial institutioins, financial markets and financial services. This course covers all the subsystems of the financial system in a systematic manner so that learners can understand and go depth into the concepts of Financial system. This course comprises of 15 units.

The first unit of the course discusses the basics of financial system. This unit will help you to understand the meaning of the term financial system, objectives of the financial system, structure and nature of financial system, role of financial system and the interlinkage between financial system and economic development. The second unit deliberates on the constituents of financial system. Important concepts discussed in the unit include different components of a financial system such as financial instruments, financial markets & financial institutions; functions of financial system and importance of a financial system. The third unit will introduce you to the concept of money market. In this unit we will discuss the meaning, characteristics, structure, functions and instruments of money market. The fourth unit deals with the Treasury Bills and Commercial Papers. This unit explains about the meaning, features, types and role of Treasury Bills, Commercial Papers and Commercial Bills. Also a brief introduction to the concept of Certificate of Deposit is included in this unit. The fifth unit discusses about the call money market. This unit will help you to understand the meaning of call money market, role of call money and issues associated with monetary policy intervention in the money market. The sixth unit will help you to acquire knowledge about the capital market. In this unit we will discuss the meaning and functions of capital market, about the primary & secondary capital market, participants in the primary capital market and instruments of raising funds in the capital market. The seventh unit deals with the price determination in the money market. This unit will help you to understand the concept of Initial Price Offerings, determination of Offer Price of Initial Price Offerings and concept of book building with its merit and limitations. The eight unit of the course discusses about the secondary market. This unit will help you to understand the meaning, types & importance of secondary market and distinction between primary and secondary market. Apart from it, functions of secondary market & stock market, demutualization of stock exchange and stock market index are also discussed in this unit, which are very important to understand the secondary market.

The ninth unit will discuss about the mutual fund. This unit will help you to acquire knowledge about the concept, functions, classification and types of mutual fund. Apart from it, you will also learn about the net asset value and its calculation. The tenth unit will help you to understand about the debt market. The important concepts like participants in the debt market, instruments traded in the debt market, government security market have been discussed in this unit. The eleventh unit of the course discusses about the insurance sector. This unit will help you to understand the concept, nature, types, functions and role of insurance. Apart from it, this unit also explains the shortcomings of insurance sector. The twelfth unit deals with the banking sector. Thus, the topics like meaning, evaluation, types and structure of banking system have been discussed in this unit. The important reforms taken in the banking sector in India have been explained in this unit. The thirteenth unit describes the non- banking financial companies. In this unit, we will discuss about the nature, types, size & growth and role of such companies. The fourteenth unit deals with derivative market.In this unit we will discuss about the features, functions, participants and types of derivative market. The final unit deliberates on financial asset valuation. This unit will help you to acquire knowledge about the concept of financial asset valuation, methods of determining present value and future value of financial assets and valuation of debt instruments.

While going through a unit, you will notice some along-side boxes, which have been included to help you to know some of the difficult, unseen terms. Again, we have included some relevant concepts in "LET US KNOW" along with the text. 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. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with "ANSWERS TO CHECK YOUR PROGRESS" given at the end of each unit.

UNIT 1: INTRODUCTION TO FINANCIAL SYSTEM

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Meaning and Concept of Financial System

1.4 Objectives of Financial System

1.5 Structure of Financial System

1.6 Nature of Financial System

1.7 Role of Financial System

1.8 Financial System and Economic Development

1.9 Let Us Sum Up

1.10 Further Reading

1.11 Answers to Check Your Progress

1.12 Model Questions

1.1 LEARNING OBJECTIVES

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

- know the meaning, concept and structure of financial system
- explain the role/function of financial systems
- understand how financial systems helps in economic development

1.2 INTRODUCTION

For economic development to take place, a well-organized financial system is essential for any country. Financial system is itself a part of the overall economic system of a country. The strength of an economy is indicated by the strength of its financial system and vice-versa. The growth and development of an economy is a reflection of the growth and development of its financial system. Financial system provides an efficient mechanism by which savings are effectively transformed into investments. It also serves as an indicator to show to what extent the funds are mobilized effectively and to what extent the mobilized funds are deployed productively.

Thus a financial system is a complex, well integrated set of sub-systems of financial institutions, markets, instruments and services which facilitates the transfer and allocation of funds efficiently and effectively. The function of a financial system is to generate savings and invest it for capital formation which ultimately leads to economic growth. Therefore, a sound and efficient financial system can contribute to economic growth and development primarily in two ways namely-

- By providing a spectrum of financial assets to meet diverse preferences of ultimate savers.
- By raising the productivity of capital through efficient allocation.

In this unit we will basically discuss about the concept of Financial System.

1.3 MEANING AND CONCEPT OF FINANCIAL SYSTEM

The financial system refers to a set of institutional arrangement through which financial resources of the economy are mobilized from surplus to deficient units, i.e. from savers to borrowers.

The term Financial System comprises two terms, “Finance” and “System”. Finance means resources comprising ownership fund and borrowed fund while System indicates a set of complex and closely connected or interlinked components. So, financial system is a complex, well integrated set of subsystems, which comprises

- Financial assets
- Financial institutions
- Financial markets
- Financial services

These subcomponents of a financial system mobilizes resources for financing economic development, channelizes the funds raised in productive activities, creating assets for people and contributes to the development of the economy. The components of a financial system can be depicted by following diagram:

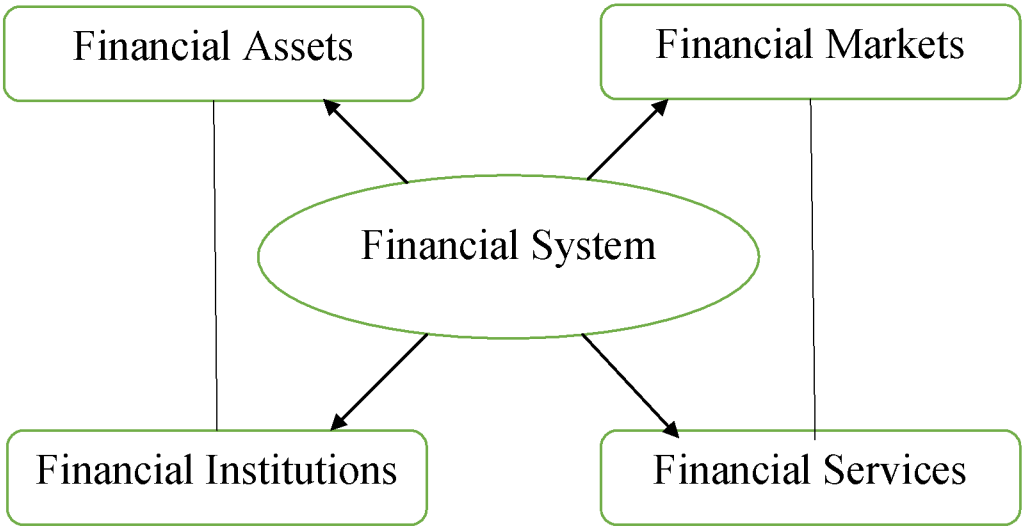


Figure1.1: Financial System

In simple words, financial system deals with money, credit and finance. Although they are very closely associated with each other, but they are also somewhat different from each other. First "Money" works as a medium of exchange or means of payment. Secondly 'Credit" or "Loan" is a sum of money to be returned with interest and finance is the management of money, in relation to companies, organizations and government.

Thus, financial system is such a system which aims at establishing and providing smooth, regular, cost effective and efficient linkage between depositors and investors.

1.4 OBJECTIVE OF FINANCIAL SYSTEM

The main objectives of a financial system of a country is to serve as a financial agent of socio-economic development in various fields, such as trade, industry, commerce and agriculture for facilitating the process of economic growth. This objective is achieved by providing support in following areas.

- Trade, commerce, industry and agriculture.
- Rural development
- Development of backward areas
- Housing, education, and health sectors
- Building infrastructure

- Provision for refinance facility
- Support for promotion of liquidity
- Research and development etc.



CHECK YOUR PROGRESS

Q 1: What is meant by Financial System? (Answer in about 20 words)

.....

.....

Q 2: State the objectives of financial system of a country. (Answer in about 40 words)

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1.5 STRUCTURE OF FINANCIAL SYSTEM

The structure of financial system is a framework or pattern or design, which is made by different components as shown below:

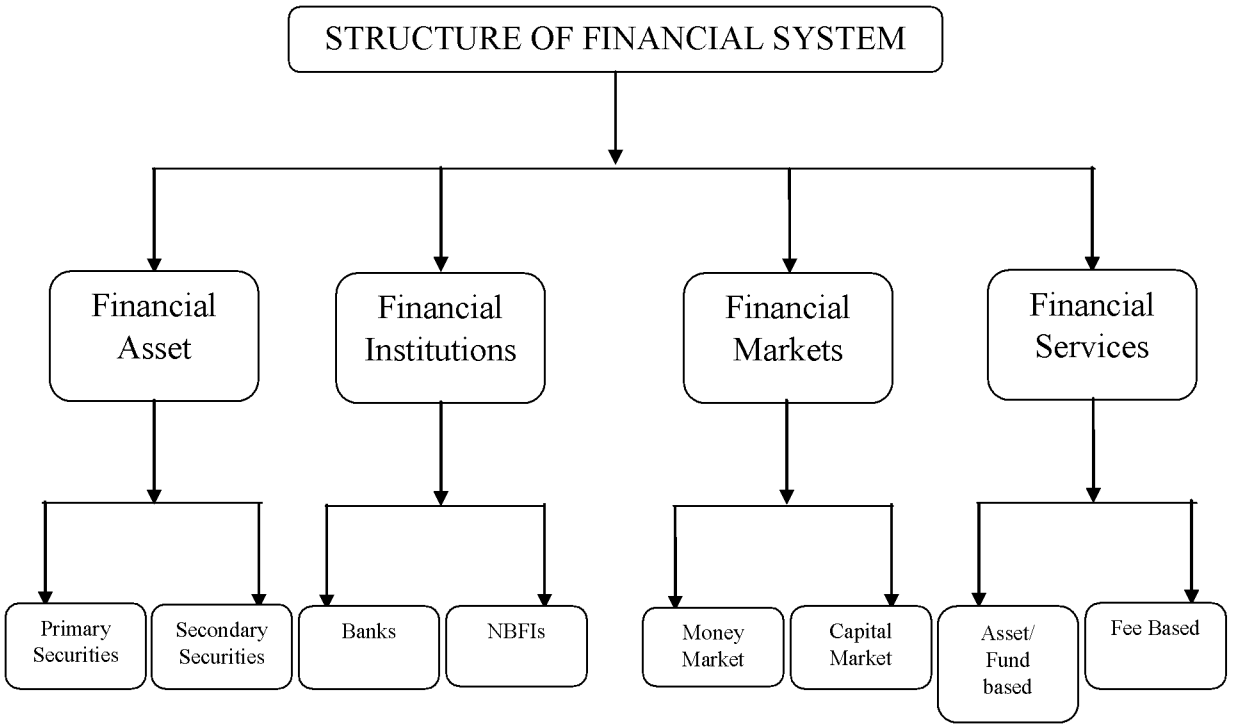


Figure1.2: Structure of Financial System

- **Financial assets** refer to those assets which are issued by the financial institution (FIs) or financial claims to raise funds from the public directly or indirectly. They are generally sub-divided under two broad heads- primary securities and secondary securities.

  The primary securities are financial claims against real-sector units. Bills, bond, equities are the examples of primary securities.

  The secondary securities are those financial claims which are issued by the financial institution against themselves to raise funds from the public. Currency, bank deposits, life insurance policies, units of UTI, IDBI bonds etc. are the examples of secondary securities.

- **Financial institutions** are business organizations engaged in the mobilization of saving from savers and channelizing the accumulated saving into profitable investments. They transform saving into capital. Financial institutions are those institutions which deal with the purchase and sell of financial assets. They are intermediary between surplus units and deficit spenders. They are generally classified under two heads- Banking and Non-banking financial institutions (NBFIs).The examples are banks, insurance companies, unit trust, investment companies, provident fund etc.

- **Financial market** is the market where financial assets are traded by the financial institutions. They are broadly sub-divided under two heads- money market and capital market.

  Money market deals with short term funds and capital market deals with medium and long term funds.

  The financial markets can be both- Organized or Unorganized. Financial markets are the most integral component of the financial system. It acts as the facilitating organization in the saving investment process.

- **Financial services** constitute an important components of the financial system. The efficiency of the financial system depends to a great extent upon the quality and variety of financial services.

Financial services refer to those activities of financial institutions which are concerned with the designing and delivery of financial products and advice to individual and business houses.

The different components consisting the structure of financial system discussed above depend on each other and interact on a regular basis. The smoother the interaction, the higher the efficiency of the financial system. Savings are mobilized by the financial institutions by the issue of financial instruments, which are traded in the financial markets.

1.6 NATURE OF FINANCIAL SYSTEM

A financial system plays a vital role in the economic growth of a country. It is an intermediary between the flow of funds belonging to those who save a part of their income and those who invests in productive assets. It mobilizes and allocates scarce resources of a country. Therefore, a financial system creates a sound economic environment, which in turn influences the firm's investing and financial decisions. Thus a financial system helps in-

- Financial system helps in transferring financial resources from one person to another. It includes financial markets, financial intermediaries, financial assets and services, which facilitates fund transfer within the economy.
- A financial system helps in allocating resources lying ideal with people into productive means. That is, a financial system obtains funds from savers and provides it to those who need it for development purposes.
- Diversification of risk in an economy is an important feature of a financial system. A sound financial system allocates funds in various sources because of which risk is diversified.
- The financial system helps to transform savings into investment and consumption. Financial system provides means and mechanism of transforming resources from those who have an

excess of income over expenditure to those who can make productive use of the same. It provides various income generating investment options to people.

- A financial system helps in maintaining liquidity in an economy. It helps in free movement of funds from households to corporate which results in availability of funds for investment.
- The different components of the financial system are closely interrelated and do change continuously. These components of the financial system do not function in isolation. Their interaction helps in the smooth functioning of financial system.
- There is the presence of strong, active, large sized non-banking financial institutions comprising stock markets, debt market, insurance components, mutual funds etc. in a financial system.
- The co-existence of both formal and informal financial sector is another important nature of a financial system. This co-existence of two sector is known as "Financial Dualism". Formal financial sector is well-organized and regulated, where as the informal financial sector is un-organized, non-institutional and non-regulated.
- In a developed financial system, there is strong and effective system of supervision, inspection, auditing and prudential norms.
- There is high level of current and capital account convertibility, minimum restrictions on foreign investment and repatriation of earnings in a financial system.
- There is effective and quick enforcement of financial contacts, recovery of debts and property rights in a developed financial system.
- The transaction cost and information cost in a well-developed financial system are low.
- There is a high degree of financial innovation in a financial system.

1.7 ROLE OF FINANCIAL SYSTEM

The financial system as a whole plays an important role in the smooth functioning of a modern complex economy and helps in promoting economic

development. The financial system helps in accelerating the volume of production, capital accumulation and growth by encouraging savings, mobilizing them and allocating them in alternative uses. Each of these functions is important and the role played by the financial system depends on how well it performs each of these functions. The major role/functions of the financial system are discussed under the following heads.

- **Acts as an intermediary**: A financial system acts as an intermediary between savers and investors by mobilizing saving from savers and providing it to investors for investment. Thus, a financial system creates a link between savers and investors by which there is growth of the economy due to increased investment.
- **Channelizes funds:** Another important role performed by financial system is that it channelizes flow of accumulated funds into profitable investment. In this way, financial system creates necessary capital for undertaking large scale investment.
- **Provides an efficient Payment system**: Financial system provides an efficient payment system for the exchange of goods and service and also ensures that funds move safely, quickly and in a timely manner. An efficient payment and settlement system contribute to the effectiveness of a financial system and thus overall economic growth can be achieved more quickly.
- **Transfer of financial resources:** Financial system facilitates transfer of financial resources across time and geographical boundaries. It also helps in creating an environment for trans-border flow of funds.
- **Controlling risks and uncertainties:** Financial system helps in managing and controlling uncertainty and risk. There are basically three basic means of controlling risk and uncertainty. These are-
  - Diversification of investment
  - Insurance
  - Hedging

  Financial system reduces risk by laying down rules governing the operations of the system. Risk reduction is achieved by holding

diversified portfolios and screening of borrowers. Risk is traded in the financial markets through financial instruments such as derivatives.

- **Generates information:** Another important role played by financial system is that it generates price related information. Financial markets disseminate information for enabling participants to develop an informed opinion about investment-disinvestment information of holding a particular asset. This information dissemination enables a quick valuation of financial assets.
- **Setting up of a Financial Structure:** Financial system helps in creation of a financial structure which facilitates lower transaction costs and higher returns. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing and encourage people to save more.
- **Monitors corporate performance**: By selecting the projects to be funded, financial system inspires the operators to monitor the performance of their investment. In this regard, both the financial markets and financial institutions helps corporate to perform profitability.
- **Provides facilities for Portfolio adjustment:** Another important role performed by financial system is that both the financial market and financial institution provide portfolio adjustment facilitates, Portfolio adjustment facilitates include services of providing a quick, cheap and reliable way of buying-selling a wide variety of financial assets.
- **Facilitates Financial deepening and broadening:** Financial system promotes the process of financial deepening and broadening. Financial deepening implies an increase of financial assets as a percentage of the Gross Domestic Product (GDP) on the other hand financial broadening implies increasing the number and variety of participants and instruments.



CHECK YOUR PROGRESS

Q 3: Show the structure of financial system. (Answer in about 30 words)

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Q 4: Discuss in brief the nature of financial system. (Answer in about 40 words)

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Q 5: Mention the various element/components of a financial system. (Answer in about 20 words)

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Q 6: Briefly explain the various roles played by a financial system. (Answer in about 50 words)

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Q 7: Mention the two broad categories of a financial market. (Answer in about 30 words)

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1.8 FINANCIAL SYSTEM AND ECONOMIC DEVELOPMENT

Economic development of a country cannot be thought of without the involvement of finance. An, efficient financial system can accelerate the process of economic development, or we can say, development and growth of financial system is a pre-condition of economic development and growth. Financial system provides diverse services through an array of instruments

and institution. The contribution of a financial system to the economy depends upon the quantity and quality of its services and efficiency with which it provides them. The components of a financial system serve as a driving force in transferring the country's saving towards productive uses, which ultimately increases the output in the economy. A good financial system helps in increasing savings, capital formation, investments, proper channelization of resources, technological development and which ultimately increases the rate of economic development. The various ways in which a financial system affects economic development can be discussed under the following heads-

- **Encouraging and motivating savings:** Financial system helps in accelerating the volume and rate of savings in the economy. By offering various financial services (such as the ease of access, nearness, better return of financial products), financial system can increase the growth of banking habits among people, which ultimately encourages and accelerates the saving rate of the economy.
- **Stimulates capital formation:** Financial system stimulates the process of capital formation through generation of saving, collection of saving and by channelization of the collected savings for productive utilization.
- **Increases investment:** A financial system helps to increase the volume of investment. It becomes possible for the deficit spending units to undertake more investment because financial system enables them to have command over capital.
- **Leads to balanced economic growth**: Usually the private entrepreneurs set up units at those places which are already developed. It causes regional imbalance in economic development. Operators of financial system (financial institutions) give priority in giving assistance to units set up in backward areas and even change lower interest rates on lending in these areas. Thus a financial system helps in balanced economic growth of a country by developing the backward areas.

- **Maintains financial discipline:** A well developed financial system plays a pivotal role in imposing financial discipline by which it can provide guidance in management of companies along with corporate governance policies in the economic system. Good corporate governance is regarded as a safe guard to maintain risk within acceptable limit and to ensure economic development.
- **Leads to employment generation:** Financial system helps in creating employment opportunities by financing new and existing industrial units through financial institutions. They help in creating employment opportunities in backward areas by encouraging the setting up of unit in those areas.
- **Influences real sector activities:** Financial systems influences real sectors activities through its functional ability. The reduction in information and transaction costs lead to development of financial market and intermediaries. Financial markets and institutions influence the rate of capital accumulation and technological innovations which are pre-requisites of economic development.
- **Facilitates Infrastructural development:** Infrastructural facilities (i.e. transport, power and communications) are the basic requisites of economic development of a country. In this regard a good financial system lays the priorities for infrastructural development and investment is made keeping in mind national requirements.
- **Development of risk management services:** Development of financial system increases the demand for more risk management services. Financial system meets this demand by helping the increase in trading services and by development of new risk management services.
- **Channelizes resources:** Various components of financial system help in proper distribution of resources toward the highest yield oriented investment for a given degree of risk. So, financial system channelizes the scarce resources towards productive uses, helping in economic development.

- **Accelerates industrialization:** Economic development of any country depends upon the level of industrialization. The setting up of more industrial units will generate direct and indirect employment opportunities, make available goods and services in the country and help in increasing the standard of living of the people. By providing requisite financial, managerial, technical help; a financial system through its financial institutions can set up new industrial units in those areas where private entrepreneurs are reluctant to take risk of investment. By doing so, financial institutions provide sufficient fund for industrialization of these areas and thereby economic development is accelerated.
- **International competitiveness:** By providing various financial services (such as leasing, hire purchase, factoring mutual funds, venture capital, merchant banking, credit rating etc.) a financial system can contribute a lot toward economic development of a country. It is found that the countries whose financial system has a diverse set of financial arrangements are able to maintain international competitiveness through updating their productive capacities.



CHECK YOUR PROGRESS

Q 8: How a well developed financial system and economic development is linked with each other? (Answer in about 40 words)

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1.9 LET US SUM UP

- Financial system refers to a set of well knitted and inter-related activity or services that work collectively for the achievement of some pre-

determined purpose or goal needed for economic development of a country. It is a set of institutional arrangements through which financial resources of the economy are mobilized from surplus to deficit units.

- The main objective of financial system of an economy is to serve as an financial agent of socio-economic development of various sector, such as trade, industry, commerce, agriculture, innovation and research etc.
- The structure of a financial system comprises the various components of financial system viz. Financial Asset, Financial Institutions, Financial Markets and Financial Services.
- Financial Asset refers to those assets which are issued by the financial institutions as financial claims to raise fund from the public directly or indirectly. They are divided as primary securities and secondary securities. Examples of primary securities and secondary securities are bills, bonds, equity etc. and secondary securities are currency, bank deposits, life insurance policies, UTI bonds etc.
- Financial Institutions are those institutions which are engaged in purchase and sell of financial assets. They are divided into two categories, Bank and Non-banking financial institutions (NBFIs). Examples are banks, insurance companies, provident funds etc.
- Financial Markets are the markets where financial assets are traded by the financial institutions. They are subdivided into money market and capital market, former deals with short term funds whereas the later deals with medium and long term funds. Financial markets are also divided into organized and unorganized sectors.
- Financial Services refer to those activities of the financial institutions which are concerned with the designing and delivery of financial products. Example of financial services are leasing, hire purchase, mutual funds, venture capital etc.
- So far as nature of financial system is concerned-
  - Financial system forms part of the overall economic development.

- Financial system consists of financial assets, financial institutions, financial markets and financial services.
- Elements of financial system are closely inter-related and do change continuously.
- Financial system facilitates growth and economic development through savings and investments.
- Co-existence and co-operation between formal and informal sector are important features of a financial system.
- There is a high degree of financial innovation in a financial system.

- The roles played by financial system are
  - It acts as an intermediary
  - Channelizes funds
  - Provides payment system and transfer of financial resources
  - Provides a way for controlling risk and uncertainty
  - Generates information
  - Helps in creation of financial structure which facilitates lower transaction costs and higher returns
  - Monitors corporate performance
  - Offers portfolio adjustment facilities
  - Promises the process of financial deepening and broadening
  - Provides liquidity to assets
- Presence of an efficient financial system accelerates the process of economic development by various ways. Such as,
  - Accelerates the rate of saving
  - Stimulates the process of capital formation
  - Channelizes scarce resources towards productive uses
  - Increases investment
  - Imposes and maintains financial discipline
  - Develops a risk management services
  - Influences real sector activities
  - Ensures balanced regional development
  - Accelerates industrialization
  - Creates employment opportunities

- Creates infrastructure facilities.



1.10 FURTHER READING

- Nag, R. (2011). *Indian Financial System*. Guwahati: Book Land.
- Sarma, A. (2013). *Elements of Monetary System*. Guwahati: Chandra Prakash.
- Gupta, K. S., Guota, N. & Chopra, A. (2017). *Money, Banking and Finance*. Ludhiyana: Kalyani Publication.



1.11 ANSWERS TO THE CHECK YOUR PROGRESS

Ans to Q No 1:

Financial system is a set of institutional arrangements through which financial resources of a country are mobilized from surplus to deficit units.

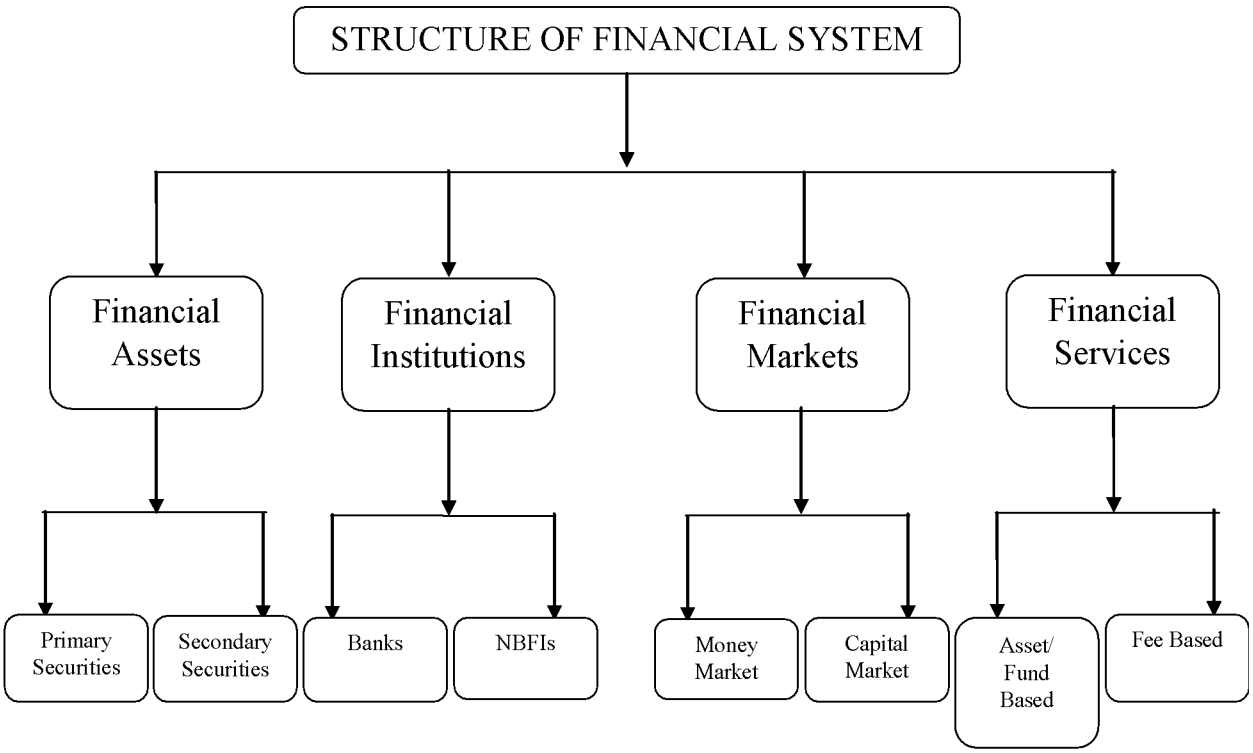
Ans to Q No 2:

The main objectives of a financial system are to serve as an agent of socio-economic development in various areas. Such as-

- To give support to trade, commerce, industry and organization
- To give support to rural development and backward areas
- To give support to housing, education, health, and infrastructure
- To make provision for refinance facility and give support for promotion of liquidity
- To help in price control and to research and development etc.

Ans to Q No 3:

The financial system as a whole operates through four major components. The structure of the financial system is shown below-



Ans to Q No 4:

The nature of financial system is that-

- Financial system forms part of the overall economic development
- Financial system consists of four elements i.e. financial asset, financial institution, financial market and financial service, by which it aims at establishing and providing smooth, regular, cost effective and efficient linkage between deposits and investments
- Elements of financial system are closely interrelated and do not change continuously
- It facilitates growth and economic development through savings and investment
- Co-existence and co-operation between formal and informal financial sector is an important feature of financial system of most developing countries.

Ans to Q No 5:

The major components or elements of the financial system are- Financial Assets, Financial Institutions, Financial Markets, and Financial Services.

Ans to Q No 6:

The role played by the financial system are-

- It helps the flow of funds from surplus to deficit units
- It acts as a intermediary between savers and investor through mobilizing saving
- It channelizes the flow of funds into profitable investment
- It provides a payment system for the change of goods and services
- It facilitates transfer of financial resources
- It provides a way for controlling risk and uncertainty
- It helps in creation of financial structure
- It monitors corporate performance
- It offers portfolio management facilities
- It promotes the process of financial deepening and broadening.

Ans to Q No 7:

Financial market is the market where financial assets are traded by the financial institutions. They are broadly sub divided in two heads- money market (deals with short term finance) and capital market (long term finance).

Ans to Q No 8:

There is a strong inter linkage between financial system and economic development as supply of finance affects the standard of living, level of National Income and employment of a country. Existence of an efficient financial system can accelerate the process of economic development in many ways, such as-

- Encouraging and motivating saving by deepening and widening the financial structure
- Channelizing the accumulated saving towards the most profitable investment, which increases capital productivity
- Facilitating the working of industrial sector, enhancement of trade and commerce, increasing employment opportunities with balanced regional development etc.



1.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Write five functions of financial system.

Q 2:. What are the major components of financial system?

Q 3: Write short notes on-

a) Financial market

b) Financial services

Long Questions (Answer each question in about 300-500 words)

Q 1:. Explain the importance and functions of the financial system in an economy.

Q 2: Explain the concept of a financial system. Discuss the components of the financial system.

Q 3: Explain the role played by a financial system in an economy.

Q 4: Explain the inter-relationship between financial system and economic development.

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UNIT 2 : CONSTITUENTS OF FINANCIAL SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Components of Financial System

- 2.3.1 Financial Instruments
- 2.3.2 Financial Markets
- 2.3.3 Financial Institutions

2.4 Functions of Financial System

2.5 Importance of Financial System

2.6 Let Us Sum Up

2.7 Further Reading

2.8 Answers To Check Your Progress

2.9 Model Questions

2.1 LEARNING OBJECTIVES

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

- know the concept of Financial System
- understand the various components of a Financial System
- know the differences between the Money Market and Capital Market
- learn about the different functions of a Financial System
- understand the importance of a Financial System in economic development.

2.2 INTRODUCTION

Economic growth and development of an economy basically depends upon a well developed and efficiently managed financial system. The term financial system means a set of sub-systems of financial institutions, financial markets, financial instruments and services which as a whole helps in mobilising resources from the surplus units of an economy and channelising the same to the deficit units. In fact, it refers to a set of

institutional arrangements through which various financial surpluses of an economy are mobilised from most of the surplus units and the same is transfer to the various categories of deficit spenders. The institutional arrangement includes all conditions and mechanism which govern the production, distribution, exchange, holding of financial assets or instruments etc. Besides, it covers some other area, like, working of financial markets, organisation of various financial instruments as well as the operation of such financial institutions.

The term 'System', which is used in case of financial system actually indicates a set of complex, intimately connected and interlinked instruments, agents, practices, transactions, markets, claims as well as various liabilities of the economy as a whole. As such, any modern economy which basically deals with money and credit is crucially dependent on the financial system. It is to be noted here that, the financial system is a broader concept as compared to the payments system. The financial system covers both cash and credit transactions where as the payments system deals with only cash payments. In the earlier unit we have already discussed about the concept of Financial System and in this unit we will discuss basically the constituents of Financial System in detail.

2.3 COMPONENTS OF FINANCIAL SYSTEM

There are basically three main components of financial system of a country and they are as in the following –

- Financial Instruments or Assets
- Financial Markets
- Financial Institutions.

Of course, in India, there are four components of financial system which can be stated as in the following –

- Financial Instruments or Assets
- Financial Markets
- Financial Institutions
- Financial Services.

A detailed explanation of the main three components, i.e., financial instruments, financial markets and financial institutions of financial system is given below –

2.3.1 Financial Instruments

The financial instruments or assets or securities are the claims which represent the future income and wealth of others. They are actually some claims against a person or an instrument for the payment of a sum of money at a specified future date. In fact, financial instruments are the 'Monetary Contracts' between parties. They are such a type of instruments which can be traded, modified and settled. These instruments or assets are the claims to money and perform some functions of money. They have high degree of liquidity, but are not as liquid as money itself.

To full-fill the various objectives of different investors of an economy, various types of instruments or securities are issued by the companies and financial institutions. These securities are basically classified into two broad categories and they are –

(a) Primary or direct assets or instruments

(b) Secondary or indirect assets or instruments

- **Primary or direct assets :** The primary assets or instruments are issued directly by the ultimate borrowers of funds to the ultimate savers or investors. In fact, the primary assets are the obligations of the ultimate borrowers and they create these assets in order to raise funds for financing their own deficit spending. The examples of primary assets are bills, bonds, equity shares, preference shares, book debits etc.
- **Secondary or indirect assets :** Secondary assets or instruments are not issued directly by the ultimate borrowers. Actually, these assets are the obligations of financial institutions as they are issued by the institutions to the ultimate savers or investors. In other words, secondary assets are the claims issued by financial institutions against themselves to raise

funds from the public. Life insurance policies, bank deposits, units of mutual funds, units of Unit Trust of India, IDBI bonds etc are the examples of secondary assets.

Depending upon the nature of claim or return, financial instruments may be further classified as in the following –

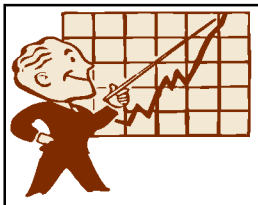
- **Equity Based** - Equity based instruments are those instruments which represent ownership of an asset, such as, equity shares, preference shares etc.
- **Debt-Based :** The debt-based financial assets are like, debentures, bonds, treasury bills, commercial bills etc.
- **Derivatives-Based :** Derivative based instruments are those which are derived from value of an underlying financial instruments. These include forwards, futures, options, swaps or mix of these all.

The most important financial instruments are - Cash or currency, Equity shares, Preference shares, Debentures or Bonds and Derivatives. All these instruments perform a significant role in diverting funds of an economy from the lenders to the borrowers through financial markets and financial intermediaries. It is to be noted here that each instrument differs from each other in terms of its marketability, risk, return, liquidity, transction costs etc. Since, 1990's, there has been a tremendous growth in new financial instruments which are issued by both the corporate sector and financial institutions. The most important among such new innovative financial instruments are - Equity Warrants, Secured Premium Notes, Collable Bonds, Deep Discount Bonds, Inflation adjusted Bonds, Easy Exit Bond with a Floating Interest Rate, Regular Income Bonds, Retirement Bonds, Index Bonds, Growth Bonds, Capital Bonds, Floating or Variable Rate Bonds etc.

At present in India, the most commonly used financial instruments comprise corporate equities, government and corporate bonds, bills, hundis currency, various types of deposits in commercial banks, post office savings deposits, compulsory deposits, deposits

with non-banking companies, provident fund contributions, pension funds, units of the UTI, life insurance policies, deposits with investment trust and investment funds, chit funds etc.

It is thus clear that in every modern economy financial instruments play a very important role specially in performing the basic functions of money.



CHECK YOUR PROGRESS

Q 1: What is meant by financial system?
(Answer in about 30 words)

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Q 2: What are the components of financial system?
(Answer in about 20 words)

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Q 3: What are the broad classification of financial instruments?
(Answer in about 30 words)

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2.3.2 Financial Markets

Another important component or constituent of financial system of a country is the financial markets. In a financial system, all kinds of operations take place through the various financial markets. The financial markets generally deal with various financial assets and instruments of different types like currency, bank deposits, cheques, drafts, bills, bonds etc.

Classification of Financial Markets : The financial markets are classified on the basis of some specific factors which can be stated as in the following–

- **Primary and Secondary Financial Markets :** Financial Markets are classified as (a) **Primary Market** and **(b) Secondary Market** on the basis of the nature of claims.

  Primary market is such a form of market in which newly issued credit instruments are bought and sold.

  Secondary market, on the other hand, is a market in which previously issued credit instruments are bought and sold.

- **Money Market and Capital Market :** Financial markets are also classified on the basis of term or period for which credit is supplied. On this basis, they are classified as–
  - Money market and
  - Capital market
  - **Money market :** Money market generally deal with short term credit requirements of the borrowers. Of course, under some circumstances, money markets may supply long term credit depending upon the specific needs of the borrowers.
  - **Capital market :** The capital market deal with the long term credit requirements of the borrowers. Just like money market, capital market may sometimes supply short-term credit to the borrowers depending upon the demands of the deficit spenders.

- **Organised and Un-organised Money Market and Capital Market :** On the basis of institutional arrangements, financial markets are also classified as Organised or Un-organised. In short, on this basis, both money market and capital markets are classified as (a) Organised and Un-organised money market and (b) Organised and Un-organised capital market.
  - **Organised and Un-organised money market :** The organised segment of the money market includes inter-bank call money market, co-llateral loan market, bill market, acceptance market etc. This category of money market actually includes different categories of banks

and non-bank financial institutions, such as, post offices, investment companies, savings and loan institutions, investment trusts, mutual funds, chit funds etc.

The un-organised segment of the money market includes indigenous bankers, hundis, money lenders etc. Besides, quasi-govt, bodies and large companies sometimes supply their surplus funds to the money market through the intermediation of banks.

- **Organised and Un-organised capital market :** The organised part of the capital market generally comprise of stock market, the loans from the banks and the non-bank financial institutions.

The un-organised segment of the capital market consist of the borrowings from indigeneous bankers, money lenders and such other related institutions.

Among the above noted classifications of financial markets, money market and capital market play a very inportant role in the functioning of a financial system. As such, a detailed explanation of these two markets is given below –

- **Money Market :** The term money market is used to mean financial institutions which deal with short-term funds in the economy. In fact, it refers to the institutional arrangements that facilitate borrowing and lending of short-term funds. Generally, in a money market, funds can be borrowed for a short period, such as, it may be a day, a week, a month or 3 to 6 months. The different types of instruments of money market are like, bills of exchange, bankers acceptances, bonds etc. and all these are also called as 'Near money'. Crowther defined money market as, "The collective name given to the various grades of near money."

It is to be noted here that the borrowers in the money market are generally merchants, traders, manufacturers,

business concerns, brokers and even government institutions. On the other hand, the lenders in the money market include the Central Bank of the country, the commercial banks, insurance companies and financial concerns.

- **Capital Market :** The term capital market refers to the institutional arrangements for facilitating the borrowing and lending of long-term funds. In broad sense, it consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises and also for public authorities. It deals with various private savings of individuals and corporate sector and invests them through new capital issues. Thus, a capital market may be defined as an organised mechanism for effective and efficient transfer of financial resources from the investing parties, that is, various categories of savers to the entrepreneurs engaged in industry or business either be in the private or public sectors of an economy.

Distinction Between Capital Market and Money Market : Money market and capital market are the most essential parts of the financial system of a country. But, a distinction between these two markets is essential as capital market deals with long-term funds and money market with short term funds. Of couse, these two markets are closely related to each other as the same institution in many a times, deal with short-term and long-term funds. The basic differences between these two markets are given below–

- **Maturity period of Funds :** The maturity period of funds of money market is less than one year as it basically deals with the short-term funds.

  On the other hand, the capital market deals with long-term funds due to which maturity period of funds is minimum one year or more.
- **Variations in Instruments :** The various financial instruments employed in the money market are- promissory notes, treasury

bills, commercial papers, bills of exchange, certificates of deposits etc.

Contrary to this, the long term securities used by the capital market are- equities, bonds, debentures, government bonds, securities of the government etc.

- **Operating Institutions :** The operating institutions in the money market include some institutions like central bank, commercial banks, non-bank financial intermediaries and the bill brokers.

  On the other hand, institutions operating in the capital market include stock exchanges, insurance companies, mutual funds, leasing companies, investment trust, investment banks etc.

- **Dominant Institution :** The most prominent institution in the money market is the commercial banks, whereas, the dominant institution in the capital market is the stock exchange market.

- **Degree of Risk :** In the money market, the degree of risk is very small as the maturity of loans of such market is generally less than one year,

  In contrast, the degree of risk in the capital market is relatively high due to long-term maturity of funds and wide variations in the prices of securities.

- **Nature of Influence of Central Bank :** The central banking operations and policies have direct and significant influence upon the money market.

  Contrary to this, the influence of central banking actions upon capital market is indirect and limited.

- **Variations in Basic Functions :** The basic function of money market is to make liquidity adjustment.

  On the other hand, the basic function of the capital market is to put the capital to the long-term productive and secure uses.

- **Purpose of Borrowing :** Generally, the businessmen and industrial enterprises seek short-term credit from the money market for meeting their working capital requirements.

  Contrary to this, the capital market basically meets the long-term capital requirements of industry for the purpose of acquiring fixed capital
- **Extent of Regulation :** In case of money market, there is greater degree of regulation by the central bank upon the commercial banks.

  On the other hand, in case of capital market, the degree of regulation by any institution is relatively low and limited.

Functions of Financial Markets : The financial markets perform many important functions in an economy and the most important among them can be stated as follows –

- Financial markets create and allocate credit to the various sectors of an economy.
- These markets serve as intermediaries in the process of mobilisation of savings.
- These markets provide all possible convenience as well as benefits to all categaries of lenders and borrowers.
- Financial markets also enable various categories of economic units to exercise their time preference.
- These markets are also very helpful for the purpose of separation, distribution, diversification and reduction of risk.
- These markets also provide facilities for transformation of various financial claims so as to suit the preferences of both the savers as well as the borrowers.
- Another important function of financial markets is that they provide efficient and easy payment mechanism.
- These markets are also helpful for increasing liquidity of financial claims through securities trading.
- Besides, the financial markets perform the portfolio management function in a much better way.

- These markets are also very reliable for promoting economic development through a balanced regional and sectoral allocation of all investible funds.

Efficiency in Financial Markets : A financial market includes both money market and capital market. The financial markets are said to be efficient when they are able to satisfy some basic conditions of an economy which can be stated as in the following–

- The prices of various assets are determined freely by the forces of demand for and supply of funds under the conditions of perfect competition.
- The market operates at the least cost level.
- There is no wastage in the use of various resources.
- Rescurces of the economy as a whole are allocated in the most socially productive purposes.

The efficiency of financial markets may take various forms and the most important among them are given below–

- **Valuation Efficiency :** The valuation efficiency is said to be achieved when the market price of a financial asset is equal to its intrinsic value or investment value. The valuation efficiency can only be achieved when the financial markets are perfectly competitive.
- **Operational or Functional Efficiency** : The financial markets are said to be functionally and operationally efficient when they fullfil some specific conditions like, minimisation of administrative and transactions costs, provision of giving maximum facilities and convenience to both borrowers and lenders, provision of getting fair return by financial intermediaries from their resources.
- **Allocational Efficiency :** Allocational efficiency is achieved by the financial markets when they are able to channelise their resources into those investment projects or uses where marginal efficiency of capital is the maximum.

- **Information Efficiency :** A financial market is able to achieve information efficiency when the people of the economy as a whole can acquire maximum gains by using various commonly available information in the economy.
- **Insurance Efficiency :** The term insurance efficiency means the degree of hedging against future contingencies. As such, when the degree of hedging and reducing risk is high, the degree of information efficiency is also high.



CHECK YOUR PROGRESS

Q 4: What is meant by financial markets? (Answer in about 30 words)

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Q 5: Explain briefly the concepts of money market and capital market? (Answer in about 40 words)

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Q 6: Point out the basic conditions for achieving efficiency in financial markets? (Answer in about 40 words)

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2.3.3 Financial Institutions

The financial institutions are the intermediaries who facilitate smooth functioning of the financial system and act as medium between the savers and the borrowers. The principal economic activity of the financial institutions is the purchase and sale of financial assets. In fact, these institutions act as half-way house or intermediaries between the primary lenders and the final borrowers. Generally, all sorts of banks act as intermediaries as they accept

deposits from various categories of depositors or savers and lend these funds to other section of customers, i.e., borrowers. Similarly, some other institutions, like GIC, LIC, Mutual funds etc. also mobilise various savings and lend these funds to the deficit spenders.

It is to be noted here that in a financial system, there are various categories of financial institutions which are operating in the money market and capital market. The prominent financial institutions of the money market include central bank, commercial banks, co-operative banks, specialised financial institutions, the non-banking financial institutions, discount houses, acceptance houses etc.

In contrast, the various financial institutions of the capital market include joint stock companies, central and state governments, local authorities, port trust, improvement trust etc. and all these institutions work on the demand side of the capital market. The various owners of financial claims like, individual investors, financial intermediaries such as commercial banks, insurance companies, specialised financial institutions, investment trusts, providend funds etc. work on the supply side of capital market. Of course, the most vital institution in the capital market is the stock exchange market.

Generally, financial institutions are classified into two broad categories and they are –

- Banking Institutions and
- Non-Banking Financial Institutions.

The main difference between these two types of institutions is that the banks posses the credit creating power, while the non-bank financial institutions do not posses such power.

The financial institutions actually deal with securities as they only buy primary securities and sell the secondary securities. They absorb primary securities in their asset portfolios and produce secondary securities to finance them. In fact, these institutions virtually transmute primary securities into secondary securities. As such, the essence and the success of financial institutions basically lie on the degree of asset transformation.

The securities produced by the financial institutions are far more acceptable to surplus units than the primary securities produced by deficit spenders. The basic reasons behind such accptalibitiy of surplus units can be stated as follows –

- **Low Risk :** All categories of lenders are interested in minimising all kinds of risks which are basically involved with their investments. As there is regulation of government on the organisation and workings of major financial institutions, hence, they can reduce the risks of their creditors.
- **Greater liquidity :** The financial institutions can offer much greater liquidity in their secondary secutities to their lenders, specifically, the demand deposits of banks are perfectly liquid and they can be drawn without any notice. Even time deposits can also be drawn under some conditions which involves some loss of interest.
- **Convenience :** The financial institutions also provide convenience to their various categories of lenders. As the deposits they sell are standardised and information about them are easily available, hence, these institutions can help their lenders to sell their secondary secutities when the lenders want to do so.
- **Other Services :** The financial institutions also, provide some other services to their lenders, As for example, banks are specialise in selling deposits with particular features along with some other services, like transfer of funds, collect cheques for their clients, offer of safe-deposit lockers to their dominant lenders etc.

These are the various reasons due to which the various surplus units prefer to lend to financial institutions rather than directly to deficit spenders.

Economic basis of financial institutions : The financial institutions are able to offer better financial facilities to both the lenders

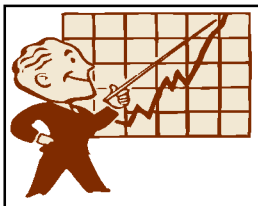
and borrowers. The true economic basis of financial institutions lies upon some basic factors, like –

- Law of large scale and
- Economies of scale in portfolio management
- **Law of large scale :** The various financial institutions like, banks, insurance companies, unit trusts etc. generally operate on the assumption that there are large numbers of customers. They also run on the assumption that all the creditors will not put forward their claims for cash at the same time. Again, they receive regularly interest payments on loans and investments. Having such knowledge, banks keep in cash only a small fraction of their demand liabilities and invest the rest of funds.
- **Economies of scale in portfolio management :** As the average size of the asset portfolios of banks, insurance companies and such other related organised sectors of the financial institutions are quite large in value, they get the benefit of economies of scale in portfolio management. In other words, financial institutions with their large asset portfolios can earn interest even on very short-term funds and can construct the maturity structure of their assets as desired.

Functions of Financial Institutions : In every economy, the financial institutions perform many important functions and the most important among them can be stated as follows–

- The most vital function of financial institutions is that they issue claims to their customers, but these claims have some such characteristics which are different from those of their own assets. As for example, banks accept deposits as liability and convert them to some other assets which are known as loans.
- Another important function of these institutions is that they choose and manage portfolios whose risk is very low and their return is high. Thus, financial institutions are able to reduce transaction costs.

- The financial institutions also perform functions like distribution of risk through diversification.This reduces the risk for savers as in the case of mutual funds.
- Another function of financial institutions is that they offer all savers alternative forms of deposits according to their liquidity preferences. Again, these institutions provide loans to borrowers which have requisite maturities.
- The financial institutions also play their important role in providing large amounts of finance on the basis of economies of scale in lending and borrowing.



CHECK YOUR PROGRESS

Q 7: Point out the broad two classifications of financial institutions? (Answer in about 30 words)

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Q 8: What are the economic basis of financial institutions? (Answer in about 40 words)

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Q 9: Explain briefly the most important functions of financial institutions? (Answer in about 40 words)

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2.4 FUNCTIONS OF FINANCIAL SYSTEMS

A financial system performs many vital functions in every economy and all such functions can be stated as follows–

- Inducement to Save
- Mobilisation of Savings

- Allocation of Funds
- Serving Production, Trade and Investment.

A detailed discussion of these functions of financial system is given below–

- **Inducement to Save :** The most important function of the financial system is that it induces the savings habits of various categories of people (savers) of the country. It provides a wide array of financial assets as strores of value which are aided by the services of financial markets and intermediaries of all kinds. All these institutions offer ample choice of portfolios with attractive combinations of income, safety and yields. As such, the potential savers can choose easily such an asset portfolio that can assure them higher return along with liquidity and safety.

  Besides, with financial progress and innovations in financial technology, the scope of portfolio choice has improved. Under such circumstances, the savings - income ratio of the economy is positively elastic with respect to both financial assets and financial institutions. It means that financial progress generally induces larger and larger savings out of the same level of real income.

  The influence upon the willingness to save of the people can be increased by an efficient functioning of the financial system. The most important measures that can be taken by the financial system for the purpose of inducing willingness to save are like lowering down the risk of default and market riskiness of financial assets along with further improvement of their yield and liquidity. In this way, diversity of financial assets along with the more efficient operations of the financial institutions can significantly promote savings of the economy as a whole.

- **Mobilisation of Savings :** Another most important function of financial system is the mobilisation of savings. Generally, savings are done by millions of individual households and firms in various amounts both for short period and long period. All such, savings are basically mobilised through an highly efficient mechanism of financial system. Actually,

mobilisation of savings takes place when savers move into financial assets, like, currency, bank deposits, post office savings deposits, life insurance policies, bills, bonds, equity share etc.

When public buy primary securities, it make its surpluses available directly to the deficit spenders which represent direct mobilisation of savings as well as allocation of credit. Similarly, when the public buy secondary securities, it entrust its savings to financial institutions and these institutions again allocate it among various categories of competing borrowers. Thus, mobilisation of savings takes place through an efficient functioning of financial system.

- **Allocation of Funds :** Another important function of financial system is to allocate the mobilised savings in an efficient and equitable way to the different categories of borrowers and for different uses. With the passage of time, the financial system is automatically improved and as such new financial assets become available. Again, the financial markets tend to be organised in a better way and new innovative financial institutions are brought into existence. Under such circumstances, mobilised savings are allocated to most productive uses and also to proper uses. As financial institutions act as the bridge between the savers and investors or lenders and borrowers, hence available financial resources are allocated by them to such uses which assure relatively higher return, greater liquidity as well as least risk. Thus, financial system helps an economy to allocate its available resources through which the investor can get best return and thus the process of economic development of the economy as a whole can be raised.
- **Serving Production, Trade and Investment :** Serving production trade and investment is the most important function of financial system. It is a well known fact that production requires various kinds and amounts of capital (funds) for different purposes. The required capital for production may be short-term working capital to finance current operations of business or medium-term capital for buying other tools and equipment or long-term capital for making fixed investment in physical plant.

It is known to all that shortage of any kind of capital generally affects adversely the productive activity of firms or any production units. The financial system helps firms in raising funds for meeting its various requirements. In short, a well-developed financial system facilitates the flow of savings throughout the economy and thereby induces the flow of funds in that direction where returns of investment is highest. It means that financial system helps in maximisation of returns from all sorts of resources.

2.5 IMPORTANCE OF FINANCIAL SYSTEM

The financial system of any country comprises of organised and un-organised financial markets, banking and non-banking financial institutions and various financial instruments. It facilitates transfer of resources from those who have surplus of funds to those who can make productive use of the funds. In fact, economic development of any country is influenced directly or indirectly by the financial system of any country. In other words, a financial system is very very important for an economy as it can enlarge the rate of capital accumulation and production potential to pay the way for a smooth and steady growth of the economy as a whole.

The role of financial system in economic development can be discussed as in the following–

- **Increase in the rate of savings :** The financial system plays a very important role of generating savings from the various surplus units of the economy. Generally, the financial markets and financial institutions provide different type of assets to the individual savers which provide high return and liquidity with a very low degree of risk. As such, the willingress to save and capacity to save of all categories of savers increases significantly.
- **Mobilisation of savings :** Another important role of financial system is that it helps mobilisation of savings which is very essential for faster rate of economic development. Because, financial system provide various means and mechanism of transfering resources from those who have an excess of income over expenditure to those who can

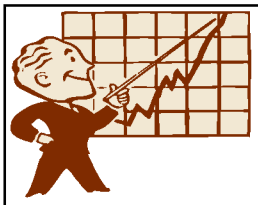
make productive use of the same resources. The commercial banks and investment institutions mobilise savings of different categories of people and channelise them to productive uses.

- **Raising the Rate of Investment :** Financial system is also very useful for raising the rate of investment of an economy. The financial institutions and financial markets place huge amount of investible resources at the disposal of business firms which had been saved by other people. As different varieties of financial assets have different degrees of risks prospects and yields, they enable the entrepreneurs to make optional choice about investment. Besides, the financial institutions bring into contact a large number of ultimate lenders (savers) and a large number of deficit spenders or investors which again results in an increase in the rate of investment.
- **Allocation of Resources :** Financial system is also very helpful for having rational and optimum allocation of available resources of an economy. The various institutions of financial system allocate surplus resources of an economy in such a way that all investments can assure the highest possible return.
- **Maximisation of Production :** The financial system is very conducive for developing the whole circumstances of an economy which ensures the maximisation of production. The various productive activity of an economy requires long-term capital for acquisition of land, buildings and machinery, the medium term capital for buying tools and equipments, short-term capital for financing the current operations of the projects. The institutions of money market and capital market provide diverse types of financial assets to corporate and non-corporate business enterprises and thus help the economy to get maximum return or production.
- **Balanced Economic Growth :** A good financial system helps in development of backward areas by providing special assistance to entrepreneurs for setting up new units in less developed areas. Financial institutions, like IDBI, IFCI, ICICI etc. generally give priority in giving assistance to projects set up in backward areas and even charge

lower rate of interest on various lendings. Thus, a financial system helps in balanced economic growth of a country by developing the backward areas.

- **Expansion of Banking Sector :** Banking sector is the key factor for all round development of an economy. As all kinds of financial transactions (except through cash) take place by the intermediation of banking and non-banking institutions, the expansion of trade, industry and other activities in the economy must lead to the activities in the economy must lead to the expansion of the banking sector. In short, the expansion of financial system strengthens the whole banking sector of an economy.
- **Effective Working of Monetary Policy :** A well developed financial system is also very useful for achicving the basic objectives of monetary policy, like, price stability, exchange stability, maximisation of employment, economic growth etc. Contrary to this, if the financial system of an economy is relatively weak, the monetary policy in the country is not likely to be sucessful in realising its objectives.
- **Mobilisation of Resources by Government :** Another most important role of financial system is that it develops the environment where the various development programmes can be initiated by the Government. If in an economy, the financial system is well-developed, then under such a situation, the government can have easy access to short-term and long-term capital at low rates of interest through loans from the commercial banks. Besides, the government can issue various bonds in the stock exchnage market which have varying maturity period. In short, mobilisation of resources is facilitated for the government sector where there prevails a well-developed financial system.

It is thus clear that a well-developed financial system can help an economy from different aspects and more specifically it can help in fastening the rate of economic development and growth of the economy as a whole.



CHECK YOUR PROGRESS

Q 10: How a financial system can help in mobilisation of savings? (Answer in about 40 words)

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Q 11: Explain briefly how a financial system can be helpful for better allocation of resources ? (Answer in about 40 words)

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Q 12: How a financial system can help an economy to maximise its production ? (Answer in about 30 words)

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2.6 LET US SUM UP

- The term financial system means a set of sub-systems of financial institutions, financial markets, financial instruments and services which help in mobilising resources from the surplus units of an economy and channelising the same to the deficit spenders. In fact, it refers to a set of institutional arrangements through, which various financial surpluses of an economy are mobilised from most of the surplus units and transferred the same to various deficit spenders.
- In case of financial system, the term 'system' means a set of complex, intimately connected and interlinked institutions, agents, practices, transactions, markets, claims and also the various liabilities of the economy as a whole.

- The 'term' financial system is a broader concept as compared to payments system. Because, financial system covers both cash and credit transactions, where as the payments system deals with only cash payments.
- In an economy, there are basically three components of financial system and they are Financial Instruments or Assets, Financial Markets and Financial Institutions.
- The financial instruments or assets or securities are actually some claims against a person or an institution for the payment of a sum of money at a specified future date. These are some such instruments which can be traded, modified and settled. These instruments are the claims to money and perform some functions of money.
- The financial instruments are broadly classified into major two categories, viz., Primary or direct assets and Secondary or indirect assets.

  The primary assets are issued directly by the ultimate borrowers of funds to the ultimate savers or investors whereas the Secondary assets are the obligations of financial institutions as they are issued by the institutions to the ultimate savers or investors.
- The most important financial instruments are like, cash or currency, equity shares, preference shares, debentures or bonds, derivatives etc. These instruments help in diverting funds from lenders to the borrowers through financial markets and financial intermediaries.
- The second important component of financial system is the financial markets and with the help of these markets, all kinds of operations take place in case of every financial system.
- The most important classification of financial market is Money market and Capital market. Money market deals with short-term credit requirements of the borrowers and the capital market deals with the long term credit requirements of the borrowers.
- The most important function of money market is to help the commercial banks, business corporations and other non-bank financial institutions for the adjustment of their liquidity position.

- The most important function of the capital market is that it helps in the generation and mobilisation of savings and thereby efficient allocation of these savings to the highly productive uses.
- The basic difference between money market and capital market is that the maturity period of funds of money market is less than one year. Contrary to this, capital market deals with long-term funds due to which maturity period of funds is minimum one year or more.
- Financial markets create and allocate credit to the various sectors of an economy. They serve as intermediaries in the process of mobilisation of savings, These markets also helpful for separation, distribution, diversification and reduction of risk.
- The valuation efficiency of financial markets is achieved only when the market price of a financial asset is equal to its intrinsic value or investment value. These markets can achieve allocational efficiency when they are able to channelise their resources into those investment projects or uses where marginal efficiency of capital is maximum.
- The financial institutions act as half way houses or intermediaries between the primary lenders and the final borrowers. The principal economic activity of the financial institutions is the purchase and sale of financial assets. In fact, financial institutions act as a middlemen between the savers and the borrowers.
- The various financial institutions which are operating in the money market include the central bank, commercial banks, co-operative banks, specialised financial institutions, the non-banking financial institutions, discount houses, acceptance houses etc.
- The various financial institutions of capital market are like, joint stock companies, central and state governments, local authorities, port trust, improvement trust etc.
- The financial institutions are classified as Banking institutions and Non-banking financial institutions. The basic difference between these two types of institutions is that the former posses the credit creating power, while the latter do not posses such power of creating credit.

- The various reasons due to which the surplus units prefer to lend to financial institutions rather than directly to deficit spenders are like, low risk, greater liquidity, better convenience etc. There are some other reasons also like, transfer of funds, collect cheques for their clients, offer of safe-deposit lockers to their dominant lenders etc.
- The financial institutions can provide better financial facilities to both the lenders and borrowers. Law of large scale and economies of scale in portfolio management are the two basic economic basis due to which these institutions can offer better financial facilities to their lenders and borrowers.
- The most important function of financial institutions is that they choose and manage portfolios whose risk is very low and their return is very high. In fact, they are able to reduce transaction costs.
- A financial system performs many vital functions in every economy and the most important among them are like, (1) Inducement to save, (2) Mobilisation of savings, (3) Allocation of funds, (4) Serving production, trade and investment etc. It induces the flow of funds in that directions where returns of investment is the highest.
- A well-developed financial system plays a very important role in every economy. In fact, it plays a very vital role in fastening the rate of economic development of a country.



2.7 FURTHER READING

1) Verma, K. N. (2015). *Monetary System.* New Delhi: Vishal Publishing Company.
2) Paul, R. R. (2011).*Money, Banking and Public Finance.* Ludhiana: Kalyani Publishers.
3) Gupta, S. B. (2012). *Monetary Economics.* New Delhi: S. Chand & Company LTD.

2.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The term financial system means a set of sub-systems of financial institutions, financial markets, financial instruments and services which help in mobilisation of resources from the surplus units of an economy and channelise them to the deficit spenders.

Ans to Q No 2: There are three basic components of a financial system and they are–

(a) Financial Instruments or Assets

(b) Financial Markets and

(c) Financial Institutions.

Ans to Q No 3: The financial instruments are broadly classied into two categories and they are–

(a) Primary or direct assets or instruments, and

(b) Secondary or indirect assets or instruments.

The primary assets are issued directly by the ultimate borrowers to the ultimate investors and the secondary assets are issued by the instititutions to the ultimate investors.

Ans to Q No 4: The term financial markets means those markets which basically deal with various financial assets and instruments of different types like, currency, bank deposits, cheques, drafts, bills, bonds etc. In a financial system, all kinds of operations take place through these markets.

Ans to Q No 5: Money markets generally deal with short term credit requirements of the borrowers. Of course, sometimes they may supply long-term credit depending upon the specific needs of the borrowers. The capital markets deal with the long-term credit needs of the borrowers. These markets may also sometimes supply short-term credit depending upon the demand of the deficit spenders.

Ans to Q No 6: For achieving efficiency in financial markets, the basic conditions to be satisfied are–

(a) Prices of assets are to be determined freely under the conditions of perfect competition,

(b) The market operates at the least cost devel,

(c) There is no wastage in the use of resources,

(d) Resources are allocated in the most socially productive purposes.

Ans to Q No 7: The financial institutions are broadly classified as–

(a) Banking institutions and

(b) Non-Banking financial institutions.

The basic difference between these two institutions is that the former posses the credit creating power, while the latter do not posses such power.

Ans to Q No 8: The financial institutions can offer better financial facilities to both the lenders and borrowers. The true economic basis of the financial institutions are–

(a) Law of large scale and

(b) Economies of scale in portfolio management.

These two are the basic economic basis of financial institutions due to which they can offer better financial facilities to their lenders and borrowers.

Ans to Q No 9: The various important functions of financial institutions are–

(a) Issue of claims to their customers,

(b) They choose and manage portfolios, the risk of which is low and return is high,

(c) They help in distribution of risk through diversification,

(d) They offer alternative forms of deposits to the savers depending upon their liquidity preferences,

(e) On the basis of economies of scale, they can provide large amounts of funds to their customers.

Ans to Q No 10: A financial system is very helpful for mobilisation of savings which is very essential for every economy. Generally, a financial system provide various means and mechanism of trasferring resources from the excess income holders of an economy to those who want to make productive use of the same resources. The commercial banks and investment institutions take the vital role in mobilising savings and channelise them to productive uses.

Ans to Q No 11: A financial system helps an economy for having better allocation of resources. The financial markets and financial institutions of a financial system act as the bridge between the savers and investors. As such, available financial resources of the economy are allocated by them to such uses which assure relatively higher return, greater liquidity and least risk.

Ans to Q No 12: The financial system is very conducive for maximisation of production of an economy. The institutions of money market and capital market provide diverse types of financial assets, viz., long-term capital, medium-term capital and short-term capital to corporate and non-corporate business enterprises to purshase various tools and equipments which are necessary for productive activity and thus help the economy to maximise its production.



2.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by financial system? Explain briefly the various components of financial system.

Q 2: Explain briefly the various functions of financial system.

Q 3: What are the financial instruments or assets? Distinguish between primary instruments or assets and secondary instruments or assets.

Long Questions (Answer each question in 300-500 words)

Q 1: What are the two broad classifications of financial markets? Explain the various functions of both the money market and capital market.

Q 2: Discuss the role or importance of financial system in an economy.

Q 3: What is meant by financial institutions? Explain elaborately the various functions of financial institutions.

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UNIT 3: THE MONEY MARKET

UNIT STRUCTURE

3.1 Learning objectives

3.2 Introduction

3.3 Characteristics of Money Market

3.4 Functions of Money Market

3.5 Instruments of Money Market

3.6 Let Us Sum Up

3.7 Further Reading

3.8 Answers to Check Your Progress

3.9 Model Questions

3.1 LEARNING OBJECTIVES

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

- know the meaning of Money market
- explain the different functions that a Money market performs in a modern economy
- describe the various instruments of Money market.

3.2 INTRODUCTION

Financial markets are structurally classified on the basis of term of credit, i. e., whether the credit is supplied for a short period (Money market) or long period (Capital market). Money market refers to the various firms and institutions that deal in short-term securities known as 'near money'. 'Near money' means short-term securities which could be encashed in a short period of time. It deals with trade bills, promissory notes and government papers which are drawn for short period. In short, Money market is a mechanism through which short-term funds are loaned and borrowed and through which a large part of financial transactions of a particular country or of the world are cleared.

In the earlier unit we have already discuss about the concept of money market. In this unit we will discuss in details about the money market and its instruments.

3.3 LEARNING OBJECTIVES

A money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than 1 year.

A well functioning money market leads to the development of a market for longer-term securities. The money market is not a physical location like the stock market; but its activities are conducted over telephone. The money market constitutes a very important segment of the Indian financial system.

Characteristics of the Money Market are as follows:

- It deals in financial assets or instruments that are close substitutes for money and could be converted into cash within a period of one year.
- Dealing in money market may be conducted with or without the help of brokers or intermediaries.
- It is not a single homogeneous market but consists of several sub-markets, each market dealing with a specific short-term credit instrument.
- One of the important features of money market is honour where the creditworthiness of the participants is important.
- The main dealers of money market are : Reserve Bank of India (RBI), Discount and Finance House of India (DFHI), mutual funds, insurance companies, banks, corporate investors, Non Banking Finance Companies (NBFCs), state governments, provident funds, primary dealers, Securities Trading Corporation of India (STCI), Public Sector Understanding (PSUs), and Non-Resident Indians.
- It is a need based market wherein the demand and supply of money shape the market.
- Though the functions of money markets in different countries are broadly the same, the instruments, institutions and practices of these markets vary considerably from country to country.

- Money market instruments are issued at a discounted price to face value.

Structure of Indian Money Market:

The Indian money market cannot be considered as an integrated unit. It can be broadly divided into two different parts, i.e., the unorganised and organised segments.

Unorganised segment of the Indian money market consists of unregulated non-bank financial intermediaries, indigenous bankers and money lenders which exist even in the small towns and big cities. Their lending activities are mostly restricted to small towns and villages. The persons who normally borrow from this unorganised sector include farmers, artisans, small traders and small scale producers who do not have any access to modern banks.

On the other hand, the organised segments of the Indian money market consists of the Reserve Bank of India, the State Bank of India with its seven associates, twenty nationalised commercial banks, other scheduled and non scheduled commercial banks, foreign banks and Regional Rural banks. It is called organized because it is systematically coordinated by the RBI.



CHECK YOUR PROGRESS

Q 1: What is meant by a money market? (Answer in about 20 words)

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Q 2: What is meant by a Capital market? (Answer in about 20 words)

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Q 3: State any two characteristics of money market in India. (Answer in about 20 words)

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3.4 FUNCTIONS OF MONEY MARKET

As discussed above, the money market is an avenue for borrowing and lending of the short-term funds. It helps in shifting huge sums of money between banks as well as it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used by banks, corporations and other institutions which need short-term money.

A money market is generally expected to perform the following broad functions:

- **Use of surplus funds:** It provides profitable investment channels for short-term surplus funds which help to enhance the profit of financial institutions. In this way, it also helps in rational allocation of resources.
- **Provides funds:** This is done by discounting trade bills through commercial banks, discount houses, brokers and acceptance houses. By providing various kinds of credit instruments which are suitable and attractive for different sections, a money market augments the supply of funds.
- **Helps in proper implementation of monetary policy:** It provides a non-inflationary way to finance government deficits and allow governments to implement monetary policy through open market operations and provide market based reference point for setting interest rate. Thus, a well organized money market helps in the successful operation of central banking policies as well as implementation of the monetary policies.
- **Helps in financial mobility:** Mobility in the flow of funds is essential for the development of commerce and industry in an economy. And also through quick transfer of funds from one place to another, it helps to avoid the regional gluts and stringencies of funds.
- **Provides funds to the government:** The money market helps the government in borrowing short-term funds at low interest rates on the basis of treasury bills for financing government projects for public welfare and infrastructural development.

- **Economy in use of cash:** As the money market deals in near-money assets and not money proper, it helps in economizing the use of cash. It provides a convenient way of transferring funds from one place to another without physical movement of cash, thereby immensely helping commerce and industry in the country.
- **Promotes liquidity and safe investment opportunities:** One of the important functions of the money market is that it promotes liquidity and safety to the entire country. Its instruments are issued by entities with good credit score which makes them safe investment options.
- **Provides funds for industries:** Money market contributes to the growth of industries by providing short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.
- **Provides assistance to commercial bank:** Developed money market helps the commercial banks to become self-sufficient as the latter can secure short-run loans from the former during emergency.

3.5 INSTRUMENTS OF MONEY MARKET

The instruments traded in the Indian money market are:

- Call/ Notice money market
- Treasury Bills (T- Bills)
- Certificate of Deposits (CDs)
- Commercial Papers (CPs)
- Commercial Bills (CBs)
- Collateralized Borrowing and Lending Obligation (CBLO)
- **Call loan/Notice Market:**The call money market is a market for very short-term finance repayable on demand, with a maturity period varying between one day and a fortnight (Fortnight shall be on a reporting Friday basis and is a mean of the period from Saturday to the second following Friday, both days inclusive). When money is borrowed or lent for a day, it is known as call (overnight) money. Intervening holidays and/or Sundays are excluded in this case. The

interest rate paid on call money loans is known as call rate. It is a highly volatile rate that varies from day-to-day and sometimes even from hour-to-hour. The funds move quickly between lenders and borrowers in case of call money. So it is considered the second most liquid asset after cash. When money is borrowed or lent for more than a day and up to 14 days, it is known as notice money. Short notice money is also considered to be a highly liquid asset, trailing after cash and call money.

No collateral securities are required to cover these transactions. Commercial Banks borrow money from other banks to maintain a minimum cash balance known as the cash reserve requirement (CRR). This inter-bank borrowing has led to the development of the call money market. The Reserve Bank intervenes in the call money market indirectly in two ways -

- by providing lines of finance / additional funding to the DFHI and other call money dealers and
- by conducting repo auctions

- **Treasury Bills (T-Bills):** A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than a year. However, treasury bills carry zero risk, i.e., they are zero risk instruments. Therefore, the returns one gets on them are not attractive. Currently, there are 3 types of treasury bills issued by the Government of India via auctions, which are 91-day, 182-day and 364-day treasury bills. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiple thereof. This instrument form the most important segment of the money market as it is used by the government to raise short term funds to overcome from seasonal or temporary gaps between its receipts and expenditure.

  Treasury bills are issued by the Central government at a lesser price than their face value and repaid at par. The interest earned by the buyer will be the difference of the maturity value of the instrument and the buying price of the bill, which is decided with the help of bidding done via auctions. For example, suppose an investor

purchases 91-day Treasury bill with a face value of Rs. 1, 00,000 for Rs. 96,000. By holding the bill until the maturity date, the investor receives Rs. 1, 00,000. The difference of Rs. 4000 between the proceeds received at maturity and the amount paid to purchase the bill represents the interest received by him.

- **Certificate of Deposits (CDs):** A Certificate of Deposit or CD, functions as a deposit receipt for money which is deposited with a financial organization or commercial bank. However, a Certificate of Deposit is different from a Fixed Deposit (FD) Receipt in two aspects. The first aspect of difference is that a CD is only issued for a larger sum of money. Secondly, unlike FDs, a Certificate of Deposit is transferable and tradable. First announced in 1989 by RBI, Certificate of Deposits have become a preferred investment choice for organizations in terms of short-term surplus investment as they carry low risk while providing interest rates which are higher than those provided by Treasury bills and term deposits. Certificate of Deposits are also relatively liquid, which is an added advantage, especially for issuing banks.

  Like treasury bills, CDs are also issued at a discounted price and their tenure ranges between a span of 7 days up to 1 year. However, banks issue Certificates of Deposits for durations ranging from 3 months, 6 months and 12 months. They can be issued to individuals (except minors), trusts, companies, corporations, associations, funds, non-resident Indians, etc. They are issued by banks at relatively high interest rates during periods of tight liquidity when the deposit growth of banks is slow but the demand for credit is high. They help to mobilize a large amount of money for short periods.

- **Commercial Papers (CPs):** Commercial Papers are short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. The Working Group on Money Market in 1987 suggested the introduction of the commercial papers (CP) in India. The Reserve Bank introduced commercial papers in

January 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Commercial papers have been in vogue in the United States since the 19th century and have become popular in money markets all over the world since the 1980s. Corporate, primary dealers (PDs) and the All-India Financial Institutions (FIs) are eligible to issue CP. A corporate would be eligible to issue CP provided –

- The tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore
- Company has been sanctioned working capital limit by bank/s or all-India financial institution/s; and
- The borrowal account of the company is classified as a Standard Asset by the financing bank/s/ institution/s

All eligible participants shall obtain the credit rating for issuance of Commercial Paper either from Credit Rating Information Services of India Ltd. (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the FITCH Ratings India Pvt. Ltd. or such other credit rating agency (CRA) as may be specified by the Reserve Bank of India from time to time, for the purpose. CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. However, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid. CP can be issued in denominations of Rs.5 lakh or multiples thereof. It is sold at a discount and redeemed at par. Commercial papers are actively traded in secondary market. Depending upon the issuing company a CP is also known as a finance paper, industrial paper or corporate paper.

It will be easy for you to understand the process of CPs with the help of this example: Suppose a company needs long term finance to buy some machinery. In order to raise the long-term funds in the capital market the company will have to incur floatation costs (costs associated with floating of an issue are brokerage, commission, printing of applications and advertising, etc.). Funds raised through commercial paper are used to meet the floatation costs. This is known as Bridging Financing.

- **Commercial Bill:** A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term, negotiable and self-liquidating instrument which is used to finance the credit sales of firms. It enhances the ability to make payment on a fixed date when goods are bought on credit. When goods are sold on credit, the buyer becomes liable to make payment on a specific date in future. The seller could wait till the specified date or make use of a bill of exchange. The seller (drawer) of the goods draws the bill and the buyer (drawee) accepts it. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discounts this bill by keeping certain margin and credit the proceeds. Banks, when in need, can also get such bills rediscounted by financial institutions such as LIC, UTI, GIC, ICIC, and IRBI. The maturity period of the bills varies from 30 day, 60 days, or 30 days, depending on the credit extended in the industry.

  Commercial bill is an important tool to finance credit sales. It may be (a) a demand bill or (b) a usance bill. A demand bill is payable on demand ie, immediately at sight or at presentation to the drawee. A usance bill is payable after a specified time. If the seller wishes to give same time for payment, the bill would be payable at a future date. These bills can either be clean bills or documentary bills. In a clean bill, documents are enclosed and delivered against acceptance by the drawee, after which payments are over. In the case of a documentary bill, documents are delivered against

payment accepted by drawee and documents of the file are held by bankers till the bill is paid.

Commercial bills can be inland bills or foreign bills. Inland bills must (a) be drawn in India and must be payable in India and (b) drawn upon any person resident in India. Foreign bills, on the other hand, are (a) drawn outside India and may be payable in and by a party outside India, or may be payable in India or drawn on a party in India.

A related classification of commercial bills is export bills and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by exporters abroad.

The indigenous variety of commercial bill of exchange for financing the movement of agricultural produce called is a "hundi". It has a long tradition of use in India. It is in vogue among indigenous bankers for raising money as remitting funds or to finance inland trade.

CBs ensure improved quality of lending and efficiency in money management. It is fully secured for investment since it is transferable by endorsement and delivery and it has high degree of liquidity. The Bills market is highly developed in industrial countries but it is very limited in India. In India, the bill market has not developed due to (i) Cash credit scheme is still the main form of bank lending, (ii) Big buyers in the corporate sector are still unwilling to use the payment mode of commercial bills, and (iii) an absence of an active secondary market.

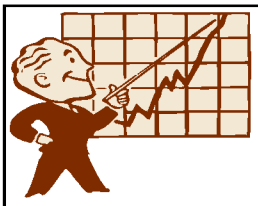
Many measures have been taken by RBI in order to strengthen Commercial Bill Market. Some of them are as follows:

- Setting up the Discount and finance House of India (DFHI)
- Enlarging the numbers of financial institutions to provide funds for smooth functioning of CBs.
- Regulation of stamp duties.

- **Collateralized Borrowing and Lending Obligation (CBLO):** The Collateralized Borrowing and Lending Obligation (CBLO) market is a segment of money market which is operated by the Clearing Corporation of India Ltd. (CCIL). Here also, financial entities can avail short term loans by providing prescribed securities like the call money market.

  Unlike the call money market, the lenders and borrowers use collateral for their activities in the CBLO market. The borrowers of fund are providing collateral in the form of government securities and lenders are receiving it at the time of giving loans.

  The uniqueness of CBLO is that lenders and borrowers use collateral for their activities. For example, borrowers of fund have to provide collateral in the form of government securities and lenders will get it while giving loans. There is no such need of a collateral under the call money market.



CHECK YOUR PROGRESS

Q 4: What is meant by call money? (Answer in about 10 words)

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Q 5: Define call rate. (Answer in about 10 words)

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Q 6: How is Certificate of Deposits different from Fixed deposits? (Answer in about 40 words)

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Q 7: In what denominations a Treasury Bill can be issued? (Answer in about 20 words)

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Q 8: What is meant by Commercial paper? (Answer in about 20 words)

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Q 9: Who can issue Commercial paper? (Answer in about 20 words)

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Q 10: What is the full form of CRISIL? (Answer in about 30 words)

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Q 11: What is meant by demand bill and usance bill?

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3.6 LET US SUM UP

- Financial markets are structurally classified on the basis of term of credit as Money market and Capital market.
- Money market is a short term credit market which deals with relatively liquid and quickly marketable assets, such as short-term govt securities treasury bills, bills of exchange etc. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than 1 year.
- Money market helps in shifting huge sums of money between banks as well as it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used by banks, corporations and other institutions which need short-term money.
- The call money market is a market for very short-term finance repayable on demand, with a maturity period varying between one day and a fortnight.
- A Treasury bill is basically an instrument of short-term borrowing by the Government of India maturing in less than a year.

- There are 3 types of treasury bills issued by the Government of India via auctions, which are 91-day, 182-day and 364-day treasury bills.
- Certificate of Deposits have become a preferred investment choice for organizations in terms of short-term surplus investment as they carry low risk while providing interest rates which are higher than those provided by Treasury bills and term deposits. Certificate of Deposits are also relatively liquid, which is an added advantage, especially for issuing banks.
- Commercial Papers are short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue.
- A commercial bill is a bill of exchange used to finance the working capital requirements of business firms. It is a short-term, negotiable and self-liquidating instrument which is used to finance the credit sales of firms.
- CBs ensure improved quality of lending liquidity, and efficiency in money management. It is fully secured for investment since it is transferable by endorsement and delivery and it has high degree of liquidity.



3.7 FURTHER READING

- Paul, R.R. (2011). *Monetary Economics*. Ludhiana: Kalyani Publisher
- Pathak, B.V. (2013). *The Indian Financial System*. Singapore: Pearson



3.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A money market is a component of financial market where short- term borrowing can be issued for one year or less.

Ans to Q No 2: A capital market is a component of financial market that allows long-term trading of debt and equity- backed securities usually the assets are held for more than one year.

Ans to Q No 3: The important two characteristics of money market are:

- It deals in financial assets or instruments that are close substitutes for money and could be converted into cash within a period of one year.
- It is not a single homogeneous market but consists of several sub-markets, each market dealing with a specific short-term credit instrument.

Ans to Q No 4:. When money is borrowed or lent for a day, it is known as call (overnight) money.

Ans to Q No 5:. The interest rate paid on call money loans is known as call rate.

Ans to Q No 6: A Certificate of Deposit is different from a Fixed Deposit (FD) Receipt in two aspects. The first aspect of difference is that a CD is only issued for a larger sum of money. Secondly, unlike FDs, a Certificate of Deposit is transferable and tradable.

Ans to Q No 7: Treasury bills are available for a minimum amount of Rs. 25,000 and in multiple thereof.

Ans to Q No 8: Commercial Papers are short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period.

Ans to Q No 9: Corporate, primary dealers (PDs) and the All-India Financial Institutions are eligible to issue Commercial paper.

Ans to Q No 10: The full form of CRISIL is Credit Rating Information Services of India Ltd.

Ans to Q No 11:A demand bill is payable on demand i.e., immediately at sight or at presentation to the drawee. And a usance bill is payable after a specified time. If the seller wishes to give same time for payment, the bill would be payable at a future date.



3.9 MODEL QUESTIONS

Short questions (Answer each question in about 150 words)

Q 1: How does Reserve Bank intervene in the call money market?

Q 2: State the major types of Treasury bills. How Treasury bills are important for the government?

Q 3: Whether all the corporate would automatically be eligible to issue Commercial paper?

Q 4: Write a difference between Inland bills and Foreign bills.

Q 5: What is meant by "Hundi"?

Long questions (Answer each question in about 300-500 words)

Q 1: Write down the important features of Money market. Also give a scenario of the structure of Indian money market.

Q 2: Explain the various important functions of Money market.

Q 3: Write in brief about the various instruments of Money market.

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UNIT 4: TREASURY BILLS AND COMMERCIAL PAPERS

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Treasury Bills

- 4.3.1 Meaning and Definition
- 4.3.2 Features of Treasury Bills
- 4.3.3 Types of Treasury Bills
- 4.3.4 Role of Treasury Bills

4.4 Commercial Papers

- 4.4.1 Meaning and Definition
- 4.4.2 Features of Commercial Paper
- 4.4.3 Types of Commercial Paper
- 4.4.4 Role of Commercial Paper

4.5 Commercial Bills

- 4.5.1 Meaning and Definition
- 4.5.2 Features of Commercial Bills
- 4.5.3 Types of Commercial Bills
- 4.5.4 Role of Commercial Bills

4.6 Certificate of Deposit

4.7 Let us Sum Up

4.8 Further Reading

4.9 Answers to Check Your Progress

4.10 Model Questions

4.1 LEARNING OBJECTIVES

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

- know about money market instruments
- learn the concepts of treasury bills and commercial papers
- explain about commercial bills and certificate of deposits.

4.2 INTRODUCTION

In the previous chapters we have studied about money market and its functions. As we know financial markets deal in financial assets and instruments of various kinds such as currency, deposits, cheques, bills and bonds, etc. Two most important instruments of money market are treasury bills and commercial papers. In this unit, we discuss about their concepts, features and role in the economy. In addition we also study about certificate of deposit.

The money market offers a variety of securities with maturity period ranging from a few days to one year. Generally, all these securities are safe investments. In the earlier unit, we have already discussed that in the money market the following instruments are traded—

- Treasury bills (T-bills)
- Call/ notice money market—Call (overnight) and short notice (up to14 days)
- Commercial Papers (CPs)
- Certificate of Deposits (CDs)
- Commercial Bills (CBs)
- Collateralized Borrowing and Lending Obligation (CBLO)

We have also discussed that Treasury bills, call money market and certificate of deposit provide liquidity for governments and banks while commercial paper and commercial bills provide liquidity for the commercial sector and intermediaries. In this unit, we will discuss some of the selective instruments of money market in details.

4.3 TREASURY BILLS

Treasury bills, or T-bills, are the most marketable short-term money market securities. Governments issue them to borrow money for a short period. T-bills are instrument of the governments to tide over short-term liquidity shortfalls. These bills are used by the government to raise short-term funds to bridge seasonal or temporary gaps between its receipts (revenue and capital) and expenditure. **T-bills** are issued with maturities

that range from 1 month to 1 year. They are sold at a discount, i.e., the government sells them for less than par value (face value) and, when they mature, buys them back at par value. Thus, T-bills are repaid at par on maturity. The difference between the purchase price (amount paid by the tender at the time of purchase which is less than the face value) and the amount received on maturity represents the interest amount on T-bills and is known as the discount. In the financial market, T-bills are considered to be the **safest investments** because they are given by the governments. However, their exceptional safety means a lower return than provided by corporate bonds, certificates of deposit and money market funds. Also, a tender does not automatically get back all of his investment if he encashes out **the T-bills** before the maturity date.

4.3.1 Meaning and Definition

A treasury bill is a promissory note or a finance bill issued by the governments under discount for a specified period stated therein. It is a short dated government security, yielding no interest but issued at a discount on its redemption price. The government promises to pay the specified amount mentioned therein to the bearer of the instrument on the due date. T-bills is purely a finance bill since it does not arise out of any trade transaction. It does not require any 'grading' or 'endorsement' or 'acceptance' since it is a claim against the government. Thus, it is highly liquid as its repayment is guaranteed by the government.

Treasury bill may be defined as 'the short-term money market instrument, issued by the central bank on behalf of the government at a discount to curb temporary liquidity shortfalls'. T-bills are known as discount instruments. This means that only the face value of the instrument is paid at maturity. The discounting is done by adopting the following formula –

Secondary market value

of a short-term security = Present value of the security's value at maturity

$$= \frac{\text{Maturity Proceeds}}{\{1 + \left(\text{current market yield X } \frac{\text{days lefto maturity}}{\text{days in year}}\right)\}}$$

4.3.2 Features of Treasury Bills

The important features of treasury bills are—

- **Duration:** T-bills are short-term instruments of money market. They are issued for different time period ranging from 1 month to 1 year.
- **Form:** They are issued either in physical form as a promissory note or in dematerialized form. The purchases and sales of the later are effected through the Subsidiary General Ledger (SGL) account.
- **Liquidity:** They are highly liquid as they are of shorter tenure and there is a possibility of inter-bank repos in them.
- **Return:** They have an assured yield, low transaction cost, and are eligible for inclusion in the securities for SLR purposes. There is no risk of default.
- **Eligibility:** All general public and state governments are eligible to invest. Any individual, firm, company, trust, bank, insurance company, financial institution, provident fund and state government can invest in treasury bills.
- **Denomination:** T-bills are available in various denominations.
- **Availability:** T-bills are negotiable securities. They are available in both financial markets, i.e, in primary and secondary markets.
- **Auction:** The ordinary treasury bills are issued through auction.
- **Issue Price:** T-bills are sold at a discount but redeemed at par. They are issued at less than face value and at maturity buyers get the par value.
- **Day Count:** The day count is 364 days in a year for treasury bills.

4.3.3 Types of Treasury Bills

There are two types of treasury bills, namely (i) ordinary or regular and (ii) ad hoc treasury bills popularly known as 'ad hocs'.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. These are issued through auction. This means that investors, particularly large banks, submit bids for the price or rate at which they would be willing to buy a given face value of bills, and the bills are issued to these bidders according to a predetermined procedure. These bills are freely marketable and they can be bought and sold at any time. They also have a secondary market.

Ad hoc means 'for the particular end or case at hand'. Thus, **Ad hoc treasury bills** are issued in favour of the central banks only. They are not marketable and not sold to the general public (or banks). They are not sold through tender or auction. They can be purchased by the central bank only. The Ad hoc treasury bills also provide investment outlets to state governments, semi-government departments and foreign central banks for their temporary surpluses.

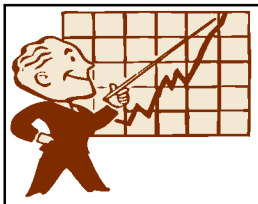
4.3.4 Role of Treasury Bills

The treasury bills play important role in the growth of the money market. T-bills play a vital role in the cash management of the government. Being risk free, their yields at varied maturities serve as short-term benchmarks and help in pricing different floating rate products in the market. The T-bills market is the preferred central bank tool for market intervention to influence liquidity and short-term interest rates. The development of the T-bills market is a pre-condition for effective open market operations. The following are some important roles of T-bills—

- **Liquidity:** Investments in T-bills are highly liquid because they can be converted into cash at any time. There is secondary market for T-bills also.

- **Safety:** Investments in T-bills are highly safe because the payment of interest and repayment of principal are assured by the Government. There is zero risk of default.
- **Ideal Short-term Investment:** Idle cash can be profitably invested for a very short period in treasury bills. Financial intermediaries can put their temporary surpluses in these instruments and earn income.
- **Ideal Fund Management:** Treasury bills are available on top as well through periodical auctions. They are also available in the secondary market. Fund managers of financial institutions build the portfolio of T-bills in such a way that the dates of maturities of them may match with the dates of payment on their liabilities. Thus, T-bills help financial managers in managing the funds effectively and profitably.
- **Statutory Liquidity Requirement:** The commercial banks have to maintain SLR to comply with the directives of the central bank. In measuring SLR, investments in T-bills are taken into account. T-bills are eligible securities for the purpose of SLR. Similarly, in maintaining cash reserve ratio, T-bills are helpful as they can be readily converted into cash.
- **Source of Short-term Funds:** In order to meet temporary budget deficits, the government can easily raise funds by issuing T-bills. This is a source of cheap finance to the government as the discount rates are very low.
- **Non Inflationary Monetary Tool:** T-bills enable the central government to support its monetary policy. For instance, if there is excess liquidity in the economy they can be absorbed by issuing T-bills. The issue of T-bills does not lead to any inflationary pressure.
- **Hedging:** T-bills can be used as a hedge against heavy interest rate fluctuations in the call money market. When the call rates are very high, money can be raised against T-bills quickly and

can be invested in the call money market and vice versa. They can be used in ready forward transactions.



CHECK YOUR PROGRESS

Q.1: State whether True(T) or False (F)

(i) Treasury bills are short-term monetary instrument. (T/ F)

(ii) The T-bills are issued at face value. (T/ F)

(iii) There is no secondary market for T-bills. (T/ F)

Q.2: State the basic difference between ordinary and ad hoc T-bills? (Answer in about 50 words)

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Q.3: Why investment in the T-bills is safe? (Answer in about 50 words)

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4.4 COMMERCIAL PAPER

The corporate or financial intermediaries can raise short-term fund by issuing commercial papers. Generally, the companies do not like to borrow short-term money from banks. If they face shortfall in working capital they prefer to use commercial paper. These corporations primarily issue commercial papers to meet their short-term liabilities such as accounts payable, for financing of payroll and inventories and meeting other short-term liabilities. Corporations issue commercial papers at a discount from the face value. The discounts usually depend on the prevailing interest rates and reputation of the issuer. Commercial paper is not backed by any form of collateral and thereby making it a form of unsecured debt. As a result, only firms with higher debt ratings will easily find buyers without having to offer a substantial discount. Maturities on commercial paper last several

days and rarely range longer than nine months or 270 days. Commercial papers provide a better return than treasury bills as the corporations have a higher risk of default than the government.

4.4.1 Meaning and Definition

Commercial paper is a money market instrument with a maturity period less than one year. It is issued as an unsecured promissory note or in a dematerialized form at a discount. The discount is freely determined by market forces. The paper is usually priced between the lending rate of scheduled commercial banks and a representative money market rate. It may be defined as "An unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading creditworthy and highly rated corporate to meet their working capital requirements. Depending upon the issuing company, a commercial paper is also known as a finance paper, industrial paper or corporate paper". Another common definition is "Commercial paper is a money market security issued (sold) in the commercial paper market by large corporations to obtain funds to meet short-term debt obligations and is backed only by an issuing bank or company promise to pay the fresh amount on the maturity date specified on the note". In the market there are primary dealers and satellite dealers. Commercial papers can be issued to individuals, banks, companies, and other registered corporate bodies and unincorporated bodies. They are issued in various denominations. Small investors can only access commercial papers indirectly through their broker or money market funds. The following formulas are used for estimation of discounted price of commercial paper—

Price = Face Value/ [1 + Yield X (No. of Days to maturity/ 365)]

Again,

Yield = (Face Value – Price)/ (Price X No. of Days to maturity) X 365 X100

4.4.2 Features of Commercial Papers

The following are the characteristics of commercial papers—

- **Nature:** Commercial papers are a short-term unsecured money market tool with a promissory note and a set maturity.
- **Purpose:** These are issued only to meet short-term obligations such as a new project or working capital needs.
- **Issuer:** The corporate or financial intermediaries can issue commercial papers. Companies with high quality debt rating could easily raise funds by issuing commercial papers. A company can directly issue the paper to investors or it can be done through banks or dealers.
- **Duration:** The commercial papers can be issued for a minimum of 7 days to a maximum of one year. The average maturity period of commercial papers range from 1 to 3 months. Rarely it ranges from 9 month to 1 year.
- **Denomination:** They are issued in various denominations. In India it starts from Rs.5 lakhs.
- **Investors:** The investors in commercial papers are individuals, banks, companies, and other registered corporate bodies and unincorporated bodies. For small retail investors it is difficult to buy commercial paper as the price is comparatively very high.
- **Issue Price:** They are issued at a discount but redeemed at par.
- **Guarantee:** The issuer guarantees the buyers to pay a fixed amount in future in terms of liquid cash and no assets.
- **Return:** The commercial paper offers a fixed rate of interest.

4.4.3 Types of Commercial Paper

Commercial papers are classified on two bases, namely, Uniform Commercial Code and Security. According to the Uniform Commercial Code, commercial papers are classified into four types—

- **Draft:** It is a third party paper confirming the payment. In this case an individual gives a written guidance to another to pay a stipulated sum to a third party.
- **Check:** It is a unique draft where the drawee is a bank. It is either payable on demand to a person specified or to the holder.
- **Promissory Note:** It is most popular form of commercial paper and is a written pledge to pay money. In it an individual is promised to pay a particular amount to another individual or bank.
- **Certificates of Deposit:** It is an acceptance by the bank of the acquisition of a specified sum of money from a depositor for a specific time. In this type, confirmation of the receipt of deposit is done by a bank and promises to repay the amount with interest after maturity.

Again, according to security, commercial papers are two types—

- **Unsecured Commercial Paper:** These are traditional papers and allotted without any security.
- **Secured Commercial Paper:** These are assured by other financial assets and are also known as Asset-Backed Commercial Papers.

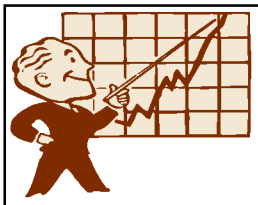
4.4.4 Role of Commercial Paper

The following are some important roles of commercial papers—

- **Fund Requirement:** The money raised by commercial paper is generally very large. Technically, it provides more funds to the issuer compared to other sources. It is beneficial when dealing with a substantial sum of money and does not require the use of cash.
- **Convenient and Cheap Financing:** The commercial papers provide a convenient financing method because it allows issuers to avoid the hurdles and expense of applying for and securing continuous business loans. It does not require the securities that trade in the money market to be registered. It is a cheap

financing option as it does not require any collateral. The cost of commercial paper to the issuing firm is lower than the cost of commercial bank loans.

- **Freely Transferable:** It is freely transferable in nature and so it has a high liquidity value. A wide flexible maturity range gives it extra flexibility. Even some financial institutions provide their customers the facility to write checks and to make transfers online with commercial paper fund account in the same manner as a cash or money market account.
- **Highly Secure:** A commercial paper is highly secure and reliable. It does not contain any restrictive condition.
- **High Return:** Investment in commercial papers is beneficial for the investors as they get a higher interest rate than they get from any guaranteed instruments. The interest rate tends to rise along with economic growth of a country. One commercial paper company can save extra funds and can earn good return. This instrument is a good alternative for retail fixed income investors who are looking for a better rate of return on their money.
- **Continuous Source of Funds:** Commercial papers produce a continuous source of funds. The issuing firm can customize the maturity range according to the firm's requirement and matured papers can be paid by selling new commercial paper.



CHECK YOUR PROGRESS

Q.4: State whether True (T) or False (F)

(i) Commercial paper is a long-term financial instrument. (T/ F)

(ii) Commercial papers provide higher return than treasury bills. (T/ F)

(iii) Commercial papers are sold at face value. (T/ F)

Q.5: What is the main purpose of issuing commercial paper? (Answer in about 40 words)

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Q.6: Who can issue commercial paper? (Answer in about 40 words)

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4.5 COMMERCIAL BILLS

Commercial bill is an instrument that helps business firms to get advance payment for the invoices they raise after making sales to their customers. By purchasing or discounting of commercial bills the banks provide the business firms the working capital requirements. The commercial bills arise out of a genuine trade transaction, i.e, credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts the bill and promises to make the payment on the due date. Such bills are called trade bills. The buyer may approach the banks for acceptance of the bill. When trade bills are accepted by commercial banks, they are called commercial bills. The bank charges a commission for the acceptance of the bills and promises to make the payment in case of default of the buyer. The bank discounts the bill by keeping a certain margin and credits the proceeds.

4.5.1 Meaning and Definition

Commercial bills are issued by the seller (drawer) to the buyer (drawee) for the sale value of goods delivered by him. It may be defined as "A commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It enhances the liability to make payment on a fixed date when goods are bought on credit". The maturity period of the commercial bills varies from 30 days, 60 days, or 90 days, depending on the credit extended in the industry. The commercial bills have secondary markets.

4.5.2 Features of Commercial Bills

- **Nature:** Commercial bill is a short-term, negotiable and self-liquidating instrument.
- **Marketable:** Commercial bills can be traded by offering the bills for rediscounting.
- **Discounting:** Banks provide credit to their customers by discounting commercial bills. The credit is repayable on maturity of the bill. In case of need for funds, banks can rediscount the bills in the money market and get ready money.
- **Liquidity:** Commercial bills ensure improved quality of lending, liquidity, and efficiency in money management.
- **Safety:** It is fully secure for investment since it is transferable by endorsement and delivery and it has high degree of liquidity.

4.5.3 Types of Commercial Bills

There are various types of commercial bills –

- **Demand Bill and Usance Bill:** A demand bill is payable on demand, i.e, immediately at sight or on presentation to the drawee. A usance bill is payable after a specified time.
- **Clean Bill and Documentary Bill:** In a clean bill, documents are enclosed and delivered against acceptance by the drawee, after which it becomes clear. In the case of documentary bill, documents are delivered against payment accepted by the drawee and documents of the file are held by bankers till the bill is paid.
- **Inland Bill and Foreign Bill:** Inland bills are those drawn upon a person resident of the country and payable in the country. Foreign bills draw outside the country or they may be payable either in or outside the country.
- **Export Bill and Import Bill:** Export bills are drawn by exporters in any country while import bills are drawn on importers by exporters outside.

- **Indigenous Bill:** These bills are those drawn and accepted according to native custom or usage of trade.

4.5.4 Role of Commercial Bills

Commercial bill is an important tool to finance credit sales. Following are the advantages of commercial bills –

- **Liquidity:** They are highly liquid assets. Bills can be readily converted into cash by rediscounting them in case of necessity of funds.
- **Certainty of Payment:** These bills impose strict financial discipline on businessmen to keep their words.
- **Ideal Investment:** It enables financial institutions to invest their surplus funds profitably by selecting bills of different maturities.
- **High Yield:** It gives higher yield to the investors than T-bills.



CHECK YOUR PROGRESS

Q.7: State whether True(T) or False (F)

(i) Commercial bills arise out of credit transaction. (T/ F)

(ii) Commercial bills are negotiable. (T/ F)

(iii) Indigenous bills are based on modern practice. (T/ F)

Q.8: What is the fundamental characteristic of commercial bill? (Answer in about 40 words)

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Q.9: How the commercial bill arouse? (Answer in about 40 words)

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4.6 CERTIFICATE OF DEPOSIT

Certificates of deposit (CDs) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. These are time deposits of specific maturity similar to

fixed deposits and are subject to SLR and CRR. The difference is that the certificates of deposit being in bearer form are transferable and tradable while fixed deposits are not. The CD is an agreement between the depositor and the bank where a predetermined amount of money is fixed for a specified time period. Since, CD is a government backed security, the investors principal amount is kept safe. This is a less risky investment option than stocks or bonds. It offers a higher rate of interest compared to other savings account. The investor also gets a grace period of 7 days to decide whether or not to reinvest the matured amount.

Features of CDs

- **Eligibility:** Only the scheduled commercial banks and financial institutions permitted by the authority could issue CD.
- **Maturity Period:** The maturity period of CDs issued by banks should be no less than 7 days and not more than 1 year while CDs of financial institutions have the maturity period range 1 year to 3 years.
- **Transferability:** Physical CDs are freely transferable by endorsement and delivery.
- **Denomination:** Minimum amount of a CD should be Rs.1 lakh and in multiples of Rs.1 lakh thereafter.



CHECK YOUR PROGRESS

Q.10: State whether True (T) or False (F)

(i) Certificate of deposit is a transferable instrument. (T/ F)

(ii) All banks and financial institutions could issue certificate of deposit. (T/ F)

Q.11: What is meant by certificate of deposit? (Answer in about 40 words)

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Q.12: What is the basic difference between certificate of deposit and fixed deposit? (Answer in about 40 words)

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4.7 LET US SUM UP

- Treasury bills provide liquidity for governments and banks while commercial paper provides liquidity for the commercial sector and intermediaries.
- Treasury bill are the short-term money market instrument, issued by the central bank on behalf of the government at a discount to curb temporary liquidity shortfalls.
- Treasury bills are sold at a discount, i.e., the government sells them for less than par value (face value) and, when they mature, buys them back at par value. The difference between the purchase price (amount paid by the tender at the time of purchase which is less than the face value) and the amount received on maturity represents the interest amount on T-bills.
- A commercial paper is an unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading creditworthy and highly rated corporate to meet their working capital requirements.
- Maturities on commercial paper last several days and rarely range longer than nine months or 270 days.
- The commercial papers provide a convenient financing method because it allows issuers to avoid the hurdles and expense of applying for and securing continuous business loans.
- A commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It enhances the liability to make payment on a fixed date when goods are bought on credit.

- Trade bills are accepted by commercial banks are called commercial bills. The bank accepted the bills and promises to make the payment in case of default of the buyer. The bank discounts the bill by keeping a certain margin and credits the proceeds.
- Certificates of deposit (CDs) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions.



4.8 FURTHER READING

- Abadie, M. J. (1993). *Investing in Treasury Bills.* England: Longmeadow Press
- Gurusamy, S. (2009). *Indian Financial System.* New Delhi: Tata McGrow-Hill Education Private Limited
- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.
- Pathak, B. V. (2012). *The Indian Financial Sysytem.* Singapore: Pearson
- Steiner, B. (2011). *Key Financial Market Concepts.* London: Pearson



4.9 ANSWERS TO CHECK YOUR PROGRESS

Ans. To Q.1: (i) True (ii) False (iii) False

Ans. To Q.2: Ordinary T-bills are sold to the public through auction. They are freely marketable and they can buy and sell at any time and they have secondary market. But Ad hoc treasury bills are issued in favour of the central banks only. They are not marketable and not sold to the general public through tender or auction.

Ans. To Q.3: Investments in T-bills are highly safe because the payment of interest and repayment of principal are assured by the Government. There is zero risk of default. They are helpful from liquidity point as they can be converted into cash at any time.

Ans. To Q.4: (i) False (ii) True (iii) False

Ans. To Q.5: Commercial papers are issued by companies to meet short-term obligations such as a new project or working capital needs. They don't prefer to go to banks for business loans in short-term, instead issues commercial paper as it is convenient and cheap.

Ans. To Q.6: The corporate or financial intermediaries could issue commercial papers. As these papers are not backed by any form of collateral so only firms with higher debt ratings will easily find buyers without having to offer a substantial discount.

Ans. To Q.7: (i) True (ii) True (iii) False

Ans. To Q.8: The main characteristic of commercial bill is that it arises from credit sale. It is a short-term, negotiable and self-liquidating instrument with low risk.

Ans. To Q.9: The commercial bills arise out of a genuine trade transaction, i.e, credit transaction. As soon as goods are sold on credit, the seller draws a bill on the buyer for the amount due. The buyer accepts the bill and promises to make the payment on the due date. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills.

Ans to Q.10: (i) True (ii) False

Ans to Q.11: Certificates of deposit (CDs) are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions.

Ans to Q.12: The difference between the certificates of deposit and fixed deposit is that the former being in bearer form is transferable and tradable while fixed deposits are not.



4.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q.1: Define a treasury bill.

Q.2: Write a note on discounting of treasury bills.

Q.3: What is meant by commercial paper?

Q.4: Evaluate the role played by commercial papers.

Q.5: Explain the types of commercial bills.

Easy type Questions (Answer each question in about 300-500 words)

Q.1: What is meant by Treasury bill? Explain their types and features.

Q.2: Discuss the role of treasury bills in an economy.

Q.3: Explain the features of commercial papers.

Q.4: Discuss the types of commercial bills.

Q.5: What is meant by certificate of deposit? Mention its features.

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UNIT 5: CALL MONEY MARKET

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Call Money Market

5.4 Call and Notice Money

5.5 Role of Call Money

5.6 Monetary Policy Intervention in the Money Market

5.7 Let Us Sum Up

5.8 Further Reading

5.9 Answer to Check Your Progress

5.10 Model Questions

5.1 LEARNING OBJECTIVES

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

- know what is a call money market and its features
- know who are the participants in the call money market
- understand how call money market functions in India.
- analyse the role of call money
- discuss the difference between call and notice money
- understand and describe the instruments of monetary policy the RBI uses to intervene in the money market.

5.2 INTRODUCTION

Call money market deals in short term financial assets, which are close substitutes for money and are repayable on demand. It deals with day-to-day surplus funds of banks. The participants in the Indian Call Money Market are Indian and Foreign Commercial Banks, Co-operative banks, Discount and Finance House of India Ltd. (DFHI) and Securities Trading Corporation of India (STCI) as both lenders and borrowers. On the other hand, Unit Trust of India (UTI), LICI, NABARD

can participate only as lenders. Call money is also known as call loans. Call loans are availed through auctions or negotiation on call rates.

Call money market is the most active and sensitive part of the organised money market in India. It is centered mainly at Mumbai, Kolkata and Chennai. The main function of the market is to redistribute the pool of day-to-day surplus funds of banks among other banks which have a temporary deficit of cash. In this unit we will discuss about the call money market in details.

5.3 CALL MONEY MARKET

Call money market is the most active and sensitive part of the formal money market. It deals in one-day loans (called call loans or call money) which may or may not be renewed the next day. The participants of call money market are mostly the banks. Therefore, it is also called inter-bank call money market.

The call money market occupies a very crucial place in Indian money market, where the day-to-day surplus funds are traded. The borrowing side is limited exclusively to banks, which are temporarily short of funds. On the lending side also, there are mostly banks who are temporarily excess in cash. As a special case, in our country, LIC and UTI are also allowed to place on call their short term funds and earn interest on them. All others have to keep their funds in term deposits of minimum 15 days with banks in order to earn interest. The banks are prohibited from paying interest on deposits made for less than 15 days. Such deposits are treated as current account deposits.

Formerly, companies as well as quasi-government bodies and individuals with large short-term surplus were allowed to place such funds on call with banks. Those funds were known as 'house money'. Finance brokers used to act as intermediaries between borrowing banks and lending houses. But, this system does not exist now.

India's leading bank State Bank of India (SBI) is always on the lenders' side of the market. It acts as the 'lender of intermediate resort.' Whereas the RBI as the country's Central Bank is the 'lender of last resort.'

The call money market is highly sensitive and competitive. It registeres very quickly the pressures of demand and supply for funds operating in the money market. Thus, it acts as the best available indicator of the liquidity position of the organized money market. Therefore, the RBI has to take due notice on the functioning of the Indian money market by adjusting its day-to-day monetary policy. The market experiences some regular seasonal changes. It is generally tighter during the busy season (October-April) than during the slack season (May-September). The peak of the busy season is April and in this month the market is much strained before the final dates of quarterly tax payments by the firms.

The call money market operates through brokers who keen in constant touch with banks in the city and bring the borrowing and lending banks together. The main function of the market is to redistribute the pool of day-to-day surplus funds of banks among other banks in temporary deficit of cash.

The call money rate of interest is highly volatile. The call money rate is the rate at which the short term funds are borrowed and lent in the money market. The pressures of excess demand push it up easily and of excess supply pull it down easily. In other words, demand and supply of liquidity affect the call money rate. A tight liquidity condition leads to a rise in call money rate and vice versa.



CHECK YOUR PROGRESS

Q.1 : What is meant by call money market.
(Answer in about 20 words)

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Q.2 : Who are the participants in the call money market ?
(Answer in about 40 words)

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Q.3 : How does call money market operate?
(Answer in about 60 words)
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5.4 CALL AND NOTICE MONEY

Call money and notice money markets are sub-markets of the Indian Money Market. These refer to the markets for very short term funds-

- Call money refers to the borrowing or lending of funds for one day.
- Notice money refers to the borrowing and lending of funds for 2-14 days.

It is to be mentioned here that there is another sub-market which is known as term money market. It refers to the borrowing and lending of funds for a period of more than 14 days.

The basic features of call and notice money may be summarised as follows -

- Scheduled commercial banks (excluding regional rural banks or RRBs), co-operative banks (other than land development banks) and primary dealers (PDs) are permitted to participate in call and notice money markets both as borrowers and lenders.
- Eligible participants are free to decide on interest rates in call/ notice money market.
- The call/notice money transaction can be executed either on NDS-call (Negotiated Dealing System Call), a screen-based, negotiated electronic trading system managed by the clearing corporation of India (CCIL) or over the counter (OTC) through bilateral communication.
- Deals in the call/notice/term money market can be done from 9-00 am to 5-00 pm on each business day or as specified by RBI from time to time.



NDS- Negotiated Dealing System is an electronic trading platform operated by the Reserve Bank of India to facilitate the issuing and exchange of government securities and other types of money market instruments. The aim is to reduce - Box inefficiencies resulting from telephone orders and manual paper-work.

OTC- Over the counter trading is done directly between two parties, without the supervision of an exchange



CHECK YOUR PROGRESS

Q.4 : What are the various sub-markets of money market ? (Answer in about 30 words)

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Q.5 : What are the basic features of call and notice money ? (Answer in about 60 words)

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5.5 ROLE OF CALL MONEY

Call money, also known as 'money at call' is a short term financial loan that is payable immediately, and in fall, when the lender demands it. Call money does not have to follow a fixed schedule like a term loan, which has a set maturity and payment schedule. Thus, call money is a short-term, interest paying loan from 1 to 14 days made by a financial institution to another financial institution. Due to the short term nature of the loan, it does not feature regular principal and interest payments, which long-term loans might. The interest charged on a call loan between financial institutions is refered to as the call loan rate.

The role of call money may be understood by the following points-

- Call money allows banks to earn interest, known as the call loan rate, on their surplus funds.
- Call money is typically used by brokerage firms for short term funding needs.
- Brokerage firms use call money to maintain margin accounts for the benefit of their customers who wish to withdraw their investments.
- The call money is the second most liquid asset that may appear on a balance sheet, behind cash.

- If the lending bank calls the funds, then the broker can issue a margin call, which will typically result in the automatic sale of securities in a client's account (to convert the securities to cash) in order to make the repayment to bank.



CHECK YOUR PROGRESS

Q.6 : What are the basic difference between call loans and term loans ? (Answer in about 40 words)

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Q.7 : Discuss briefly the role of call money in an economy. (Answer in about 60 words)

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5.6 MONETARY POLICY INTERVENTION IN THE MONEY MARKET

THE MONEY MARKET :

Monetary policy is the policy adopted by the monetary authority of a country that controls either the interest rate payable on very short term borrowing or the money supply. In other words, monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and in the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

The money market is an organised exchange market where participants can lend and borrow short term, high quality debt securities with average maturities of one year or less. The markets enable governments, bank and other large institutions to sell short term securities to fund their short term cash flow needs. It also allows individual investors to invest small amounts of money in a low risk market. Some of the instruments traded in this market include treasury bills, certificates of deposit, commercial paper, federal funds, bills of exchange and asset backed securities.

Thus, money market is a market where money and highly liquid marketable securities are bought and sold. It is not a place like the stock market but an acitivity and all the trading is done through telephones. One of the important features of money market is honour of commitment and creditworthiness.

Monetary Policy Intervention

Monetary policy refers to the use of monetary instruments under the control of the Central Bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate goal of the economic policy. In India, Reserve Bank of India (RBI) is vested with the responsibility of regulating monetary policy. It has issued regulations over time covering different money market products- call money, repo rate, commercial paper, certificates of deposit and other debt instruments with original maturity of less than one year. So, now let us take a look at the various instruments of monetary policy which are used by RBI to intervene in the money market.

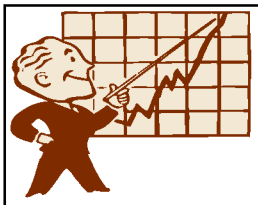
- Open Market Operations : The open market operations mean the sale and purchase of short term securities by the RBI itself directly in the open market. To control inflation and tackle the problem of excess liquidity due to foreign exchange inflows the RBI sells Government Securities. This is a direct and effective way to increase or decrease the supply of money in the market. It has also a direct effect on the ongoing rate of interest in the market.
- Bank rate : One of the most effective instruments of monetary policy is the bank rate. A bank rate is essentially the rate at which the RBI lends money to commerical banks without any security or collateral. It is also the standard rate at which the RBI will buy or discount bills of exchange and other such commercial instruments.

  So, now if the RBI were to increase the bank rate, the commercial banks would also have to increase their lending rates. And this will help control the supply of money in market and vice-versa.

- Reserve Ratio : The central bank can control the money market by setting a necessary reserve ratio, which would restrict the ability of the commercial banks to increase the money supply by loaning out money. There are two components of this instrument of monetary policy, namely- The Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

  The cash reserve ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank.

  The statutory liquidity ratio (SLR) is the percentage of total deposits that the commercial banks have to keep with themselves in form of cash reserves or gold. So, increasing the SLR will mean the banks have fewer funds to give as loans thus controlling the supply of money in the economy.
- Liquidity Adjustment Facility : The Liquidity Adjustment Facility (LAF) is an indirect instrument for monetary control. It controls the flow of money through repo rates and reverse repo rates. The repo rate is actually the rate at which commercial banks and other institutes obtain short term loans from the central bank. And, the reverse repo rate is the rate at which the RBI parks its funds with the commercial banks for short time periods. So the RBI constantly changes these rates to control the flow of money in the market according to the economic situations.
- Moral Suasion : This is an informal method of monetary control. The RBI, being the central bank of the country enjoys a supervisory positiion in the banking system. If there is a need it can urge the commercial banks to exercise credit control at times to maintain the balance of funds in the market. This method is actually quite effective since banks tend to follow the policies set by RBI.



CHECK YOUR PROGRESS

Q.8 : What is meant by monetary policy? (Answer in about 30 words)

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Q.9 : What are the instruments used by the RBI to intervene the money market ? (Answer in about 20 words)

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Q.10 : Explain briefly the components of reserve ratio. (Answer in about 50 words)

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5.7 LET US SUM UP

- The Call money market is an essential part of the Indian money market, where the day-to-day surplus funds are traded. The money market is a market for short term financial assets that are close substitutes of money.
- The loans are of short term duration varying from 1 to 14 days, are traded in call money market. The money that is lent for 1 day is called 'Call Money', and if it exceeds 1 day, but less than 15 days, it is referred to as 'Notice Money.' The money lent for 15 days or more is knwon as 'Term Money.'
- As per the RBI guidelines, the participants in the call money market include scheduled commercial banks excluding the regional rural banks (RRBs), Development Financial Institutions, Co-operative banks (Other than land development banks) and Primary

Dealers (PDs) both as lenders and borrowers. The UTI and LICI are allowed to participate as lender only.

- The call money rate is the rate at which the short term funds are borrowed and lent in the money market.
- Call money refers to the borrowing or lending of funds for one day.
- Notice money refers to the borrowing or lending of funds for two to fourteen days.
- Being the central bank, the RBI employs various instruments of monetary policy to regulate the money market in India. Those are- Open Market Operations, Bank Rate, Reserve Ratio, Liquidity Adjustment Facility and Moral Suasion.



5.8 FURTHER READING

1) Gupta, S.B. (1999). *Monetary Economics- Institutions, Theory and Policy.* New Delhi : S Chand and Company Ltd.

2) Jhingan, M.L .(2004), *Moneytary Economics*. New Delhi : Vrinda Publicatioins (P) Ltd.

3) Paul, R.R. (2008). *Moneytary Economics.* Ludhiana : Kalyani Publisher.



5.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1 : The call money market is an essential part of the Indian money market, where day-to-day surplus funds (mostly of banks) are traded. The loan are of short term duration (1 to 14 days) are dealt in call money market.

Ans to Q No. 2 : Participants in the call market are banks and related entities specified by the central bank, e.g. RBI in India scheduled commercial banks (excluding RRBs), co-operative banks (other than land development banks) and Primary Dealers (PDs) who

are permitted to participate as both borrowers and lenders. As per the new regulations, payment banks are also allowed to participate in call money market as both borrowers and lenders. The UTI and LICI are also given permission to participate but only as lender.

Ans to Q No. 3 : In call money market, day to-day surplus funds are traded. The borrowing side is limited to the banks, which are temporarily short of funds. On the lending side also, there are mostly banks with temporarily excess of funds. SBI, the leading bank in India, is always on the lenders side of the market. It acts as the 'lender of intermediate resort'. The call money market operates through broker who keep in constant touch with banks and their duty is to keep the borrowing and lending banks together.

Ans to Q No. 4 : Call money, Notice money and Term money markets are the sub markets of Indian money market. Call money refers to the borrowing or lending of funds for 1 day, Notice money for 2-14 days and for more than 14 days is called Term money market.

Ans to Q No. 5 : The basic features of call and notice money are as follows-

- Scheduled commercial banks (excluding RRBs), co-operative banks (Other than land development banks) and primary delares (PDs) are the participants of call and notice money markets both as borrowers and lenders.
- Eligible participants are free to decide on interest rates in the market.
- The call and notice money transactions can be executed either on Negotiated dealing system call or Over The Counter (OTC) through bilateral communication.
- The market is generally open from 9.00 am to 5.00 pm on each business day or as specified by RBI from time to time.

Ans to Q No. 6 : The basic difference between call loans and term loans are-

- A call loan is a loan that the lender can demand to be repaid at any time. On the other hand, a term loan is a monetary loan

that is repaid in regular payments over a set period of time.

- Call loan does not have to follow a fixed schedule whereas term loan has a set maturity and payment schedule.

Ans to Q No. 7 : The role of call money in an economy may be summarized as follows-

- Call money is a short term and interest earning financial loan.
- It is typically used by brokerage firms for short term funding needs.
- Call money is used by brokerage firms to maintain margin accounts for the benefit of their customers.
- It is the second most liquid asset that may appear on a balance sheet, behind cash.
- Call money helps the bank to fill the gaps or temporary mismatches in fund.
- Call money helps to meet the CRR and SLR mandatory requirements as stipulated by the RBI.

Ans to Q No. 8 : Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

Ans to Q No. 9 : The Principal instruments used by the RBI to intervene money market are- Open Market Operations, Bank Rate Policy, Reserve Ratio System, Liquidity Adjustment Facility (LAF) and Moral Suasion.

Ans to Q No. 10 : There are two components of reserve ratio- Cash Reserve Ration (CRR) and Statutory Liquidity Ratio (SLR)

The Cash Reseve Ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank.

The Statutory Liquidity Ratio (SLR) is the percentage of total deposits that the commercial banks have to keep with themselves

in form of cash or gold. So, increasing the SLR will mean the banks have fewer funds to give loans and thus, the RBI controls the supply of money in the economy.



5.10 MODEL QUESTIONS

Short questions (Answer in about 150 words)

Q.1. Discuss briefly the basic features of call money market.

Q.2. Explain why call money is regarded as the most active segment of money market.

Q.3. Write a short note on the call money market in India.

Long questions (Answer in about 300-500 words)

Q.1. Mention the basic objectives of Call Money Market. Why do banks borrow to participate in the call money market ?

Q.2. Discuss briefly the functioning of call money market.

Q.3. What is meant by money market? Also discuss the various instruments used by the RBI to intervene the Indian money market.

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UNIT 6: THE CAPITAL MARKET

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning and Functions of the Capital Market

6.4 Primary Capital Market

6.5 Participants of the Primary Capital Market

6.6 Instruments of the Primary Market for Raising Funds

6.7 Let Us Sum Up

6.8 Further Reading

6.9 Answers to Check Your Progress

6.10 Model Questions

6.1 LEARNING OBJECTIVES

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

- know the meaning of capital market
- explain the functions of the capital market
- understand the meaning of primary and secondary capital market
- know about the participants in the primary capital market
- explain the instruments of raising funds in the capital market.

6.2 INTRODUCTION

The term 'market' in economics refers to an institutional arrangement for facilitating the exchange of goods and services. Financial market, as such is an institutional complex that facilitates the buying and selling of financial assets. For economic progress and optimal allocation of resources a financial market is of immense importance. It may be defined as a mechanism of transmission of funds to the deficit spenders from units having surplus funds and the two are interconnected by a mechanism of rules and communication network. Financial institutions, agents, brokers, dealers, borrowers and lenders are the participants in the financial market. The financial assets exchanged may include deposits, loans, government bonds,

corporate stocks and bonds and the like. Financial markets are conventionally categorised into money and capital markets on the basis of the maturity period of financial assets exchanged in the two markets. The money market includes transactions of financial claims having a short-term maturity of a period of one year or less. On the other hand, capital market involves transactions of financial claims of maturity period of above one year. In this unit, we will discuss about the capital market, its features and its functions.

6.3 MEANING AND FUNCTIONS OF THE CAPITAL MARKET

The part of the financial system that is concerned with the borrowing and lending of long-term capital requirements is the capital market. The phrase 'long term' refers to a term of anything beyond one-year time. The fund exchanges of term maturity of a year or less is classified as the money market. Yet, the money and capital markets are essentially performing the same basic function of transferring funds for productive investment from surplus lenders to deficit borrowers.

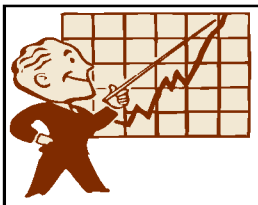
The arrangements in the capital market consists of the individual savers and investors as well as the institutional providers of long-term capital like the insurance companies, commercial banks, investment trust, mutual funds, specialised financial institutions and the like on the supply side. On the other hand, the demand side of long-term funds is associated with the requirement for acquiring working capital, inventories and fixed assets. Accordingly, a well-developed and efficient capital market is essential for the economic development of a country.

Finance is considered to be the main lever that helps the wheels of any economy to move forward. A developed and versatile financial system is core to the progress of an economy. In this context the capital market is of immense significance through the provisioning of financial flows to the productive sectors of the economy. The functions of a capital market are discussed as below.

- **Acts as a link between lenders and borrowers:** The primary securities issued by the borrowers are bought by the lenders either directly or through financial intermediaries. Accordingly, the capital market establishes a link between the savers or the units with surplus funds and the units with paucity of funds for productive uses. The capital market augments the generation of savings and directs the same onto productive uses.
- **Provides inducement to save:** A developed capital market is essential for pooling the savings into a vast reservoir of funds for further investment in productive ventures. The capital market is a mechanism to divert the surplus savings of the people so that idle savings, wasteful uses or investment in unproductive or less productive assets are minimized. It provides strong incentives such that present consumption becomes more costly than future consumption, inducing people to save more.
- **Promotes capital formation:** Capital market can, not only augment savings but, also, can direct the flow of the same for investment in the most productive ventures. The producers are in need of two different types of capital, namely, the short term or working capital requirements and the long term or the fixed capital requirements. While the first need is taken care of by the functioning of the money market; the second requirement is taken care of by the primary capital market. The capital market is basically divided into primary and secondary capital markets, which is discussed in the following section. Producers raise funds from the investing public for investment in their ventures through the primary market. Savings mobilisation for enhancing investment leads to capital formation and ultimately leads to the economic development of the country.
- **Protects the interest of the investors:** A developed capital market is versatile in that it provides a wide variety of avenues for investors to choose from in terms of yields, term of maturities and liquidity. Now, an efficient capital market is indeed necessary to attract investors because without the protection of the interest of the investors it will not be successful in raising capital.

- **Speeds up economic growth and development:** Capital market increases production and productivity in the economy by making funds available for long period of time. This helps in meeting the financial requirements of business houses. Increased production leads to an increase in employment and development of infrastructure.
- **Stability in Stock prices:** The operations of the stock market and the various institutions operating in the capital market brings forth stability in the prices of the stocks and securities and curbing out the speculative activities. They ensure the optimal allocation of capital in reasonable rate of interest.
- **Provides continuous availability of funds:** Capital market is a liquid market as it makes fund available on continuous basis. Both buyers and sellers can easily buy and sell securities as they are continuously available.

Considering the importance of the capital market in the context of the economic development of a country it is rightly said that the capital market is a mark of the development of a country. In the context of the underdeveloped countries it is thus identified that the lack of an organised and well-developed capital market inhibits the process of economic growth in such countries.



CHECK YOUR PROGRESS

Q.1 : What is meant by capital market?
(answer in about 20 words)

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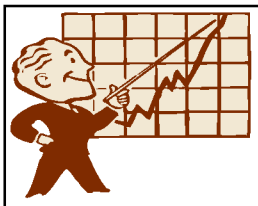
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6.4 PRIMARY CAPITAL MARKET

Capital market is basically divided into two segments, the primary and the secondary capital market. The primary market is concerned with the raising of funds for investment in the enterprises, both new or previously existing enterprises. For the initiation of new enterprises or for expansion

or diversification of existing ones, capital for the purpose of investment becomes necessary. In this context, the enterprises may raise the required venture capital or initial capital through the primary market. In other words, the buying and selling of new securities for the first time falls in the ambit of the primary capital market. Accordingly, the primary market is also called the new issue market (NIM). A large number of financial intermediaries' function in this segment of the capital market offering a wide number of services which are crucial to the functioning and development of the capital market. The secondary capital market, on the other hand, is the market of already existing securities. It facilitates the buying and selling of existing securities from the first holder to the second and subsequent holders. The secondary market, its working and structure is beyond the scope of the present chapter.

The fundamental distinction between the primary and secondary capital market is that the primary market deals in new offerings of securities to the public that were not previously available. However, the secondary market deals in already existing securities. Secondly, the primary market helps enterprises raise funds for investment. But in the secondary market the corporates whose securities are traded have no role as such because the transaction takes place between investors alone.



CHECK YOUR PROGRESS

Q 2: Define a primary capital market (answer in about 20 words)

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Q 3: Distinguish between the primary and secondary capital market (answer in about 30 words)

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6.5 PARTICIPANTS OF THE PRIMARY CAPITAL MARKET

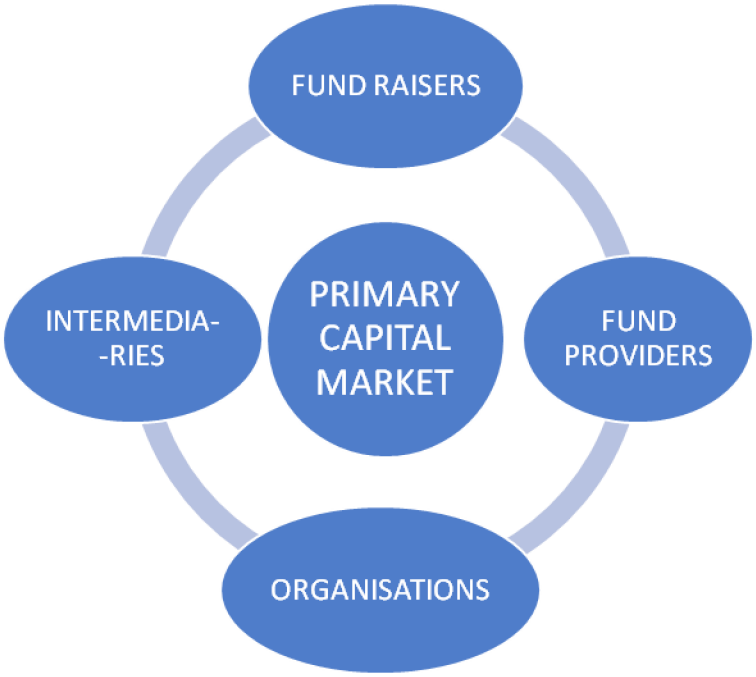


Figure 6.1: Participants of the Primary capital market

To understand the working of the primary capital market the knowledge of the participants in this segment of the capital market is of immense importance. The participants of the primary market are primarily classified into the demand side and the supply side of long-term fund requirements and the different intermediaries that help as the conduit of the same between the two parties. On the demand side we have the corporate enterprises and the various local, state or the central governments that need long term funds for acquiring working capital, inventories or their fixed capital assets. On the supply side we have the investors of long-term funds. The investors are indeed the pivot which drives the wheel of the new issue market. It is them who makes the transfer of funds to the needy investors possible. Investors may be either institutional or non-institutional or retail investors. The institutional investors include the mutual funds, insurance companies, etc who invest the funds of individuals in the capital market.

In the organisational structure of the NIM as well as the secondary capital market we need to mention the stock exchange and the providers of

the depository and custodial services. The stock exchange is a place where the securities issued by the companies are listed and traded. The stock exchanges are the core of the working of the capital market as such. Again, the expansion of the size and working of the primary market and secondary market raises the amount of paper work delaying the activities of the same as well as raises the risk of theft of securities, forged certificates, wrong signatures and the likes. So, depositories were initiated for the safe keeping and efficient trade of securities, which are kept in electronic formats. For instance, we have the National Stock Depository Limited (NSDL) or the Central Depository Services India Limited which are registered depositories in India.

Besides the above the primary capital market organisation consists of a number of intermediary institutions and agencies whose functions are core to the working of the primary market. The various categories of these are discussed below.

- **Lead managers:** In the primary capital market, a lead manager is appointed by the enterprises for managing all the activities associated with an effective sale of the new issues of enterprises to the public. The activities assigned for the same are for instance, drafting of prospectus, marketing of the public issue, advisory services relating to appointment of underwriters, registrars , advertising agents, etc and advising these institutions and agencies on related matters, preparation of the budget of expenses involved with the new issue and most significantly planning the suitable time of the issue. They have a significant role to play in attracting the public to invest their funds in the new issue of the respective enterprise. Lead managers can be the merchant banking division of the different financial institutions, subsidiaries of commercial banks, foreign banks, the private sector banks or other private agencies.
- **Register to the issue:** These represents an intermediary in the public issues who are appointed in consultation with the lead managers. As the name suggests, registers to issue are concerned

with all activities of new issue management. Aptitude, proficiency, infrastructure, etc. are criterion on which registers may be appointed by an enterprise. Their functions include collection of the share applications from the collection centres and keeping a record of the same, preparing the basis of the allotment among applicants and finalising the list of the same and dispatching the allotment letters and other related documents to shareholders.

- **Underwriters**: Underwriting is an activity practised in the primary market irrespective of the country in consideration. This consists of the respective underwriting institution to guarantee that in case of non-subscription of the issues of any company it will subscribe the same. Thus, the underwriting is like providing an insurance against the risk of non-subscription or inadequate subscription of the company shares issued to the public. Especially in case of new enterprises whose shares may not be able to attract the investors otherwise, benefit the most, from underwriting by reputed institutions. Underwriting is done in lieu of commissions. To reduce the burden of underwriting the underwriters may further sub-underwrite. A related term with underwriting is prewriting. Here, on a commission basis promotional measures are taken to attract large investing institutions prior to making the issues open for public subscription. Underwriting services are conducted by investment banks, insurance companies, commercial banks and term lending institutions.
- **Banks :** The role of banks in new issues may be diverse and is very significant. They may perform the role of collection agents, coordinating agents, merchant bankers or even brokers, all in lieu of commissions for their services.
- **Brokers:** The brokers and the network of brokers spread throughout any economy are agents to the investors. They play an imperative role in the execution of buying and selling of securities and charge commissions in return of their services. The role of brokers is significant in both the primary and secondary capital market.

- **Advertising Agents:** These are intermediaries in the issue that are responsible for promotion of the issue so that it can be successfully carried out. They carry out massive promotion measures through the use of both print and electronic media.



CHECK YOUR PROGRESS

Q 4: Define a primary capital market (answer in about 20 words)

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Q 5: Differentiate between the primary and secondary capital market (answer in about 30 words)

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6.6 INSTRUMENTS OF THE PRIMARY MARKET FOR FUNDS RAISING

This section deals with those financial assets which enable transfer of funds for investment in the capital market in India. Unlike as in the money market, capital market instruments have a maturity of more than a year. The principal capital market instruments are described below:

- **Government securities:** Government securities market is a very significant segment of the stock market in India. These include the securities issued by the central government, state governments and the semi-government authorities like the city corporations, municipalities, state electricity boards or the government agencies like housing boards, NABARD, etc. In any given year, the government, whether it is the central or state governments, to meet its short term or long term needs or even for conversion or refinancing of maturing securities issue such securities. Government bonds may be in the form of promissory notes, stock certificates or bearer bonds. Stock certificates is sent to the applicant directly by the public debt office and interest thereof are remitted by money order or

interest warrant drawn on any treasury office or bank as stipulated by the applicant. But they are not easily transferrable. Promissory notes are easily transferrable and so more popular among the investors. Bearer bonds as the name suggest are bearer instruments, the bearer being the owner. A unique feature of the government securities market must necessarily be mentioned here. These are an ideal financial instrument which are secure and guarantees the certainty of income and capital. Thus, the government securities market is also called the gilt-edged market.

- **Industrial Securities:** Business concerns raise their capital for long-term and medium-term requirements by using different instruments. These instruments have varied features to satiate the investors preferences. Under this head we shall discuss the three major types of securities, viz. equity shares, preference shares and debentures.
  - **Equity shares:** These are also most commonly referred to as ordinary shares. The investors in ordinary shares are fractional owners of the company, they have a claim on the assets and earnings of the company and accordingly they enjoy voting rights and the rights to receive dividends. The existence of a developed secondary market for shares makes this type of financial instrument liquid as the investors can resell their shares in the secondary market.
  - **Preferences shares:** The preference shareholders do not enjoy voting rights. But as the name suggests these shareholders enjoy a priority on the assets and earnings of the company. For instance, after the claims of the creditors are met these shareholders are entitled to the income before the equity shareholders. But it needs to be noted that preference shareholders are only entitled to a fixed dividend paid regularly. There have been several types of modifications on these type of shares for which we observe different types of preference shares which are discussed here.

- **Cumulative and non-cumulative preference shares:** If the dividend to be paid against preference shares is not or cannot be paid on grounds like low or inadequate profit and if the dividends are accumulated to be paid in subsequent years then it is a cumulative preference share. Otherwise it is a non-cumulative preference share.
- **Convertible and non-convertible preference shares:** If at the time of issue there was included the right to convert preference shares into ordinary shares at the end of a definite period as per the terms and conditions fixed, it is called a convertible preference share and otherwise it is a non-convertible preference share.
- **Redeemable and non-redeemable preference shares:** Redeemable preference shares are a type of preference share. A company issues them to shareholders and later redeems them. This means the company can buy back the shares at a laterdate. No- redeemable preference shares do exist, although companies cannot redeem them.
- **Participating and non-participating preference shares:** Preference shareholders as mentioned above earn a fixed dividend even in the instance of the company making high profits. However, terms and conditions at the time of issue may entitle certain preference shareholders to be paid higher dividends in such instance after the claims of equity and preference shareholders are met. This is then called participating preference shares. Of course, preference shares otherwise are non-participating.

➢ **Debentures or Bonds:** These are securities with a fixed rate of return, having a fixed maturity and income certainty.

The debenture is a document which is an evidence of the lender creditor relationship. Debentures are classified into various forms which are discussed below

- **Secured or unsecured debentures:** Debentures may be secured by the mortgage of whole or part of the tangible physical assets of the company in which case it is called secured and otherwise it is called unsecured debentures.
- **Bearer bonds and registered bonds:** Debentures on which dues are payable to the bearer of the bond and are transferrable by mere delivery are the bearer bonds. However, in case of registered bonds the dues are payable only to the registered holders that is whose name appears on the debenture certificate and is recorded in the companies register of debenture holder.
- **Redeemable and perpetual debentures:** Debentures that are redeemable at certain time period are called redeemable debentures. The debentures that are issued subject to redemption under circumstances of certain specific events that are not normally conceived to happen are called perpetual shares.
- **Convertible and non-convertible debentures:** Debentures that are converted to equity shares after a certain period are called convertible and otherwise non-convertible debentures. There may be debentures that are partly convertible and the convertible portion is converted to equity shares at the end of the maturity period.

- **Hybrid instruments:** Corporates are issuing various innovative security that has features of the above-mentioned capital market instruments. Some of such hybrid instruments includes the **secured premium notes** which are redeemable after a notice

period of four to seven years and have detachable warrants that enable the holders to get equity shares. There may also be **equity shares with detachable warrants** which are separate entities registered separately with the stock exchanges and traded separately. Warrants are actually an attraction medium attached which enables the issuer to pay low interest or dividends due to it. The holders therefore can apply for the warranted shares at some predetermined date and specified price. **Tracking stocks** also called designer stock is a security issued by a company to track the performances of a division of it. The parent company's financial statements are here treated as a separate entity. If the division shows good performance the value of its stock rises and vice versa irrespective of the parent company's performance. There may also be **disaster bonds** which are also called catastrophe bonds which are issued in case of a catastrophe. It is insurance linked. In case of a catastrophic loss then the issuers repayment obligation may be deferred or completely ruled out. Certain bonds have the option of paying the interest in the initial years through issue of new bonds and are called pay-in-kind bonds. Some bonds are characterised by easy liquidity by allowing the holders to get ready encashment in the case of the need to withdraw or redemption or the feature of buy back to the investor. These are **easy exit bonds**.

- **Derivatives:** These are a complex set of capital market instruments of which examples may be stated of futures, options and swaps. The value of the derivatives, which are contracts between two parties, are derived from their values form other financial assets that are called underlying. They are also termed as deferred delivery or deferred payment instruments. Options are contracts where the sellers are bound to sell the assets agreed at the time of contract as per the terms set in the contract. Futures are forward contracts between parties which are characterised with fixed terms of exchange. Swaps are agreements between two parties to exchange cash flows on a determined date or in many cases multiple dates.



CHECK YOUR PROGRESS

Q 6: Define equity shares.
(answer in about 50 words)

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Q 7: What are the different instruments used by businesses to raise funds in the new issue market. (answer in about 20 words)

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6.7 LET US SUM UP

- The financial market can be classified into money and capital market on the basis of the term maturity of funds lend and borrowed.
- Capital market is that component of the financial market that is concerned with the borrowing and lending of long-term capital requirements.
- Capital market is of immense significance to economic development, as it boosts savings and enhances capital formation.
- Capital market is classified into primary and secondary capital market.
- Primary capital market is the market of new issue.
- Primary market working is carried out by a varied set of institutional complexes. It consists of the suppliers of funds and the enterprises that demand the same and also a lot of other institutions that carries out the functions necessary for the transmission of funds between the two.
- Primary market participant institutions include the lead managers, registers to the issue, bankers, brokers, underwriters and advertising agents each having their own set of unique significant functions to make a fresh issue successful.

- Business concerns raise capital through three major types of securities, viz., ordinary shares, preference shares and debentures. Besides, various innovative hybrid instruments are now used for the purpose.



6.8 FURTHER READING

- Bhole, L.M. (2008). *Financial Institutions and Markets Structure, Growth and Innovations.* New Selhi :Tata McGraw Hill Publishing Company Limited
- Baye, R.M. & Jansen, D.W. (1996). *Money, Banking and Financial Markets*. New Delhi :A.I.T.B.S Publishers and Distributors.



6.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Capital market is a part of the financial market of the financial system of a country which is concerned with the borrowing and lending of long-term capital requirements.

Ans to Q No 2: The primary market is concerned with the buying and selling of new securities with the purpose of investment in enterprises.

Ans to Q No 3: The primary market deals in new offerings of securities but the secondary market deals in existing securities. Secondly, the primary market helps enterprises raise funds but the enterprises have no role in the other.

Ans to Q No 4: The activity of providing guarantee to any new issue of securities that in case of non-subscription or inadequate subscription the underwriter institution will subscribe the securities is called underwriting.

Ans to Q No 5: The major participants in the new issue market are the lead managers, brokers, bankers, advertising agents, underwriters, etc.

Ans to Q No 6: The equity shares are financial assets used by the business to raise investible funds and entitle owners of the shares to a claim

over the assets and earnings of the company and they enjoy voting rights and the rights to receive dividends.

Ans to Q No 7: Businesses raise funds through a wide variety of instruments including ordinary shares, preference shares, debentures and also hybrid instruments.



6.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by capital market?

Q 2: Differentiate between the money and capital market.

Q 3: State the functions of lead managers.

Q 4: Differentiate between ordinary and preference shares.

Q 5: What is meant by government securities?

Long Questions (Answer each question in about 300-500 words)

Q 1: Mention the functions of capital market.

Q 2: How does the capital market help in economic development of a country?

Q 3: Discuss the structure of the participating institutions in the primary capital market.

Q 4: Elaborate on the wide variety of instruments used by businesses to raise funds in the capital market.

Q 5: Discuss the different types of preference shares.

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UNIT 7: PRICE DETERMINATION IN THE MONEY MARKET

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Initial Public Offerings

- 7.3.1 Follow-on Public Offering
- 7.3.2 Rights Issue
- 7.3.3 Private Placement Market
- 7.3.4 Preferential Issue

7.4 Book Building

- 7.4.1 The Process of Book Building
- 7.4.2 Book Building Options and Guidelines
- 7.4.3 Book Building Process Merits
- 7.4.4 Book Building Process Limitations

7.5 Let us Sum up

7.6 Further Reading

7.7 Answers to Check Your Progress

7.8 Model Questions

7.1 LEARNING OBJECTIVES

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

- understand the concept of primary market and its participants
- explain the concept of Initial Price Offerings (IPO)
- understand the determination of offer price of IPO
- describe the concept of book building with its merits and limitations.

7.2 INTRODUCTION

Before an in-depth analysis to the Initial Price Offerings (IPO) and Book Building Process it is important to understand the concept of Primary

market and its participants, because both IPO and Book Building Process are related to it.

Primary market is a segment of financial market that deals with new issues and mobilises fresh funds. Therefore it is also called the new issue market. In the primary market, particularly in India, funds are mobilised through prospectus, rights issues and private placement by government companies, non-government public limited companies, private sector undertakings, banks and financial institutions. Primary Market has three categories of participants: issuer of securities, investors in securities and intermediaries (who render service to both issuer and investors). There are various intermediaries to an issue such as merchant banker, registrar to the issue, bankers to the issue etc and it is mandatory to issue all new initial public offerings in dematerialised form.

In India prior to 1992, the new issues market was regulated by the Controller of Capital Issues (CCI) under the Capital Issues (Control) Act, 1947. However, in 1992 the act was repealed and the controls in raising of resources from the market were removed, allowing both new and existing companies to decide the price of their issue themselves. Hence the free pricing regime emerged with unrealistic projections and the shares were sold for very high premiums. This hampered the functioning of primary market and most of the issues were quoted below their offer price on the day of listing at the stock exchange. In the period of 1992-96, due to these unrealistic projections the free market turned into a free falling market. As such the regulators brought strict regulations for the intermediaries and laid guidelines for full disclosure for investor projections about the issue price in the prospectus, and also the risk factors in the offer document.

The primary issues are listed in the new issue market in three ways: Public Issue, Rights Issue and Private Placement. Under Public Issue the primary issues are made through Initial Public Offering (IPO) and Follow-on Public Offering (FPO). Again under Private Placement the issues are made through Private Placement, Preferential Issue and Qualified Institutions Placement. In this unit we will particularly discuss about the initial public offerings and book building process in details.

7.3 INITIAL PUBLIC OFFERINGS

Initial Public offerings refers to the offering of fresh issue of securities or sale of existing securities or both, for the first time to the public by an unlisted company. SEBI has laid down certain entry norms for raising funds through Initial Public Offerings. There are three entry norms as laid by SEBI. These entry norms were made so that the investors can take informed decisions and their interests are protected in case of information asymmetry and do not fall into problems of moral hazard and adverse selection.

In the Entry Norm I, a company desiring to tap the primary market needs to have net tangible assets of atleast Rs 3 crores for complete 3 years and not more than 50 per cent is held in monetary assets. Besides the net worth of the company desiring to tap primary market should be atleast Rs 1 crore in three years and out of the preceding five years there should be distributable profits in atleast three years. Further, if a company changes its name then atleast 50 percent revenue for the preceding one year should be earned from the new activity and the issue size should not exceed 5 times the pre-issue net worth. SEBI has provided two alternative routes viz. Entry Norm II and Entry Norm III to a company not meeting the requirements of Entry Norm I.

According to Entry II, Issues should be made through book building and atleast 50 percent of the issue to be mandatorily allotted to Qualified Institutional Buyers. Further, the minimum post-issue face value capital shall be Rs 10 crore or compulsory market making for atleast 2 years. Again according to Entry III, the project should be appraised and participation by Financial Institutions should to the extent of 15 percent.



LET US KNOW

Qualified Institutional Buyers are those buyers who are the sophisticated investors like accredited investors, banks, trust funds etc requiring less regulatory protection than the unsophisticated regular investors.

Further the company need to have atleast 1000 prospective allottees in its issue. A company desiring to tap the primary market needs to disclose certain information in the offer document relating to earnings per share, pre-issue of earnings per share for the preceding three years etc and also other information relating to credit rating, risks in relation to first issue, internal and external risk factors, funding plans etc. Before filing the offer document with the registrar of companies (ROC) and stock exchanges (SE), a company has to file a draft offer document with SEBI atleast 21 days before filing offer document. Based on the offer document SEBI might specify changes, if any and it has to be compiled by the issuer or the lead merchant banker before the offer document is filed with the registrar of companies and stock exchanges. The merchant banker has to compile all the requirements of the disclosure and investor protection (DIP) guidelines while submitting the offer document to SEBI. The draft offer document is made available for 21 days on SEBI website for public comments from the filing of the draft offer.

The issuer is allowed to price the issue freely, but they have to justify the issue price in the prospectus. To determine the issue price there are two ways:

- Fixed Price Method and
- Book Building Method

Fixed price method is the method in which the issuer in consultation with the merchant banker decides the price of the issue. On the other hand, book building method is the process in which the issuer and the merchant banker stipulate a floor price based on market forces. The final price can be any price above the floor price and is usually the price at which the entire issue is exhausted. The issue price is also called the cut-off price. Some issuers can also go for differential pricing. The final prospectus is filed with the registrar of companies. The final prospectus has details of the final issue price and also the issue size. The bids are then segregated under different categories viz. Firm allotment, qualified institutional buyers, non-institutional buyers and retail investors, once there is closure of the issues.

For a company to make a public or rights issue of debt instruments it has to fulfil two conditions:

- It should obtain credit rating which is no less than investment grade from atleast two SEBI registered credit rating agencies. Further, it should not be in the list of willful defaulters of the Reserve Banks.
- The company should not have defaulted payment of interest or repayment of principal for a period of more than six months.

Further, the issuer company should not allot any non-convertible debt instrument pursuant to a public issue in case the proposed allottees are less than fifty. Besides, the IPOs are quoted at a premium to their offer price on getting listed.



LET US KNOW

Offer Document: It refers to the prospectus in case of public issue and letter of offer in case of right issue.

Public Issue: It refers to an invitation by a company to the public to subscribe to the securities offered by them through a prospectus.

Differential Pricing: It refers to the pricing of an issue where there is a price difference between a category of share with other category of share.

Firm Allotment: It refers to the allotment to the investors on firm basis.

7.3.1 Follow-on Public Offering

Follow-on Public Offering also known as subsequent public offering refers to the offer of sale of securities by a listed company. The listed companies can issue Follow-on Public Offerings to finance growth plans and is easier for them to raise funds through Follow-on Public Offerings.

7.3.2 Rights Issue

The Right Issue refers to the issue of new shares to its existing share holders with the preemptive rights to subscribe to the new issue on a pro-rata basis. There are four options open to the share holders in case of rights:

- The first option is to buy new shares at the offered price
- The second option is to renounce his rights and sell them in the open market
- The third option is to renounce a part of his rights and exercise the remainder
- The fourth option is to not to exercise any of the three options and choose to do nothing.

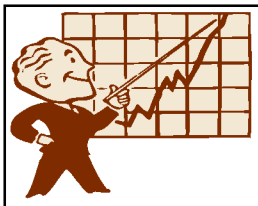
Usually the rights issues are kept open for atleast 30 days but not more than 60 days. There are number of reasons why companies offer shares on a rights basis. It usually the most favoured means of mobilising capital for the corporate sector or to expand, diversify, restructure their balance sheet or raise the promoter stake.

7.3.3 Private Placement Market

Besides public issues and rights issue, companies can raise funds through private placement as well. Private placement refers to direct sale of securities that are newly issued to small number investors through merchant bankers. Usually the investors are high net worth individuals. There is certain advantage of raising funds through private placement like the time and cost involved in issue through private placement is lesser than that of public issues and rights issue. Besides, the private placement issues can be tailor-made to suit the requirements of both the issuer and investor. Due to its flexibility private placement is a preferred way for raising resources by the companies. Some of the major issuers of privately placement securities are financial institutions, banks, central level undertakings and state level undertakings. The companies willing to list privately placed bonds has to adhere to the Companies Act and SEBI guidelines that regulate them and have to make disclosures accordingly. Besides, they also need to comply with the listing agreement of stock exchanges and credit rating is also compulsory for privately placed debt issues.

7.3.4 Preferential Issue

Many companies also opt for preferential issues for raising funds by allotting shares to various strategic groups that includes promoters, foreign partners, technical collaborators and private equity funds. Preferential issue refers to the issue of shares by listed companies to a select group of persons which are under Section 81 of the Companies Act, 1956. A company can make preferential issue of equity shares, partly or fully convertible debentures or any other financial instruments convertible or exchanged with equity shares at a later date. Preferential issue can be offered by a listed company, only when its entire shareholding is held in dematerialised form. When making preferential issue, the company needs to keep the entire pre-preferential allotment shareholding under lock-in. Preferential allotment is usually preferred in bullish market as it enables quick fund raising at low cost and also bringing on board a company's business partners.



CHECK YOUR PROGRESS

Q 1: Define Initial Public Offering. (Answer in about 20 words)

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Q 2: Why does SEBI has certain entry norms for raising funds through Initial Public Offerings? (Answer in about 40 words)

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Q 3: Distinguish between Fixed price method and Book building method. (Answer in about 40 words)

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Q 4: Define Follow-on Public Offering. (Answer in about 20 words)

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7.4 BOOK BUILDING

The mechanism of determining offer price under Controller of Capital Issues (CCI) regime was to offer the share at fixed price. However the pattern of pricing changed with the free pricing era and there was unrealistic pricing structure, which led to inefficient functioning of the capital market. As such an alternative method of book building slowly came into existence. Booking Building is a recognised mechanism for raising capital. SEBI has certain guidelines to define the book building process. It defines the book building as a process by which demand for the securities which is proposed to be issued by a corporate body is elicited and built-up. Further, the price for such securities needs to be assessed for quantum and also be issued by the means of a notice, circular, advertisement, information or offer document.

7.4.1 The Process of Book Building

The book building means the auctioning of shares where a book is being built. Investors can watch the book being built which shows the bid price and also number of shares being bid for both in the BSE and NSE. In the process of book building the company appoints a book runner usually a merchant banker who prepares and submits the draft documents to the SEBI and also obtains an acknowledgement card. It is the job of the issuer and book runner to decide and offer shares at a price within a specified price range. The issuer arrives at the cut-off rate and the final allocation is based on the bids received by the book runner and the lead manager. The issuer and the book runner may impose restrictions on the number of shares that can be allotted to each client. The final prospectus is filed with the Registrar of Companies along with the procurement agreement and then the placement portion opens from subscription. The placement portion closes one day before it is opened for public issue portion.

The price determined in the book building process is applicable to the public portion. In case the public portion remains

oversubscribed, the allotment is made on a proportionate basis. On the situation where the public portion remains undersubscribed, then the shortfall is distributed amongst those opting for placement.

The concept of book building was first introduced by SEBI in the year 1999 with the moving price band, which a reintroduced in book built IPOs. Price band includes the floor and cap price and denotes the range of bidding. The floor and the cap of the price band can vary not more than 20 percent, which states that it is not more than 120 per cent of the floor price. If there is a revision of price it has to be informed to the stock exchanges and public through press release, website and terminals of the syndicate members.

Book Building can be of two types:

- **Open Book:** It refers to the system of book building where during the bidding period; there is an online display of the demand and bids.
- **Closed Book:** It refers to a system of book building, where the book is not made public. The investors bid without having any information on the bids that is submitted by other bidders.

A book can be built under entry Norm-II, under which the book-built issue shall not offer less than 50 percent to the qualified institutional buyers and less than 25 percent to the retail investors. The remaining of the issue can be allotted to the non-institutional buyers. The basis of allotment is finalised by the Book Running Lead Managers (BRLM) within two weeks from the date of closure of the issue. The listing on the stock exchanges is done within 7 days from the finalisation of the issue.

7.4.2 Book Building Options and Guidelines

Securities can be issued through book building can be done either through: 75 per cent book building or 100 per cent book building.

In 75 percent book building the issue can be categorised into: placement portion and public portion. Placement portion is the

portion of the issue by the method of book building is offered to the public through the syndicate which has entities like underwriters, merchant bankers, financial institutions, brokers and individuals of high net worth. The investors can have a share in public portion and can also have it through syndicate members. The corporate that are eligible to make an issue to the public can also resort to 75 percent book building option adhering to SEBI Guidelines.

The SEBI also grants 100 percent book building in which the issuer is permitted to opt for 100 percent book building without offloading any portion of the issue in the market. Under the 100 percent book building, the entire issue is offered at a single stage, without the mandatory fixed price offering.

In the book building process, the companies need to follow the guidelines specified by the SEBI. The book building process was approved by SEBI with effect from November 1, 1995.

According to SEBI guidelines, the 100 percent book building issue was available to those issuers making an issue capital of and above Rs 100 crore. But the guidelines were reformed in 1998-99 due to its restrictive nature, because of which no issue was floated under the mechanism. Under the new guidelines the ceiling of issue size under book building was reduced to 25 crore from 100 crore. The issuers were free to choose from the existing or modified book building. Again in April, 2000, the guidelines were modified by SEBI for 100 percent one-stage book building process, under which a maximum of 60 percent of the issue was to be allotted to institutional investors and at least 15 percent to non-institutional investors applying for more than 1000 shares. The remaining 25 percent needs to be allotted on pro-rata basis to small investors. Further, modifications in guidelines were introduced by SEBI in 2004. SEBI also reintroduced the moving price band in book built IPOs which can move 50 percent either upwards and downwards depending on the demand and direction of the book being built. Again, SEBI revised the book building guidelines on August 2005 by removing

the discretionary allotment of QIBs. SEBI imposed 10 percent margin on discretionary allotment of QIBs while bidding for shares in an IPO.

7.4.3 Book Building Process Merits

Following are the merits of book building:

- It enables the issuers to reap benefits that arise from price and demand discovery.
- Book building also lowers the cost and time for making public issues.
- The investors are also benefited as they can trust the price at which the syndicate members have purchased the shares.

7.4.4 Book Building Process Limitations

The book building method has its own limitations which are as follows:

- The book building process in India is still dependent on good faith. It relies on interaction among firms, merchant bankers and investors, which is absent in India.
- In developed markets, the issue price is arrived at few hours before the issue opens. But for the Indian Scenario no such provision is available.
- There is also lack of transparency and absence of strong regulation at critical steps of book building process.
- The issues may not succeed in inviting the desired response as the price fixed for the public portion and the placement portion is the same.
- Many issues have been listed below their issue price. As such it is not a good price discovery mechanism. And the issuers may have to sell at cheaper price.
- The role of retail investors decreases in determining the price.

- The limits fixed on pricing are fungible and can also be altered depending on the market conditions.
- Although the retailer investors are not able to discover price, book building is thrust upon them.



LET US KNOW

Moving Price Band: It refers to the price band in which depending on the demand and direction on which the book is being built the range can be moved upwards or downwards.

Public Portion: It refers to that portion which is offered to the public.



CHECK YOUR PROGRESS

Q 5: Why Book- Building came into existence? (Answer in about 60 words)

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Q 6: Distinguish between open and closed book building. (Answer in about 60 words)

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Q 7: How is a book being built under entry Norm-II? (Answer in about 80 words)

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7.5 LET US SUM UP

- Primary market is a segment of financial market that deals with new issues and mobilises fresh funds. Therefore it is also called the new issue market.
- Prior to 1992, the new issues market was regulated by the Controller of Capital Issues (CCI) under the Capital Issues (Control) Act, 1947.

However, in 1992 the act was repealed and the controls in raising of resources from the market were removed, allowing both new and existing companies to decide the price of their issue themselves.

- The primary issues are listed in the new issue market in three ways: Public Issue, Rights Issue and Private Placement. Under Public Issue the primary issues are made through Initial Public Offering (IPO) and Follow-on Public Offering (FPO). Again under Private Placement the issues are made through Private Placement, Preferential Issue and Qualified Institutions Placement.
- Initial Public Offering refers to the offering of fresh issue of securities or sale of existing securities or both for the first time to the public by an unlisted company.
- SEBI has laid down certain entry norms for raising funds through Initial Public Offerings.
- There are three entry norms as laid by SEBI. These entry norms were made so that the investors can take informed decisions and their interests are protected in case of information asymmetry and do not fall into the problems of moral hazard and adverse selection.
- The mechanism of determining offer price under Controller of Capital Issues (CCI) regime was to offer the share at fixed price. However the pattern of pricing changed with the free pricing era and there was unrealistic pricing structure, which led to inefficient functioning of the capital market. As such an alternative method of book building slowly came into existence.
- Booking Building is a recognised mechanism for raising capital. SEBI has certain guidelines to define the book building process. It defines the book building as a process by which demand for the securities which is proposed to be issued by a corporate body is elicited and built-up. Further, the price for such securities needs to be assessed for quantum and also be issued by the means of a notice, circular, advertisement, information or offer document.



7.6 FURTHER READING

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- Grabble, J.O. (2004). *International Financial Markets*. New York: Elsevier.



7.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Initial Public Offering refers to the offering of fresh issue of securities or sale of existing securities or both for the first time to the public by an unlisted company.

Ans to Q No 2: SEBI has laid down certain entry norms for raising funds through Initial Public Offerings so that the investors can take informed decisions and their interests are protected in case of information asymmetry and do not fall into the problems of moral hazard and adverse selection.

Ans to Q No 3: Fixed price method is the method in which the issuer in consultation with the merchant banker decides the price of the issue. On the other hand, book building is the process in which the issuer and the merchant banker stipulate a floor price based on market forces.

Ans to Q No 4: Follow-on Public Offering also known as subsequent public offering refers to the offer of sale of securities by a listed company.

Ans to Q No 5: The mechanism of determining offer price under Controller of Capital Issues (CCI) regime was to offer the share at fixed price. However the pattern of pricing changed with the free pricing era and

there was unrealistic pricing structure, which led to inefficient functioning of the capital market. As such an alternative method of book building slowly came into existence.

Ans to Q No 6: Open Book refers to the system of book building where during the bidding period; there is an online display of the demand and bids. On the other hand, Closed Book refers to a system of book building, where the book is not made public. The investors bid without having any information on the bids that is submitted by other bidders

Ans to Q No 7: A book can be built under entry Norm-II, under which the book-built issue shall not offer less than 50 percent to the qualified institutional buyers and less than 25 percent to the retail investors. The remaining of the issue can be allotted to the non-institutional buyers. The basis of allotment is finalised by the Book Running Lead Managers (BRLM) within two weeks from the date of closure of the issue. The listing on the stock exchanges is done within 7 days from the finalisation of the issue.



7.8 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Discuss the entry norms laid by SEBI for Initial Public Offering.

Q 2: Discuss the two methods to determine issue price?

Q 3: What are the conditions that a company needs fulfil to make a public or rights issue of debt instruments?

Q 4: Discuss the process of Rights Issue.

Q 5: What is meant by private placement? Discuss the process briefly.

Q 6: Define Book building according to SEBI guidelines.

Q7: State the difference between 75 percent and 100 percent book building options.

Q 8: Briefly explain the merits of Book Building Methods.

Q 9: Briefly explain the limitations of Book Building Methods.

Long Questions (Answer each question in about 300-500 words)

Q 1: Discuss the process of Initial Public Offerings.

Q 2: What is meant by preferential Issue? When can companies make preferential issues?

Q 3: Discuss the process of book building.

Q 4: Discuss briefly the book building guidelines.

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UNIT 8: THE SECONDARY MARKET

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Concept of Secondary Market

- 8.3.1 Types of Secondary Market
- 8.3.2 Importance of Secondary Market
- 8.3.3 Distinction between Primary and Secondary Market

8.4 Functions of Secondary Market

8.5 Instruments of Secondary Market

8.6 Functioning of Stock Market

- 8.6.1 Listing of Securities
- 8.6.2 Trading Arrangement and Settlement

8.7 Demutualization of Stock Exchange

8.8 Stock Market Index

8.9 Let Us Sum Up

8.10 Further Reading

8.11 Answers to Check Your Progress

8.12 Model Questions

8.1 LEARNING OBJECTIVES

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

- know the meaning and functions of secondary market
- distinguish between primary market and secondary market
- describe the importance of the stock market
- explain the transaction procedure in the stock market
- know the meaning of demutualization of the stock market

8.2 INTRODUCTION

Capital market, one of the two main constituents of financial market, is classified into two, namely, primary market and secondary market. In the previous unit you have already learnt about the primary market. In this unit,

you will be familiarized with the concept of another division of capital market- the secondary market.

8.3 CONCEPT OF SECONDARY MARKET

Secondary market is a market in which already issued financial instruments such as bonds and stocks are traded. Both the equity market and debt market are available in the secondary market. Equity shares, bonds, preference shares, treasury bills are the main products of secondary market. In this market investors sell securities they own through IPO (Initial Public Offering) in primary market or purchase shares that are not new. That is, here both the buyer and sellers are the investors. It is an alternative market for an existing asset. After being offered in the primary market, the securities are listed and then these are traded in the secondary market. The companies that issue securities in the primary market get listed in the stock exchange. Secondary market provides a continuous and regular market for the secondary trade of already existing securities purchased by investors directly from the companies in the primary market. Therefore, it is also known as 'after market'. Secondary market indirectly contributes to the supply of capital by making already existing securities more liquid. In India SEBI (Securities and Exchange Board of India) is the regulator of secondary market.

The main advantages of secondary market are as follows –

- Secondary market gives liquidity to all investors. The seller can easily sell the securities according to his requirements.
- It acts as an alternative source of saving.
- In secondary market huge volume of transaction take place. It reduces the transaction costs.
- Safety of the investments made by the investors in secondary market is ensured by heavy regulations imposed by the government.
- Price is flexible in secondary market. Market forces of demand and supply determines price of securities.

8.3.1 Types of Secondary Market

Secondary market can be divided into four on the basis types of transactions done between buyers and sellers-

- Direct Search Market
- Broker Market
- Dealer Market
- Auction Market
- **Direct Search Market:** Both the buyer and seller themselves get involved in search of each other. They do not take any help in doing so. Transactions are not held frequently. This distracts the brokers to get interested in the market. It is considered the least efficient secondary market.
- **Broker Market:** In this market, the brokers are involved in the transaction between the buyers and the sellers. They provide detailed information about the prices of the stock, which will be bought/sold. This market is more efficient than the direct search market.
- **Dealer Market:** There is fixed bidding of the stocks in this market. The dealers trade the inventories of stocks they own. It is considered more efficient than the broker market.
- **Auction Market:** Both the buyers and sellers negotiate and bargain for the price of the stocks in this market. Here, a person acts as an arbitrator between the buyers and sellers and he is considered as a specialist. The arbitrator is also a dealer of certain stocks.

8.3.2 Importance of Secondary Market

The importances of secondary market are as follows:

- **A Good Exit Strategy for IPO Investors:** Due to higher liquidity, the risk premium in secondary market is less. Usually, an investor can sell the stock as fast as possible. He gets the current market price which lowers the perceived risk. The value

of traded final assets gets increased. Thus, it becomes a great exit route for IPO investors.

- **Freedom to Trade:** Secondary market is an organized place for buyers and sellers to come together and transact the stocks. It provides a safe environment to the investors and they can freely buy and sell the stocks.
- **Opportunities for further transactions:** The secondary market provides an opportunity for the investors to sell their stocks if they are unwilling to own the stocks in future. So, without any hesitation and anxiousness, they can purchase stocks from the primary market and sell them whenever necessary.
- **Helps in Economic Growth:** In secondary market, there is no restriction in the choice of the investors. Therefore, investors are free to purchase any stocks which will help the whole economy to grow. Thus, this market can enhance the better productive investment for prosperity and economic growth of a country as a whole.
- **Place of Monitoring and Control:** Secondary market act as a channel in providing information regarding the demand of stocks of the investors in the market. The investors also get the information about any downfall or upward movement in the market. This makes them aware of the profit or loss of the concerned stock and they can take action accordingly.

8.3.3 Distinction between Primary and Secondary Market

There exist some differences between primary and secondary markets so far as types of deal, propensity, fluctuation of price etc. are concerned. Distinctions between the two markets are discussed on the following grounds –

- **Type of deal**: In primary market, direct transaction between companies and investors has takes place. Companies sell their new stocks and bonds for the first time and the investors buy the stocks directly from the companies. This is termed as Initial Public Offering (IPO) in financial term.

On the contrary, in secondary market transaction happens indirectly. Investors buy securities from other investors through stock exchange. That is, buying and selling takes place only between investors.

- **Parties involved**: In primary market, investment bankers are usually engaged to purchase the shares from an initial public offering (IPO).

  In secondary market, on the other hand, brokers are engaged to purchase the stocks from the investors.
- **Frequency of selling a security**: In primary market, security is sold only once while in secondary market a security can be sold multiple times.
- **Fluctuation of price**: Price is fixed in primary market. But, in secondary market, price of shares fluctuates regularly. Price depends on the forces of demand and supply.
- **Organizational structure**: There is no specific geographical location for primary market. Secondary market, on the other hand, has physical existence.
- **Gainer of the sale proceeds:** The issuing company gains the sale proceeds in primary market. In secondary market, the investors who sell the shares gain the amount on the sale of shares.



CHECK YOUR PROGRESS

Q.1: Who will gain the sale proceeds in secondary market? (Answer in about 20 words)

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Q.2: Who regulates secondary market in India? (Answer in 20 words)

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Q.3: What are the main advantages of secondary market? (Answer in about 40 words)

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8.4 FUNCTIONS OF SECONDARY MARKET

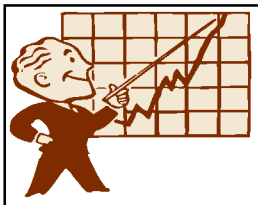
A well-organized secondary market performs several useful functions. All the functions of secondary market are done in stock exchange. A stock exchange or stock market is a market in which buying and selling of previously issued securities are done systematically. Important functions of a stock exchange are given as follows –

- **Continuous Market for Securities**: Stock market provides a ready and continuous market opportunity for securities. It helps the investors to invest in good securities and in case of any risk, it enables people to switch over from one security to another. Thus, it helps to make capital more mobile and more easily accessible.
- **Evaluation of Securities**: The performances of the companies are well reflected in the prices of securities which integrates the demand and supply of securities effectively. Stability of the companies can also be understood by the prices. Thus, investors are in a better position to take decision and invest according to their requirement.
- **Mobilizes Savings**: Attractive opportunities of investment are offered in the stock market. This opportunity attracts people to invest in securities and thereby enables the availability of funds. Thus, stock exchange facilitates mobilisation of savings and funds. The savings of the public are mobilized through mutual funds, investment trust and various other securities. Even a little amount can also be invested in mutual funds and investment trust.
- **Healthy Speculation**: The stock exchange encourages healthy speculation. The businessmen speculate and earn profits from fluctuations in prices of securities. The price of security is based on

supply and demand position. It creates a healthy trend in the market. Any artificial scarcity is prevented due to the rules and regulations of the market.

- **Protection of Investors**: Both the listing of securities and controlling of activities of the stock exchange protect the funds of the investors in stock exchange. Transactions in stock exchange take place under well defined rules and regulations.
- **Helps in Capital Formation**: Stock exchange plays a pivotal role in capital formation of the country. Companies raise funds either by issuing more shares through rights shares or bonus shares. The company can also go for diversification and raise more funds. Thus, they are able to generate more capital and this promotes economic growth in the country.
- **Liquidity:** Institutions like bank can invest their idle funds in the stock exchange and earn profit even within a short period. When necessity arises, these securities can immediately be sold for raising funds. Thus, stock exchange provides liquidity for which securities can be easily converted into cash.
- **Economic Barometer**: Stock exchange acts as an economic indicator of conditions prevailing in the country. The index of prices of various securities maintained by stock exchange indicates booms and depression. A strong government will have an upward trend in the stock market whereas an unstable government with heavy borrowings will have a downward trend in the stock market. So, generally every government adopts policies to make the stock exchange dynamic.
- **Control of Companies**: If a company wishes to trade in stock exchange, the company must get their securities listed in the exchange. The listed companies have to follow certain rules and satisfy certain conditions. They have to submit their annual report and audited balance sheet to the stock exchange. Only genuine companies can transact. Thus, stock exchange controls the companies and the interest of the investing public is protected.

- **Attracts Foreign Capital**: Due to dynamism and higher return on capital, stock exchange is capable of attracting more foreign funds. This may increase the exchange rate of the currency if more trade is undertaken by the government.



CHECK YOUR PROGRESS

Q.4: What is meant by stock exchange? (Answer in about 20 words)

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Q.5: State whether True (T) or False (F) : Stock exchange facilitates the flow of savings into the most productive and profitable channels.

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Q.6: Explain the role of secondary market in capital formation. (Answer in about 30 words)

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8.5 INSTRUMENTS OF SECONDARY MARKET

The financial product traded in secondary market is known as "instrument". Generally shares and bonds are dealt in secondary market. The shares traded in secondary market are equity shares, right shares, bonus shares and preference shares. Preference shares are of two types, namely, cumulative preference share and cumulative convertible preference share.

The bonds that are traded in secondary market are- zero coupon bond, convertible bond and treasury bills.

The instruments (i.e. shares and bonds) dealt in secondary market can be categorised into three –

- Fixed Income Instruments
- Variable Income Instruments

- Hybrid Income Instruments
- **Fixed Income Instruments**: It mainly consists of debt instruments. In this instrument, a regular form of payment like interest is ensured. On maturity the principal is repaid. Debentures, bonds, term/fixed deposit, life insurance or annuity pension plan and preference shares are the examples of fixed income instruments.
- **Variable Income Instruments**: In this instrument, the investors get an effective rate of return determined by various market forces. This instrument exhibits both higher risks and higher rewards to the investors. For example equity and derivative.
- **Hybrid Income Instrument**: In this instrument, two or more different financial instruments are combined. That is, hybrid instrument is created by combining the features of other instruments such as equity, preference and bonds. For example mutual fund, convertible debentures.



CHECK YOUR PROGRESS

Q.7: What are the instruments in secondary market? (Answer in about 20 words)

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Q.8: Distinguish between fixed income instrument and hybrid income instrument.(Answer in about 40 words)

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8.6 FUNCTIONING OF STOCK EXCHANGE

Functioning of secondary market takes place in the stock exchange. Stock exchange is a market place for buyers and sellers trading in existing securities. These can be brokers, agents, individuals. The companies first issue shares for public in primary market and after listing of these securities in the stock exchange, the securities are traded in secondary market. That is, only listed securities are traded in the stock market. Listing of securities

is the first step in trading procedure on stock exchange. Then, trading arrangement and settlement procedure are executed.

8.6.1 Listing of Securities

Listing of securities implies registration of securities of a company for trading in a stock exchange. If a public limited company wishes to issue shares to the public, it must get its shares listed in a stock exchange. It is known as listing of securities. On stock market, only the listed securities are traded. In other words, registration of the companies in the stock exchange is mandatory for trading in the stock exchange. The company, desirous of listing its securities in a stock exchange, has to satisfy certain conditions according to Companies Act. Then, the companies get their securities listed in stock exchange for trading. Offering of company's shares to the public for subscription is the first condition of listing. Only then it will be allowed to list its securities in the stock exchange. The company has to offer 60% of its minimum equity capital for public subscription. When a stock exchange is satisfied with all the aspect of a company including financial soundness, the name of the company is included in listed securities. The objectives of listing of securities of the companies in the stock exchange are as follows-

- To ensure proper management and effective control of dealings in securities.
- To protect the interest of the stakeholders and investors.
- To avoid concentration of economic power.
- To provide ready marketability and liquidity to securities.
- To mobilize savings for economic development.
- To provide free negotiability to stocks.

Listing provides an exclusive privilege to securities. Stock exchange provides transparency in transactions of listed securities.

Listed securities are divided into two- cleared or specified or Group A securities and non-cleared or unspecified or Group B securities. Cleared securities, after fulfilling certain conditions, are

included in the cleared list by the governing body of that exchange. Generally cleared securities are few in number. But they are actively traded in the stock exchange.

8.6.2 Trading Arrangement and Settlement

In the stock market, buying and selling of securities are done simultaneously. That is, when an investor purchases a certain number of shares, there is another investor who sells the shares. On receipt of shares and money by the buyer and seller respectively, the trade is settled in the stock exchange. Investors give orders to the broker to execute their transaction in the stock market. There are three phases in a stock market transaction, namely, trading, clearing and settlement. The stock exchange uses an electronic order matching to match buy and sell orders from different traders. Thus, each trade is executed. After matching of two orders, a trade is executed and then, the clearing process takes place. Clearing is the process of updating the accounts of the trading parties and arranging for the transfer of money and securities. It identifies the number of shares and amount of money received to the buyer and the seller respectively. The entire process is managed by clearing houses. After clearing, the next step is settlement i.e. fulfilment of the financial obligation identified in the clearing step.

The procedure of transaction i.e. trading arrangement and settlement in stock exchanges may be different. But, generally following steps are carried out in a trading procedure of stock exchange:

- **Selection of Broker**: The first step is the selection of broker. Individuals cannot trade in their individual capacity in the stock exchange. Transaction can be done through broker only. The brokers are the members of the stock exchange. They can be an individual or a partnership or a company or a financial institution. In India, the brokers must be registered under SEBI (Securities and Exchange Board of India). After appointment of

broker, an individual can trade shares in the stock exchange. Brokers involve in purchasing or selling of securities on behalf of the investors.

- **Opening of a Demat Account:** All securities are now in electronic format and that is why, it is mandatory that an investor must open a dematerialized account (Demat) account to hold and trade in securities. The investor or his/her broker opens a Demat account with the depository participant. Central Depository Services Ltd (CDSL) and National Depository Services Ltd (NSDL) are the two depository participants in India.
- **Placing the Order:** The investor places the order to buy or sell a particular security at a fixed or at the best possible price. The order can be placed with the broker or the individual can transact online if the broker provides such services.
- **Executing the Order:** It is the transaction whereby the seller agrees to sell and the buyer agrees to buy a security in a legally enforceable transaction. On receiving the order from the investor, the broker executes it and makes the bargain. As per the instruction of the investor, the broker executes the order i.e., he buys or sells the securities. The broker prepares a contract note for the order executed. It contains all the information about the transaction like the number of shares traded, the price, date and time of transaction etc.
- **Reporting the deal:** After making the bargain, the details of the deal are recorded by the broker and reported to the investor.
- **Settlement:** It means actual transfer of securities. It is the actual exchange of money and securities between the parties of a trade on the settlement date. This is the last step in the trading of securities done by the broker on behalf of his clients. There are two types of settlement of transaction depending upon the nature of transaction, they are –
  - **On the spot settlement:** Settlement is done immediately. In this ready delivery transaction, payment has to be made

immediately on the transfer of the securities or within a minimum period of time. Generally, this settlement follows the T+2 pattern. That is, if trade is taking place on Tuesday, it gets settled by Thursday.

- **Forward Settlement:** In this settlement, it is decided that settlement will take place on a fixed date in future. Both the parties agree to it.



CHECK YOUR PROGRESS

Q.9: What is meant by listing of securities? (Answer in about 20 words)

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Q.10: Write the objectives of listing. (Answer in about 40 words)

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8.7 DEMUTUALIZATION OF STOCK EXCHANGE

Demutualization of stock exchange is a process in which the stock exchange is converted into a public company. The conversion process is done by converting the interest of the members into shareholdings. These holdings can then be traded like the shares of a company. That is, in demutualization process, shareholders become the member of a company. Thus, Demutualized stock exchange is that exchange which is owned by share holders, having the status of public limited company and having the share capital. It provides scope of corporate and effective governance.

Generally, a mutually dependent, co-operative structure is the characteristic feature of stock exchange. Demutualization changes three aspects of stock exchange, namely, ownership, objectives and corporate governance. A flexible governance structure promoting decisive action, more participation of the investors in the governance of the exchange, greater flexibility and access to global markets are some of the positive outcome of demutualization of stock exchange.

8.8 STOCK MARKET INDEX

A stock market index is a statistical measure which shows changes taking place in the stock market. It is calculated by taking the values of the stocks. To compute the stock market index some similar stocks are selected from amongst the listed stocks in the exchange and grouped together. The criterion used for similarity of stocks may be the type of industry, market capitalization or the size of the company. Then prices of the selected stocks are used to compute the index. So, changes in the price of the selected stocks may affect the overall value of the index. Generally weighted average is taken to compute the index.

Stock market index reflects overall conditions of the stock market and direction of price movement of the products. It helps the investors to analyze the market performance by comparing current price level with the past prices. It facilitates the investors in identifying the general pattern of the market and to take decision regarding his investment. NSE Nifty, BSE Sensex are two examples of stock market indices in India.



8.9 LET US SUM UP

- Secondary market is a market in which already issued financial instruments such as bonds and stocks are traded. Both the equity market and debt market are available in the secondary market.
- There are four types of secondary market - Direct Search Market; Broker Market; Dealer Market and Auction Market.
- Secondary market performs several useful functions like mobilization of savings, evaluation of securities, continuous market for security, capital formation, providing liquidity etc. It acts as barometer of the economy.
- Functioning of secondary market is taken place in stock exchange.
- Listing of securities is the first step in trading procedure on stock exchange.
- Trading and Settlement procedure in stock exchange consists of the following stages: Selection of broker, Opening of Demat Account,

Placing the order, Execution of the order, Reporting the deal and Settlement of trade.

- Demutualization of stock exchange is a process in which the stock exchange has been converted into a public company. The conversion process is done by converting the interest of the members into shareholdings.
- A stock market index is a statistical measure which shows changes taking place in the stock market. It is calculated by taking the values of the stocks.



8.10 FURTHER READING

- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.
- Pathak, B. V. (2012). *The Indian Financial Sysytem.* Singapore: Pearson
- Paul.R.R.(2004). *Money, Banking and Public Finance.* New Delhi: Kalyani Publishers
- https://efinancemanagement.com
- https://accountlearning.com



8.11 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q. No. 1: The selling investor gains the sale proceeds in secondary market.

Ans. to Q. No.2: Securities and Exchange Board of India (SEBI) regulates secondary market in India.

Ans. to Q. No.3: The main advantages of secondary market are as follows–

- Secondary market gives liquidity to all investors.
- It acts as an alternative source of saving.
- In secondary market huge volume of transaction are taken place. It reduces the transaction costs.
- The government imposes heavy regulations on secondary markets. It helps to ensure the safety of the investments made by the investors.

- Price is flexible.

Ans. to Q. No 4: A stock exchange is a market in which buying and selling of previously issued securities are done systematically.

Ans. to Q. No 5: True.

Ans. to Q. No 6: Stock exchange plays a pivotal role in capital formation of the country. Companies are raising funds either by issuing more shares through rights shares or bonus shares. The company can also go for diversification and raise more funds. Thus, they are able to generate more capital and this promotes economic growth in the country.

Ans. to Q. No 7: Listing of securities means registration of securities of a company for trading in a stock exchange.

Ans. to Q. No 8: The objectives of listing of securities of the companies in the stock exchange are as follows-

- To ensure proper management and effective control of dealings in securities.
- To protect the interest of the stakeholders and investors.
- To avoid concentration of economic power.
- To provide ready marketability and liquidity to securities.
- To mobilize savings for economic development.
- To provide free negotiability to stocks.



8.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q.1: What is meant by demutualization of stock exchange?

Q.2: What are the products deal with in secondary market?

Q.3: What is initial public offering (IPO)?

Easy type Questions (Answer each question in about 300-500 words)

Q. 1: Assess the importance of secondary market in an economy.

Q. 2: Write the difference between primary market and secondary market on basis of source of the purchase, type of deal and fluctuation of price.

Q. 3: Explain the procedure of transaction in stock exchange.

Q. 4: How is stock market index computed?

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UNIT 9: MUTUAL FUND

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Origin of Mutual Fund

9.4 Meaning and Concept of Mutual Fund

9.5 Function and Features of Mutual Fund

9.6 Classification and Types of Mutual Fund

9.7 Mutual Fund Fees

9.8 Advantages of Mutual Fund

9.9 Disadvantages of Mutual Fund

9.10 Net Asset Value

9.10.1 Meaning of High and Low NAV

9.10.2 Importance of NAV in Mutual Fund

9.11 Factors Help to Choose Mutual Fund

9.12 Let Us Sum Up

9.13 Further Reading

9.14 Answers to Check Your Progress

9.15 Model Questions

9.1 LEARNING OBJECTIVES

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

- know the origin and development of Mutual Fund
- understand about the concept and features of Mutual Fund
- identify the advantage and disadvantages of Mutual Fund
- learn about the various fees charged in Mutual Fund
- understand Net Asset Value and its calculation
- learn the importance of NAV in Mutual Fund.

9.2 INTRODUCTION

A mutual fund (MF) is a financial intermediary that performs the basic functions of pooling the savings of investors for collective investment in a

diversified portfolio of securities. The investors in mutual fund are given the share in total funds which is proportionate to their investments. Thus a mutual fund serves as a link between the investor and the securities market by mobilising savings from the investors and investing them in the securities market to generate returns. That is, the special advantage of mutual fund is that it provides investors of small and moderate means the same opportunity to realise high and secure returns on investments as enjoyed by large investors.

In this unit, you will learn about the functions and types of mutual funds. Also, you will learn about the concept of NAV and its calculation.

9.3 ORIGIN OF MUTUAL FUND

Mutual fund captured the public attention in 1980s and 1990s when the mutual fund investment hit record highs and investors received incredible return. The idea of pulling asset for investment purpose originated long back when the financial crisis hit Europe in the early 1770s. However, the historians are uncertain about the origin of investment fund. Some cites the close end investment companies lunched in the Netherland in 1822 by ***King William I*** as the first mutual fund. While others point to a Dutch Merchant named Adriaan Ven. Ketwich whose earlier investment trust created in 1774 may have originated the idea.

The next wave of mutual fund was an investment trust lunched in Switzerland in 1849 followed by similar wave created in Scotland in 1880s. The idea of pulling resources soon took root in Great Britain and France making its way to the United States in 1890s. The *Boston Personal Property Trust* formed in 1893 was the first close end fund in US.

A mutual fund is a trust pool investment from the investors who share a common financial goal. The pool resources are invested in several investment instruments such as debt, shares and other profitable sectors. The agency managing the fund is called Asset Management Company (AMC) that is essentially registered with the Securities and Exchange Board of India (SEBI). The AMC generates and distributes return among the members

according to the pool in ratio of investment. In investing the amount the AMC ensures that returns from investment are maximized and while risks of such investments are kept at minimum level.

The first agency dealt mutual fund in India was Unit Trust of India set up in 1963 as a joint venture of Govt. of India and Reserve Bank of India (RBI). The objective of UTI was to guide small and unaware investors who wanted to invest in shares and other financial schemes or products of different firms. In the phase of 1964 – 1987, UTI was the sole operator of Indian mutual fund industry. In 1971, UTI launched the Unit Linked Insurance Plan (ULIP) and until 1986 UTI introduced several investment plans. Income Tax rebate played a very important role in introducing the concept of mutual fund in India. During the period of 1984 – 88 the investable corpus of UTI swelled from 600 crores to 6700 crores.

From 1987 onwards many public sector banks started their own mutual fund. In November 1987 the first non UTI Asset Management Fund (AMF) was set up by State Bank of India followed by other public sector banks and public undertakings like Canara Bank, Indian Bank, Life Insurance Corporation of India, General Insurance Corporation etc. In 1993 the cumulative investment of all AMC was around Rs 44000 crores.

In 1991 – 1996 the Govt. of India realized the importance of liberalization of Indian economy and financial sector reforms. Keeping this in mind, the Government opened up mutual fund industry for private sector as well. In this period 11 private sectors in collaboration with foreign entities launched their Asset Management Fund. Some of the top AMC in the private sector were ICICI Prudential, HDFC Mutual Fund, Kotak Mahindra Mutual Fund etc. Meanwhile the mutual fund industry also realized the importance of self regulation as a result a body the Association of Mutual Fund of India (AMFI) was set up in 22 August 1995. The aim of AMFI was to develop mutual fund market by improving ethical and professional standard.

In February, 2003 the UTI was split in to two separate entities UTI Mutual Fund (which is under SEBI regulation) and the Specified Undertaking of Unit Trust of India (SUUTI).

After the global economic recession of 2009 the mutual fund market across the globe were at an all time low and Indian market was no exception to it. In September 2012, SEBI launched numerous progressive measures with a view to bring more transparency and security for the interest of the stakeholders. This was SEBI's idea to re-energize the mutual fund industry and boost the overall penetration of mutual fund amongst investors. The measures bore fruit and the negative trend that was set because of global financial crisis was reversed. The situation improved considerably since May 2014 and Indian mutual fund industry has experienced a consistent inflow and rise in the overall Asset under Management (AUM) as well as the total number of investor account portfolio.

9.4 MEANING AND CONCEPT OF MUTUAL FUND

A mutual fund is a type of financial vehicle made up of a pool of money(savings) collected from many investors to invest in securities like stocks, bonds, money market instruments and other assets. *Mutual means people are joining together and Fund means money pooled together*. Mutual funds are operated by professional fund managers who allocate the fund's asset and attempt to produce highest capital gains or income for the fund investors. It is a trust that collects money from a number of investors who share a common investment objective. Each investor owns units of their investment, which represents the portion of holdings of the fund. The income or returns (called Net Asset Value/ NAV) generated from this collective investment is distributed proportionately amongst the investors after deducting certain expenses. Mutual fund is one of the viable investment options for common man as it offers an opportunity to invest in diversified professionally managed basket of securities at a relatively low cost.

The value of Mutual Fund Company depends on the performance of the fund they manage. So, when an investor invests on mutual fund he buys the performance of the portfolio or more precisely a part of portfolio value. Investment in share of a mutual fund is different from investing in shares of stock. Unlike stock, mutual fund share do not provide voting rights to the holders. A share of mutual fund represents investment in many different

stocks or securities instead of just holding one share. Therefore, the price of mutual fund share is referred to as NAV. The NAV is derived by dividing the total value of the securities in the portfolio by the total amounts of shares outstanding. Outstanding shares are those held by all shareholders. The NAV, unlike stock price does not fluctuate during market hours but it is settled at the end of each trading day.

A mutual fund holds hundred of different securities which mean mutual fund shareholders gain important diversification at low price. Consider an investor, who buys only a company share before the company has made loss. The investor incurs loss as his investment was in one company. On the other hand, a different investor who invests on mutual fund is less affected by the loss of the said company because the company share is just a small part of the mutual fund portfolio. A mutual fund is both an investment and an actual company. When an investor buys the company share he is buying partial ownership of the company and its asset. Similarly, a mutual fund investor is buying partial ownership of Mutual Fund Company and its assets.

Mutual fund generate income in following ways

- Income is earned from dividends on stocks and interest on bonds held in the fund portfolio
- Income is also generated when the price of securities rises and the holder of the securities sells at a higher price.

9.5 FUNCTIONS AND FEATURES OF MUTUAL FUND

The primary role of mutual fund is to assist investors in earning an income or building their wealth by participating in the opportunities available in various securities and markets. Mutual fund pool assets from several investors and invest it in different industries and different types of stocks and bonds with the help of investment professionals. These funds have multiple functions such as saving time and money as well as help to reach financial objectives. The fund managers on behalf of the investors track the financial market and day to day fluctuation of different industries for better performance of the fund. People can diversify their investment holdings by purchasing mutual funds, which contain a variety of stocks and bonds.

Diversification minimise risk levels because investors are not reliant on the performance of any one security or sector of the economy.

Features of Mutual Fund

- Mutual fund is formed or accumulated by pooling investment from several investors
- Mutual funds are professionally managed fund to earn highest possible return at low price
- A mutual fund is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities
- Mutual fund diversifies holdings in many securities to reduce risk
- Mutual funds are divided into several kinds of categories (close-end, open-end etc) based on investment objectives
- Mutual funds charge annual fees (called expense ratio) and in some cases commission which affect overall returns
- Mutual fund allows investing and withdrawing anytime anywhere
- Mutual funds are flexible as fund portfolio changes with change of market conditions
- Mutual funds are registered with Securities Exchange Board of India (SEBI) and Association of Mutual Funds in India (AMFI).

9.6 CLASSIFICATION AND TYPES OF MUTUAL FUND

Mutual fund can be classified by their principal investments. There are four main categories of funds i.e. money market fund, bond or fixed income fund, stock or equity fund and hybrid or balanced fund. Within these categories funds may be sub classified by investment objectives, investment approach or specific focus. The investment objective describes the type of income that the fund seeks. For example a capital appreciation fund generally looks to earn most of its returns from increases in the price of the securities it holds, rather than from dividend or interest income. The investment approach describes the criteria that the fund manager uses to select investments for the fund. Bond, stock and hybrid funds may be classified as either index (passively managed) fund or actively managed fund.

- **Money Market Fund:**Money market funds invest in money market instruments, which are fixed income securities with a very short time maturity and high credit quality. Investors often use money market funds as a substitute for bank saving account, though money market funds are not insured by the Government unlike bank saving accounts.

  Money market funds are safe and short term debt instruments, mostly the Government Treasury Bill. This is a safe place for investment. In money market the investor do not receive very high returns but risk is very low.

- **Bond or Fixed Income Fund:** A fixed income mutual fund focuses on investment that gives a set rate of return such as Government bonds, corporate bonds or other debt instruments. The fixed income fund portfolio generates income by interest which it then passed on to the shareholders. Sometimes these mutual funds are likely to pay higher returns than certificate and deposits in money market investments but bond fund are not without risk. The returns from bonds differ depending on their investments. For example a fund specializing in high yield junk bond is much riskier than a fund invested in Government securities. Furthermore, nearly all bonds are subject to *interest rate risk* which means that if rates go up the value of the fund goes down.

- **Stock or Equity Fund:** The largest category of fund is stock or equity fund. Equity funds primarily invest in shares of different companies. Equity fund investment would make a profit when the share prices surge, but suffers a loss when the share prices fall. Investing in equity funds is appropriate for those who invest for an extended period and is comfortable with moderate to high risk. In equity there are various subcategories. Some equity funds are named depending on the size of the companies they invest in as *small, mid or large cap*. Others are named by their investment approach as aggressive growth, income oriented, value and others. Equity funds are also categorized by whether investment is done in domestic stocks or foreign equities.

The idea is to classify funds in equity based on both the size of the companies invested in market capitalization and the growth prospects of the invested stocks. *Large cap* companies have high market capitalization.

Market Capitalization = Current Stock Price x Number of Outstanding Shares.

In India large cap company refers to those with a market capitalization value of more than Rs. 20,000 crores. Large cap companies are typically blue chip firms that are often recognized by name. Mid cap (Stock) companies fill the gap between small and large cap with market capitalization between Rs. 5,000 crores and less than 20,000 crores. The small cap (Stock) companies have market capitalization less than Rs. 5,000 crores. These small cap companies are new small and have more risks. A mutual fund may adopt strategy for investment either size of the company or market capitalization. The large cap companies have strong financial base and investment is relatively safe compared to small cap; but recently it is observed that their share prices also fall. On the other hand, the fund invested in small cap or start-up technology companies have excellent growth prospects.

- **Hybrid or Balanced Fund:** As the name suggests, balanced or hybrid funds invest in both equity and debt instruments to balance the risk and maintain a specific rate of return. The fund manager decides the ratio to reap the best of both debt and equity instruments. The hybrid fund is also known as an asset allocation fund. There are two variation of such funds designed to cater to the investors objectives. Some funds are defined with a specific allocation strategy that is fixed such that the investors have a predictable exposure to various asset classes. Other funds follow a strategy for dynamic allocation to meet various investor objectives. This may include responding to market conditions, business cycle changes, or changing phases of the investors own life.

- **Index Fund:** Index mutual fund invests in stocks that imitate a stock market index like the NSE Nifty, BSE Sensex etc. These are passively managed fund which means that the fund manager invest in the same securities as present in the underlying index in the same proportion and does not change the portfolio composition. These funds endeavour to offer returns comparable to the index that they track.
- **International or Global Fund:** An international mutual fund invests only in assets anywhere of the world located outside the home country. These funds are also referred to as foreign mutual fund or overseas funds. Investing in these can have higher risk exposure but also has chances of higher returns. Over the last decade the awareness of investment opportunities around the globe has increased. Investors want to explore international markets and tap into their earning potential.
- **Speciality Funds:** Speciality funds forgo broad diversification to concentrate on a certain segment of the economy or a targeted strategy. The targeted strategy of the funds aims at specific sectors of the economy such as financial, technology, health and so on.
- **Exchange Traded Fund:** Exchange traded fund (ETF) purchases and sells various tradable monetary assets like shares, debt, securities etc as per requirement during the trading time. Changes in the share price of an ETF depend on the costs of the underlying assets present in the pool of resources. If the price of one or more assets increases the share price of ETF increases proportionately and vice versa.

9.7 MUTUAL FUND FEES

A mutual fund classify expenses either as annual operating fees or shareholder fees. Annual fund operating fees are an annual percentage of the funds under management, usually ranging from 1 – 3 %. Annual operating fees are collectively known as the *expense ratio*. A fund expense ratio is the summation of the advisory or management fee and its administrative cost. The mutual fund expenses fall into five categories.

- **Management Fee:** The management fee is paid by the fund to the management company that organizes the fund, provides the portfolio management or investment advisory services and normally lends its brand to the fund. The management fees declines as the assets increases. The fund board reviews the management fees annually, fund shareholder must vote on any proposed increase of fees but the fund manager or sponsor can agree to waive some or all of the management fees in order to lower the fund expense ratio.
- **Distribution Charge:** Distribution charges paid for marketing, distribution of funds shares as well as services to investors. There are three types of distribution charges
  - Front-end load or sales charge that is paid to the broker as commission. The front-end load is paid by the investor and it is deducted from the amount invested
  - Back-end load is paid by the investor when shares are redeemed
  - Distribution and annual fee is charged annually from the investors for providing ongoing services to fund shareholders. The distribution and annual fee is also called 12b – 1 fee.
- **Securities Transaction Fees:** A mutual fund expenses related to buying and selling the securities in its portfolio is referred to as securities transaction fees. These expenses may include brokerage commissions. These costs are positively correlated with turnover.
- **Shareholder Transaction Fees:** Shareholders may be required to pay fees for certain transactions, such as buying or selling shares of the fund. Some funds charge redemption fees on percentage basis when an investor sells fund shares shortly after buying them (usually within 30, 60 or 90 days of purchase). The shareholder transaction fees are not part of the expense ratio.
- **Fund Services Charge:** A mutual fund may pay for other services which include.
  - Board of director's trustee fees and expenses
  - Custody fees paid to custodian bank
  - Fund administration fees

- Fund accounting fees
- Professional service fees
- Registration fees
- Shareholder communication expenses
- Other/miscellaneous fees.



CHECK YOUR PROGRESS

Q 1: What is meant by mutual Fund?
(Answer in about 50 words)

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Q 2: What is meant by balance or hybrid Fund?
(Answer in about 50 words)

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Q 3: What are the difference between investment in Stock and mutual fund share? (Answer in about 50 words)

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9.8 ADVANTAGES OF MUTUAL FUND

Mutual fund investment offers various benefits that make them the most lucrative investment option. Some of such advantages are mentioned below-

- **Professional Fund Management:** The primary advantage of mutual fund is that the investment is managed by professional fund managers. The fund manager takes care of all the assets by skilled trading and needful research. Investor purchase funds because they often do not have the time or the expertise to manage their own portfolios, or do not have assess to the same kind of information that a professional fund managers has. A mutual fund is a relatively inexpensive way of small investor to get a full time manager to monitor investment and help them to achieve all kinds of investment goals.

- **Diversification of Fund:** Diversification of fund is mixing of investments and assets within a portfolio to reduce risk. Buying an individual company stocks contains risk while investment in mutual fund offers diversified portfolio in different securities with different capitalization industries and bonds. Mutual fund diversifies the fund cheaper and faster than by buying individual securities.
- **Economics of Scale:** A mutual fund buys and sell large amount of securities at a time therefore, its transaction cost are lower than what an individual would pay for securities transaction. Since mutual fund pool money from many investors and accumulate a fund which is further invested professionally by expert fund managers, it creates economics of investment.
- **Freedom of Choice:** Investors have the freedom to choose a variety of investment and management goals. A fund manager may focus on investment in developed market, commodities, macroeconomic investing and other styles of investments like stocks, bonds etc. An investor may select any one or more from his choice.
- **Tax Efficiency:** Equity Linked Saving Schemes (ELSS) of mutual fund offers twin benefit of tax deduction and wealth accumulation. Investments in ELSS are eligible for tax deduction under Section 80C of Income Tax Act 1961.
- **Safe Investment:** All mutual funds are under purview of Securities and Exchange Board of India (SEBI) and Association of Mutual Fund of India (AMFI). Both are Government bodies; so investment is safe in mutual fund.
- **Ease of Trade and Transaction:** Buying, selling and redeem of funds in current market price per unit (NAV) is simple. All these transactions are possible by a request with mutual fund house and fund manager will take care of the rest. The liquid nature of mutual fund helps the investors in emergency situation.
- **Flexibility of Switch and Easy to Track:** A good investor knows to switch funds to keep away from worse situation and stay ahead of the market. There are various mutual fund schemes that allow investors wish to switch fund. At the same time mutual fund provide

the opportunity to track the fund with regular statement of the fund performance.

- **Minimum Investment (SIP) Option:** Mutual fund offers minimum or Systematic Investment Plan (SIP) to the investors based on the requirements. The minimum investment of mutual fund is Rs 500 in an instalment.

9.9 DISADVANTAGES OF MUTUAL FUND

The mutual funds have the following drawbacks-

- **Fluctuation of Returns:** The returns of mutual funds are not guaranteed as like other investments, there is possibility that the value of mutual fund might depreciate. Investment in equity has high risk and fluctuation of returns.
- **High Fees:** Mutual funds provide professional management but it comes at a cost and at the same time the investors have to pay other charges to the management for handling the fund. These expenses reduce the fund's overall performance.
- **Complexity:** Too much diversification of fund involves risk and might lead to a portfolio more complicated. Mutual funds have small holdings in many different companies; high returns in few investments often do not make much difference on the overall return.
- **Cash Drag:** Mutual funds pool money from thousands of investors, every day people are putting money in to the fund as well as withdrawing it. To maintain the capacity to accommodate withdrawals, funds typically have to keep a large portion of their portfolios in cash. So, the portion kept in cash for day to day withdrawals earn no returns.
- **Difficult to Evaluate Fund:** The net asset value (NAV) of fund offers some basis of comparison but due to diversity of portfolios, there is complexity to track the fund.
- **Lack of liquidity:** Unlike stock that trades throughout the day, many mutual fund redemptions take place only at the end of each trading day.

9.10 NET ASSET VALUE

The net asset value (NAV) is the market value per unit of all securities held by mutual fund schemes. NAV help an investor to assess the performance of a particular mutual fund. When an investor invests in mutual fund he gets unit of exchange of his investment and become the unit holder of mutual fund. It is like becoming a shareholder after buying stocks. But the difference of NAV from stocks is that the NAV of mutual funds are book value of the unit calculated at the end of each trading day based on the closing market price of the portfolio securities. The NAV of mutual fund is both the book value and the market price of the fund unit. On the other hand, when a company gets listed on the stock exchange, its shares become available for the investors to buy. The cost of company share is mentioned on the stock exchange. That is the stock market price of its share. Factors such as demand supply scenario and the company's potential affect the price of the share with every passing second. So, the stock market price is different from the book value.

Since the market value of the securities changes every day the NAV also varies daily. It is mandatory for mutual funds to disclose the NAV on regular basis. This may be done daily or weekly depending on the type of the schemes. Open ended funds (*The funds don't have fixed maturity period and investors are free to buy or sell units of NAV*) publish their NAV on the end of each working days. Close end funds (*Funds have fixed maturity period which are not redeemable and created by fund managers to meet demand from investors*) do so once a week.

To arrive at the NAV of mutual fund, first we have to calculate the Total Net Asset of the mutual fund. This is the market value of all the assets of mutual fund minus liabilities (*Expenses of managing the fund*) at a certain date. The NAV is then calculated by dividing Total Net Assets by the Total Number of Units (*Total Number of Units are dependent on the mutual fund Management)*. Thus,

$$\text{NAV} = \frac{Assets - Liabilities}{Total\ Number\ of\ Units}$$

The assets of mutual fund include the total market value of the fund's investments cash and cash equivalents, receivable and accrued income. Since a fund may have a certain amount of capital in the form of cash and liquid assets that portion is accounted under cash and equivalent heading. Receivable include items such as dividend and interest on that day while accrued income refers to money that is earned by a fund but yet to be received. The sum of all these items constitutes the **Fund's Asset (***Asset = Market Value of Fund's Investment + Cash and Cash equivalents + Receivable and Accrued Income***)**.

Liabilities of mutual fund typically include pending payments and variety of charges and fees owed to various associated entities. Additionally a fund may have foreign liabilities that may be share issued to non-residents' and sale proceeds pending repatriation. The liabilities of fund also include *accrued expenses* like staff salaries, operating expenses, distribution and marketing expenses, transfer agent fees, custodian charge of bank, audit fees and other operational charges.

Let, the total assets of a mutual fund is Rs 10,000/ and total liabilities Rs 2,000/. The number of outstanding units is 200 in this case NAV would be as follows

NAV = (10000 – 2000) / 200

NAV = 8000/200

NAV = Rs 40/

9.10.1 Meaning of High and Low NAV

Some mutual fund company promote new fund by highlighting their low NAV. They lead investors to believe that buying a mutual fund with a low NAV means getting a good deal. But, the NAV simply tells the ***current value per unit*** of a mutual fund. A high NAV only reflect the positive performance and the fund has been around a long time. The NAV affect the ***number of units*** that an investor received by a certain amount of investment. A mutual fund with high NAV gives fewer units and low NAV provides more units while investment is same in two mutual fund schemes. It will be clear by following example.

Let assume an investor invest Rs. 1,00,000/ each in two mutual fund schemes X and Y. Scheme X has NAV Rs. 10 and scheme Y has NAV Rs. 50. It is observed that NAV in scheme X is cheaper than scheme Y.

So, the investor received

For X mutual fund scheme 10,000 units (10,000 x Rs.10/ = Rs.1,00,000/)

For Y mutual fund Scheme 2,000 units (2,000 x Rs.50/ = Rs.1,00,000/)

Let assume both schemes give a return of 10% after six months. This means that both the schemes investment value increases from Rs. 1,00,000/ to Rs. 1,10,000/. Now,

NAV of scheme X increases to Rs. 11 (So scheme X earned return 1,10,000 – 1,00,000 = 10,000).

NAV of scheme Y increases to Rs. 55 (So scheme Y earned return 1,10,000 – 1,00,000 = 10,000).

Therefore, NAV means the current value per unit share of mutual fund. A fund cannot be judged how expensive or cheap a fund is by its NAV. The difference between high or low NAV is that, the low NAV provides more units to the investor compared to high NAV.

9.10.2 Importance of NAV in Mutual Fund

- NAV indicates simply how many units in a particular fund an investor is able to purchase. The difference of NAV in two dates, during the time of investment and redemption tells whether a certain investment is profitable or not. If the NAV increases during the time of redemption the investor get profit and vice versa.
- Depending on investment goal, the NAV helps to know how a fund will grow over a period of time. So, NAV is an indicator to choose a particular mutual fund.
- NAV helps the investors to track and to know the performance of a fund. A high NAV only reflect the positive performance as

well as inform that the fund has been around for long time but it does not mean investment with high NAV units provide high returns to the investors.

- NAV is most frequently compared to market capitalization to find undervalued or overvalued investment. Generally mutual fund companies having growth prospect and market capitalization overvalued their NAV.

9.11 FACTORS THAT HELP TO CHOOSE MUTUAL FUND

Following are the factors that help to choose mutual fund :

- How it has performed over the year.
- How it is consistent in giving returns.
- Strategy of the fund manager in different situations and his performance.
- Is the fund overriding normal turbulences in the market?



CHECK YOUR PROGRESS

Q 4: What is meant by Net Asset Value?
(Answer in about 50 words)

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Q 5: How NAV is important in Mutual Fund?
(Answer in about 50 words)

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9.12 LET US SUM UP

- A mutual fund is a trust poll investment from the investors who share a common financial goal. The poll resources are invested in several investment instruments such as debt, shares and other profitable sectors.
- The value of Mutual Fund Company depends on the performance of the fund they managed. So, when an investor invests on mutual fund he buys the performance of the portfolio or more precisely a part of portfolio value.
- Unlike stock, mutual fund share do not provide voting rights to the holders. A share of mutual fund represents investment in many different stocks or securities instead of just holding one share.
- Mutual fund charge annual fees (called expense ratio) and in some cases commission which affect overall returns.
- People can diversify their investment holdings by purchasing mutual funds, which contain a variety of stocks and bonds.
- Mutual funds are registered with Securities Exchange Board of India (SEBI) and Association of Mutual Funds in India (AMFI).
- The NAV is the market value per unit of all securities held by mutual fund. NAV is calculated by dividing Total Net Assets by the Total Number of Units.
- Depending on investment goal the NAV helps to know the performance of a fund over a period of time. So, NAV is an indicator to choose a particular mutual fund.



9.13 FURTHER READING

- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.

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9.14 ANSWERS TO THE CHECK YOUR PROGRESS

Ans to Q No 1: A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in securities like stocks, bonds, money market instruments and other assets. Mutual funds are operated by professional fund managers who allocate the fund's asset and attempt to produce highest capital gains or income for the fund investors.

Ans to Q No 2: By name suggests balanced or hybrid funds invest in both equity and debt instruments to balance the risk and maintain a specific rate of return. The fund manager decides the ratio to reap the best of both debt and equity instruments. The hybrid funds also known as an asset allocation fund.

Ans to Q No 3: Investment in share of a mutual fund is different from investing in shares of stock. Unlike stock, mutual fund share do not provide voting rights to the holders. A share of mutual fund represents investment in many different stocks or securities instead of just holding one share. Therefore, the price of mutual fund share is referred as NAV. The NAV, unlike stock price does not fluctuate during market hours but it is settled at the end of each trading day.

Ans to Q No 4: The NAV is the market value per unit of all securities held by mutual fund. NAV help an investor to assess the performance of a particular mutual fund. The NAV is calculated by dividing Total Net Assets by the Total Number of Units. Thus,

$$\text{NAV} = \frac{Assets - Liabilities}{Total\ Number\ of\ Units}$$

Ans to Q No 5: NAV indicates the number of units held by mutual fund. The difference of NAV in two dates, during the time of investment and redemption tells whether a certain investment is profitable or not. Depending on investment goal the NAV helps to know how a fund will grow over a period of time.



9.15 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by mutual fund?

Q 2: Briefly explain the features of mutual fund.

Q 3: What is meant by Mutual Fund Fees?

Q 4: How NAV is calculated?

Long Questions (Answer each question in about 300-500 words)

Q 1: Explain different classification and types of mutual fund.

Q 2: Explain the advantages and disadvantages of investing in mutual fund.

Q 3: Explain the importance of Net Asset Value in mutual fund.

Q 4: Discuss the various factors that help to choose the mutual fund.

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UNIT 10 : THE DEBT MARKET

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Participants in the Debt Market

10.4 Instruments traded in the Debt Market

10.5 The Government Security Market

10.5.1 Market Segments of Government Securities Market

10.6 Let Us Sum Up

10.7 Further Reading

10.8 Answers to Check Your Progress

10.9 Model Questions

10.1 LEARNING OBJECTIVES

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

- understand the concept of debt market and its participants
- explain the Instruments traded in debt market
- describe the concept of government security market.

10.2 INTRODUCTION

The Debt Market is one of the most critical components of a financial system of an economy. A fairly well-segmented debt market comprises the following segments: Private Corporate Debt Market, Public Sector Undertaking Bond Market, and Government Securities Market. In India the debt market is regulated by Securities Exchange and Board of India (SEBI).

An efficient debt market is characterised by a competitive market structure, Strong and safe market infrastructure, Low transaction costs and Heterogeneity among market participants.

In this unit we will discuss about the participants in the debt market, instruments traded in the debt market and government security market in details.

10.3 PARTICIPANTS IN THE DEBT MARKET

There are a small number large players who participants in the debt market. Some of these participants are high net worth individuals, cooperative banks, large corporate, mutual funds and insurance companies. Some of the major participants in the debt market are as follows:

- **Central and State Governments:** To finance budget deficit and financial requirements the central government raises money through the issue of dated securities and treasury bills through the Reserve Bank of India.
- **Public Sector Undertakings:** To meet their long-term as well as working capital, the PSUs issues both taxable and tax-free bonds and also invest in debt securities.
- **Banks:** In the call money market the banks participates as both lenders and borrowers. Again in commercial paper market they participate as arrangers and investors. Further for their short-term and long term requirements the banks issues certificates of deposits and bonds respectively.
- **Corporates:** The corporates are both issuers and investors in the debt market.
- **Primary Dealers:** The primary dealers intermediate between government securities and the debt market and are appointed by the Reserve Bank of India.
- **Mutual Funds:** The mutual funds are active participants and traders in the debt market who deals with specialised debt funds as market mutual funds etc.
- **Foreign Institutional Investors:** The Foreign Institutional Investors can invest in both government securities and corporate bonds within the specified limit of investment for them.
- **Provident Funds:** The provident funds are not active traders but nonetheless are large investors on government securities and Public Sector Undertakings bonds.

- **Charitable Institutions and Trusts:** Just like Provident Funds the Charitable Institutions and Trusts are also not active traders but is one of the large investors in government securities and bonds abiding by the bye-laws governing them.



LET US KNOW

Linkage Between Money Market and Debt Market : The money market deals with short-term debt instruments (up to one year). On the other hand, debt market deals with long-term debt instruments (more than one year). The long-term debt market is supported by the money market as it increases the liquidity of the securities. As such the money market needs to be developed for the efficient working of the debt market.

10.4 INSTRUMENTS TRADED IN THE DEBT MARKET

The different type of instruments that is traded in the debt market is classified into the following market segments:

- Government Securities
- Public Sector Bonds
- Private Sector Bonds

Government securities are issued by both the Central and State Governments. The type of instruments traded in this market are zero coupon bonds, coupon bearing bonds, treasury bills, floating rate bonds and STRIPS.

Public Sector Bonds are issued by government agencies or statutory bodies and public sector units. The government agencies or statutory bodies issues government guaranteed bonds and debentures. On the other hand, Public Sector Units trades in instruments like PSU bonds both taxable and tax-free, debentures, commercial papers and deep discount bonds.

Again the major issuers of private sector bonds are the corporates, banks and financial institutions. The corporates trade in instruments like: debentures, bonds, commercial paper, floating rate bonds, secured premium notes, zero coupon bonds and inter-corporate deposits. On the other hand,

the banks trade in certificate of deposits, debentures and bonds. Further, the financial institutions deal in certificate of deposits and bonds.



LET US KNOW

Segments of Debt Market:

There are two segments of the debt Market:

- the primary market
- the secondary market

The primary market is a market for new debt issues which are floated either through prospectus, rights issue or private placement.In the secondary market, the debt instruments are traded on the OTCEI, the BSE and the Wholesale Debt Market (WDM) segment of the National Stock Exchange (NSE). The clearing and settlement of the trades is undertaken through the clearing house of the exchange.



CHECK YOUR PROGRESS

Q 1: What are the segments of a debt market? (Answer in about 30 words)

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Q 2: Who regulates the debt market in India? (Answer in about 20 words)

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Q 3: What are the characteristics of an efficient debt market? (Answer in about 30 words)

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10.5 THE GOVERNMENT SECURITY MARKET

The Government needs money to regulate economic activity, make public provisions available, regulate the banking system and monetary

policies and create and maintain physical infrastructure. To perform these activities, revenue is generated by the government in the form of taxes and income from the ownership of assets. The government also borrows from the public, banks and financial institutions to meet its expenditure in excess to the revenue generated. The government raises shot-term and long-term funds by issuing securities in government securities market (GSM). GSM is the largest market in any economic system and is risk-free. Therefore, it acts as a benchmark for other markets.

The GSM is one of the principal segments of debt market and acts as a bench mark for pricing debt securities like corporate papers of varying maturities. GSM also plays an important role in the transmission mechanism of monetary policy and implementation of fiscal policy of the government. Further government securities facilitate borrowing by the government as they act as the highest type of collateral.

Government securities are issued by the central government, state government and semi-government authorities. Apart from the RBI, some of the major investors in this market are the nationalised banks, insurance companies, state governments, provident funds, mutual funds, individuals, corporate, financial institutions, non-banking finance companies and primary dealers. Besides, foreign institutional investors and non-resident Indians can invest in government securities to a limited extent.

The government securities are usually of two types: treasury bills and government dated securities. The trading of government securities is done by brokers over telephone which is reported to the negotiated dealing system (NDS). It is cleared and settled on the Clearing Corporation of India Limited.



LET US KNOW

- The government securities are eligible for the maintenance of SLR ratio and are therefore known as SLR securities.
- **Segments of Investors in Government Securities**

There are three segments of investors in government securities

- The **wholesale market segment** comprising of banks, insurance companies, financial institutions, primary dealers and mutual funds.
- The **middle segment** comprising of provident funds, corporates, non-banking finance companies, trusts and small co-operative banks.
- The **retail segment** consisting individuals and non-institutional investors.

10.5.1 Market Segments of Government Securities Market

The government securities market trades in both the primary and secondary markets. In the primary market debt instruments are issued. In the primary market the debt instruments are subscribed by various investors. These investors may or may not trade in the debt instruments in the secondary market. The government securities are issued by the Reserve Bank of India on behalf of the government. The instruments traded in the primary market are treasury bills and government dated securities through which the central and the state governments respectively mobilises funds. The government securities are issued either through auction, sale or private placement with the RBI.

There are two segments of the secondary market in government securities: the wholesale institutional segment and the retail segment.

The wholesale institutional segment consists of banks, primary dealers, mutual funds, insurance companies and others. On the other hand, the retail segment includes cooperative banks, provident funds, non-banking finance companies and others.



CHECK YOUR PROGRESS

Q 4: Who issues Government securities?
(Answer in about 20 words)

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Q 5: Name some of the major investors in Government securities market apart from the RBI? (Answer in about 60 words)

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Q 6: What are the two segments secondary market securities? (Answer in about 20 words)

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10.6 LET US SUM UP

- The Debt Market is one of the most critical components of a financial system of an economy.
- In India the debt market is regulated by Securities Exchange and Board of India (SEBI).
- There are a small number large players who participants in the debt market. Some of these participants are high net worth individuals, cooperative banks, large corporate, mutual funds and insurance companies.
- The different type of instruments that is traded in the debt market is classified into the market segments as Government Securities, Public Sector Bonds and Private Sector Bond.
- The government raises shot-term and long-term funds by issuing securities in government securities market (GSM). GSM is the largest market in any economic system and is risk-free. Therefore, it acts as a benchmark for other markets.
- Government securities are issued by the central government, state government and semi-government authorities.
- The government securities are usually of two types: treasury bills and government dated securities.
- The government securities market trades in both the primary and secondary markets. In the primary market debt instruments are issued.



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10.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A fairly well-segmented debt market has emerged comprises of the following segments: Private Corporate Debt Market, Public Sector Undertaking Bond Market, and Government Securities Market

Ans to Q No 2: In India the debt market is regulated by Securities Exchange and Board of India (SEBI).

Ans to Q No 3: An efficient debt market is characterised by:

- a competitive market structure
- Strong and safe market infrastructure
- Low transaction costs and
- Heterogeneity among market participants.

Ans to Q No 4: Government securities are issued by the central government, state government and semi-government authorities.

Ans to Q No 5: Apart from the RBI, some of the major investors in this market are the nationalised banks, insurance companies, state governments, provident funds, mutual funds, individuals, corporate, financial institutions, non-banking finance companies and primary dealers. Besides, foreign institutional investors and non-resident Indians can invest in government securities to a limited extent.

Ans to Q No 6: There two segments of the secondary market in government securities: the wholesale institutional segment and the retail segment.



10.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is the prerequisite of an efficient debt market?

Q 2: What are the segments of the debt market? Discuss.

Q 3: What are three segments of investors in government securities?

Q 4: What are the Market Segments of Government Securities Market?

Long Questions (Answer each question in 300-500 words)

Q 1: Discuss the participants of the debt market.

Q 2: Discuss the instruments traded in the debt market.

Q 3: Write a note on the government securities market.

Q 4: Why were the reforms in government securities market necessary?

Q 5: What was the objective of reforms in government securities market? Validate your answer.

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UNIT 11: THE INSURANCE SECTOR

UNIT STRUCTURE

11.1 Learning objectives

11.2 Introduction

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11.1 LEARNING OBJECTIVES

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

- know the different types and methods of Insurance
- understand the various functions and principles of insurance
- discuss the need of insurance for future uncertainties in present context

11.2 INTRODUCTION

In our day to day life we all anticipate and face various kinds of risks. No one can foresee the loss he/she may suffer in future. He who walks on road, works in office, fields, shops etc may anticipate variety of risks. Similarly, there can be loss due to floods, earthquakes, disease, fire etc. Every risk may result in loss of one or the other kind. Where ever there is uncertainty to a probable loss of one or of the other kind. If it is small, he

may bear it. But if it is large he may not be in a position to bear it at its own. It is possible to take precautions again such events. Hence, it would be wise to adopt a device or plan to provide help to those who suffer a loss. Such a device is 'Insurance' which safeguards the person from various risks which he anticipates. And in this unit we will discuss in details about the insurance sector.

11.3 CONCEPT OF INSURANCE

The aim of all kinds of insurance is to provide help to those who happen to suffer a loss. Most of the losses can be identified in terms of money. The risk of loss can not be averted but loss occurred can be distributed among the agreed persons. Insurance is an assurance that if a particular kind of event happens, the insured person will be paid the money. The person who seeks such protection against such a risk is called the 'insured' or 'assured' and who undertakes to protect such person from financial loss or some mishappening is called the 'insurer' or 'assurer or 'underwriter', and the consideration collected by the insurer companies to provide such security is called the 'premium' or 'premia'. The document containing term and conditions of contract is called the 'policy' or 'insurance policy'.

It is the universally accepted phenomenon that what is created will be destroyed. No one can predict or foresee the time of destruction or loss he may suffer in future. Every risk result in loss of one or other kind. The risk cannot be eliminated but loss can be. This desire to protect a person from uncertain loss brings the business of insurance into existence.

The function of insurance is to protect the insured from variety of risks he/she anticipates by spreading the loss to persons who agreed to co-operate each other at the time of loss by making contributions to the common fund.

Illustration:

In a town, there are 500 car owners. Each car can be valued Rs.3,00,000. Every year 1 car is lost due to theft. If all the 500 car owners agree to come together and each one contribute Rs.600 annually, the common fund would be Rs. 3,00,000 a year. This would be sufficient to pay

Rs. 3,00,000 to the Contributor whose car is lost due to theft. Thus, the risk of one contributor is distributed amongst the 500 contributors of the town.

Definition of Insurance

The definition of insurance can be classified under two categories:

- *Functional Definitions* - According to Allen C. Mayerson, " Insurance is a device for the transfer of certain risks of economic loss to an insured, that would otherwise be borne by the insured."

  As per Disnadle, " Insurance is an instrument of distributing the loss of few among many."
- *Contractual definition*- According to E.W.Patterson, " Insuance is a contract by which one party, for a considertion called premium, assumes a particular risk of the other party and promises to pay to him or his nominee a certain or ascertainable sum of amount on a specified contingency."

According to MacLean "Insurance is a method of spreading over a large number of persons a possible financial loss too serious to be conveniently borne by an individual."

11.4 NATURE OF INSURANCE

The nature of insurance is as follows:

- Insurance is a mechanism of sharing risk by large number of people among the few who are exposed to risk by one or the other reason.
- If a large number of subscribers to insurance serve the purpose of compensation to few among them exposed to uncertain risks appears as a co-operative look.
- Valuation of risk is determined as per predefined terms and conditions of the insurance policies.
- Insurance provides facility of financial help in case of contingency.
- Financial help depends on the value of insurance for which payment is made in case of contingency. This provides basis of the amount to be paid.
- Insurance is a policy regulated under laws and therefore the amount of insurance can neither be paid as gambling nor as charity.

11.5 ROLE OF INSURANCE

Human beings, his/her family and properties are always exposed to different kinds of risks. Risk involve the losses. Insurance is a tool which reduces the cost of loss or effect of loss caused by variety of risk. It accumulates funds to meet individual losses. It is not device to prevent unwanted event of happening or cause of loss but protects them against that loss by compensating which is lost. The role and importance of insurance are discussed as follows:

- **Insurance provides security:** Insurance provides safety and security against the loss on a particular event. Life insurance provides security against death and old age sufferings. Fire insurance protects against loss due to fire while Marine insurance provides protection and safety against loss of ship and cargo. For personal accident and sickness insurance financial protection is given when the individual is unable to earn. In other insurance too, this security is provided against the loss at a given contingency.
- **Insurance reduces business risk or losses:**In Business, commerce and industry, huge properties are employed. Because of slight negligence, the property may be turned in to ashes. A person may not be sure of his life, health and cannot continue the business up to the longer period to support his dependents. With the help of insurance, he can be sure of his earning, because the insurance company will pay a fixed amount at the time of death, damage by fire, theft, accident and other perils.
- **Insurance provides peace of mind:** Insurance removes the tensions, fears, anxiety, frustration and weakness of the human mind associated with the future uncertainty. By providing financial support and promise to compensate losses arising out from various risk, it provides peace of mind and stimulates more and better work performance of an individual.
- **Life insurance encourages saving:** In some specified life insurance policies, the insured has an obligation to pay premium

regularly and cannot be withdrawn easily before the expiry of the term of policy. Life insurance encourages the habit of regular and systematic saving through premium and after a certain period, it would be a part of necessary saving of the insured person.

- **Insurance accelerates the economic growth of the country:** To develop the economic growth of the country, insurance provides strong hand and mind, with protection against loss of property and capital to produce more wealth. It provides protection against different kinds of loss caused by risk. It accumulates the capital from the insured and utilizes for the development of country. Thus, the insurance meets all the requirements for the economic growth of a country.
- **Insurance provides credit facilities:** The insured person can get loan by pledging insurance policy and the interest will not exceed the cash value of policy charged by insurer. In case of death of insured person, the policy can be utilized for setting of the loan with interest. Business person can take loan on the basis of insurance documents from the bank also.
- **Insurance helps to reduce inflation:** Inflation created from over supply of money and on less production entities. Insurance can help to reduce the inflationary pressure in two ways. Firstly, it collects money as an amount of premium which controls over supply of money and secondly, it provides sufficient funds for increase production entities. Thus, it reduces the impact of inflation.
- **Insurance makes security and welfare of employees:** The security and welfare of employees is the responsibility of employer. These security and welfare can easily be met by life insurance, accident and sickness benefit and pension which are generally covered by group insurance. The premium for group insurance is normally bear by the employer. Insurance is the simple method for employer to fulfill their responsibility. Due to these benefits, employees will devote their maximum capacities to complete their job.

- **Other Importance of Insurance:**
  - Insurance helps to promote foreign trade providing protection again trade risk.
  - Insurance increases business efficiency eliminating the loss of damage, destruction, or disappearance of property of goods.
  - Insurance protects the social wealth providing protection against social evil.
  - Development of insurance business helps to solve the evil of unemployment, generating employment opportunity in the country.
  - The insured gets tax benefit in life insurance.



CHECK YOUR PROGRESS

Q 1: Which sector regulates Insurance and reinsurance in India?

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Q 2: Write a short note on Indian insurance sector. (Within 50 words)

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Q. 3: When was life insurance sector was nationalised in India?

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.....

Q. 4: State whether the following statement are True (T) or False (F)

(a) A coverage that protects businesses engaged in electronic commerce from losses caused by hackers is termed as Hacker Insurance.

(b) Insurance is a policy regulated under laws and therefore the amount of insurance can neither be paid as gambling nor as charity.

11.6 TYPES AND METHODS OF INSURANCE

11.6.1 Types of Insurance

Basically, there are two broad types of insurance – Life Insurance and General Insurance.

- **Life Insurance:** Life Insurance is a financial cover for a contingency linked with human life, such as death, disability, accident, retirement etc. Human life is subject to risks of death and disability due to natural and accidental causes. When human life is lost or a person is disabled permanently or temporarily, there is loss of income to the household. Although human life cannot be valued, a monetary sum could be determined based on the loss of income in future years. Hence, in life insurance, the Sum Assured (the amount guaranteed to be paid in the event of a loss) is by way of a 'benefit'. Life Insurance products provide a definite amount of money in case the life insured dies during the term of the policy or becomes disabled on account of an accident.

Types of Life Insurance Policies:

- **Term Insurance:** One can choose to have protection for a set period of time with Term Insurance. In case of death or total and permanent disability, if the benefit is offered, the dependants of the insured will be paid a benefit. However, in Term Insurance, no benefit is normally payable if the life assured survives the term.
- **Whole Life Insurance**: With whole life insurance, the insured is guaranteed lifelong protection. Whole life insurance pays out a death benefit so the insured can be assured that his/her family is protected against financial loss that can happen after the insured's death.
- **Endowment Policy**: An Endowment Policy is a savings linked insurance policy with a specific maturity date. If an unfortunate event by way of death or disability occurs to

the insured during the period, the Sum Assured will be paid to his/her beneficiaries.

- **Money back plans or cash back plans**: Under this plan, certain percent of the sum assured is returned to the insured person periodically as survival benefit and after the expiry of the term, the balance amount is paid as maturity value. The life risk may be covered for the full sum assured during the term of the policy irrespective of the survival benefits paid.
- **Children Policies:** These types of policies are taken on the life of the parent/children for the benefit of the child. By such policy the parent can plan to get funds when the child attains various stages in life. Some insurers offer waiver of premiums in case of unfortunate death of the parent/ proposer during the term of the policy.
- **Annuity (Pension) Plans:** When an employee retires he/ she no longer gets his salary while his/her need for a regular income continues. Retirement benefits like Provident Fund and Gratuity are paid in lump sum which are often spent too quickly or not invested prudently with the result that the employee finds himself/herself without regular income in his/her post - retirement days. Pension is therefore an ideal method of retirement provision because the benefit is in the form of regular income. It is wise to provide for old age, when we have regular income during our earning period to take care of rainy days. Financial independence during old age is a must for everybody.

- **General Insurance:** General Insurance is the insurance of assets, financial assets etc. If there is an economic loss by a contingency and if it is covered under a policy, the loss is compensated by general insurance policies. Types of general insurance are as follows:

- **Health Insurance:** It covers the medical expenses of the insured if the insured fall ill or injured and need medical assistance.
- **Motor Insurance:** This is the plan for vehicles. These plans are mandatory as per law and have to be bought for every vehicle.
- **Travel Insurance:** These plans are to cover financial emergencies that the insured person may face during his travelling.
- **Home Insurance:** These plans cover the financial losses that one may suffer in case of his home and its contents are damaged.
- **Fire Insurance:** These policies cover the damages caused by fire and other related hazards.

Some other types of general insurance are:

- **Marine Insurance:** It is a contract by which insurer engage to assure the owner of a ship, cargo or freight against losses from certain perils or sea risks to which their ship or cargo may be exposed.
- **Credit Insurance:** Credit insurance means insuring the payment of commercial debts against the risk of non-payment by the borrower because of his insolvency or for some other reason.
- **Group Insurance:** Group Insurance is insurance or life insurance obtained by a person as a member of a group, such as a professional organization, rather than as an individual, because in this way better terms can often be obtained. This is because there is an administrative saving for the company, and sometimes also because a particular group has a better life expectancy than people in general.
- Cyber risk insurance
- Commercial General Liability insurance
- Professional Indemnity insurance etc.

11.6.2: Methods of Insurance

- Co-insurance – risks shared between insurers
- Dual insurance – having two or more policies with overlapping coverage of a risk (both the individual policies would not pay separately – under a concept named contribution, they would contribute together to make up the policyholder's losses. However, in case of contingency insurances such as life insurance, dual payment is allowed)
- Self-insurance – situations where risk is not transferred to insurance companies and solely retained by the entities or individuals themselves
- Reinsurance – situations when the insurer passes some part of or all risks to another insurer, called the reinsurer.

11.7 NEED OF INSURANCE

Life of everyone is full uncertainties. Nobody knows what is going to happen in next moment. This element of uncertainty always pursues around the mind of a person and keeps him worried to think as to what will happen in future in case of any mishappening. This worry is to think about the future of the person and his family. Among a number of worries the main and very important is economic uncertainty of himself or his family. There remain many fields to worry about. Every field need some security cover and to ensure such security cover one is not able to catch the future unfortunate happenings. It therefore becomes prudential to get insured for visual or un-visual events one is able to foresee. There are various reasons behind insurance which are discussed below:

- **Nobody knows what is going to happen:** This is the main reason for having insurance. If one is covered and someone breaks in to his/her home and steals something one get it replaced. This is how insurance should work.
- **Nobody can trust nature:** In 2010, a cloud burst in Himachal Pradesh took life of hundreds of people and thousands of persons

were left as homeless people. In a situation of terrorist's regime any one is exposed to the risk of life and business. Similarly, storms, hurricanes, tornadoes, earthquakes, tsunamis, floods etc. into the mix and it becomes very clear that insurance is still very necessary.

- **Nobody can trust other people:** Accidents happen to everyone, but there are people who cause accidents through negligence, a drunk driver, as for example.
- **For peace of mind:** Knowing that one (and his/her family) are covered by an insurance policy if something unfortunate does happen can help put one's mind at ease.

11.8 FUNCTIONS OF INSURANCE

When we talk about functions of insurance one thing comes to our mind that after purchasing an insurance policy we need not to worry about our future, which is a wrong concept. Every insurance policy is subject to the terms and conditions contained in the insurance agreement and therefore any insurance serves a limited purpose as agreed to between two parties the Insurer and the Insured. One cannot expect more than what one has insured him. It is pertinent to note that the functions of any insurance remained confined to the terms and conditions of different type of insurance policies. The basic functions of an insurance company are discussed below:

Primary Functions

- **Protection:** Primary function of Insurance is to provide protection against future risks, accidents and uncertainty. No insurance can arrest the risk from taking place; no insurance can prevent future miss happenings, but can certainly provide some cover for the losses of risk. Insurance is a protective cover against economic loss by sharing the risk with others, (the pooling members).
- **Collective Risk:** The Insurance policies whether life insurance or general insurance are purchased by many people. However, all of them are not subjected to losses every year. It is only a few who become victim of some misshappenings. It is clear

that insurance is a method by means of which a few losses are shared by a large number of people. All the people insured contribute by paying annual premium towards a fund out of which the persons exposed to risks are paid as per the terms and conditions of the insurance policy purchased by them.

- **Assessment of Risk:** The volume of risk is determined by the Insurance companies by assessing various factors that give rise to risk. The rate of premium is also decided on the basis of risk involved.
- **Certainty:** Unless we are insured we remain uncertain about our capability to meet the future risks. But once we are insured it converts our uncertainty into certainty of bearing future risks.

Secondary Functions

- **Prevention of losses:** We know that precautions are better than the treatment. It is better instead of seeking the help of insurance if one adopts such measure which prevents the losses. Every Insurance prescribes to take preventive measures against losses. As for example, installation of safety devices like automatic sparkler or alarm system, CCTV system etc. If such preventive measures exist, there shall be lower rate of premium for getting insurance cover against risks. Prevention of losses is to adopt preventive measures against unexpected losses.
- **Covering Larger Risks with small capital:** Every businessman is always worried about the security of his business. After making large investments in the business it is natural to take care of the business investments. There are two alternatives- a) the concerned businessman should invest out of his own pocket to create a proper security and to get his business activities insured. In such a case the insurance relives a businessman from security investments by paying small amount in the shape of premium against larger risks and uncertainties. This assures the businessman from security

investments for a small amount of premium against larger losses.

- **Helps in development of larger Industries:** Larger Industries are prone to more risks in their setting up. The large industries have diversified fields of functioning where one field sometimes has no relation with the other field of the same industry. The activities of large industries are diversified that it goes above any planning to cover every type of risk. It is only the insurance that comes not only to help these large industries against possible risk but also help them to grow. It becomes possible only because insurance provides an opportunity to develop to those larger industries which have more risks in their setting ups.

Other Functions

- **Insurance is a tool used for saving and investments:** By purchasing any Insurance Policy it becomes completion by the purchaser to make payment of the insurance policy. This completion is blessing in disguise. Most of the policy buyers particularly individuals do not know the purpose of payment of premium. They know only one thing that paying premium is compulsory for them. Such savings help growth in national economy.
- **It is one of sources to earn Foreign Exchange:** It being an international business, any country is free to earn foreign exchange as much as per the policies of insurance devised in a way to attract more and more foreign business. It is a good source of earning foreign exchange for any country.
- **Risk Free Trade:** Insurance promotes export as insurance, makes the foreign trade risk free with the help of different types of polices under marine insurance cover.
- **Subrogation:** In its most common usage it refers to circumstances in which an insurance company tries to recoup expenses for a claim it paid out when another party should have

been responsible for paying at least a portion of that claim. However there are certain functions which apply to every kind of insurance including life insurance as well as general insurance that includes every type of insurance such as home, automobile, jewellery, property and other valuable assets.

11.9 SHORTCOMINGS OF INSURANCE

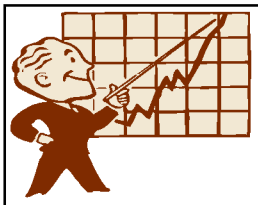
Insurance is just a risk transfer mechanism wherein the financial burden which may arise due to some accidental event is transferred to a bigger entity called Insurance Company by way of paying premiums. This only reduces the financial burden and not the actual chances of happening of an event. Insurance is a risk for both the insurance company and the insured. The insurance company understands the risk involved and will perform a risk assessment when writing the policy. As a result, the premiums may go up if they determine that the policyholder will file a claim. The shortcomings are:

- **Moral hazard:** An insurance company may inadvertently find that its insured may not be as risk-averse as they might otherwise be a concept known as moral hazard. This 'insulates' many from the true costs of living with risk, negating measures that can mitigate or adapt to risk and leading some to describe insurance schemes as potentially maladaptive.
- **Complexity of insurance policy contracts:** Insurance policies can be complex and some policyholders may not understand all the fees and coverage included in a policy. As a result, people may buy policies on unfavourable terms. In response to these issues, many countries have enacted detailed statutory and regulatory regimes governing every aspect of the insurance business, including minimum standards for policies and the ways in which they may be advertised and sold.
- **Limited consumer benefits:** Consumers are in most cases advised to select high deductibles and to not insure losses which would not cause a disruption in their life. However, consumers have

shown a tendency to prefer low deductibles and to prefer to insure relatively high-probability, small losses over low-probability, perhaps due to not understanding or ignoring the low-probability risk. This is associated with reduced purchasing of insurance against low-probability losses, and may result in increased inefficiencies from moral hazard.

- **Redlining:** Redlining is the practice of denying insurance coverage in specific geographic areas, supposedly because of a high likelihood of loss, while the assumed motivation is unlawful discrimination. Racial profiling or redlining has a long history in the property insurance industry in the United States.

Inspite of all these shortcomings, in the present day affairs insurance means financial protection against losses arising out of happenings of an uncertain event. In order to protect against such losses one has to bear some financial burden also. This can be ensured by paying certain amount, depending on the risk covered and the amount of expected loss in the form of paying premium to any of the insurance companies. So in simple words the meaning of insurance is to keep a person fearless and unworried about the future happenings which always remain uncertain. It absolves the risk of uncertainty and provides a piece of mind because the insurance facilitates reimbursement during crises situations and compensate for any potential future losses.



CHECK YOUR PROGRESS

Q.5: State the primary functions of insurance. (Answer in about 20 words)

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Q.6: Discuss various roles of Insurance. (Answer in about 60 words)

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Q.7: How moral Hazard problem arises in Insurance market?
(Answer in about 60 words)

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11.10 LET US SUM UP

- Insurance is a means of protection from financial loss. It is a form of risk management, primarily used to evade against the risk of a contingent or uncertain loss. An entity which provides insurance is known as an insurer, insurance company, insurance carrier or underwriter. A person or entity who buys insurance is known as an insured or as a policyholder.
- The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insurer will compensate the insured. The amount of money charged by the insurer to the policyholder for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster.
- Its basic roles are to provide safety and security to human life, generates financial resources by collecting premium which later on encourages saving, improves investment channel by enabling systematic savings due to payment of regular premium and thus insurance plays a crucial role in sustainable growth of an economy.
- India's economy has been in a boom for the last two decades. There has been increased manufacturing and financial activities. This, in turn, has triggered a rapid growth in the insurance sector as well. In the year 2000, the authorities allowed private companies to be a part of the insurance business. Today there are 13 companies in life insurance and 13 in general insurance. The most prominent one is of course LIC. And then there are other major players like New India, Tata AIG, Bajaj Allianz, ICICI Lombard etc.

- The shortcomings of insurance are- problems of moral hazards, complexity in understanding various insurance schemes, denying insurance coverage and limited consumer benefits. Even though in the present day context, insurance means financial protection against losses arising out of happenings of an uncertain event.



11.11 FURTHER READING

- Howard, C. K., Mark, V. and Pauly, S. McMorrow. (2013). *Insurance and Behavioral Economics*. Cambridge University Press.
- Mishra, K.C. and Bakshi, M. (2009). *Insurance Business Environment & Insurance Company Operations*. Cengage Learning.



11.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Insurance Regulatory and Development Authority of India (IRDA) is an autonomous and the statutory body tasked with regulating and promoting insurance and reinsurance in the country. IRDA was constituted by the Insurance Regulatory and Development Authority Act - IRDA Act, 1999 and has its headquarters in Hyderabad, Telangana..

Ans to Q No 2: India's economy has been in a boom for the last two decades. There has been increased manufacturing and financial activities. This, in turn, has triggered a rapid growth in the insurance sector as well. In the year 2000, the authorities allowed private companies to be a part of the insurance business. Today there are 13 companies in life insurance and 13 in general insurance. The most prominent one is of course LIC. And then there are other major players like New India, Tata AIG, Bajaj Allianz, ICICI Lombard etc.

Ans to Q No.3: Life insurance in India was completely nationalised on 19th January 1956, through the Life Insurance Corporation Act.

Ans to Q No.4: (a) True (b) True

Ans to Q No.5: The primary functions of insurance are- protection, collective risks, assessment of risk and certainty.

Ans to Q No 6. The insurance industries develop financial institutions and reduce uncertainties by improving financial resources. Its basic roles are-

- Provide safety and security: Insurance provide financial support and reduce uncertainties in business and human life.
- Generates financial resources: Insurance generates funds by collecting premium. These funds are invested in government securities and stock.
- Life insurance encourages savings: Insurance provides an investment channel too. Life insurance enables systematic savings due to payment of regular premium. Thus life insurance encourages savings.
- Promotes economic growth: Insurance generates significant impact on the economy by mobilizing domestic savings.
- Medical support: A medical insurance considered essential in managing risk in health. The insured gets a medical support in case of medical insurance policy.

Ans to Q No.7: "Moral hazard" refers to the additional health care that is purchased when persons become insured. When people become insured, insurance pays for their care. For example, life insurance companies may require higher premiums or deny coverage altogether to people who work in hazardous occupations or engage in dangerous sports. Liability insurance providers do not provide coverage for liability arising from intentional misconduct committed by or at the direction of the insured. Even if a provider desired to provide such coverage, it is against the public policy of most countries to allow such insurance to exist, and thus it is usually illegal.



11.13 MODEL QUESTIONS

Short questions (Answer each question in about 150 words)

Q 1: Define the term 'Insurance'. Discuss the various types and methods of Insurance.

Q 2: What is meant by the terms a) Group insurance b) Marine Insurance c) Health insurance.

Q 3: Mention the different methods of insurance.

Q 4: Write a short note on-

a) Redlining

b) Moral hazard

Long questions (Answer each question in about 300-500 words)

Q 1: Discuss the various needs for taking Insurance.

Q 2: Explain the primary and secondary functions performed by insurance?

Q 3: Critically discuss the various shortcomings of insurance? Inspite of these limitations do you think that it plays an important role in development of the economy? Justify your answer.

Q 4: Discuss briefly the nature of Insurance.

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UNIT 12: THE BANKING SECTOR

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 History of Banking in India

12.4 Meaning and Definition of Bank

12.5 Classification of Banking Industry in India

12.6 Structure of Banking systems

12.7 Role of Banking Institutions

12.8 Banking Sector Reforms

12.9 Let Us Sum Up

12.10 Further Reading

12.11 Answers to Check Your Progress

12.12 Model Questions

12.1 LEARNING OBJECTIVES

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

- know the concept and evolution of banking system in India
- explain the various types of banks operating in India
- understand the structure of banking system in India
- discuss the role of banking institutions
- explain the important banking sector reforms for developing banking in India.

12.2 INTRODUCTION

A good financial system not only helps in boosting up the economic development of a country but also helps in overall growth of a country. Banking system acts as an important pillar in the financial system of a country. A bank is a financial institution which deals in accepting deposits and advancing loans to its customers. A banking system is also referred as a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolio.

The Indian banking has come a long way from being sleepy business institution to a highly proactive and dynamic entity. This transformation has been largely brought about by the large dose of liberalization and economic reforms that allowed banks to explore new business opportunities rather than generating revenues from conventional system. Over the past three decades, India's banking system has several outstanding achievements to its credit. In this unit, we shall discuss about the history of banking system in India, types of banks, banking structure in India and the reasons behind the banking sector reforms and its various recommendations suggested by Narasimham committee.

12.3 HISTORY OF BANKING IN INDIA

The origin of modern banking in India can be traced back to the English Agency Houses in Kolkata and Mumbai which used to serve as bankers to the East India Company. The General Bank of India, which was established in 1786, was the first banking institution in India. The East India Company established The Bank of Bengal (1809), the Bank of Bombay (1840), Bank of Madras (1843). These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks.

During the last part of the 19th century and the early phase of 20th century, the Swadeshi Movement induced the establishment of a number of banks with Indian Management. For example, Punjab National Bank Ltd in 1895, The Bank of India Ltd in 1906, The Canara Bank Ltd in 1906, The Indian Bank Ltd in 1907, The Bank of Baroda Ltd in 1908, The Central Bank of India Ltd in 1911 and many other banks were established on the same line. But most of the weak banks went bankrupt due to wrong policy decisions taken by the management and also severe banking crisis occurred during the period of World War I. However, the stronger and well managed banks like those mentioned above survived the crisis.

In the year 1920, the "Imperial Bank of India Act" was passed for amalgamating the three Presidency Banks. As such, the 'Imperial Bank of India' was established in 1921. It was given power to hold the Government

funds and manage the Public debt. However, it was not authorized to issue currency.

Between the years 1913 to 1948, there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949. During 18th century, the need to have Cetral Bank was felt but it could be materialized only in the 20th century. On the basis of the recommendations of the Banking Enquiry Committee, the Reserve Bank of India Act was passed in the year 1934. Accordingly, on April 1935 the Reserve Bank of India was constituted.

After independence, the Government has taken some important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. In 1959, the 'State Bank of India' (Subsidiary Banks) Act was passed by which the public sector banking was further extended. The following are the subsidiary of State Bank of India:

- The State Bank of Bikaner
- The State Bank of Jaipur
- The State Bank of Indore
- The State Bank of Mysore
- The State Bank of Patiyala
- The State Bank of Hyderabad
- The State Bank of Saurashtra
- The State Bank of Travancore

In the year 1963, the first two subsidiary bank of SBI were amalgamated under the name of "The State Bank of Bikaner and Jaipur."

In the year 1969, the process of nationalization was carried out and in this process, 14 major commercial banks were nationalized. These banks are Allahabad Bank, Bank of Baroda, Bank of India, Canara Bank, Central Bank of India, Dena Bank, Indian Bank, Indian Overseas Bank, Punjab National Bank, Syndicate Bank, Union Bank of India, United Bank of India,

United Commercial Bank and Vijaya Bank. Again, in the year 1980, six other banks were also nationalized and accordingly the total number of nationalized banks rose up to 20. The six banks are Andhra Bank, New Bank of India, Oriental Bank, Corporation Bank, Punjab & Sindh Bank and Vijaya Bank. But in the year 1993, New Bank of India and Punjab & Sindh Bank merged with the Punjab National Bank.

12.4 MEANING AND DEFINITION OF BANK

Etymologically, the word "bank" is derived from the Greek word 'banque' or the Italian word ' banco', both the word has a common meaning i.e. a bench at which money lenders and money changers used to display their coins and transact business in the market place.

A bank or banker or banking business is one which is engaged in trading in money, depositing & lending and serving the society at large in achieving its goal of economic progress and social wellbeing. The **Webster's Dictionary** defines bank as "an institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another".

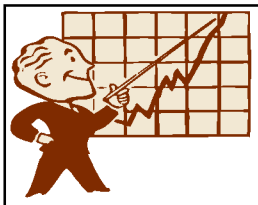
Some of the definitions of banks given by different authors are as follows:

According to **Horace White,** "Bank is manufacturer of credit and machine for facilitating exchange"

According to **Crowther,** "Bank is the one that collects money from those who have it to spare or who are saving it out of their income and lends the money so collected to those who require it"

According to **Dr. L. Hart,** "The banker is the one who in the ordinary course of business honors cheques drawn upon him by persons from and for whom he receives money on current accounts."

According to **Sir Kinley,** "A bank is an establishment which makes to individuals such advances of move as may be required and to which individuals entrust money when not required by them for use."



CHECK YOUR PROGRESS

Q 1: Which three banks together constitute the presidency bank? (Answer in about 30 words)

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Q 2: When State Bank of India was nationalized? How many subsidiaries do the State bank of India have? (Answer in 40 words)

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Q 3: Define the term bank? (Answer in about 50 words)

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12.5 CLASSIFICATION OF BANKING INDUSTRY IN INDIA

Today is the age of specialization and we can find specialization in all fields including banks. Banks have specialization in finance. Now-a-days, various types of banks operate in our country to meet the financial requirements of the customer. Banking industry in India are classified on the basis of its functions, ownership, domicile etc.. These are explained below:

- **Classification on the basis of function**
  - Central bank
  - Commercial bank
  - Industrial bank
  - Agricultural bank
  - Exchange bank
  - Saving bank

- **Classification on the basis of ownership**
  - Public sector bank
  - Private sector bank
  - Co-operative bank
- **Classification on the basis of domicile**
  - Domestic bank
  - Foreign bank
- **Scheduled bank and Non-Scheduled bank**

The above mentioned classifications are explained below:

- **Classification on the basis of functions**
  - **Central bank**: Central bank is considered as the bank of the nation. In India, Reserve Bank of India (RBI) is the central bank, which was established in 1935. The main functions of the Central Bank are to issue currency notes, guide and regulate the banking system in India. The head office of RBI is located at Mumbai. The Central Bank acts as the leader of the banking system and money market of the country by regulating money and credit. RBI is the banker to the government, it is the bankers' banks and the ultimate custodian of a nations foreign exchange reserves. The aim of the Central Bank is not to earn profit, but to maintain price stability and to strive for economic development along with all round growth of the country.
  - **Commercial banks:** A commercial bank is a financial institution whose main business is to accept deposits from the public and to give loans to those who require it. The major role played by commercial banks are – mobilizing savings, promotion of investment, facilitate commerce and trade, development of agriculture and priority sector in the economy, creation of credit, clearing of cheques. It is to be worth mentioning that, large part of the deposits in commercial banks is demand deposits which can be withdrawn and transferred by cheques.
  - **Industrial banks:** An Industrial Bank is one which specialises by providing loans and fixed capital to industrial concerns by

subscribing to share and debenture issued by public companies. They play an important role in the establishment and growth of industries. They provide long-term loans and credits for periods varying between 5 and 15 years for industries to acquire fixed assets. They serve as catalytic agents in mobilisation of capital in other forms of assistance such as, underwriting, guarantee etc. These banks are now a days grouped as 'Development Financial Institutions'. Both, Development Financial Institutions and Commercial banks, finance infrastructural development activities which include construction of transport facilities, building of power-supply stations etc.

- **Agricultural banks:** The main business of agricultural banks is to provide funds to farmers. The agricultural bank worked on the co-operative principle. This fund generally are of two types such as short term fund to buy seeds, fertilizers and other inputs and long term fund to purchase land, to make permanent improvements on land, to purchase agricultural machinery and equipment etc. National Bank for Agriculture and Rural Development (NABARD) is the apex development bank in India entrusted with matters concerning policy, planning and operations in the field of agriculture.
- **Exchange banks:** Exchange banks mainly deal with foreign exchange and foreign exchange transaction. They deal in foreign bills of exchange, import and export of bullion and otherwise participate in the financing of foreign trade. They do a number of incidental services such as opening of letters of credit, issue of foreign currency, drafts and travelers' cheques and supply of information about foreign customers. They provide credit and loans in foreign currency and also accept deposits in Foreign Currency. Nowadays, many banks in India deal in foreign exchange with special authorization from Reserve Bank of India and are known as Authorized Dealers in Foreign Exchange. As per Foreign Exchange Regulation Act, banks dealing in Foreign

Exchange related activities require the permission of Reserve Bank of India. This is applicable to both Indian and Foreign Banks.

- **Savings banks:** The saving banks are the institutions that help in building up the habit of savings among the general public and mobilize their small savings. The main objective of this bank is to promote thrift and saving habits among the middle and lower income sections of the society. The first savings bank was started in Hamburg in 1765. In India, postal savings bank is the example of saving bank. Besides this, all commercial banks have saving accounts. The minimum balance which is required to be kept in the accounts differs from bank to bank. The rate of interest payable on the accounts by banks is determined by RBI. Co-operative banks are normally allowed to pay an additional 0.5 percent interest per annum. Interest rate on savings account with post offices is determined by Government of India.

- **Classification on the basis of ownership**
  - **Public sector banks:** Public sector banks are those banks which managed by the Government of India. Major stake of these banks are held by government. The shares of these banks are listed on stock exchanges. At present, there are 12 public sector banks operating in India.
  - **Private sector banks:** Private sector banks are those banks which are controlled by the private individuals i.e. majority of the stakes of private sector banks are controlled by private individuals. The concept of private sector banking is not a new one, it was practiced since the beginning of banking system in India. Indusland bank was the first private sector bank in India. At present, there are 22 private sector banks operating in India.
  - **Co-operative banks:** Co-operative banks are those banks which are operated on the principle of mutual help and assistance. A co-operative society has to obtain licenses from

Reserve Bank of India before starting banking business and has to follow the guidelines issued by the Reserve Bank of India. Co-operative banks grant short-term loans to the agriculturists for purchase of seeds, harvesting and for other cultivation expenses. They also accept money on deposit form and make loans for their members at a low rate of interest.

- **Classification on the basis of domicile**
  - **Domestic banks:** Any bank having their registered head office in India and operate their business within the same country is called domestic bank. The example of domestic bank in India is the State Bank of India whose head office and branches are situated in India.
  - **Foreign banks:** The banking institution whose head quarter is situated in one country and operates its banking business in another country is called foreign bank. For example, CITY bank which has its head quarter in USA and have their branch in India as well.
- **Scheduled Bank and Non- Scheduled Bank**
  - **Scheduled banks:** Scheduled banks are those bank which have been included in the second schedule of Reserve Bank of India Act 1934. RBI in turn includes only those bank in this schedule which satisfy the criteria laid down vide Section 42(6)(a) of the Act. They are-
    - It must have a paid up capital and reserves for an aggregate value of at least Rs.5,00,000.
    - It must satisfy RBI that its affair is not conducted in a manner detrimental to the interest of its depositors.
    - It must be a corporation and not a partnership or a single owner firm.
  - **Non- scheduled banks:** Non-scheduled banks in India means a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act 1949.



CHECK YOUR PROGRESS

Q 4: What is meant by Commercial bank?
(Answer in about 50 words)

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Q 5: State the difference between Public and Private sector bank?
(Answer in about 50 words)

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12.6 STRUCTURE OF BANKING SYSTEMS

The structure of banking is also termed as organization of banking. The structure of banking differs from country to country depending upon their economic conditions, political structure and financial system. Different country adopts different types of banking system. The commonly identified systems are as follows:

- **Unit banking:** Unit banking refers to a single bank which renders services and operates without any branches anywhere. This type of bank was originated and developed in USA. This type of bank has their own board of directors and stockholders. Unit banking is also termed as "Localised Banking". According to **Solomon and Whilt,** a unit bank is, "a corporation that operates one office and is not related to other banks through either ownership or control". The main reason for the development of unit banking in America is said to be the fear of monopoly in banking.
- **Branch banking:** Branch banking refers to a single bank which operates through network of branches spread all over the country. Branch banking system originated in England. In India most of the

bank operates their business under branch banking system. These branch banks operate under their head offices which is generally situated in big cities. Branch banking is also known as "de-localised banking". In India, the State Bank of India has emerged as one of the biggest banks with large number of branches all over the country.

- **Correspondent banking:** Correspondent banks are those banks which connects two or more banks under unit banking system. Correspondent banking system is developed to remove the difficulties in unit banking system. Correspondent banks are intermediaries through which all unit banks are linked with bigger banks in financial centers. Through correspondent banking, a bank can carry out business transactions in another place where it does not have a branch. This system is very common in international banking transactions.
- **Group banking**: This banking system refers to the system of banking in which two or more banks are directly controlled by a holding company. The holding company may or may not be a banking company. Under group banking, the individual banks may be unit banks, or banks operating branches or a combination of the two. Participating banks retain their own Boards of Directors which are responsible to the supervising and regulatory authority and depositors for the proper operation of the bank. This type of banking system was developed in USA in the year 1900.
- **Chain banking:** It is another form of group banking. It refers to the system in which two or more banks are brought under the common control by a device other than holding company. This may be:
  - Through some group of persons owning and controlling a number of independent banks.
  - Each bank retains its separate identity.
  - Each one carries out its operations without the intervention of any central organization.

- **Pure banking:** Under Pure Banking, the commercial banks give only short term loans to industry, trade and commerce. They specialize in short term finance only. This type of banking is popular in U.K.
- **Mixed banking:** Mixed banking is that system of banking under which the commercial banks perform the dual function of commercial banking and investment banking i.e., it combines deposit and lending activity with investment banking. Commercial banks usually offer both short-term as well as medium term loans. The German banking system is the best example of mixed banking.
- **Universal banking:** Universal banking is the combination of commercial bank, investment banking, development banking, insurance and many other financial activities. It is a place where all financial products are available under one roof. They deal with individual customers as well as big corporate customers. The universal banks expands their lines of business activity by combining the functions of commercial banking and the functions of merchant banking, mutual funds, factoring, credit cards, retail loans, insurance etc. Examples of universal bankers are Citi group (i.e. Citi bank), Hongkong and Shanghai Banking Corporation (HSBC). In Europe universal banks are known as "Bancassurance".
- **Retail banking:** Retail banking is a banking system which executes transactions directly with customers rather than corporations or other banks. Under retail banking system, banks approach to the customers for sale of their products. The products offered by the bank under retail banking system are consumer-oriented like offering a car loan, home loan facility, financial assistance or purchase of consumer durables etc. Therefore, retail banking has large customer-base and hence, large number of transactions with small values. The major players of retail banking in India are ICICI bank, State Bank of India, Punjab National Bank, Bank of India, HDFC and Canara Bank.
- **Wholesale banking:** Wholesale or corporate banking refers to the banking system which deals with limited large-sized customers such

as government agencies, pension funds, and other institutional customers and corporations with strong balance sheets and sound income statement. Instead of maintaining thousands of small accounts and incurring huge transaction costs, under wholesale banking, the banks deal with large customers and keep only large accounts. Services of wholesale bank include cash management, large-sum loans, loan participation, merchant banking, and trust services. This results into few transactions with large amounts thus resulting into cost reduction and higher fees. Foreign banks in India are mostly concentrating in wholesale banking which is aided by fully computerized banking operations. In India, largest players of wholesale banking are SBI, ICICI, IDBI bank, Canara Bank, Bank of India, Punjab National Bank and Central bank of India.

- **Regional rural banking:** Commercial banks generally provide loans to the large borrowers who are engaged in commercial or business activities. Due to these, small traders, village artisans, agricultural laborers etc. in rural and semi-urban areas do not get adequate credit facilities from Commercial banks. In order to solve this issue and provide adequate and timely credits to small borrowers in rural and semi-urban areas, the Central Government set up Regional Rural Banks in 1975 in all over India jointly with State Governments and some Commercial Banks. The Regional Rural Banks was mooted for the development of banking in rural areas and for rural people.



CHECK YOUR PROGRESS

Q 6: What is meant by unit banking?

(Answer in about 30 words)

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Q 7: Write any two advantages of mixed banking?

(Answer in about 30 words)

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Q 8: Write any three difference between unit banking and branch banking? (Answer in about 60 words)

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12.7 ROLE OF BANKING INSTITUTIONS

Role of Banking Institutions

Banks have always played an important role in the economic development of the country. In this modern time money is regarded as essential aspect of our everyday life. A developed financial system of the country ensures to attain development. A modern bank provides valuable services to a country. To attain development there should be a good developed financial system to support not only the economy but also the society. So, a modern bank plays a vital role in the socio-economic matters of the country. Some of the important roles of banks in the development of a country are discussed below.

1. **Promote savings habit among people:** Banks help to promote saving habits among the depositors by introducing different attractive saving schemes. Banks also provide rewards or return on savings in the form of interest. This enables the banking habit or saving habit among the people in the country.
2. **Promotion of investment**: Banks provide various loans and advance facility for the purpose of investment in plant and machinery which in turn helps to promote economic development of the country and also helps to increase production of goods and services.
3. **Capital formation and promote industry**: Capital is one of the most important part of any business or industry. It is the life blood of business. Banks increases its capital formation by collecting deposits from depositors and convert these deposits into loans advances to promote industries.

4. **Facilitate commerce and trade**: In this modern era, trade and commerce plays important role between any countries. For smooth functioning of commerce and trade, the money transactions of a country should be user friendly. A modern bank helps its customers to send and receive funds around the world. A well developed banking system provides various attractive services like mobile banking, internet banking, debit cards, credit cards etc. These kinds of services provides fast and smooth transactions. So, banks help to develop trade and commerce.
5. **Generate employment opportunity**: As banks promote industry and investment these automatically generate employment opportunity. Therefore, banks assists an economy in terms of employment opportunity.
6. **Applying monetary policy**: A good monetary policy helps to stabilize the financial system of the country from inflation, deflection, crisis etc. A well developed banking system is necessary for effective monetary policy of the country.
7. **Balanced regional development:** In tune with the policy of the government to have more balanced development of the economy, the banks do promote lending and investment in those regions and parts of the country which are less developed and thus banks promote social objectives.
8. **Development of agricultural and other priority sectors in the economy:** Agricultural and priority sector are the integral part of any economy. The banks give special treatment in their lending operations to these sectors, such as agriculture, small scale industry (SSI),retail trade, small borrowers, self- employed persons etc. so as to facilitate their growth and provide productive employment in the economy. Exports are also a priority sector which banks helps in various ways.

12.8 BANKING SECTOR REFORMS

In 1969, due to nationalization of bank, the banking sector has been dominated by the public sector banks. Financial repression, limited role of

technology, no risk management etc., are the factors resulting in low rate of profitability and poor assets quality in banks. This resulted in deep economic crisis within the country. In order to overcome this constraints and making the banking environment flexible, the Government then decided to introduce comprehensive economic reforms. Banking sector reforms were part of this economic reform.

Banking Sector Reforms 1991

Banking sector reforms was introduced to bring a transformation change in the structure, efficiency and stability of the banking system in India. Banking sector in India were facing numerous problems till 1991. The problems were:

- Highly regulated by RBI
- Low productivity and efficiency of public sector banks
- Continuous loss borne by public sector bank
- Increasing Non Performing Assets (NPA)
- Poor customer service
- Obsolete work technology
- Unable to meet competitive environment.

In order to counter these problems, a proper and constructive reform was needed. Keeping this in view, the Government of India appointed a High-Level Committee under the Chairmanship of M. Narasimham. The name of the committee was "The Committee on Financial System" (CFS).This committee was also known as "Narasimham Committee". The objectives of this committee were to rebuild the financial health of commercial banks and to make their functioning efficient and profitable. The said committee submitted their report within three months on November 1991. Major recommendations made by Narasimham Committee on banking sector were as follows:

- **Merger**: On the basis of structure of the banking sector in India, the committee recommended that banks can be restructured by creating 3 to 4 large banks (including SBI), which would become international in character and 8 to 10 national banks with network of branches throughout the country engaged in universal banking. Local

bank operations will be confined to only specific region and rural banks operation would be prominently engaged in financing agricultural and allied activities.

- **Phasing out direct credit:** The committee had recommended to redefine priority sector and also fixed the target of this redefined sector at 10% of the aggregate credit, subject to review after three years. The Government decided not to reduce the priority sector lending from 40%, although the priority sector definition has been redefined.
- **Transparency**: The committee has recommended that the balance sheets of banks and financial institutions should be transparent and full disclosure should be made in balance sheets as recommended by International Accounting Standard Committee. Accordingly, RBI has modified their balance sheet format w.e.f March 1992 and all banks are preparing balance sheets as per modified format.
- **Customer service:** On the recommendation of the committee, Banking Ombudsman Scheme which was introduced in 1995 was revised by RBI and came into force in January 2006. The extent and scope of new scheme is wider than earlier scheme. As per new scheme, customers are allowed to submit online complaint. Again, as per new scheme, banks are advised to frame their KYC policies, keeping in view four elements, such as Customer Acceptance Policy, Customer Identification Procedure, Monitoring of Transactions and Risk Management as required by Prevention of money Laundering Act.
- **Deregulation of interest rates:** The committee recommended that the Interest rates, both on the deposits and advances should be determined on the basis of market forces.
- **New private banks:** The committee recommended that the private sector banks are allowed to operate their businesses. The private sector banks are allowed to raise capital contribution from FIIs up to 20% and from NRIs up to 40%. This has led to increase competition.



FIIs: Foreign Institutional Investors (**FIIs**) are such kind of institutional investors who invest in the assets belonging to a different country other than that where these organizations are based.

- **Phased reduction of SLR and CRR:** The high rate of Statutory Liquidity Ratio(SLR) and Cash Reserve Ratio (CRR) reduced the profits of the banks. Therefore, the committee has recommended to reduce the SLR and CRR in a phased manner.
- **Prudential norms:** As per the recommendation RBI have started prudential norms in order to impart professionalism in commercial banks. Prudential norms include proper disclosure of income, classification of assets and provisions for bad debts so that the books of accounts of commercial banks can depict the accurate picture of financial information.
- **Recovery of debts:** As per recommendation, the Government of India passed the "Recovery of debts due to Banks and Financial Institution Act 1993" in order to facilitate and seep up the recovery of debts due to banks and financial institutions.
- **Local Area Banks (LAB):** As per the recommendation, RBI has issued guidelines for setting up of Local Area Banks (LABs) in 1996. LABs will help in mobilizing rural savings and helps in channelizing them into investment in local areas.



CHECK YOUR PROGRESS

Q 9: State reasons for which reforms in banking sector was needed? (Answer in about 60 words)

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Q 10: State two recommendations suggested by M. Narasimham on banking sector? (Answer in about 40 words)

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12.9 LET US SUM UP

- The first banking institution in India was "The General Bank of India". It was established in the year 1786.
- The combination of three banks namely Bank of Calcutta, Bank of Bombay, and Bank of Madras were called as Presidency Banks. But in 1920 when "Imperial Bank of India Act" was passed, these three banks were amalgamated and renamed as Imperial Bank of India. In the year 1955 Imperia Bank was nationalized and again renamed as State Bank of India.
- The process of nationalization of banking sector started in 1969 with nationalization of 14 banks in India. Again, in 1980 6 new banks were nationalized.
- Central bank in a country is considered as bankers' bank. In India Reserve bank of India is the central bank, which monitors the whole banking system in India.
- Since 1991, banking sector in India was facing numerous problems such as low productivity, continuous loss, increasing NPA, poor customer services, obsolete work technology etc. In order to solve these issues and making banking sector stronger, the Government of India introduced banking sector reforms.
- In 1991, the Government has appointed a committee under the chairmanship of M. Narasimham in order to rebuild the financial health of the banking sector. This committee was well known as "The committee on financial system" or Narasimham committee. The said committee submitted their reports on banking sector reforms on 1991.



12.10 FURTHER READING

- Srivastava, P.K.(2016). *Banking Theory and Practice*. Mumbai: Himalaya publishing House

- Nayak, Niranjan. (2012). Emerging *Scenario of Indian Banking sector*. New Delhi: Neha publishers and distributors.



12.11 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q No 1: The combination of Bank of Calcutta, Bank of Bombay and Bank of Madras were called as Presidency Banks.

Ans. to Q No 2: In the year 1955 Imperial Bank was nationalized and named as State bank of India. After nationalization there were 8 subsidiaries of SBI.

Ans. to Q No 3: An institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another. **Horace White** defines bank as a manufacturer of credit and machine for facilitating exchange.

Ans. to Q No 4: A commercial bank is a financial institution whose main business is to accept deposits from the public and to give loans to those who require it. The major role played by commercial banks are – mobilizing savings, promotion of investment, facilitate commerce and trade, development of agriculture and priority sector in the economy, creation of credit, clearing of cheques.

Ans. to Q No 5: The major difference between public and private sector bank is that control and administration of public sector bank is in the hands of Government of India i.e. majority of the shares of public sector bank are in the hands of government. On the other hand, the control and administration of private sector bank is in the hands of private individuals i.e majority of the shares of public sector bank are in the hands of individuals.

Ans. to Q No 6: Unit banking refers to a single bank which renders services and operates without any branches anywhere. This type of bank was common in USA.

Ans. to Q No 7: Advantages of mixed baking are:

- Provides investment guidance to general public
- Promote rapid industrial development through investment banking.

Ans. to Q No 8: The difference between unit banking and branch banking are:

- **Location:** Unit banking operates in a single branch. On the other hand, branch banking operates through multiple offices i.e. branches.
- **Rate of interest:** The rate of interest in unit banking system is not uniform whereas rate of interest of branch banking is uniform as specified by RBI.
- **Competition:** In unit banking competition is less as compared to branch banking.

Ans. to Q No 9: Reasons for banking sector reforms were:

- Low productivity and efficiency of public sector banks
- Continuous loss borne by public sector bank
- Increasing Non Performing Assets (NPA)
- Poor customer service
- Unable to meet competitive environment

Ans. to Q No 10: Recommendations of banking sector reforms are:

- Establishment of four tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at top and at bottom rural banks engaged in agricultural activities.
- Phased reduction in CRR and SLR.



12.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by exchange bank?

Q 2: State the difference between domestic bank and foreign bank.

Q 3: Mention two advantages and two disadvantages of branch banking.

Q 4: What is meant by retail banking?

Q 5: Mention the need for banking sector reforms.

Long Questions (Answer each question in about 300-500 words)

Q 1: Discuss the history of development of banking system in India.

Q 2: Write a note on various structure of banking system in India.

Q 3: Discuss the recommendations of banking sector reforms chaired by M. Narasimham.

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UNIT 13: NON-BANKING FINANCIAL COMPANIES

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Call Money Market

13.4 Call and Notice Money

13.5 Types/Categories of Non-Banking Financial Companies

13.6 Size of Non-Banking Financial Companies

13.7 Role of Non Banking Financial Companies

13.8 Let Us Sum Up

13.9 Further Reading

13.10 Answer to Check Your Progress

13.11 Model Questions

13.1 LEARNING OBJECTIVES

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

- know the various nature of Non Banking Financial Companies (NBFCs)
- acquire knowledge on different categories of NBFCs
- explain size and growth of NBFCs in recent time
- understand various roles of NBFCs in the economy.

13.2 INTRODUCTION

In the previous chapter we have learnt about various types of banking institutions and their role in the economy, along with the reforms introduced in banking institutions in recent years. This unit accounts for various aspects associated with Non Banking Financial companies (NBFCs). NBFCs is now come an important segment of financial intermediaries in Indian financial system. The first section of the unit describes the nature of NBFCs, followed by different types of NBFCs in the next section. The third section describes the size and growth of NBFCs and the last section describes the role of NBFCs in Indian economy.

13.3 CALL MONEY MARKET

Non-Banking Financial Company (NBFC) is a company or financial institution registered under the Companies Act 2013 (previously Companies Act,1956). Its principal business is to provide financial services of accepting deposits (except demand deposit) and to issue loans and advances under any scheme. Moreover it acquires bonds, shares or debentures which are issued by the Government or any local bodies in different times. NBFCs are also involved in the business of micro finance, leasing, chit business, hire purchase finance, and insurance. Agricultural activity, industrial activity, purchase or sale of any goods (other than securities) and services and purchase, sale or construction of immovable property does not come under the purview of NBFCs.

According to the Reserve Bank of India (Amendment Act) 1997, A Non-Banking Finance Company means: (i) A Financial Institution which is a company; (ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner; (iii) Such other non-banking institution or class of such institutions as the bank may with the previous approval of the Central Government specify.

Non-banking financial companies are different from banks from the following grounds:

Firstly, NBFCs ,unlike banks, neither accept demand deposits which are repayable on demand nor it issues cheques.

Secondly, Deposit Insurance facility of Deposit Insurance and Credit Guarantee Corporation(DICGC) is not available for NBFCs unlike banks.

13.4 NATURE OF NON-BANKING FINANCIAL COMPANIES

- The NBFCs can take public deposits for a period of 1 to maximum 5 years.
- Payment and settlement systems do not come under the purview of NBFCs.

- NBFCs provide various other services like creating and mobilising credit to meet working capital needs of micro, small and medium scale industries and enterprises. It deals with underwriting of shares and advice on mergers and acquisitions. NBFCs do play a critical role in the development of sectors like transport, employment generation, wealth creation, bank credit in rural segments and to support financially weaker sections of the society. NBFCs also encourage investment in income generating projects.
- NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time
- RBI has not given the guarantee of repayment of deposit by NBFCs.
- Only the companies registered under Companies Act,2013 or under Companies Act, 1956 are incorporated as NBFCs.
- A Non-Banking Financial Institution must possess a Net Owned Funds of Rs 2 crores since April 1999.
- As per the last audited balance sheet NBFCs whose asset size is of Rs 500 crores or more are considered as systemically important NBFCs.
- Though all Non Banking financial companies are registered under Companies Act,2013 or 1956, all are not regulated by RBI. Some are regulated by National Housing Bank (Housing finance companies like Aditya Birla Housing Finance Ltd). All the Merchant Banker/ Venture Capital Fund Company/stock-exchanges/stock brokers/ sub-brokers are regulated by Securities and Exchange Board of India(SEBI). Insurance Regulatory and Development Authority (IRDA) regulates all the general and life insurance companies. Similarly, Chit Fund Companies are regulated by the respective State Governments and the Ministry of Corporate Affairs. Government of India regulates all the Nidhi companies. All these companies do not require to registrar under Section 45-IA of the RBI Act, 1934

13.5 TYPES/CATEGORIES OF NON-BANKING FINANCIAL COMPANIES

Non Banking Financial Companies are categorized on the basis of deposits it receives and the type of credit it offers. The types of NBFCs are-

- **Asset Finance Company (AFC)**: AFCs are engaged in the principal business of providing financial assistance to purchase physical assets such as machinery, heavy industrial equipment, large power generator sets etc.which are used for productive or economic activities.
- **Investment Company(IC):** Acquisition of money from the public and investment of this money in various securities and financial products is the principal business of these companies. Bajaj Allianz General Insurance Company, SBI Mutual Fund are some of the examples of investment company
- **Loan company(LC):** Loan company is a financial institution whose principal business is to provide loans and advances
- **Infrastructure Finance Company (IFC):** It is a non-banking finance company which issues at least 75% of its total assets as infrastructural loan. Moreover it should have a minimum net owned fund of Rs 300 crores. . For example- India Infrastructure Finance Company Limited (IIFCL)
- **Systemically Important core investment Company.(CIC-ND-SI):** It is a NBFC which carries its principal business in acquisition of shares and securities. RBI recognises a company as CIC-ND-SI if at least 90% of its total assets are in the form of investment in shares, debentures or in securities.
- **Infrastructure Debt Fund**: It provides long term debt into infrastructure projects.
- **NBFC Micro Finance Institution (NBFC-MFI):** It is a non deposit taking NBFC which has more than 85% of its assets in the nature of qualifying assets (i.e., borrowers have to satisfy some criteria to qualify for its assets.)

- **NBFC-Factors:** It is a NBFC which is engaged in the principal business of factoring . Factoring is a financial transaction where a company sells its invoices or bills receivables to a third party at a discount rate called as factor. 50% of NBFC-Factor financial assets are distributed to finance factoring businesses.
- **Mortgage Guarantee Company (MGC)**: MGCs transacts in the business of providing mortgage guarantee. If a borrower becomes defaulter of his loan payment Mortgage Guarantee Company provides the guarantee. For example-India Mortgage Guarantee Corporation Pvt Ltd.

In terms of liability structures, NBFCs are subdivided into-

- **Deposit-taking NBFCs (NBFCs-D) -** Which accept and hold public deposits.
- **Non-deposit taking NBFCs (NBFCs-ND) -** Which rely on markets and banks to raise money.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are true (T) or false (F)

a) Acquisition of money from the public and investment of this money in various securities and financial products is the principal business of Investment companies.

b) The NBFCs can take public deposits for a maximum period of 4 years.

Q 2: Write a short note on NBFCs (Answer in about 60 words)

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13.6 SIZE OF NON-BANKING FINANCIAL COMPANIES

In the year 1960, the business of NBFCs started in India as an alternative source of financial need for the investors in the mainstream

banking system. Muthoot finance limited was established as the first NBFC. Afterwards, the size of NBFCs had increased gradually. In the year 1964, RBI formed an expert committee chaired by Dr A.C Shah to regulate, evaluate and supervise the increased structures of NBFCs. The size of the NBFCs had increased tremendously from 7000 in 1981 to around 30,000 in 1992. The guidelines made under the RBI Act, 1934 as amended in 1997 ensured smooth functioning and protection of NBFCs. Afterwards the NBFCs grew significantly in terms of its diversified operations, technological advancements, market products etc. Between 2009 to 2019, the Compounded Annual Growth Rate (CAGR) of total assets of NBFCs were at 18.6%. NBFCs performed better in 2015 in terms of expansion of loan and balance sheet size, decline of gross NPAs, enhancement of capital adequacy level and providing working capital loans for corporate entities.

The asset size of NBFC sector (including HFCs), as on March 31, 2020 is Rs.51.47 lakh crore . As at end-March 2020, NBFCs have been the largest net borrowers of funds from the financial system of which more than half of the funds were from SCBs, followed by Asset Management Companies-Mutual Funds (AMC-MFs) and Insurance Companies.

Though the combined effect of economic slowdown and COVID-19 pandemic has resulted in decline in the non-bank credit growth in the fiscal year 2020 which was started in the second half of 2019, however, Industry, retail loans and service remained the largest recipient of credit extended by NBFCs. Sanction of retail loan increased in 2019-20 as the share prices of all other sectors had fallen. Overall there was a sharp reduction in credit growth in all sectors. 85.7% of the total assets of the sector is dominated by NBFCs-ND-SI Few large government-owned NBFCs, mainly the infrastructure space, comprise 43.3% of the total assets of NBFCs-ND-SI.

Among NBFCs-ND, those with an asset size of ₹500 crore or more are classified as non-deposit taking systemically important NBFCs (NBFCs-ND-SI). At the end of 31st January, 2021 there were 58 NBFCs-D and 292 NB. Moreover Microfinance Company and Non deposit taking Non-Systemically Important Companies registered with RBI as on 31st

January,2021 are 94 and 9123 respectively. **(https://rbi.org.in/Scripts/BS_NBFCList.aspx)**

On the basis of **activities** NBFCs undertake, till February 21, 2019, NBFCs were divided into 12 categories. Thereafter, these categories were harmonised in order to provide NBFCs with greater operational flexibility. As a result, Asset Finance Companies (AFCs), Loan Companies (LCs) and Investment Companies (ICs) were merged into a new category called Investment and Credit Company (NBFC-ICC). At present, there are 11 categories of NBFCs in the activity- based classification.

The prime dominant of the NBFC sector is NBFCs- ND-SI, which constitute 86.3 per cent of the total asset size of the sector. Within this segment, government owned NBFCs particularly the two largest NBFCs i.e Power Finance Corporation Limited and Rural Electrification Corporation (REC) Limited hold around two-fifth of the total assets of NBFCs.

Although the NBFC sector grew in size from 26.2 lakh crore in 2017-18 to 51.47 lakh crore in March, 2020 the balance sheet expanded at a very slower rate due to the default on the part of Infrastructure Leasing & Financial Services(IL&FS) and rating downgrade of a few companies. RBI has cancelled the registration of 5,322 NBFCs as recorded on 31st January, 2021. This slowdown was witnessed mainly in the NBFCs- ND-SI category, whereas NBFCs-D broadly maintained their pace of growth. However, in 2019-20 (up to September) growth in balance-sheet size of NBFCs-ND-SI as well as NBFCs-D moderated due to a sharp deceleration in credit growth. Credit expansion was primarily made to the industrial sector and retail loan and service sector. However as per the data released by Finance Industry Development Council (FIDC) at the end of March,2020, the amount of loan sanctioned by NBFCs amounted to Rs 2,56,330.05 cr.

13.7 ROLE OF NON BANKING FINANCIAL COMPANIES

Non banking financial companies contribute to economic development in different ways. It mobilizes resources in the economy by converting the public savings into investments. By increasing the capital

stock in the economy it helps in capital formation. NBFCs provide long term and specialised credit thereby developing the financial market. Moreover it aids in employment generation. The role played by NBFCs in an economy can be studied under the following heads:

- **Role of NBFCs in financial inclusion:** Financial inclusion basically means linking ,awaring and empowering every family in the country to the financial system. As per Rangarajan Committee Report Financial Inclusion is the process of ensuring access to appropriate financial products and services by vulnerable groups such as weaker, unattended and low income groups at an affordable cost in a fair and transparent manner by NBFCs apart from the other formal agencies of financial system such as bank, Micro Finance Institutions (MFI) (most companies are included under NBFCs) etc. These financial services include payments and remittance facilities, savings, loan and insurance services. Micro finance has been looked upon as an important means of financial inclusion in India. Microfinance is not just provision of micro credit but also other services in small quantities to the poor i.e. providing essential financial services to the poor in an affordable way. Financial Inclusion provides the poor with not only deposit accounts or credit but also insurance and remittance facilities. As suggested by the Mor Committee report, in terms of Financial Inclusion, the overall situation remains very insignificant and, on a regional and sectoral basis, very uneven. Previously only the commercial banks were permitted by the Reserve Bank of India for financial inclusion. Later on non-banking financial companies began to take part along with the banks in the financial inclusion initiatives. Since September 2010, several non-bank entities for e.g. NBFC-MFIs that form the significant part of the MFI sector have deeper reach in the rural areas. NBFC-MFIs provide the necessary assistance to the poor borrowers to gain access to various essential financial services. The newly established commercial banks,regional Rural Banks(RRB) and NBFCs would surely give stimulus to the country's financial inclusion initiatives.

- **Role of NBFC in capital market:** Investment activity of NBFCs in the capital market comprises around 16% of their total assets. Some specialized NBFCs are basically engaged in trading of securities in the capital market. These NBFCs therefore help to provide liquidity in the capital market. Further, NBFCs also lend to investors for investing in the capital market.
- **Role of NBFCs in factoring:** Factoring as defined in Factoring Regulation Act,2011 is a financial service under which the factor (assumed to be the third party who does not directly involved in the particular business)renders various services which includes:
  - Discounting bills and collection of clients debts. Under this, the receivables of account of sale of goods or services are sold to the factor at a certain discount rate.
  - The factor becomes responsible for all credit control and debt collection from the buyer and provides protection against any bad debts losses to the firm.

Following the notification of the Factoring Regulation Act by the Government, the Reserve Bank formed a new category of NBFCs called NBFC-Factors and issued directions to them. NBFC-Factors are almost exclusively engaged in providing factoring services. Factoring service which is considered as complementary to bank finance is expected to enable the availability of much needed working capital finance for the small and medium scale industries(MSIs) especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral. By having a continuous business relationship with the Factor in place, small traders, industries and exporters get the advantage of improving the cash flow and liquidity of their business as it also avail some supportive services like sales ledger accounting, collection of receivables, credit protection etc. Factoring helps them to free their resources and have a one stop arrangement for various business needs enabling smooth running of their business.

- **Role of NBFCs in infrastructure financing:** NBFCs have been playing a significant role in the widespread development of the

country's infrastructure. By offering long-term and specialized credit these institutions are enabling the funding and growth of large infrastructure projects across the country. Infrastructure Finance Companies (IFCs) and Infrastructure Debt Funds are the specialized NBFCs exclusively engaged in financing the infrastructure sector. Some of these companies have crores of asset size and are experts in financing long term projects. Recognising their importance, the Reserve Bank of India has given special provisions in the form of enhanced bank credit, higher exposure norm ceiling (Banks has to fix ceiling limits on their exposure to specific industry or sector or to a single or group of borrowers with the aim of better risk management and avoidance of credit risk) and provision of External Commercial Borrowing (ECB) i.e., these are the loans in India made by non-resident lenders in foreign currency to Indian borrowers like various Indian corporations and PSUs under automatic route for on-lending to the infrastructure sector. The asset liability pattern however, is a matter of concern in the case of IFCs as these are lending for a longer period of time against comparatively short term liabilities.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are true (T) or false (F).

a) NBFCs creates liquidity in the capital market.

b) NBFCs-D accept and hold public deposits.

Q 4: Explain the role of NBFCs in infrastructure financing. (Answer in about 60 words)

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13.8 LET US SUM UP

- Non-banking financial company means only the non-banking institution which is an investment and credit company or a mutual benefit financial company or a factor registered with the Bank.
- NBFCs are not allowed to accept demand deposits and hence can not issue cheques.
- It provides various services like issuing repeated,specialized and larger loans, delivering credit to a wide variety of niche segments, ranging from infrastructure to consumer durables.
- It mobilises and provides financial and technical assistance and training to micro enterprises.
- The NBFCs should have a minimum investment grade credit rating for its survival.
- To be recognized as NBFC it should be registered under company's Act ,1956 and should have a NOF of Rs. 5 crores.
- NBFCs whose asset size is of Rs 500 crores or more are considered as systemically important NBFCs.
- Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/ sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are all NBFCs but these companies are not regulated by RBI but by some respective authorities.
- There are various types of NBFC which provides financial assistance and loans for several purposes . Out of which some are asset finance company or loan company or investment company or others.
- Non Banking Financial Institution (NBFIs) consist of a group of financial institutions. These are All India Financial Institution(AIFIs), NBFCs, Primary dealers(PD) and Housing Finance Companies (HFCs).

- NBFCs can be classified on the basis of their asset/liability structures, their systemic importance,the activities they undertake.
- The prime dominant of the NBFC sector is NBFCs- ND-SI, which constitute 86.3 per cent of the total asset size of the sector.
- The credit facility has been expanded to various sectors.
- NBFCs play a significant role basically in financial inclusion, investment activity in the capital market,factoring and infrastructure financing.



13.9 FURTHER READING

- Bharati V Pathak.T*he Indian Financial System- Markets,Institutions and Services.* Pearson Education, South Asia.
- www.m.rbi.org.in



13.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) True b) False

Ans to Q No 2: Non-Banking Financial Company (NBFC) is a company or financial institution registered under the Companies Act 2013 (previously Companies Act,1956). Its principal business is to provide financial services of accepting deposits (except demand deposit) and to issue loans and advances under any scheme. Moreover it acquires bonds, shares or debentures which are issued by the Government or any local bodies in different times. NBFCs are also involved in the business of micro finance, leasing, chit business, hire purchase finance and insurance. Agricultural activity, industrial activity, purchase or sale of any goods (other than securities) and services and purchase, sale or construction of immovable property does not come under the purview of NBFCs. Non-banking financial companies are different from banks from the following grounds:

Firstly, NBFCs ,unlike banks, neither accept demand deposits which are repayable on demand nor it issues cheques.

Secondly, Deposit Insurance facility of Deposit Insurance and Credit Guarantee Corporation(DICGC) is not available for NBFCs unlike banks.

Ans to Q No 3: a) True b) True

Ans to Q No 4 : NBFCs have been playing a significant role in the widespread development of the country's infrastructure. By offering long-term and specialized credit these institutions are enabling the funding and growth of large infrastructure projects across the country. Infrastructure Finance Companies (IFCs) and Infrastructure Debt Funds are the specialized NBFCs exclusively engaged in financing the infrastructure sector. Some of these companies have crores of asset size and are experts in financing long term projects. Recognising their importance, the Reserve Bank of India has given special provisions in the form of enhanced bank credit, higher exposure norm ceiling (banks has to fix ceiling limits on their exposure to specific industry or sector or to a single or group of borrowers with the aim of better risk management and avoidance of credit risk) and provision of External Commercial Borrowing (ECB) i.e., these are the loans in India made by non-resident lenders in foreign currency to Indian borrowers like various Indian corporations and PSUs under automatic route for on-lending to the infrastructure sector. The asset liability pattern however, is a matter of concern in the case of IFCs as these are lending for a longer period of time against comparatively short term liabilities.



3.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words):

Q 1: What are the different types of NBFCs?

Q 2: How NBFCs are classified in terms of their asset-liability structure?

Q 3: What is meant by factoring ? How NBFCs play a role in factoring?

Essay-type Questions (Answer each question in about 300-500 words)

Q 1: Explain the nature of Non Banking Financial Companies(NBFCs)

Q 2: Explain the size and growth of NBFCs in recent period.

Q 3: Explain the role of NBFCs in financial inclusion.

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UNIT 14: THE DERIVATIVE MARKET

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Overview of Derivatives

14.4 Features of the Derivative Market

14.5 Functions of the Derivative Market

14.6 Participants in a Derivative Market and Their Role

14.7 Types of Financial Derivatives

14.8 Let Us Sum Up

14.9 Further Reading

14.10 Answers to Check Your Progress

14.11 Model Questions

14.1 LEARNING OBJECTIVES

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

- know about the derivative market and its participants
- explain the various functions of the derivative market
- learn about the various participants in a derivative market and the role played by them.

14.2 INTRODUCTION

Risk is a characteristic feature of all commodity and capital markets. Prices of all commodities both agricultural and non-agricultural commodities are subject to fluctuations overtime keeping with the prevailing supply and demand conditions. Similarly, the price of shares, debentures, and bonds and other securities are also subject to continuous change. Therefore, the sellers and buyers are constantly and continuously exposed to the risk of losses on account of fluctuations in the prices of such assets. Thus, derivatives came into being primarily to deal with and also to eliminate such price risks prevalent in commodity and security market.

The objective of any investment decision is to get a return with minimum risk. To achieve this objective, various instruments, practices and strategies have been devised and developed in the recent past. With the opening of boundaries for international trade and business, the world trade gained momentum. In the last decade, the world has entered into a new phase of global integration and liberalization. The integration of capital markets world-wide has given rise to increased financial risk with the frequent changes in the interest rates, currency exchange rates and stock prices. To overcome the risk arising out of these fluctuating variables and increased dependence of capital markets of one set of countries to the other and risk management practices have also been reshaped by inventing such instruments as can mitigate the risk element. These new popular instruments are known as financial derivatives which not only reduce financial risk but also open new opportunities for high risk takers. As Derivative is a financial instrument of risk management, these generally do not influence the fluctuation in the underlying asset prices. However, by locking-in asset prices, derivative products minimize the impact of fluctuation in asset prices on the profitability and cash flow situation of risk-averse investors. Derivatives are used by different investors with different purposes to hedge the risk arising from the investments made on the underlying asset to speculate on the underlying asset and gain from price fluctuations, for arbitrage, or to create synthetic products. These are also used to make investment strategies for safe and risk –free investment.

14.3 OVERVIEW OF DERIVATIVES

In the Indian context the **Securities Contracts (Regulation) Act, 1956 SC(R) A**, defines "derivative" as — "A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security".

John C. Hull has defined a derivative as - "A derivative is a financial instrument whose value depends on (or derives from) the values of other, more basic underlying variables".

According to Robert L. Mc Donald, "A financial instrument "which has a value determined by the price of something else. This "something else" can be almost anything: it can be assets or commodities".

Thus a derivative is a financial instrument whose value depends on underlying assets. The underlying assets could be prices of traded securities of gold, copper, aluminium and may even cover prices of fruits and flowers. In practice, it is a contract between two parties that specifies conditions especially dates, resulting values of the underlying variables, and notional amounts under which payments are to be made between the parties. Derivatives have become important in India since 1995, with the amendment of the Securities Contract Regulation Act of 1956.

Derivatives are broadly categorized by the relationship between the underlying asset and the derivative, the type of underlying asset, the market in which they trade, and their pay-off profile. The most common types of derivatives are forwards, futures, options and swaps (We will study about forwards, futures, options and swaps in details in the section of Types of Financial Derivatives of this unit). The most common underlying assets include commodities, stocks, bonds, interest rates, and currencies. Derivatives such as options and futures are traded actively on many exchanges. Forward contracts, swaps and different types of options are regularly traded outside exchanges by financial institutions, banks and corporate clients in over-the-counter markets. There is no single market place or an organized exchange. Organized exchanges began trading in options in 1973, whereas exchange traded debt options started trading in 1982. On the other hand, fixed income futures began trading in 1975, but equity related futures started trading in 1982. The reasons for debt options being stronger than futures are that stock exchanges tend to introduce those instruments that they think will be successful in trading.

Derivatives are used by investors for the following:

- To provide leverage, such that a small movement in the underlying value can cause a large difference in the value of the derivative.
- To speculate and make a profit if the value of the underlying asset moves the way they expect.

- To hedge or mitigate risk in the underlying, by entering into a derivative contract whose value moves in the opposite direction to the underlying position and cancels part or all of it out.
- To obtain exposure to the underlying where it is not possible to trade in the underlying .
- To create option ability where the value of the derivative is linked to a specific condition or event (e.g. the underlying reaching a specific price level).

There are two groups of derivative contracts, which are distinguished by the way they are traded in the market and they are -

***Over-the-counter (OTC)* derivatives**: These are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Products such as swaps, forward rate agreements, exotic options – and other exotic derivatives – are almost always traded in this way. The OTC derivative market is the largest market for derivatives, and is mostly unregulated with respect to disclosure of information between the parties.

Exchange-traded derivative contracts (ETD): These are standardized derivative contracts such as futures and options contracts that are transacted on an organised futures exchange. Exchange traded derivatives have become increasingly popular because of the advantages they have over 'over-the-counter'(OTC) derivatives, such as standardization, liquidity and elimination of default risk. Futures and options are two of the most popular exchange traded derivatives. It acts as an intermediary to all related transactions, and takes initial margin from both sides of the trade to act as a guarantee.

ADVANTAGES OF DERIVATIVES

Derivatives exert a significant impact on modern finance because they provide numerous advantages to the financial markets:

- **Hedging risk exposure -** Since the value of the derivatives is linked to the value of the underlying asset, the contracts are primarily used for hedging risks. For example, an investor may purchase a derivative contract whose value moves in the opposite direction to the value

of an asset the investor owns. In this way, profits in the derivative contract may offset losses in the underlying asset.

- **Underlying asset price determination** - Derivates are frequently used to determine the price of the underlying asset. For example, the spot prices of the futures can serve as an approximation of a commodity price.
- **Market efficiency** - It is considered that derivatives increase the efficiency of financial markets. By using derivative contracts, one can replicate the payoff of the assets. Therefore, the prices of the underlying asset and the associated derivative tend to be in equilibrium to avoid arbitrage opportunities.
- **Access to unavailable assets or markets** - Derivatives can help organizations get access to otherwise unavailable assets or markets. By employing interest rate swaps, a company may obtain a more favourable interest rate relative to interest rates available from direct borrowing.

DISADVANTAGES OF DERIVATIVES

Despite the benefits that derivatives bring to the financial markets, the financial instruments come with some significant drawbacks. They are

- **High risk** - The high volatility of derivatives exposes them to potentially huge losses. The sophisticated design of the contracts makes the valuation extremely complicated or even impossible. Thus, they bear a high inherent risk.
- **Speculative features** - Derivatives are widely regarded as a tool of speculation. Due to the extremely risky nature of derivatives and their unpredictable behaviour, unreasonable speculation may lead to huge losses.
- **Counter-party risk** - Although derivatives traded on the exchanges generally go through a thorough due diligence process, some of the contracts traded over-the-counter do not include a benchmark for due diligence. Thus, there is a possibility of counter-party default.

14.4 FEATURES OF THE DERIVATIVES MARKET

The features of the derivatives market are as follows –

- Derivatives have a maturity or expiry date post on which they terminate automatically.
- Derivatives have the characteristic of leverage or gearing. The value of derivative can move exponentially in comparison to the value of its underlying.
- Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.
- All the transactions in the derivatives takes place in a future specified date.
- There are no specified limits on the number of units that can be transacted in the derivative market as there are no physical assets for transactions.
- The derivatives market is liquid and thus the transaction be easily effected.

14.5 FUNCTIONS OF THE DERIVATIVE MARKET

- **Risk Management:** The prices of derivatives are related to their underlying assets, as mentioned before. They can thus be used to increase or decrease the risk of owning the asset. For example, you can reduce your risk by buying a spot item and selling futures contract or call option. This is how it works. If there is a fall in the spot price, the corresponding futures and options contract will also fall. One can repurchase the contract at a lower price, which will result in a gain. This can partially offset the loss on the spot item. The ease of speculation in the derivatives market makes it easier for an investor seeking to protect a position or an anticipated position in the spot market.
- **Price Discovery:** Derivative market serves as an important source of information about prices. Prices of derivative instruments such as futures and forwards can be used to determine what the market

expects future spot prices to be. In most cases, the information is accurate and reliable. Thus, the futures and forwards markets are especially helpful in price discovery mechanism.

- **Operational Advantages:** Derivative markets have greater liquidity than the spot markets. The transactions costs therefore, are lower. This means commissions and other costs for traders are lower in derivatives markets. Further, unlike securities markets that discourage shorting, selling short is much easier in derivatives. Therefore, by virtue of risk management, short selling, price discovery, and improved liquidity, derivatives make the markets more efficient.



CHECK YOUR PROGRESS

Q 1: What do you understand by the term derivatives? (Answer in about 20 words)

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Q 2: Explain in brief about *over-the-counter (OTC)* derivatives contracts. (Answer in about 20 words)

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Q3: Mention two advantages of derivatives.

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14.6 PARTICIPANTS IN A DERIVATIVE MARKET AND THEIR ROLE

The participants in the derivatives market can be broadly categorized into the following groups:

- **Hedgers -** Hedging is an act, whereby an investor seeks to protect a position or anticipated position in the spot market. It is done by using an opposite position in derivatives. This means that if you have a buy position, you have to create a sell position and vice-

versa. The parties who perform hedging are known as hedgers. In the process of hedging, parties such as individuals or companies owning or planning to own a cash commodity like corn, pepper, wheat, treasury, bonds, notes or bills, etc. are concerned that the cost of the commodity may change before either buying it in the cash market. They want to reduce or limit the impact of such movements, which, if not covered, would incur a loss. In such a situation, the hedger achieves protection against changing prices by purchasing or selling futures contracts of the same type and quantity. One can achieve such similar objectives by exercising options. In a situation when the prices of any underlying stock are intended to fall one can buy put options. Similarly, in situations with price rise, a call option is preferred.

- **Speculators** - Speculators are basically traders. They enter the futures and options contract, with a view to making the profit from the subsequent price movements. They do not have any risk to hedge. In fact, they operate at a high level of risk in anticipation of profits. Speculation provides liquidity in the market. The speculators also perform a valuable economic function of feeding information. These pieces of information are not readily available elsewhere. They also help others in analyzing the derivatives markets.
- **Arbitragers** - Some traders participate in the market for obtaining risk-free profits. They do so by simultaneously buying and selling financial instruments like stocks futures in different markets. This process is known as 'arbitrage'. Thus, 'arbitrageurs' are the person who does such kind of trading. For example, one can always sell a stock on the National Stock Exchange exchange and buy simultaneously back on the Bombay Stock Exchange platform. The arbitrageurs continuously monitor various markets. And wherever there is a chance of arbitraging, they buy from one market and sell in the other market. In this way, they make a riskless profit. They

keep the prices of derivatives and current underlying assets closely consistent and perform a valuable economic function.

Arbitragers and speculators perform almost a similar function. Since they both do not possess any risk to hedge for. They help in identifying inefficiencies that exist among the markets. It is also a fact that arbitragers help in price discovery of stocks. Further, this leads to market efficiency. On the other hand, speculators help in enhancing liquidity in the market.

- **Margin Traders** - A margin refers to the minimum amount that one need to deposit with the broker to participate in the derivative market. It is used to reflect some one's losses and gains on a daily basis as per market movements. It enables to get a leverage in derivative trades and maintain a large outstanding position. Imagine that with a sum of Rs. 2 lakhs you buy 200 shares of ABC Ltd. of Rs 1000 each in the stock market. However, in the derivative market you can own a three times bigger position i.e. Rs 6 lakhs with the same amount. A slight price change will lead to bigger gains/losses in the derivative market as compared to stock market.

14.7 TYPES OF FINANCIAL DERIVATIVES

The four major types of derivative contracts are options, forwards, futures and swaps.

- **Options** - Options refer to a right but not an obligation of the buyer of the option to either buy or sell an underlying at a future date at a pre-determined price. It is, however, an obligation of the seller. The buyer pays a premium to the seller to buy the right. Options can be OTC or exchange traded. The option to buy is call option and the option to sell is a put option. Thus, options are of two types –calls and puts. While "calls" give the buyer the right, but not the obligation, to buy a given quality of the underlying asset at a given price on or before a given future date, "puts" give the seller the right, but not the obligation, to sell a given quantity of the underlying asset at a given price on or before a given date.

- **Futures** - Futures are standardised contracts which allow the holder to buy/sell the asset at an agreed price at the specified date. The parties to the future contract are under an obligation to perform the contract. These contracts are traded on the stock exchange. The values of future contracts are marked-to-market everyday. It means that the contract value is adjusted according to market movements till the expiration date.
- **Forwards** - Forwards are like futures contracts wherein the holder is under an obligation to perform the contract. But forwards are unstandardised and not traded on stock exchanges. These are available over-the-counter and are not marked-to-market. These can be customised to suit the requirements of the parties to the contract.
- **Swaps** - Swaps are derivative contracts wherein two parties exchange their financial obligations. The cash flows are based on a notional principal amount agreed between both the parties without exchange of principal. The amount of cash flows is based on a rate of interest. One cash flow is generally fixed and the other changes on the basis of a benchmark interest rate. Interest rate swaps are the most commonly used category. Swaps are not traded on stock exchanges and are over-the-counter contracts between businesses or financial institutions.



CHECK YOUR PROGRESS

Q 4: Who are the participants in the derivatives market? (Answer in about 50 words)

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Q 5: What is meant by Swaps Derivatives Contract? (Answer in about 30 words).

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14.8 LET US SUM UP

- Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.
- Derivatives have a maturity or expiry date post which they terminate automatically.
- Derivatives have become important in India since 1995, with the amendment of the Securities Contract Regulation Act of 1956.
- *Over-the-counter (OTC)* derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary whereas *Exchange-traded derivative contracts (ETD)* are those derivatives instruments that are traded via specialized derivatives exchanges or other exchanges.
- The participants in the derivatives market can be broadly categorized into hedgers, speculators, arbitragers and margin traders.
- Forwards are over the counter trades and are customized whereas futures are exchange traded and are standardized.
- In futures, the performance of the contract is done only at the future specified date, but in the case of options, the performance of the contract can be done at any time before the expiry of the agreed date. Futures are riskier than the options.



14.9 FURTHER READING

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14.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A derivative is a financial instrument whose value depends on underlying assets. The underlying assets could be prices of traded securities of gold, copper, aluminium and may even cover prices of fruits and flowers.

Ans to Q No 2: *Over-the-counter (OTC)* derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary.

Ans to Q No 3: Two advantages of derivatives are hedging risk exposure and underlying asset price determination.

Ans to Q No 4: The participants in the derivatives market can be broadly categorized into the following groups and they are hedgers, speculators, arbitragers and margin traders.

Ans to Q No 5: Swaps are derivative contracts wherein two parties exchange their financial obligations. The cash flows are based on a notional principal amount agreed between both the parties without exchange of principal. The amount of cash flows is based on a rate of interest. One cash flow is generally fixed and the other changes on the basis of a benchmark interest rate.



14.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q1: Write a short note on derivatives as a financial instrument.

Q2: State the features of the derivatives market.

Q3: What are the various functions of the derivatives market?

Long Questions (Answer each question in about 300-500 words)

Q1: Discuss briefly about the various participants in the derivatives market?

Q2: Briefly discuss about the advantages and disadvantages of the derivatives market.

Q3: Write a note about the types of derivative contracts.

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UNIT 15: FINANCIAL ASSET VALUATION

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Financial Asset Valuation

15.3.1 Financial Asset Valuation- Determining Present Value

15.3.2 Financial Asset Valuation- Determining Future Value

15.4 Valuation of Debt Instruments

15.5 Valuing Income and Growth Stocks

15.6 Let Us Sum Up

15.7 Further Reading

15.8 Answers to Check Your Progress

15.9 Model Questions

15.1 LEARNING OBJECTIVES

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

- understand the concept of financial asset valuation
- know the methods of determining present value and future value of financial assets
- discuss the valuation of Debt Instruments
- describe valuing income and growth stocks.

15.2 INTRODUCTION

There are two ways in which the firm may raise funds from investors. The firm can raise money by issue of shares (own funds) or by issue of debt instruments like debentures (borrowed funds).

A company sells shares to raise capital. Shareholders (or stockholders) are regarded as the legal owners of the company. There are two types of shareholders i.e. ordinary (also known as equity shareholders) and preference shareholders. The preference shareholders have two preferences over equity shareholders. One at the time of payment of dividend, and second at the time of repayment of capital during winding up of the company.

The payment of dividend to shareholders is neither a legal obligation nor the rate of dividend is fixed. The dividend rate varies from year to year depending on distributable profits of the company and decision of the Board of Directors. Stockholders invest their money in anticipation of return on their invested funds. Their return comprises of capital appreciation of their invested funds and the returns in the form of dividend. Shareholders make capital gains (or losses) by disposing of their shares.

Another important source of finance in companies for raising capital is lenders or creditors. The company may borrow funds from various sources such as banks, financial institutions, public, or by issuing bonds and debentures. Lenders are not the owners and they provide loan or debt capital to the company. They make available the funds by retaining the title to the funds lent. The debts are provided for a fixed period and at a fixed rate of interest. Payment of interest is a legal obligation for the company. Unlike dividend, interest must be serviced even when the company earns low or no profits. The amount of interest which a company pays for servicing its debt in a particular year is a deductible expense for calculating corporate income tax liability for the company. This interest tax shield is valuable to the company as it leads to saving in taxes. A debenture or a bond is an acknowledgement of debt. It certifies the amount of money the company has borrowed, the rate of interest and the maturity period.

Financial assets, also known as securities, are financial instruments or papers like shares, debentures and bonds. The companies raise funds by issuing these securities in primary capital market. These securities are traded by investors in the secondary capital market also called as stock exchanges. Financial asset also indicates lease obligations and borrowings from financial institutions including banks and others. Both the types of financial assets i.e. stocks and debt instruments are traded in secondary market. In this unit, we will learn the different aspects of asset valuation.

15.3 FINANCIAL ASSET VALUATION

Valuation is a method that explains the relationship between risk and return to indicate the worth of an asset. The process of valuation can

be applied to anticipate benefits from real/ physical and financial assets. It helps in estimating their worth at a given point of time. One of the most crucial principle in all types of financial valuation is 'value of a rupee today and value of rupee in future'. As financial asset is represented by a sequence of future cash flows, valuation of a financial asset pertains to estimating the present value of future cash inflows that the financial asset is expected to generate over its life. To attract investors and to maximise shareholders value a firm must take the best possible investment, financing, and dividends decisions. These decisions have significant bearing on the firm's value.

Time value of money indicates that value of a unit of money differs in different time periods

Any rationale investor attaches more value to a specific amount of money today compared to same amount of money receivable at some future date. In other words, the present value of a rupee received at some future date will be less than a rupee received today. This phenomenon is known as **time preference for money** or **time value of money**.



Time value of money indicates that value of a unit of money differs in different time periods.

Now the question is why a rupee today is more valuable than a rupee at some future date? Individuals time preference for money can be attributed to following reasons:

- Alternative investment opportunities
- To cover inflation
- Preference for present consumption
- Risk of uncertainty
- **Alternative investment/ reinvestment opportunities:** The simplest answer is that one could have invested the same rupee somewhere else i.e. alternative investment/ reinvestment opportunities are present in the market and could have earned a return, in the form of interest, dividend, or price appreciation. Thus, if one could earn 4% interest in savings deposit in a bank account, the rupee would be worth Rs. 1.04 after a year.
- **To cover inflation:** One may again ask a question why we need to earn an interest rate to save? The answer is to cover inflationary

effects. As due to inflation the purchasing power of money decreases with passage of time, hence an interest rate is required to compensate for the decline in the purchasing power of the money. The rupee today will fetch more in terms of real goods compared to the same rupee a year later. Hence, an interest rate is required to make good the loss in purchasing power due to inflation.

- **Preference for present consumption:** As money is the means of acquiring goods and services, one needs to be compensated for postponing their present consumption to future. An individual would attach more value to present consumption compared to future consumption. Even if there is no inflationary pressure and a rupee today or after a year will fetch the same quantity of goods, one would prefer to consume the goods today. If one must postpone the consumption, the individual needs to be compensated in the form of an interest rate/ return on the savings. This interest rate is also known as real interest rate. Stronger is the preference for current consumption, higher is the real interest rates.
- **Risk of uncertainty:** So far, we have assumed guaranteed return on savings in future. However, the world lives under the risk of uncertainty. As individuals are exposed to the risk of uncertainty about future returns, they might prefer to enjoy the money now. Hence, they need to be compensated for bearing the risk of uncertainty. Thus, a premium in the form of 'returns' is desired by the investors for bearing the risk of uncertainty.



CHECK YOUR PROGRESS

Q 1: What are two ways in which the firm may raise funds from investors? (Answer in about 40 words)

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Q 2: What are the two preferences the preference shareholders have? (Answer in about 30 words)

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Q 3: Write the meaning of a debenture or bond? (Answer in about 30 words)

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Q 4: What is meant by valuation of a financial asset? (Answer in about 25 words)

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15.3.1 Financial Asset Valuation- Determining Present Value

For investors who want to save now and buy later, the concept of present value is of utmost importance. The practice of estimating the present value of future cash flows is very common. It is the process of estimating the present values of a series of future cash flows. In simple words, it is the current value of a future amount.

A cash flow is either a cash that we expect to receive (cash inflow) or a cash that we expect to pay (cash outflow). Horne and Dhamija define present value as 'a future amount discounted to the present by some required rate'. Thus, present value of future cash inflows and outflows is the current cash equivalents.

To determine the present value of future cash flows the technique of discounting is applied. The rate used for discounting the future cash flows is known as discounting rate. Discounting enables us to convert future cash flows into cash flows today, so that we can compare different alternatives with respect to our investment decisions and decide the best course of action. This concept is central to the notion of financial asset valuation and is applied to determine the present value of a future amount. It is

pertinent to note that present value decreases for a given discount rate as the period increases.

We would discuss the technique of calculating the present values in the following two circumstances:

- Present value of a single cash flow
- Present value of an annuity
- **Present value of a single cash flow:**

Present values can be calculated for any combination of number of years and interest rate. Present value of a single cash flow (Lump Sum) to be received after some future period can be calculated with the help of following formulae:

$PV = F_n \times PVF_{n,i}$

Where,

'PV' is the present value;

'F_n' is the future value to be received after a period 'n' for which the applicable discounting rate is indicated by 'i'.

Thus, $PVF_{n,i}$ is the **present value factor** for n periods at i rate of interest.

PVF can be computed by using a scientific calculation in a scientific calculator or by using the precalculated 'Present value factor table for a lump sum'.

For calculating the present value of a future amount, one needs to simply find out the present value factor (PVF) for given n and i from the present value factor table and multiply the same by the given future value.

When the cash flows are discounted annually-i.e. interest payments are calculated at the end of the year, based on the balance at the beginning of the year, it is known as 'discrete discounting'.

However, if the interest is calculated more frequently such as half yearly or monthly, it is known as continuous discounting.

The following examples will make it clear –

Ex. 1: What will be the present value of Rs. 1,00,000 payable after 15 years at the interest rate of 12%.



Present / Compound value factor tables for 'a lump sum' and 'an annuity' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These present value factor tables for lump sum gives the pre-computed present values of Rs. 1 after n number of years at i interest rates.

$PV = F_n \times PVF_{n,i}$

In case of *discrete discounting*:

The present value factor (PVF) for 15 years at 12 percent interest rate is 0.183.

Hence, the PV= Rs.1,00,000 X 0.183 = Rs. 18,300

Ex. 2: What will be the present value of Rs. 1,00,000 payable after 15 years at the interest rate of 12% under continuous discounting?

'Continuous discounting table' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These Continuous discounting table' gives the continuous discounted values (e^{-x}) where '-X' is calculated by multiplying 'n' number of years with 'I' interest rates.



'Continuous discounting table' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These Continuous discounting table' gives the continuous discounted values (e^{-x}) where '- X' is calculated by multiplying 'n' number of years with 'I' interest rates.

In case of continuous discounting:

PV is calculated with the help of the following formulae:

$PV = F_n \times e^{-x} = F_n \times e^{-i \times n.}$ = Rs. 1,00,000 X 0.16530 = Rs. 16,530

For calculating the present value of a future amount under continuous discounting, one needs to simply find out the value of e^{-x} from the table of Continuous discounting and multiply the same by the given future value.

- **Present value of an annuity:**

An annuity is a stream of constant periodic amount that occur at regular intervals for a specific period. The present value of annuity refers to the present value of sum of all cash inflows of the annuity. This can be explained with the help of the following example.

Ex. 3: Suppose you want to buy a machine for your enterprise. You have two options- First, you might buy it for cash by paying Rs. 11,000 now; or Second option is you may procure the same on instalment basis by paying Rs. 3,000 a year plus interest @ 12% for next five years. Which option would you prefer?

In the first option, the outflow of a lumpsum of Rs. 11,000 will be there. However, in the second option outflow of Rs. 3,000 plus interest @ 15% will be there for next five years.

Hence, you must calculate the present value of the annuity i.e. Rs. 3,000.

It can be calculated as follows:

Present Value = Annuity X Present Value Factor of an Annuity of Rs. 1.

$PV = A \times PVFA_{n,i}$ = Rs. 3,000 X 3.605 = Rs. 10, 815

Thus, in this case second option seems to be more profitable as the present value of the future cash flows is less than the current price of the machine.



CHECK YOUR PROGRESS

Q 5: What is meant by cash flow? (Answer in about 20 words)

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Q 6: What is discounting rate? (Answer in about 30 words)

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Q 7: Write the meaning of present value? (Answer in about 30 words)

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Q 8: What will be the present value of Rs. 50,000 payable after 10 years at the interest rate of 12% if interest is payable half yearly under continuous discounting?

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Q 9: Suppose a person receives an annuity of Rs. 10,000 for four years. If the rate of interest is 10%, What is the present value of Rs. 10,000 anuity?

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15.3.2 Financial Asset Valuation- Determing Future Value

Compounding technique is applied to find out the future values of present cash flows. In determining the future values, the process of compounding of interest is done. Compound interest is the interest earned on the original (principal) amount as well as interest earned on interest of the earlier periods which is not withdrawn. Determining future value of present cash flows enables the investor to take best investment decision. The alternative which gives highest future value keeping the other things constant is chosen by the investor. The future value of a financial asset will increase with the time and increase as the compounding rate increases.

We would discuss the technique of calculating the future values in the following two circumstances:

- Future value of a single cash flow
- Future value of an annuity
- **Future value of a single cash flow:**

Future value of a single cash flow (Lump Sum) can be calculated with the help of following formulae:

$FV = P \times CVF_{n,i}$

Where 'FV' is the future or compound value to be received after a period 'n' for which the applicable compounding rate is indicated by 'i'.

Thus, $CVF_{n,i}$ is the compound value factor for n periods at i rate of interest.

CVF can be computed by using a scientific calculation in a scientific calculator or by using the precalculated 'Compound value factor table for a lump sum'.

For calculating the future value of a present amount, one needs to simply find out the compound value factor (CVF) for given n and i from the compound value factor table and multiply the same by the given present value. The following example will make it clear.



'Compound value factor table for 'a lump sum' and 'an annuity' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These compound value factor tables for lump sum gives the precomputed future values of Rs. 1 after n number of years at i interest rates.

Ex. 4: Suppose an investor deposits Rs. 20,000 in the savings account of a bank at 8% for 5 years. How much shall it grow at the end of five years?

In case of *discrete discounting*:

The compound value factor (CVF) for 5 years at 8 percent interest rate is 1.469.

Hence, FV = P X $CVF_{n, i.}$ = Rs. 20,000 X 1.469 = Rs. 29,380

Ex. 2: What will be the future value of Rs. 75,000 receivable after 12 years at the interest rate of 10% under continuous compounding?

In case of continuous compounding:

FV is calculated with the help of the following formulae:

FV = PV X e^x = PV X $e^{i X n.}$ = Rs. 75,000 X 3.3201 = Rs. 2,49,007.5

For calculating the future value of a present cash flow under continuous compounding, one needs to simply find out the value of e^x from the table of Continuous compounding and multiply the same by the given present value.

- **Future value of an annuity:** The future value of annuity refers to the sum of all cash outflows each year for a specified number of years. This can be explained with the help of the following example.

  Ex. 5: Suppose Rs. 50,000 is deposited at the end of each of the next five years. What would be its future value if the rate of interest is 9%?

  It can be calculated as follows:

  Future Value = Annuity X Compound Value Factor of an Annuity of Rs. 1.

  FV = A x $CVFA_{n, i}$ = Rs. 50,000 X 5.985 = Rs. 2,99,250



When the cash flows are compounded annually- i.e. interest incomes are calculated at the end of the year, based on the balance at the beginning of the year, it is known as 'discrete compounding'. However, if the interest is calculated more frequently such as half yearly or monthly, it is known as continuous compounding.



'Continuous compounding table' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These Continuous compounding table' gives the continuous compounded values (e^x) where 'X' is calculated by multiplying 'n' number of years with 'I' interest rates.



CHECK YOUR PROGRESS

Q 10: What is compounding rate? (Answer in about 30 words)

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Q 11: What will be the future value of Rs. 50,000 receivable after 10 years at the interest rate of 6% if interest is compounded continuously?

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Q 12: Suppose a firm deposits Rs. 20,000 for six years. If the rate of interest is 8%, how much would this annuity accumulate at the end of sixth year?

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15.4 VALUATION OF DEBT INSTRUMENTS

As the nature of debt instrument is significantly different from equity instrument, hence their process of valuation also differs. In case of debt instruments, the future cash flows are known in advance and the life of the instrument is usually defined. These financial assets are risk - free and the interest rate earned on them are risk free rates. The value of these assets is the present value of the cash flows, discounted at these risk-free rates.

These debt instruments are commonly known as bond. The bonds issued by governments are usually riskless as the governments have power to print currency to meet its obligations which they otherwise fail to cover. Bonds issued by public sector undertakings are also relatively secure but not free from risk of default. The bonds issued by private sector companies are known as debentures in India. These debentures can be secured as well as unsecured. The rate of interest on these long-term debt instruments are usually fixed. Redeemable bond is repayable after its maturity period. The bond or debenture is generally issued at par value or face value and

fixed interest is payable on par value. The fixed interest rates which are payable on these debt instruments are also known as coupon rate. The value at which the debt instrument is redeemed at the time of maturity is known as redemption value. Redemption value may be higher than the par value (redemption at premium) or equal to par value or it may be less than par value (redemption at discount). Further, the value at which these instruments are traded in market is known as market value which may be different from par value or redemption value.

The basic bonds valuation is explained below:

Ex. 6: Suppose a firm has issued a 10 percent coupon interest rate, 10-year bond with a Rs. 1000 par value that pays interest annually. Compute the value of the bond.

Here,

Bond Value (B_O) = Present Value of Annual Interest (I) + Present Value of Maturity Value (M)

It can be calculated with the help of the following formulae:

$B_O = I \times PVFA_{n,i} + M \times PVF_{n,I}$ = Rs. 100 X 6.145 + Rs. 1000 X 0.386 = Rs. 1,000.

Ex. 7: In the example 6, what would be the value of the bond if the required rate of return is 12 percent.

$B_O = I \times PVFA_{n,i} + M \times PVF_{n,I}$ = Rs. 100 X 5.650 + Rs. 1000 X 0.322 = Rs. 887



CHECK YOUR PROGRESS

Q 13: What is meant by a 'bond'? (Answer in about 40 words)

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Q 14: What is a 'debenture'? (Answer in about 30 words)

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Q 15: Write the meaning of 'coupon rate' with reference to debenture or bond? (Answer in about 30 words)

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Q 16: What is meant by 'redemption value'? (Answer in about 50 words)

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15.5 VALUING INCOME AND GROWTH STOCKS

Investors buy stocks either for dividends or capital gain. Investors who desire to earn higher return via capital gains prefer growth stocks whereas investors who prefer regular income would like to buy income stocks. The stocks which offer higher possibilities of capital gain (due to increase in the market price) are known as Growth stocks. These companies follow low dividend pay-out policy and retain major portion of dividend to achieve a high growth rate. Whereas, the shares on which dividend yield (i.e. dividend per share as a percentage of the market price of the share) is generally high are called Income stocks. Because of high dividend pay-out the prospects of capital gains are lower. The process of valuing income and growth stocks is explained in brief below:

Ex. 8 A company estimates its earnings per share (EPS) at Rs. 6.67, it follows a 100 percent pay-out policy for dividend distribution (i.e. its retention ratio 'b' is zero). In this case its dividend per share (DIV) will be equal to its EPS. Its earnings and dividends would not grow as it does not reinvest any earnings and 'g' would be equal to zero. What would be the price of the shares of the company if the opportunity cost of capital 'K_e' were 15 percent.

The Price of the share 'P_o' can be calculated with the help of the following formulae:

$$Po = \frac{DIV}{Ke - g} = \frac{EPS(1-b)}{Ke - rb} = \frac{6.67(1-0)}{0.15 - 0} = Rs.44.47$$

'r' indicates rate of return

Suppose the company decides to pay dividend of Rs. 3 per share and retain and reinvest the balance earnings at a rate of return of 25 percent. What is the company's pay out ratio, retention ratio and growth rate?

$$\text{Payout ratio} = \frac{DIV}{EPS} = \frac{3}{6.67} = 44.98 \text{ or approx } 45 \text{ percent}$$

Retention ratio (b) = 1- pay out=1- 0.45 = 55 percent

Growth rate (g) = Retention ratio X r = b X r = 0.55 X 0.25 = 13.75 percent

If further we assume that the company will follow a constant policy of retaining 55 percent earnings at 25 percent rate of return, then its earnings and dividends will grow continually at 13.75 percent. What would be the effect of this change on the price of the shares?

$$Po = \frac{DIV}{Ke - g} = \frac{EPS(1-b)}{Ke - rb} = \frac{6.67(1-0.55)}{0.15 - 0.25 \times 0.55} = Rs.240.12$$

It is evident that without retention of earnings, the growth is zero and the price of its share is Rs. 44.47. However, when the growth rate becomes 13.75 percent due to retention of earnings, the share price rises to Rs. 240.12. Thus, the difference (Rs. 240.12 - Rs. 44.47) of Rs. 195.65 the value of growth opportunities. The retained and reinvested earnings create additional value since it generates cash flows.



15.6 LET US SUM UP

- There are two ways in which the firm may raise funds from investors. The firm can raise money by issue of shares (own funds) or by issue of debt instruments like debentures (borrowed funds).

- Valuation is a method that explains the relationship between risk and return to indicate the worth of an asset.
- Individuals time preference for money can be attributed to reasons like availability of alternative investment opportunities, to cover inflation, individual's preference for present consumption and risk of uncertainty
- Present value of future cash inflows and outflows is the current cash equivalents. To determine the present value of future cash flows the technique of discounting is applied. The rate used for discounting the future cash flows is known as discounting rate.
- Compounding technique is applied to find out the future values of present cash flows. Compound interest is the interest earned on the original (principal) amount as well as interest earned on interest of the earlier periods which is not withdrawn.
- In case of debt instruments, the future cash flows are known in advance and the life of the instrument is usually defined. These financial assets are risk - free and the interest rate earned on them are risk free rates. The value of these assets is the present value of the cash flows, discounted at these risk-free rates.
- The stocks which offer higher possibilities of capital gain are known as Growth stocks. These companies follow low dividend pay-out policy and retain major portion of dividend to achieve a high growth rate. Whereas, the shares on which dividend yield is generally high are called Income stocks.



15.7 FURTHER READING

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15.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: There are two ways in which the firm may raise funds from investors. The firm can raise money by issue of shares (own funds) or by issue of debt instruments like debentures (borrowed funds).

Ans to Q No 2: The preference shareholders have a preference over equity shareholders at the time of payment of dividend. They also have a preference at the time of repayment of capital at the time of winding up of the company.

Ans to Q No 3: A debenture or a bond is an acknowledgement of debt. It certifies the amount of money the company has borrowed, the rate of interest and the maturity period.

Ans to Q No 4: Valuation of a financial asset pertains to estimating the present value of future cash inflows that the financial asset is expected to generate over its life.

Ans to Q No 5: A cash flow is either a cash that we expect to receive (cash inflow) of cash that we expect to pay (cash outflow).

Ans to Q No 6: To determine the present value of future cash flows the technique of discounting is applied and the rate used to for discounting the future cash flows is known as discounting rate.

Ans to Q No 7: It is the process of estimating the present values of a series of future cash flows. Present value of future cash inflows and outflows is the current cash equivalents.

Ans to Q No 8: In this case, the interest rates 'i' every six months will be 6% (12%/2) and discounting periods 'n' will be 20 six months compounding periods in 10 years.

Hence, PV = PV = F_n X e^{-x} = F_n X $e^{-i X n.}$ = Rs. 50,000 X 0.30119 = Rs. 15,059.5

Ans to Q No 9: PV = A x $PVFA_{n,I}$ = Rs. 10,000 X 3.170 = Rs. 31,700

Ans to Q No 10: Compound interest is the interest earned on the original (principal) amount as well as interest earned on interest of the earlier periods which is not withdrawn.

Ans to Q No 11: FV = PV X e^{x} = PV X $e^{i X n.}$ = Rs. 50,000 X 1.8221 = Rs. 91,105

Ans to Q No 12: FV = A x $CVFA_{n,I}$ = Rs. 20,000 X 7.336 = Rs. 1,46,720

Ans to Q No 13: A 'bond' is a long - term debt instrument repayable after a specified period. The bond or debenture is generally issued at par value or face value and fixed interest is payable on par value.

Ans to Q No 14: The bonds issued by private sector companies are known as debentures in India. These debentures can be secured as well as unsecured. The rate of interest is usually fixed.

Ans to Q No 15: The fixed interest rates which are payable on bonds or debentures are also known as coupon rate.

Ans to Q No 16: The value at which the debt instrument is redeemed at the time of maturity is known as redemption value. Redemption value may be higher than the par value (redemption at premium) or equal to par value or it may be less than par value (redemption at discount).



15.9 MODEL QUESTIONS

Short Questions (Answer each question in about 200 words)

Q 1: Explain the concept of financial asset valuation.

Q 2: Explain the concept of present value.

Q 3: Explain the process of calculating the present value of an annuity with the help of suitable example.

Long Questions (Answer each question in about 300-500 words)

Q 1: "A rupee today is more valuable than a rupee at some future date". In the light of this statement discuss the reasons why individuals have time preference for money.

Q 2: Explain the process of calculating the present value of a single cash flow with the help of suitable examples.

Q 3: Explain the process of calculating the future values of 'a single cash flow' and of 'an annuity' with the help of suitable examples.

Q 4: Describe the process of bond valuation with suitable example.

Q 5: Discuss the process of valuing income and growth stocks with example.

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Name of the Paper: Course Code:

Centre for Internal Quality Assurance (CIQA)
Krishna Kanta Handiqui State Open University
City Office, Housefed Complex, Guwahati- 06

Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

The Director, Centre for Internal Quality Assurance, KKHandiqui State Open University
Housefed Complex, Dispur, Guwahati- 781006
(E-mail id: ciqa@kkhsou.in)

1. Approximately how many hours did you spend for studying the units in the course? | | | |
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II.	The units of the SLM could satisfy my academic needs and expectations					
III.	The Unit writers have excellent knowledge about the course contents					
IV.	Language and contents of the units were presented at a level which I could readily understand					
V.	Ample opportunity for participation in the activities provided in the units					
VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
VII.	Quality of content is engaging, relevant, and up-to-date					
VIII.	The self check questions are very helpful					
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot					

Additional Comments: *(Please feel free to provide your open comments)*

1. Which aspects of the SLM, according to you, worked well?

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2. What sort of changes/improvements do you feel KKHSOU could implement to improve the overall quality of the SLM?

Thank you for taking the time to complete this form.

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