PGCM S4-02 (DSC) (Finance)

TWO YEAR MASTER'S DEGREE COURSE

(CBCS in Accordance with NEP-2020)

SEMESTER - IV

FINANCIAL MARKETS AND SERVICES
COMMERCE

Maniram Dewan School of Management

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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MASTER OF COMMERCE

FINANCIAL MARKETS AND SERVICES

(Finance and Accounting Specialization)

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COURSE INTRODUCTION

This is the second course of M.Com. Programme of fourth semester Finance and Accounts specialisation . This course “Financial Markets and Services” of M. Com. 4th semester has been structured to give the learners a broad idea about the financial markets and services.The course is designed keeping in mind the present changes in the financial system. The course consists of 15 units that discussing the basics of Indian financial system, money market, capital market, listing of securities, merchant banking services and trading and settlement system in stock exchange, OTCEI, stock market indices, SEBI, new instruments and participants in Indian stock market, derivative market, NBFIs and Microfinance.

Each unit of the course includes some along-side boxes to help you know some of the difficult, unseen terms. You may find some boxes marked with: “LET US KNOW”. These boxes will provide you with some additional interesting and relevant information. Again, you will get “CHECK YOUR PROGRESS” questions. These have been designed to self-check your progress of study. It will be helpful for you if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with “ANSWERS TO CHECK YOUR PROGRESS” given at the end of each unit. This will help you in making your learning more active and efficient. And, at the end of each section, you will get “CHECK YOUR PROGRESS” questions. These have been designed to self-check your understanding.

UNIT DISTRIBUTIONS

This course consists of the following fifteen units:

UNIT 1: Indian Financial System And Markets

UNIT 2 : Money Market

UNIT 3 : Capital Market in India-I

UNIT 4 : Capital Market in India-II

UNIT-5 : Listing of Securities

UNIT-6 : Merchant Banking

UNIT 7 : Trading and Settlement system in Stock Exchanges

UNIT 8 : Over the Counter stock exchanges and foreign stock exchange

UNIT 9 : Stock Market Indices

UNIT 10 : Securities and Exchange Board of Inida (SEBI)

UNIT 11 : New instruments and participants in Indian stock markets

Unit 12 : Derivaties markets

UNIT 13 : Non-Banking Financial Institutions

UNIT-14 : Insurance sector in India

UNIT 15 : Micro Finance

UNIT-1 : INDIAN FINANCIAL SYSTEM AND MARKETS

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Meaning Nature and Definitions of Financial System

1.4 Elements of Financial System

1.5 Functions of Financial System

1.6 Role of Financial System in economic development

1.7 Financial Markets

1.8 Overview of Indian Financial System

1.9 Growth and Development of Indian Financial System

1.10 Weaknesses of Indian Financial System

1.11 Let us Sum Up

1.12 Further Reading

1.13 Answers to Check Your Progress

1.14 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning of financial system
- describe needs of financial system
- interpret money market and capital market
- identify elements of financial system
- enumerate composition of financial markets
- explain functions and role of financial system
- discuss major participants of financial system

1.2 INTRODUCTION

The economic development of a country depends on a great extent on the well organized financial system. The financial system is the most impor-

tant institutional arrangement for the economic transformation in particular and economic development in general. The production of goods and services needs financial inputs which come from the financial system, which in turn determines the well being and the overall standard of living of the people. This chapter will discuss about the meaning, nature and role of financial system. It will also discuss about the meaning of financial markets as well as the relation between financial system and financial markets. After completion of this unit you will be able to understand the role of financial system in economic development of a country. This chapter tries to give an overview of Indian financial system.

1.3 MEANING, NATURE AND DEFINITIONS OF FINANCIAL SYSTEM

Financial system functions as an intermediary between savers and investors. It facilitates the flow of funds from the areas of surplus to the areas of deficit. It is concerned about the money, credit and finance. These three parts are very closely interrelated with each other and depend on each other. Financial system comprises of set of subsystems of financial institutions, financial markets, financial instruments and services which helps in the formation of capital. It provides a mechanism by which savings are transformed to investment.

Financial system of any country consists of financial markets, financial intermediation and financial instruments or financial products. A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. The economic development of a nation is reflected by the progress of the various economic units, broadly classified into corporate sector, government and household sector. A financial system consists of financial market, financial instruments and financial intermediation.

The word ‘system’, in the term ‘financial system’, implies a set of complex and closely connected or interlinked institutions, agents, practices, markets, transactions, claims, and liabilities in the economy. The financial system

is concerned about money, credit and finance. These three terms are intimately related yet are somewhat different from each other.

In the worlds of Van Horne, *"financial system allocates savings efficiently in an economy to ultimate users either for investment in real assets or for consumption".*

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

According to Prasanna Chandra, *"financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments".*

According to L. M. Bhole, "*the financial system of any country consists of specialized and non-specialized financial institutions, of organized and unorganized financial markets, of financial instruments and services which facilitate the transfer of funds. Procedures and practices adopted in the markets and financial interrelationships are also part of the system.*"

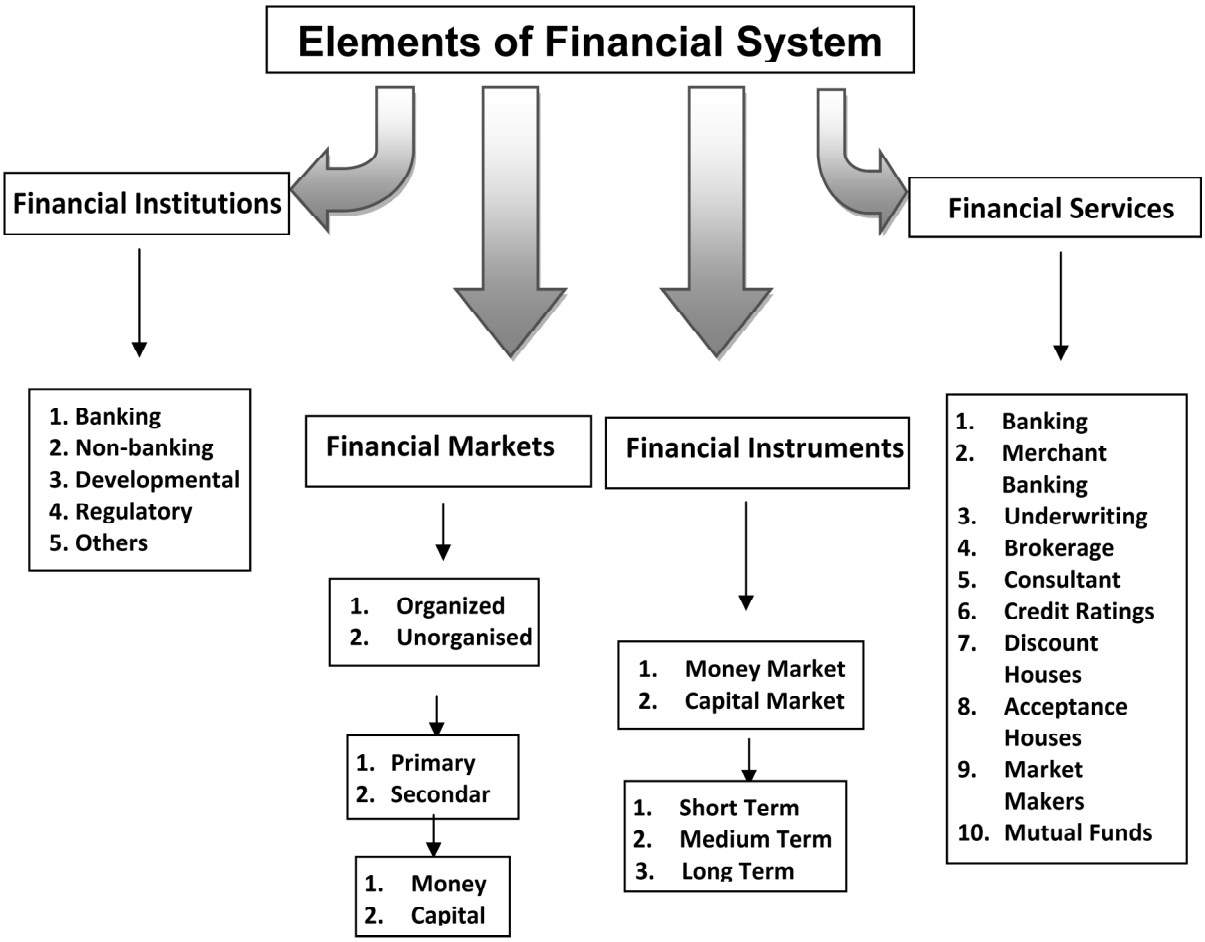
According to S. B. Gupta, "*the financial system is set of institutional arrangements through which financial surpluses available in the economy are mobilized*."

Thus financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments and services which facilitate the transfer of funds. Financial institutions mobilise funds from suppliers and provide these funds to those who demand them. Similarly, the financial markets are also required for movement of funds from savers to intermediaries and from intermediaries to investors. In short, financial system is a mechanism by which savings are transformed into investments.

1.4 ELEMENTS OF FINANCIAL SYSTEM

Financial system is the set of complex and closely connected financial institutions of an economy. It is an institutional arrangement through which financial surpluses are mobilized from the units generating surplus income

and transferring them to the others in need of them. Financial system of every country including India has several interrelated parts, which works harmoniously to achieve certain objectives. The major elements/components of financial system may be shown with the help of the following diagram:



1.5 FUNCTIONS OF FINANCIAL SYSTEM

The financial system of a country performs certain valuable functions for the economic growth of that country. According to Robert Merton the financial system performs the following functions in the modern economy:

- It provides a payment system for the exchange of goods and services
- It enables the pulling of funds for undertaking large scale enterprises

- It provides a mechanism for spatial and temporal transfer of resources
- It provides a way for managing uncertainty and controlling risk
- It generates information that helps in coordinating decentralized decision making
- It helps in dealing with the problem of informational symmetry

The general main functions of a financial system may be briefly discussed as below:

1. Saving Function: An important function of a financial system is to mobilize savings and channelize them into productive activities. It is through financial system the savings are transformed into investments. The banks and other financial institutions mobilize savings and help allocation of resources for investment purposes. In this way financial institution helps capital formation and production process by channelizing the funds from the savers to the investors engaged in production.

2. Liquidity Function: The most important function of a financial system is to provide money and monetary assets for the production of goods and services. Monetary assets are those assets which can be converted into cash or money easily without loss of value. All activities in a financial system are related to liquidity-either provision of liquidity or trading in liquidity.

3. Payment Function: The financial system offers a very convenient mode of payment for goods and services. It ensures that the transactions of buying and selling are carried out safely and swiftly. It is important that both buyers and sellers of goods and services have the confidence that the instruments used to make payments will be accepted and honoured by all the parties. The cheque system, credit card system and electronic payment system are the easiest methods of payment in the economy.

4. Risk Function: Risk and uncertainty pertain to future events which are unknown and difficult to predicate every time. Different financial institutions like banks and financial intermediaries provide services which are both complementary and competitive to each other. They distribute risk through diversifica-

tion and thereby reduce it for savers. The financial markets provide protection against life, health and income risks. These are accomplished through the sale of life, health insurance and property insurance policies.

5. Information Function: The financial institutions have enlarged their scope with the emergence of variety of institutions and dealing in diverse activities. A financial system with the development in communication technology makes available price-related information. This is a valuable help to those who need to take economic and financial decisions.

6. Transfer Function: A financial system provides a mechanism for the transfer of the resources across geographic boundaries. It transfers funds from those who have a surplus and lends them to those who are in deficit and who need to borrow. The transfer of resources can be done directly or indirectly.

7. Reformatory Functions: A financial system undertaking the functions of developing, introducing innovative financial assets/instruments services and practices and restructuring the existing assts, services etc, to cater the emerging needs of borrowers and investors (financial engineering and re engineering).

8. Other Functions: It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

1.6 ROLE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

- Financial system links the savers and investors. It helps in mobilizing and allocating the savings efficiently and effectively. It plays a crucial role in economic development through saving-investment process. This savings-investment process is called capital formation.
- It helps to monitor corporate performance.
- It provides a mechanism for managing uncertainty and controlling risk.

- It provides a mechanism for the transfer of resources across geographical boundaries.
- It offers portfolio adjustment facilities (provided by financial markets and financial intermediaries).
- It helps in lowering the transaction costs and increase returns. This will motivate people to save more.
- It promotes the process of capital formation.
- It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments. In short, a financial system contributes to the acceleration of economic development. It contributes to growth through technical progress.

1.7 FINANCIAL MARKETS

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country's economy.

Financial markets are a mechanism enabling participants to deal in financial claims. Money market and capital market are the organized financial markets. Money market is for short term securities while capital market is for long term securities. The participants in the financial markets are corporations, financial institutions, individuals and the government.

Financial markets deal in financial securities (or financial instruments) and financial services. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. These

are the markets in which money as well as monetary claims is traded in. Financial markets exist wherever financial transactions take place.

Functions of Financial Markets

The main functions of financial markets are outlined as below:

- To facilitate creation and allocation of credit and liquidity
- To serve as intermediaries for mobilisation of savings
- To help in the process of balanced economic growth
- To provide financial convenience
- To provide information and facilitate transactions at low cost
- To cater to the various credits needs of the business organisations

Classification of Financial Markets

1. Money Market: Money market is a market for dealing with financial assets & securities which have a maturity period of up to one year. The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions. Money market consists of:

- **Call Money Market:** Call money market is a market for extremely short period loans say one day to fourteen days. It is highly liquid.
- **Commercial Bills Market:** It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.
- **Treasury Bills Market:** It is a market for treasury bills which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the government. It is highly liquid because its repayment is guaranteed by the government.
- **Short-term Loan Market:** It is a market where short- term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market.

2. **Capital Market**: The capital market is the market for long term securities, that is, securities having a maturity period of one year or more. The capital market is a market for financial assets which have a long or indefinite maturity. This market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year. Components of Capital market:

- **Industrial Securities Market:** It is a market for industrial securities namely equity shares or ordinary shares, preference shares and debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into primary and secondary market.
- **Government Securities Market:** It is otherwise called gilt-edged securities market. It is a market where government securities are traded. In India there are many kinds of govt. securities- short-term and long-term. Long-term securities are traded in this market while short term securities are traded in the money market.
- **Long-term Loans Market:** Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long-term loans market may further be classified into-term loans market, mortgages market and financial guarantees market.

3. **Forex Market**: The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe.

4. **Credit Market**: Credit market is a place where banks, FIs and NBFCs purvey short, medium and long-term loans to corporate and individuals.



CHECK YOUR PROGRESS

1. Fill in the blanks:

a) ———— functions as an intermediary between savers and investors.

b) Financial markets are markets that deal in ———— and credit instruments.

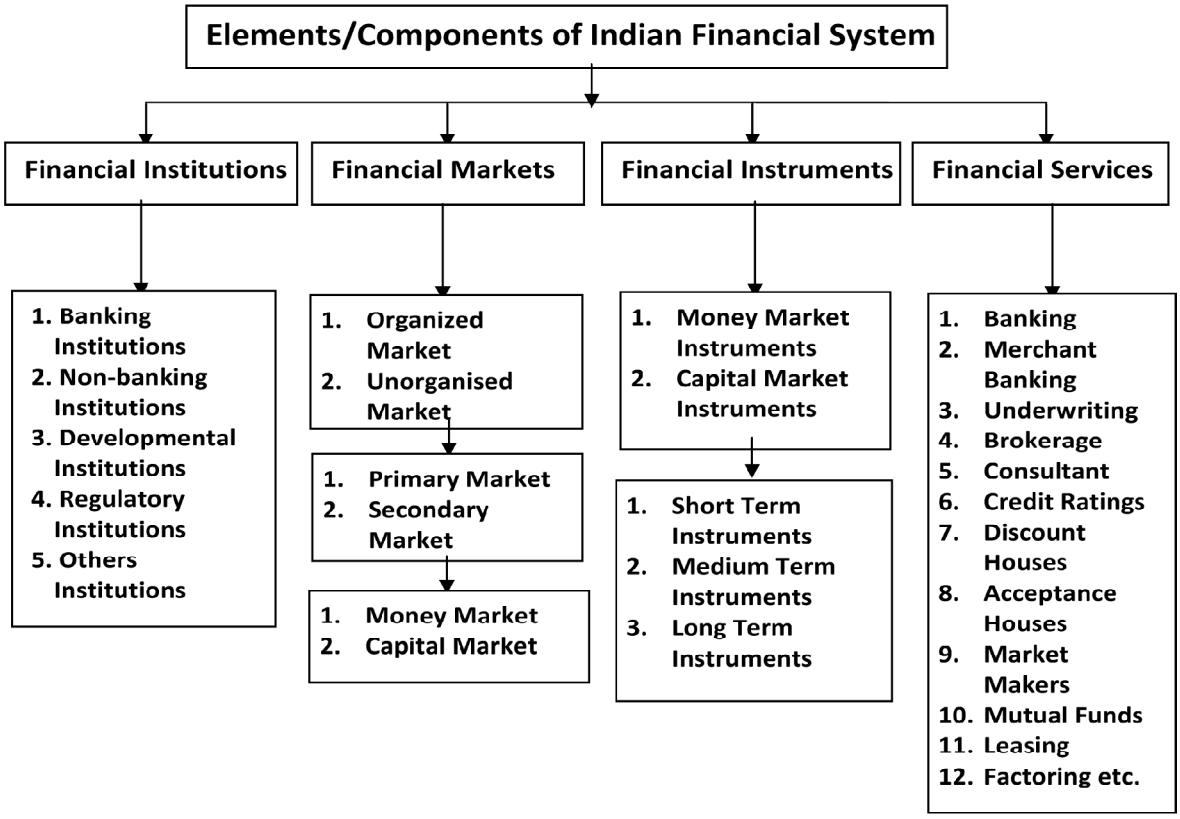
c) The market for extremely short period loan is called ————.

d) _____ facilitate the transfer of funds from savers to the borrowers.

e) Financial institutions are also known as ————.

1.8 OVERVIEW OF INDIAN FINANCIAL SYSTEM

Indian Financial system comprises of set of subsystems of financial institutions, financial markets, financial instruments and services which helps in the formation of capital. It provides a mechanism by which savings are transformed to investment. The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether the mobilization of savings or their efficient, effective and equitable allocation for investment, it the access with which the financial system performs its functions that sets the pace for the achievement of broader national objectives. The primary function of the system is to provide a link between savings and investment.



Structure of Indian Financial System

Financial structure refers to shape, components and their order in the financial system. The Indian financial system can be broadly classified into formal (organised) financial system and the informal (unorganised) financial system. The formal financial system comprises of Ministry of Finance (MOF), Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and other regulatory bodies. The informal financial system consists of individual money lenders, groups of persons operating as funds or associations, partnership firms consisting of local brokers, pawn brokers, and non-banking financial intermediaries such as finance, investment and chit fund companies.

The informal financial system consists of (i) Individual money lenders such as neighbors, relatives, land lords, traders, store owners and so on, (ii) Groups of persons operating as funds or 'associations'. These groups function under a system of their own rules, and (iii) Partnership firms consisting of local brokers, pawn brokers and non banking financial intermediaries such as finance, investment and chit fund companies.

1.9 GROWTH AND DEVELOPMENT OF INDIAN FINANCIAL SYSTEM

At the time of independence in 1947, there was no strong financial institutional mechanism in the country. The industrial sector had no access to the savings of the community. The capital market was primitive and shy. The private and unorganised sector played an important role in the provision of liquidity. On the whole, there were chaos and confusions in the financial system.

After independence, the government adopted mixed economic system. A scheme of planned economic development was evolved in 1951 with a view to achieve the broad economic and social objective. The government started creating new financial institutions to supply finance both for agricultural and industrial development. It also progressively started nationalizing some important financial institutions so that the flow of finance might be in the right direction. The following developments took place in the Indian financial system:

1. Nationalisation of Financial Institutions: RBI, the leader of the financial system, was established as a private institution in 1935. It was nationalized in 1949. This was followed by the nationalisation of the Imperial bank of India. One of the important mile stone in the economic growth of India was the nationalisation of Life Insurance Corporation in 1956. As a result, Life Insurance Corporation of India came into existence on 1st September, 1956. Another important development was the nationalisation of 14 major commercial banks in 1969. In 1980, 6 more banks were nationalized. Another landmark was the nationalisation of general insurance business and setting up of General Insurance Corporation in 1972.

2. Establishment of Development Banks: Another landmark in the history of development of Indian financial system is the establishment of new financial institutions to supply institutional credit to industries. In 1949, RBI undertook a detailed study to find out the need for specialized institutions. The first development bank was established in 1948. That was Industrial Finance Corporation of India (IFCI). In 1951, Parliament passed State Financial Corporation Act. Under this Act, State Governments could establish financial corporation's for their respective regions. The Industrial Credit and Investment Corporation of India (ICICI) were set up in 1955. It was supported by Government of India, World Bank etc. The UTI was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. The Industrial Development Bank of India (IDBI) was established on 1st July 1964 as a wholly owned subsidiary of the RBI.

On February 16, 1976, the IDBI was delinked from RBI. It became an independent financial institution and started coordinating the activities of all other financial institutions. In 1971, the IDBI and LIC jointly set up the Industrial Reconstruction Corporation of India with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as Industrial Reconstruction Bank of India. Now its new name is Industrial Investment Bank of India (IIBI).

In 1982, the Export-Import Bank of India (EXIM Bank) was set up to provide financial assistance to exporters and importers. On April 2, 1990 the Small Industries Development Bank of India (SIDBI) was set up as a wholly owned subsidiary of IDBI. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

3. Establishment of Institution for Agricultural Development: In 1963, the RBI set up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects, minor irrigation, farm mechanization, land development etc. In order to meet credit needs of agriculture and rural sector, National Bank for Agriculture and Rural Development (NABARD) was set up in 1982. The main objective of the establishment of NABARD is to extend short term, medium term and long term finance to agriculture and allied activities.

4. Establishment of Institution for Housing Finance: The National Housing Bank (NHB) has been set up in July 1988 as an apex institution to mobilize resources for the housing sector and to promote housing finance institutions.

5. Establishment of Stock Holding Corporation of India (SHCIL): In 1987, another institution, namely, Stock Holding Corporation of India Ltd. was set up to strengthen the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, support services etc. to investors.

6. Establishment of Mutual Funds and Venture Capital Institutions: Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies. Venture capital is a long term risk capital to finance high technology projects. The IDBI venture capital fund was set up in 1986.

The ICICI and the UTI have jointly set up the Technology Development and Information Company of India Ltd. in 1988 to provide venture capital.

7. New Economic Policy of 1991: Indian financial system has undergone massive changes since the announcement of new economic policy in 1991. Liberalisation, Privatisation and Globalisation has transformed Indian economy from closed to open economy. The corporate industrial sector also has undergone changes due to delicensing of industries, financial sector reforms, capital markets reforms, disinvestment in public sector undertakings etc.

Since 1990s, Government control over financial institutions has diluted in a phased manner. Public or development financial institutions have been converted into companies, allowing them to issue equity/bonds to the public. Government has allowed private sector to enter into banking and insurance sector. Foreign companies were also allowed to enter into insurance sector in India.

1.10 WEAKNESSES OF INDIAN FINANCIAL SYSTEM

Even though Indian financial system is more developed today, it suffers from certain weaknesses. These may be briefly stated below:

1. Lack of co-ordination among financial institutions: There are a large number of financial intermediaries. Most of the financial institutions are owned by the government. At the same time, the government is also the controlling authority of these institutions. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

2. Dominance of development banks in industrial finance: The industrial financing in India today is largely through the financial institutions set up by the government. They get most of their funds from their sponsors. They act as distributive agencies only. Hence, they fail to mobilise the savings of the

public. This stands in the way of growth of an efficient financial system in the country.

3. Inactive and erratic capital market: In India, the corporate customers are able to raise finance through development banks. So, they need not go to capital market. Moreover, they do not resort to capital market because it is erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets.

4. Unhealthy financial practices: The dominance of development banks has developed unhealthy financial practices among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a predominance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing enterprises uneven and lopsided. When these enterprises face financial crisis, the financial institutions permit a greater use of debt than is warranted. This will make matters worse.

5. Monopolistic market structures: In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance, the entire life insurance business is in the hands of LIC. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement. Ultimately, it would retard the development of the financial system of the country itself.

6. Other factors: Apart from the above, there are some other factors which put obstacles to the growth of Indian financial system. Examples are:

- Banks and Financial Institutions have high level of NPA
- Government burdened with high level of domestic debt
- Cooperative banks are labeled with scams
- Investors' confidence reduced in the public sector undertaking etc.
- Financial illiteracy



CHECK YOUR PROGRESS

(Fill in the blanks)

2. Indian financial system comprises of both organised and _____ sector.
3. Write true or false:
   a) The market regulator of Indian Capital Market is SEBI.
   b) The Indian money market does not deal in cash or money but in promissory notes, government paper.



1.11 LET US SUM UP

We have discuss the following points in this unit:-

- Financial system functions as an intermediary between savers and investors.
- Financial system comprises of set of subsystems of financial institutions, financial markets, financial instruments and services which helps in the formation of capital.
- The Indian financial system can be broadly classified into formal (organised) financial system and the informal (unorganised) financial system.
- The financial system of a country performs functions like saving, liquidity, payment, risk and information functions for the economic growth of that country.
- Financial markets deal in financial securities (or financial instruments) and financial services.
- Financial markets are broadly classified into money and capital market.
- Though Indian financial system is more developed today, it suffers from certain weaknesses.



1.12 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy



1.13 ANSWERS TO CHECK YOUR PROGRESS

1. (a) Financial system (b) Financial assets (c) Call money market (d) Financial markets (e) Financial intermediaries

2. un-organised
3. (a) True (b) False



1.14 POSSIBLE QUESTIONS

1. Write short notes on the following:

a) Financial Services

b) Financial Intermediation

c) Financial Instruments

d) Financial Institutions

e) Financial Markets

2. What do you mean by financial system? Discuss the components of Financial System.
3. Discuss the importance of regulators to make financial system of a country stronger.
4. What is the importance of financial system in promoting economic growth?
5. Define financial system. Discuss the present structure of Indian Financial System.

6. Discuss the India financial system by highlighting its features and weaknesses.
7. Discuss about the functions of Indian Financial System in the economic development of the country.
8. Give an overview of the Indian financial system. What are the essential elements of Indian financial system? Explain them briefly.
9. Write a brief note on growth and development of Indian financial system.

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UNIT 2 : MONEY MARKET

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Meaning and Definitions Money market

2.4 Features of Money Market

2.5 Functions of Money Market

2.6 Importance of a Developed Money Market

2.7 Characteristics of a Developed Money Market

2.8 Components/Compositions/Structure of Money Market

2.9 Role of Central Bank in Money Market

2.10 Indian Money Market

2.11 Structure of Indian Money Market

2.12 Participants of Indian Money Market

2.13 Money Market Instruments

2.14 Characteristics of Indian Money Market

2.15 Defects of Indian Money Market

2.16 Recent Development in Indian money market

2.17 Let Us Sum Up

2.18 Further Reading

2.19 Answers to Check Your Progress

2.20 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and functions of money market
- describe the characteristics and importance of a developed money market in the economy
- interpret features of developed money market
- enumerate the components and structure of money market
- explain the structure and functions of Indian money market
- discuss the various instruments used in Indian money market

- discuss the characteristics and defects of Indian money market
- enumerate the recent trends and development of Indian money market

2.2 INTRODUCTION

Financial market deals in financial instruments (securities) and financial services. Financial markets are classified into two, namely, money market and capital market**.** Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. This unit will discuss the meaning, characteristics, constituents, functions and instruments of money market. It will also discuss about the recent trends of Indian Money market as well as the importance of a developed money market in the economy.

2.3 MEANING AND DEFINITIONS MONEY MARKET

Money market is a segment of financial market. It is a market for short term funds. It deals with all transactions in short term securities. These transactions have a maturity period of one year or less. These short term instruments can be converted into money at low transaction cost and without much loss. Thus, money market is a market for short term financial securities that are equal to money.

The money market is a market for short-term funds, which deals in financial assets whose period of maturity is up to one year. It should be noted that money market does not deal in cash or money as such but simply provides a market for credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc. These financial instruments are close substitute of money. These instruments help the business units, other organisations and the Government to borrow the funds to meet their short-term requirement.

Money market does not imply to any specific market place. Rather it refers to the whole networks of financial institutions dealing in short-term funds, which provides an outlet to lenders and a source of supply for such funds to

borrowers. Most of the money market transactions are taken place on telephone, fax or Internet.

According to Crowther, **"***Money market is a collective name given to various firms and institutions that deal in the various grades of near money*". Money market is not a place. It is an activity. It includes all organizations and institutions that deal in short term financial instruments. However, sometimes geographical names are given to the money market according to the location, e.g. Mumbai Money Market.

2.4 FEATURES OF MONEY MARKET

The following are the characteristics of money market:

- It is a market for short term financial assets that are close substitutes of money.
- It is basically an over the phone market.
- It is a wholesale market for short term debt instruments.
- It is not a single market but a collection of markets for several instruments.
- It facilitates effective implementation of monetary policy of a central bank of a country.
- Transactions are made without the help of brokers.
- It establishes the link between the central bank and other banks.
- The players in the money market are central bank(s) of the country, governments, commercial banks, brokers and other companies/organizations relating to short term funds.

2.5 FUNCTIONS OF MONEY MARKET

Money market performs the following functions:

- Facilitating adjustment of liquidity position of commercial banks, business undertakings and other non-banking financial institutions
- Enabling the central bank to influence and regulate liquidity in the economy through its intervention in the market
- Providing a reasonable access to users of short term funds to meet their requirements quickly at reasonable costs

- Providing short term funds to government institutions
- Enabling businessmen to invest their temporary surplus funds for short period
- Facilitating flow of funds to the most important uses
- Serving as a coordinator between borrowers and lender of short term funds
- Helping in promoting liquidity and safety of financial assets

2.6 IMPORTANCE OF A DEVELOPED MONEY MARKET

A well-developed money market is essential for the development of a country. It supplies short term funds adequately and quickly to trade and industry. A developed money market helps the smooth functioning of the financial system in any economy in the following ways:

1. Development of Trade and Industry: Money market is an important source of finance to trade and industry. Money market finances the working capital requirements of trade and industry through bills, commercial papers etc. It influences the availability of finance both in the national and international trade.

2. Development of Capital Market: Availability funds in the money market and interest rates in the money market will influence the resource mobilisation and interest rate in the capital market. Hence, the development of capital market depends upon the existence of a developed money market. Money market is also necessary for the development of foreign exchange market and derivatives market.

3. Helpful to Commercial Banks: Money market helps commercial banks for investing their surplus funds in easily realisable assets. The banks get back the funds quickly in times of need. This facility is provided by money market. Further, the money market enables commercial banks to meet the statutory requirements of CRR and SLR. In short, money market provides a stable source of funds in addition to deposits.

4. Helpful to Central Bank: Money market helps the central bank of a country to effectively implement its monetary policy. Money market helps the

central bank in making the monetary control effective through indirect methods (repos and open market operations). In short, a well-developed money market helps in the effective functioning of a central bank.

5. Formulation of Suitable Monetary Policy: Conditions prevailing in a money market serve as a true indicator of the monetary state of an economy. Hence, it serves as a guide to the government in formulating and revising the monetary policy. In short, the government can formulate the monetary policy after taking into consideration the conditions in the money market.

6. Helpful to Government: A developed money market helps the government to raise short term funds through the treasury bill floated in the market. In the absence of a developed money market, the government would be forced to issue more currency notes or borrow from the central bank. This will raise the money supply over and above the needs of the economy. In short, money market is a device to the government to balance its cash inflows and outflows. Thus, a well-developed money market is essential for economic growth and stability.

2.7 CHARACTERISTICS OF A DEVELOPED MONEY MARKET

In every country many types of money market exist. Some of them are highly developed while others are not well developed. A well developed and efficient money market is necessary for the development of any economy. The following are the characteristics or prerequisites of a developed and efficient money market:

1. Highly Developed Commercial Banking System: Commercial banks are the centre of the whole short term funds. They serve as a vital link between the central bank and the various segments of the money market. When the commercial banking system is developed or organized, the money market will be developed.

2. Presence of a strong Central Bank: In a developed money market, there always exists a central bank. The central bank is necessary for di-

rection and control of money market. Central bank absorbs surplus cash during off-seasons and provides additional funds in busy seasons. This is done through open market operations. Being the bankers' bank, central bank keeps the reserves of commercial banks and provides them financial accommodation in times of need.

3. Existence of Sub-markets: Money market is a group of various sub-markets. Each sub market deals in instruments of varied maturities. There should be large number of sub-markets. The larger the number of sub markets, the broader and more developed will be the structure of money market. Besides, the sub-market must be interrelated and integrated with each other.

4. Availability of Credit Instruments: The continuous availability of readily acceptable negotiable securities is necessary for the existence of a developed money market. In addition to variety of instruments or securities, there should be a number of dealers (participants) in the money market to transact in these securities.

5. **Existence of Secondary Market**: There should be active secondary market in these credit instruments. The success of money market always depends on the secondary market. If the secondary market develops, then there will be active trading of the instruments.

6. **Availability of Ample Resources**: There must be availability of sufficient funds to finance transactions in the sub markets. These funds may come from within the country and outside the country. Availability of sufficient funds is essential for the smooth and efficient functioning of the money market.

7. **Demand and Supply of Funds:** Money market should have a large demand and supply of funds. This depends upon the number of participants and also the government policies in encouraging the investments in various sectors and monetary policy of RBI.

8. **Other Factors:** There are some other factors that also contribute to the development of a money market. These factors include industrial develop-

ment, volume of international trade, political stability, trade cycles, foreign investment, price stabilisation etc.

2.8 COMPONENTS/COMPOSITION/STRUCTURE OF MONEY MARKET

Money market consists of a number of sub-markets. All sub-markets collectively constitute the money market. Each sub-market deals in a particular financial instrument. The main components or constituents or sub-markets of money markets are as follows:

- Call money market
- Commercial bill market
- Treasury bill markets
- Certificates of deposits market
- Commercial paper market
- Acceptance market
- Collateral loan market

2.8.1. Call Money Market

Call money is required mostly by banks. Commercial banks borrow money without collateral from other banks to maintain a minimum cash balance known as cash reserve ratio (CRR). This interbank borrowing has led to the development of the call money market. Call money market is the market for very short period loans. If money is lent for a day, it is called call money. If money is lent for a period of more than one day and up to 14 days is called short notice money. Thus call money market refers to a market where the maturity of loans varies from 1 day to 14 days. In India call money markets are mainly located in big industrial and commercial centres like Mumbai, Kolkata, Chennai, Delhi and Ahmadabad. Participants or players in the Call Money Market are:

- Scheduled commercial banks and RBI
- Non-Scheduled commercial banks
- Co-operative banks
- Foreign banks

- Discount and Finance House of India
- Primary dealers

The above players are permitted to operate both as lenders and borrowers. On the other hand, participants like LIC, UTI, GIC, IDBI, NABARD, Specific mutual funds, etc. are permitted to operate as lenders.

2.8.2. Commercial Bill Market

Commercial bill market is another segment of money market. It is a market in which commercial bills are bought and sold. Commercial bills are widely used in both domestic and foreign trade to discharge the business obligations. Discounting is the main process in this market. Hence commercial bill market is also known as discount market. There are specialized institutions known as discount houses for discounting commercial bills accepted by reputed acceptance houses. In India, RBI has permitted the financial institutions, mutual funds, commercial banks and cooperative banks to enter in the commercial bill market.

2.8.3. Treasury Bills Market

Treasury bill market is a market which deals in treasury bills. Treasury bills are important instruments of short term borrowing by the government. These are the promissory notes or a kind of finance bill issued by the government for a fixed period not extending beyond one year. Treasury bill is used by the government to raise short term funds for meeting temporary government deficits. Thus it represents short term borrowings of the government.

Advantages or importance of Treasure Bill Market:

Advantages to the Issuer/Government*:*

- The government can raise short term funds for meeting temporary budget deficit.
- The government can absorb excess liquidity in the economy through the issue of bills in the market.
- It does not lead to inflationary pressure.

Advantages for the Purchaser/Investor*:*

- It is a ready market for purchasers or investors.

- It is a safety instrument to invest.
- Treasury bills are eligible securities for SLR requirement.
- The market provides hedging facility.

2.8.4. Certificates of Deposits (CD) Market

CD market is a market which deals in Certificate of Deposits (CDs). CDs are short term deposit instruments to raise large sums of money. These are short term deposits which are transferable from one party to another. Banks and financial institutions are major issuers of CDs. These are short term negotiable instruments.

Advantages of CD Market:

- It enables the depositors to earn higher return on their short term surplus.
- The market provides maximum liquidity.
- The bank can raise money in times of need. This will improve their lending capacity.
- The market provides an opportunity for banks to invest surplus funds.
- The transaction cost of CDs is lower.

2.8.5. Commercial Paper Market

Commercial Paper Market is another segment of money market. It is a market which deals in commercial papers. Commercial papers are unsecured short term promissory notes issued by reputed, well established and big companies having high credit rating. These are issued at a discount. They can be issued to (or purchased by) individuals, banks, companies and other registered Indian corporate bodies.

The Working Group on Money Market (Vaghul Committee) in 1987 suggested the introduction of the Commercial Paper (CP) in India. As per the recommendation of the committee, the RBI introduced commercial papers in January 1990. The Committee suggested the following:

- CP should be issued to investors directly or through bankers.
- The CP issuing company must have a net worth of not less than Rs. 5 crores.
- The issuing company's shares must be listed in the stock exchange.

- The minimum amount of issue should be Rs. 1 crore and the minimum denomination of Rs. 5 lakhs
- The CPs issuing cost should not exceed 1% of the amount raised.
- RBI is the sole authority to decide the size of issue and timing of issue.
- The instrument should not be subject to stamp duty at the time of issue and there should not be any tax deduction at source.
- The interest on CP shall be a market determined.
- The issuing companies should get certification of credit rating for every six months and 'A' grading enterprises may be permitted to enter the market.

2.8.6. Acceptance Market

Acceptance Market is another component of money market. It is a market for banker's acceptance. The acceptance arises on account of both home and foreign trade. Banker's acceptance is a draft drawn by a business firm upon a bank and accepted by that bank. It is required to pay to the order of a particular party or to the bearer, a certain specific amount at a specific date in future. It is commonly used to settle payments in international trade. Thus acceptance market is a market where the bankers' acceptances are easily sold and discounted.

2.8.7. **Collateral Loan Market**

Collateral loan market is another important sector of the money market. The collateral loan market is a market which deals with collateral loans. Collateral means anything pledged as security for repayment of a loan. Thus collateral loans are loans backed by collateral securities such as stock, bonds etc. The collateral loans are given for a few months. The collateral security is returned to the borrower when the loan is repaid. When the borrower is not able to repay the loan, the collateral becomes the property of the lender. The borrowers are generally the dealers in stocks and shares.

2.9 ROLE OF CENTRAL BANK IN MONEY MARKET

Central bank is the leader, guide, controller and policy maker of the banking system of a country. If a nation's economy is a human body, then its heart would be the central bank. And just as the heart works to pump life-giving blood throughout the body, the central bank pumps money into the economy to keep it healthy and growing.

The central bank is at the peak of all financial institutions in the money market. No money market can exist without the central bank. As a guardian of the money maker, it takes all necessary steps. To make a powerful and sound money market, central bank control and direct the money market. It decides the interest rates, bank rates, repo rate, CRR and SLR ratio; and also creates balance between inflation and deflation of the nation. The central bank is the lender of the last resort of the money market. It does the following activities as the controller of the money market:

- Policy making, planning development, and implementing to create a powerful and sound money market;
- Acts as a regulator and supervisor of the money market;
- It helps in case of establishment of financial institutions;
- Establishing the stability of the value of currency through credit control;
- To keep the balance between local currency with foreign currency control, bank select the suitable rate of exchange;
- Circulation of money is kept at an optimum level to reduce inflation;
- Give advice and information to the government in case of economic decision making;
- Taking necessary steps to control default at culture;
- Accelerating export and discouraging import;
- Creating and imposing of law for the purpose of public welfare;
- Trying to speed-up and updating economy in comparison to the developed country.



CHECK YOUR PROGRESS

1. Write True or False:

a) The Indian money market does not deal in cash or money but in promissory notes, government paper.

b) Money market supplies funds for financing working capital of industries.

c) 'Ad hoc' treasury bills are always issued in favour of the RBI only.

2. Fill in the gap:

a) The market for extremely short period is called _____.

b) _____ are drawn by contractors on the Government Departments for the goods supplied to them. (Fill in the gap)

c) The bill which does not require any acceptance is called _____.

d) _____ has been set up mainly to provide a secondary market in Government securities.

3. Choose the correct answer from the given alternatives:

a) The market for short term loans is called _____.

i) Call money market

ii) Treasury bill market

iii) Money market

iv) Acceptance market

b) Bills drawn and accepted payables after three months are called _____.

i) Indigenous bills

ii) Usance bills

iii) Clean bills

iv) Supply bills

c) The market which helps commercial banks to maintain their SLR requirements is _____.

i) Call loan market

ii) Discount market

iii) Acceptance market

iv) Commercial bill market

d) The certificate which evidences an unsecured corporate debt of short-term maturity is _____.

i) Short-term loan certificate

ii) Certificate of deposit

iii) Inter-bank participation certificate

iv) Commercial paper

2.10 INDIAN MONEY MARKET

In India, money market is regulated by RBI. Indian money market is divided into organized and unorganized segments. Organized market is that part which comes under the regulatory purview of RBI. The key players in the organized money market include Governments (Central and State), Discount and Finance House of India (DFHI), Mutual Funds, Corporate, Commercial/ Cooperative Banks, Public Sector Undertakings (PSUs), Insurance Companies and Financial Institutions and Non-Banking Financial Companies (NBFCs). enous bankers, money lenders etc.

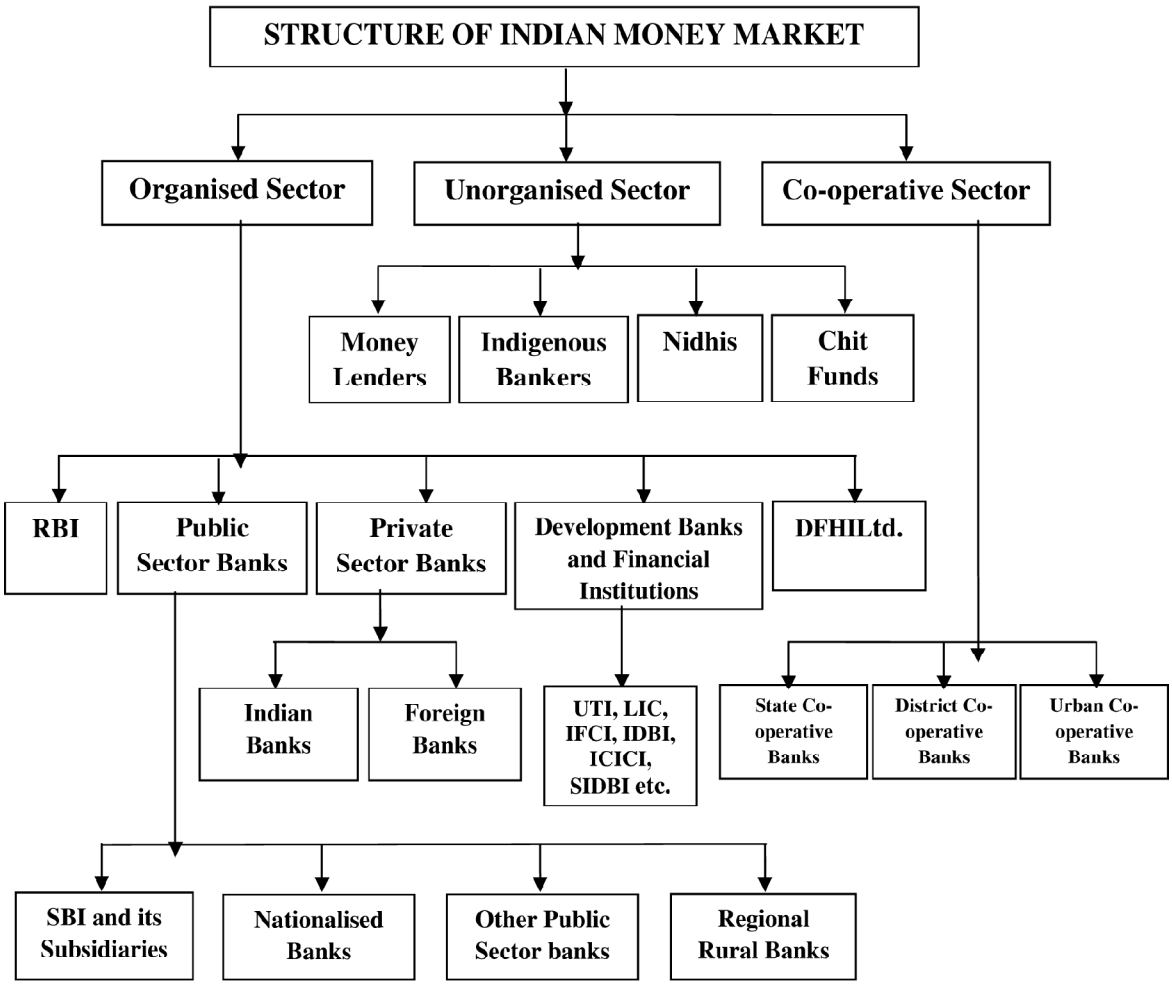
Unorganized market is the indigenous market mainly made of indigenous bankers, money lenders etc. A large portion of India's money market remains unorganized even today. The unorganized sector of India's money market consists of a wide range of non-banking financial institutions. They are not under the control of the RBI. So their presence reduces the effectiveness of the RBIs control over the money market. A large portion of India's money market remains unorganized even today. They also do not always specify the purposes of finance, that is, whether finance is required for genuine productive purposes or for indulging in speculative activities. Therefore, the money market in India is yet to be treated as underdeveloped one.

2.11 STRUCTURE OF INDIAN MONEY MARKET

In the Indian money market RBI occupies a key role. It is the nerve centre of the monetary system of our country. It is the leader of the Indian

money market. The Indian money market is highly disintegrated and unorganized. The Indian money market can be divided into two sectors-unorganized and organised. In between these two, there exists the co-operative sector which can be included in the organised sector.

The organised sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions. Whereas, the unorganised sector comprises of indigenous bankers, money lenders, chit funds etc. These are outside the control of RBI. This is the reason why Indian money market remains underdeveloped.



2.12 PARTICIPANTS OF INDIAN MONEY MARKET

The following are the players in the Indian money market:

- Governments
- RBI, the central bank
- Commercial banks
- Co-operative banks
- Financial institutions like IFCI, IDBI, ICICI, SIDBI, UTI, LIC etc.
- Discount and Finance House of India
- Brokers
- Mutual funds
- Public sector undertakings
- Corporate units etc.

2.13 MONEY MARKET INSTRUMENTS

Money market is involved in buying and selling of short term instruments. The important money market instruments are:

- Call and short notice money
- Commercial bills
- Treasury bills
- Certificate of deposits
- Commercial papers
- Repurchase agreements
- Money market mutual funds
- Depository Receipts (ADR/GDR/IDR)

These instruments are issued for short period. These are interest bearing securities. These instruments may be discussed in detail in the following:

2.13.1. Call and Short Notice Money

These are short term loans. Their maturity varies from one day to fourteen days. If money is borrowed or lent for a day, it is called call money or overnight money. When money is borrowed or lent for more than a day and up to fourteen days, it is called short notice money. Banks are the borrowers as well as the lenders for the call money. Banks borrow call funds for a short period to meet the cash reserve ratio (CRR) requirements. Banks repay the call fund back once the requirements have been met. The interest rate paid on call loans is known as the call rate. It is a highly volatile rate. It varies from day to day, hour to hour, and sometimes even minute to minute.

Features of Call and Short Notice Money

- These are highly liquid
- The interest (call rate) is highly volatile
- These are repayable on demand
- Money is borrowed or lent for a very short period
- There is no collateral security demanded against these loans. This means they are unsecured
- The risk involved is high

2.13.2 Commercial Bills

When goods are sold on credit, the seller draws a bill of exchange on the buyer for the amount due. The buyer accepts it immediately and agrees to pay the amount mentioned therein after a certain specified date. After accepting the bill, the buyer returns it to the seller. This bill is called trade bill. The seller may either retain the bill till maturity or due date or get it discounted from some banker and get immediate cash. When trade bills are accepted by commercial banks, they are called commercial bills.

A bill of exchange contains a written order from the creditor (seller) to the debtor (buyer) to pay a certain sum, to a certain person after a certain period. According to Negotiable Instruments Act, 1881, a bill of exchange is ‘an

instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument'.

Features of Commercial Bills

- These are negotiable instruments.
- These are generally issued for 30 days to 120 days. Thus these are short term credit instruments.
- These are self-liquidating instruments with low risk.
- These can be discounted with a bank. When a bill is discounted with a bank, the holder gets immediate cash. This means bank provides credit to the customers. The credit is repayable on maturity of the bill. In case of need for funds, the bank can rediscount the bill in the money market and get ready money.
- These are used for settling payments in the domestic as well as foreign trade.
- The creditor who draws the bill is called drawer and the debtor who accepts the bill is called drawee.

2.13.3 Treasury Bills

Treasury bills or T-bills are short term instruments issued by RBI on behalf of the government. These are short term credit instruments for a period ranging from 91 to 364. These are negotiable instruments. These are issued at a discount. These are repaid at par on maturity. These are considered as safe investment. Thus treasury bills are credit instruments used by the Govt. to raise short term funds to meet the budgetary deficit.

Features of Treasury Bills

- They are negotiable securities
- They are highly liquid

- There is no default risk (risk free). This is because they are issued by the government
- They have an assured yield
- The cost of issue is very low. It does not involve stamp fee
- These are available for a minimum amount of ₹ 25000 and in multiples thereof

Types of Treasury Bills

There are two categories of T-Bills. They are:

1. Ordinary or Regular T-Bills: These are issued to the public, banks and other institutions to raise money for meeting the short term financial needs of the government. These are freely marketable. These can be bought and sold at any time.

2. Ad hoc T-Bills: These are issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI on tap. The RBI is authorised to issue currency notes against there. On the basis of periodicity T-bills may be classified into four. They are as follows:

- *14-Day T-Bills*: To meet the cash management needs of various segments of the economy and to facilitate the emergence of a more comprehensive yield curve, a scheme for the sale of a new category of 14-day Treasury Bills on an auction basis was announced on May 20, 1997 and the first auction was held on June 6, 1997.
- *91-Day T-Bills*: These have been the traditional instruments in the Indian money market. From January 1993, the government introduced the system of selling 91 days treasury bills through weekly auction.
- *182-Day T-Bills*: These bills were introduced in November 1986 to provide short term investment opportunities to financial institutions and others. These were variable interest bills and were sold through fortnightly auctions.
- *364-Day T-Bills*: These bills were introduced at the end of April 1992. These have become an important instrument of government borrow-

ing and also lending money market instrument in the sense that their yield is most reflective of market conditions. T

2.13.4 Certificate of Deposits (CDs)

With a view to give investor's greater flexibility in the development of their short term surplus funds, RBI permitted banks to issue Certificate of Deposits (CDs). CDs were introduced in June 1989. CDs are issued by the banks either directly to the investors or through the dealers. CDs are documents of title to time deposits with the banks. They are interest bearing, maturity dated obligations of banks and are technically a part of bank deposits. It is a document of title to a time deposit. It is issued as a bearer instrument and is negotiable in the market. It has a maturity period ranging from three to twelve months.

Features of CDs

- These are unsecured promissory notes issued by banks or financial institutions.
- These are short term deposits of specific maturity similar to fixed deposits.
- These are negotiable (freely transferable by endorsement and delivery).
- These are generally risk free.
- The rate of interest is higher than that on T-bill or time deposits.
- These are issued at discount.
- These are repayable on fixed date.
- These require stamp duty.

2.13.5 Commercial Papers (CPs)

Commercial paper was introduced into the market in 1989-90. It is a finance paper like Treasury bill. It is an unsecured, negotiable promissory note. It has a fixed maturity period ranging from three to six months. It is generally issued by leading, nationally reputed credit worthy and highly rated corporations. It is quite safe and highly liquid. It is issued in bearer form and on dis-

count. It is also known as *industrial paper* or *corporate paper.* CPs can be issued in multiples of Rs. 5 lakhs subject to the minimum issue size of Rs. 50 lakhs. Thus a CP is an unsecured short term promissory note issued by leading, creditworthy and highly rated corporates to meet their working capital requirements.

Advantages of Commercial Paper

- These are simple to issue.
- The issuers can issue CPs with maturities according to their cash flow.
- The image of the issuing company in the capital market will improve. This makes easy to raise long term capital
- The investors get higher returns
- These facilitate securitisation of loans. This will create a secondary market for CP.

Disadvantages of Commercial Papers

- It cannot be repaid before maturity.
- It can be issued only by large, financially strong firms.

2.13.6 Repurchase Agreements (REPO)

REPO is basically a contract entered into by two parties (parties include RBI, a bank or NBFC). In this contract, a holder of the government securities sells the securities to a lender and agrees to repurchase them at an agreed future date at an agreed price. At the end of the period the borrower repurchases the securities at the pre-determined price. The difference between the purchase price and the original price is the cost for the borrower. This cost of borrowing is called Repo Rate.

A transaction is called a Repo when viewed from the perspective of the seller of the securities and Reverse Repo when described from the point of view of the suppliers of funds. Thus whether a given agreement is termed Repo or Reverse Repo depends largely on which party initiated the transaction. Thus Repo is a transaction in which a participant (borrower) acquires

immediate funds by selling securities and simultaneously agrees to repurchase the same or similar securities after a specified period at a specified price.

2.13.7 Money Market Mutual Funds (MMMFs)

Money Market Mutual Funds mobilise money from the general public. The money collected will be invested in money market instruments. The investors get a higher return. They are more liquid as compared to other investment alternatives. The MMMFs were originated in the US in 1972. In India the first MMMF was set up by Kothari Pioneer in 1997. But this did not succeed.

Advantages of MMMFs

- These enable small investors to participate in the money market
- The investors get higher return
- These are highly liquid
- These facilitate the development of money market

Disadvantage of MMMFs

- Heavy stamp duty
- Higher flotation cost
- Lack of investors' education

2.13.8 American Depository Receipt (ADR), Global Depository Receipt (GDR) and Indian Depository Receipt (IDR)

American Depository Receipts (ADRs) are instruments in the nature of depository receipt and certificate. These instruments are negotiable and represent publicly traded, local currency equity shares issued by non-American company. For example, an NRI can invest in Indian Company's shares without bothering dollar conversion and other exchange formalities. If the facilities extended globally, these instruments are called GDR. ADR are listed in American Stock Exchanges and GDR are listed in other than American Stock Exchanges, say Landon, Luxembourg, Tokyo etc.

Recently SEBI has issued guidelines for foreign companies who wish to raise capital in India by issuing Indian Depository Receipts (IDRs). Thus,

IDRs are transferable securities to be listed on Indian stock exchanges in the form of depository receipts. Such IDRs are created by a Domestic Depositories in India against the underlying equity shares of the issuing company which is incorporated outside India. Each IDR represents a certain number of shares of the foreign company. The shares are not been listed in India, but have to be listed in the home country. The IDRs allow the Indian investors to tap the opportunities in stocks of foreign companies and that too without the risk of investing directly which may not be too friendly. Thus, now Indian investors have easy access to international capital market.

2.14 CHARACTERISTICS OF INDIAN MONEY MARKET

1. Existence of Un-organised Segment: A major feature of Indian money market is the existence of dichotomy i.e. existence of two markets - organised money market and un-organised money market. Organised sector consists of RBI, commercial banks, and financial institutions etc. The un-organised sector consists of indigenous bankers, money lenders, chit funds, nidhis etc. The RBI does not have control over them and they do not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the un-organised market. It is difficult for RBI to integrate the organised and un-organised money markets.

2. Seasonal Scarcity of Credit: Another important characteristic of Indian money market is the seasonal scarcity of loanable funds and the consequent high rates of interest during the busy season. But in the off-season, banks have surplus funds. So, they are eager to lend more and often reduce the rates of interest. Therefore, the RBI follows two types of credit policy; one for the busy season and another for the slack season.

3. Lack of Integration: Another feature of India's money market is that it has several segments. But the various parts or segments are not connected with one another. Each part of the money market- such as the SBI and its subsidiaries, the foreign exchange banks, the co-operative banks and indigenous banks carry on a particular type of banking business or provide a specific type of financial service. Each financial institution acts independently.

4. Absence of the Bill Market: The existence of an organized bill market is absolutely essential for linking various credit agreements with the RBI in an effective manner. No doubt there is a Treasury bill market in India. But the commercial bill market has not been fully developed.

5. Volatile Call Money Market: The inter-bank call money market is volatile. The borrowing rate in this market is determined by the market forces, that is, by the forces of demand and supply. The demand or short-term funds originates from all types of banks -nationalized, private and foreign. Most bankers are either borrowers or lenders but most banks act as both. The major portion of funds in this market is supplied by non-banking financial institutions such as IDBI, LIC and GIC.

2.15 DEFECTS OF INDIAN MONEY MARKET

Indian money market is relatively underdeveloped when compared with advanced markets like New York and London Money Markets. The defects of the Indian money market are as follows:

1. **Existence of Un-organised Segment**: The most important defect of the Indian money market is the existence of un-organised segment. The un-organised segment comprises of indigenous bankers, money lenders etc. This un-organised sector does not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the un-organised market.
2. **Lack of Integration:** Another important drawback of the Indian money market is that the money market is divided into different sections. Unfortunately, these sections are loosely connected to each other. There is no co-ordination between the organised and un-organised sectors.
3. **Disparities in Interest Rates**: Interest rates in different money markets and in different segments of money market still differ. Too many interest rates are prevailing in the market. For example, borrowing rates of government lending rate of commercial banks, the rates of co-operative banks and rates of financial institutions.

4. **Seasonal Diversity of Money Market**: The demand for money in Indian money market is of seasonal in nature. During the busy season from November to June, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, jaguar, etc. From July to October the demand for money is low. As a result, the money rates fluctuate from one period to another.

5. **Absence of Organized Bill Market:** The bill market in India is not popular due to over dependence of cash transactions, high discounting rates, problem of dishonour of bills etc. The bill market in India is not well developed. There is a great paucity of sound commercial bills of exchange in our country. As a matter of habit, Indian traders resort to hundies rather than properly drawn bill of exchange.

6. **Shortage of Funds:** In Indian money market demand for funds exceeds the supply. There is shortage of funds in Indian money market an account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy etc. There is also vast amount of black money in the country which has caused shortage of funds.

7. **Inadequate Banking Facilities**: Though the commercial banks, have been opened on a large scale, yet banking facilities are inadequate in our country. The rural areas are yet to be covered. The involvement of banking system in different scams and the failure of RBI to prevent these abuses of banking system shows that Indian banking system is not yet a well organised sector.

8. **Inefficient and Corrupt Management**: One of the major problems of Indian money market is its inefficient and corrupt management. Inefficiency is due to faulty selection, lack of training, poor performance appraisal, faulty promotions etc. In India some of the bank officials are inefficient and corrupt.

9. **Limited Instruments:** The supply of short term instruments like commercial bills, treasury bills etc. are very limited and inadequate.

10. **Limited Number of Participants**: The participants in the Indian money market are limited. Entry in the money market is tightly regulated.
11. **Restricted Secondary Market:** Secondary market for money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills.
12. **No Contact with Foreign Money Markets**: Indian money market has little contract with money markets in other countries.

2.16 RECENT DEVELOPMENTS IN THE INDIANS MONEY MARKET

The recent developments in the Indian money market may be briefly explained as below:

- **Integration of un-organised sector with the organised sector:** RBI has taken many steps to bring the institutions in the un-organised sector within its control and regulation. These institutions are now slowly coming under the organised sector. They started availing of the rediscounting facilities from the RBI.
- **Widening of call money market: In** recent years, many steps have been taken to widen the call money market. The number of participants in the call money market is increasing. LIC, GIC, IDBI, UTI and specialised mutual funds have been permitted to enter into this market as lenders only. The DFHI and STCI have been permitted to operate both as lenders and borrowers.
- **Introduction of innovative instruments:** New financial instruments have been introduced in the money market. On the recommendation of the Chakkraborty Committee, the RBI introduced 192 days T-bills since 1986. A new instrument in the form of 364 days T-bills was introduced at the end of April 1992. Again, new instruments such as CDs, CPs, and interbank participation certificates have been introduced. Necessary guidelines also have been issued for the operation of these instruments.

- **Introduction of negotiable dealing system:** As negotiable dealing system has been introduced with a view to facilitating electronic bidding in auctions and secondary market transactions in Govt. securities and dissemination of information.
- **Offering of market rates of interest:** In order to popularise money market instruments, the ceiling on interest rate has been abolished. Call money rate, bill discounting rate, interbank rate etc. have been freed. Thus, today Indian money market offers full scope for the play of market forces in determining the rates of interest.
- **Satellite system dealership:** The satellite system dealership was launched in 1996 to serve as a second tier to primary dealers in retailing of Govt. securities. RBI has decided to allow players such as provident funds, trusts to participate in government bond auctions, on a non-competitive basis.
- **Promotion of bill culture:** All attempts are being taken to discourage cash credit and overdraft system of financing and to popularise bill financing. Exemption from stamp duty is given on rediscounting of derivative usance promissory notes arising out of genuine trade bill transactions. This is done to promote bill culture in the country.
- **Introduction of money market mutual funds:** Recently certain private sector mutual funds and subsidiaries of commercial banks have been permitted to deal in money market instrument. This has been done with a view to expand the money market and also to develop secondary market for money market instruments.
- **Setting up of credit rating agencies:** Recently some credit rating agencies have been established. The important agencies are the Credit Rating Information Services of India Ltd (CRISIL), Investment Information and Credit Rating Agency of India (IICRA) and, Credit Analysis and Research Ltd. (CARE). These have been set up to provide credit information through financial analysis of leading companies and industrial sectors.

- **Adoption of suitable monetary policy:** In recent years the RBI is adopting a more realistic and appropriate monetary and credit policies. The main objective is to increase the availability of resources in the money market and make the money market more active.
- **Establishment of DFHI:** The DFHI was set up in 1988 to activate the money market and to promote a secondary market for all money market instruments.
- **Setting up of Securities Trading Corporation of India Ltd. (STCI):** The RBI has set p the STCI in May 1994. Its main objective is to provide a secondary market in Govt. securities. It has enlarged the T-bill market and the call market and provided an active secondary market for T-bills. Because of these recent developments, the Indian money market is developing.

CHECK YOUR PROGRESS



4. Write True or False:

a) LIC and UTI can act as both lenders and borrowers of call loans in India.

b) 91 days' treasury bills do not carry any fixed rate of discount.

c) Certificate of deposit can be issued only by commercial banks.

5. The Discount and Finance House of India was set up in the year _____. (Fill in the gaps)

6. The major player in the Indian money market is/are _____.

i) Co-operative banks ii) Indigenous banks

iii) Commercial banks iv) Reserve Bank of India

(Choose the correct answer)



2.17 LET US SUM UP

We have discuss the following points in this unit:-

- Money market is a market for short term funds. It deals with all transactions in short term securities. Maturity period of them are one year or less.
- Money market does not imply to any specific market place.
- Central bank is the leader, guide, controller and policy maker of the banking system of a country.
- The Indian money market consists of Reserve Bank of India, Commercial banks, Co-operative banks, and other specialized financial institutions. The Reserve Bank of India is the controller of the money market in India.
- Money market consists of a number of sub-markets. All sub-markets collectively constitute the money market.
- The Indian money market can be divided into two sectors-unorganized and organised.



2.18 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy



2.19 ANSWERS TO CHECK YOUR PROGRESS

1. (a) False, (b) True (c) True

2. (a) Call money market, (b) Supply bills, (c) Treasury bill, (d) STCI

3. (a) Money market (b) Usance bills (c) Call loan market (d) Commercial paper

4. (a) False (b) False (c) False

5. 1987

6. Commercial banks



2.20 MODEL QUESTIONS

1. Write short notes on the following:
   a) Call Money Market
   b) Call loan Market
   c) Non-performing Asset
   d) Instruments of Money Market
   e) Commercial Paper
2. What is Money Market? Discuss the role of money market in the Indian Financial System.
3. Give the structure of Indian money market and point out its deficiencies.
4. Discuss the role of RBI as a regulator of Indian Money Market.
5. Define money market. Explain the different sub-markets of money market.
6. Discuss the various components of money market and bring out their features.
7. What is meant by Instruments of Money Market? Discuss the role of money market in the Indian Financial System.
8. Explain the role of Indian money market in the Indian financial system. What are the essential characteristics of a develop money market?
9. What steps have been taken in recent years to make the Indian money market a developed one?

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UNIT 3 : CAPITAL MARKET IN INDIA-I

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Meaning of Capital Market

3.4 Functions of Capital Market

3.5 Subsidiaries of capital market

3.6 Primary / New issue Market

3.7 Functions of New Issue Market

3.8 Methods of Floatation in Primary Market

3.9 Abuses in New Issue Market

3.10 Problems of New Issues Market

3.11 Initial Public Offering (IPOs)

3.12 On-Line IPOs

3.13 Investor Protection in Primary Market

3.14 Recent Trends in Primary Market

3.15 Book Building Mechanism

3.16 SEBI Measures for Primary Market

3.17 Regulatory Measures of SEBI

3.18 Let Us Sum Up

3.19 Further Readings

3.20 Answers to Check Your Progress

3.21 Model Questions

3.1 LEARNING OBJECTIVES

After reading this unit you will able to:

- state the meaning and functions of capital market
- describe the historical background of Indian capital market
- enumerate the functions of new issue market
- interpret the various types of sub-markets like debt market, equity market and derivatives market with their features and classification

- state the methods of floatation in primary market
- know about the SEBI measures for primary market
- understand the recent trends in primary market

3.2 INTRODUCTION

Transfer of resources from those with idle resources to others who have a productive need for them is perhaps most efficiently achieved through the capital market. Thus, capital market provides channels for reallocation of savings to investments and entrepreneurship and thereby decouples these two activities. As a result, the savers and investors are not constrained by their individual abilities, but by the economy's abilities to invest and save respectively, which inevitably enhances savings and investment in the economy. This unit will include the meaning, definition, constituents, instruments, functions and role of capital marker especially primary market or new issue market in India.

3.3 MEANING OF CAPITAL MARKET

The capital market refers to the institutional arrangements which facilitate the lending and borrowing of long-term and medium-term funds. Capital market deals in medium-term and long-term loans. It is a market in which long-period securities (with a maturity of one year or more) are exchanged. Capital market is divided into two parts: a) The new securities market called New Issue Market which deals with the sale of new securities and shares and b) the secondary market or stock exchange which specialises in buying and selling of old securities, shares, stocks, bonds, debentures, etc. The new issue market attracts new capital investment, while the secondary market determines the ownership of existing securities, i.e. to which they are transferred.

The investors and issuers of financial securities constitute two important elements of the securities markets. The most important elements of security markets are the investors. The third critical element of markets is the intermediaries who act as conduits between the investors and issuers. Regulatory bodies, which regulate the functioning of the securities markets, constitute another significant element of securities markets. The process of mobili-

zation of resources is carried out under the supervision and overview of the regulators. The regulators develop fair market practices and regulate the conduct of issuers of securities and the intermediaries. They are also in charge of protecting the interests of the investors.

3.4 FUNCTIONS OF CAPITAL MARKET

Capital market plays an important role in mobilising resources and diverting them in productive channels. It facilitates and promotes the process of economic growth in the country. The various functions and significances of capital market are discussed bellow:

1. **Link between Savers and Investors:** The capital market functions as a link between savers and investors. It plays an important role in mobilising the savings and diverting them in productive investment. In this way, capital market plays a vital role in transferring the financial resources from surplus and wasteful areas to deficit and productive areas, thus increasing the productivity and prosperity of the economy.
2. **Encouragement for Savings:** With the development of capital market, the banking and non-banking institutions provide facilities which encourage people to save more money. In the absence of capital market, there are very little savings and those who save often invest their savings in unproductive and wasteful directions, in real estate (like land, gold and jewellery) and conspicuous consumption.
3. **Encouragement to Investment:** The capital market facilitates lending to the businessmen and the government, and thus encourages investment. It provides facilities through banks and non-bank financial institutions. Various financial assets, e.g. shares, securities, bonds, etc. induce savers to lend to the government or invest in industries.
4. **Promotes Economic Growth:** The capital market not only reflects the general condition of the economy, but also smoothens and accelerates the process of economic growth. Various institutions of capital market allocate the resources rationally in accordance with the development needs for the country. The proper allocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growth in the country.

5. **Stability in Security Prices:** The capital market tends to stabilise the values of stocks and securities and reduce the fluctuations in the prices to the minimum.
6. **Benefits to Investors:** The capital market helps the investors in many ways: (a) it brings together the buyers and sellers of securities and thus ensure the marketability of investments, (b) by advertising security prices, the stock exchange enables the investors to keep track of their investments and channelize them into most profitable lines, (c) it safeguards the interests of the investors.

3.5 SUB-DIVISIONS OF CAPITAL MARKET

3.5.1 DEBT MARKET:

Debt instruments represent contracts whereby one party lends money to another on pre-determined terms with regard to rate of interest to be paid by the borrower to the lender. In the Indian securities markets, the term 'bond' is used for debt instruments issued by the Central and State governments and public sector organisations, and the term 'debentures' for instruments issued by private corporate sector. So, financial Instruments that have a fixed income claim and have a maturity of more than one year are traded in the debt market. The market for government securities is the most dominant part of the debt market.

Debt markets are pre-dominantly wholesale markets, with institutional investors being major participants. Banks, financial institutions, mutual funds, provident funds, insurance companies and corporates are the main investors in debt markets. Many of these participants are also issuers of debt instruments. The major market participants in the debt market are as follows:

- Central Government raises money through bond and T-bill issues to fund budgetary deficits and other short and long-term funding requirements.
- Reserve Bank of India, as investment banker to the government, raises funds for the government through dated securities and T-bill issues. RBI participates in the market through open-market operations and also conducts daily repo and reverse repo to moderate money supply in the economy.

- Primary Dealers (PDs), who are market intermediaries appointed by RBI, underwrite and make market in government securities by providing two-way quotes, and have access to the call and repo markets for funds.
- State governments, municipal and local bodies issue securities in the debt markets to fund their developmental projects as well as to finance their budgetary deficits.
- Public Sector Undertakings (PSUs) and their finance corporations are large issuers of debt securities. They raise funds to meet the long term and working capital needs.
- Corporate issue short and long-term paper to meet their financial requirements. They are also investors in debt securities issued in the market.
- Development Financial Institutions (DFIs) regularly issue bonds for funding their financing requirements and working capital needs. They also invest in bonds issued by other entities in the debt markets.
- Banks are the largest investors in the debt markets, particularly the government securities market due to SLR requirements.
- Mutual funds have emerged as important players in the debt market, owing to the growing number of debt funds that have mobilised significant amounts from the investors.

3.5.2 EQUITY MARKET

This market is characterized by the exchange of equity instruments that offer ownership on the holder of the security. Equity implies ownership rights in the corporate entity that has issued the instruments to the public. The claim of the owners of these instruments is residual in nature and the securities have no maturity. Equity Market is the market in which shares are issued and traded, either through exchanges or over the counter markets. Equity market is also known as Stock Market.

Types of Equity Capital

Companies raise capital through equities, which can be classified into Ordinary Shares and Preference Shares.

a) Equity/Ordinary Shares : Equity shares are known as Ordinary Shares. Every company has to issue equity shares. Equity capital is also known as Owned Capital or Risk Capital or Venture Capital. Indian Companies Act, 1956 defines equity shares as 'those shares which are not preference shares.' Ordinary shares have a face value in terms of price of each share.

Features of Equity Shares

- Permanent Capital : Equity share capital represents the permanent capital of the company. They are irredeemable. There is no obligation on the part of the company to repay the capital during the life time of company.
- Fluctuating Dividend : Equity shares get fluctuating dividend as the rate of dividend depends upon the earnings of the company. There is no guarantee of minimum dividend.
- Limited Liability : Even though the equity holders share the ownership risk their liability is limited to the extent of their investment in the share capital of the company.
- Voting Rights : Equity shareholders enjoy normal voting rights. They can vote on all resolutions passed at the shareholder's meetings.
- Residual Share : Ordinary shareholder's claim on assets of the company is residual. Their claim would rank after the claims of creditors and preference shareholders in the event of liquidation.
- *Right to Control*: As owners of the company equity holders have the right to control the operations of the company.
- *Pre-Emotive Rights*: Ordinary shareholders have a legal right to be offered by the company, the first opportunity to purchase additional issues of equity capital in proportion to their current holdings.
- *Increases Shareholders Wealth*: Equity shares increases shareholders' wealth. This is due to regular dividend and issue of bonus shares.

b) Preference Shares: Preference share capital is a type of long-term capital. It combines the features of equity shares and debentures. It is an ownership security like an ordinary share, but it carries fixed rate of dividend like debentures. The holders of preference shares are entitled to income after the

claims of creditors of the company have been met, but before ordinary shareholders receive any income.

Features of Preference Shares

- *Fixed Dividend*: Preference shares are also called a fixed income security. Preference share dividends are fixed and expressed as a percentage of par values.
- *Voting Rights*: Ordinarily a preference share holder does not carry voting rights.
- *Convertibility*: Sometimes preference shares may be convertible partly or fully into equity shares or debentures at a certain ratio during a specified period.
- *Redeemability*: Preference share has a limited life after which it just be retired.
- *Cumulative Dividends*: Preference share is cumulative. All unpaid dividends are carried forward and payable before any ordinary dividend is paid.
- *Prior Claim on Income and Assets*: Preference shares have a prior claim (preference) over equity share both on the income and assets of the company.

3.5.3 DERIVATIVES MARKET

The term derivatives refer to a broad class of financial instruments which mainly include options and futures. These instruments derive their value from the price and other related variables of the underlying asset. They do not have worth of their own and derive their value from the claim they give to their owners to own some other financial assets or security. A simple example of derivative is butter, which is derivative of milk. The price of butter depends upon price of milk, which in turn depends upon the demand and supply of milk.

The general definition of derivatives means to derive something from something else. According to Securities Contract Regulation Act (SCRA) 1956, derivatives may be defined as:

a) 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;
b) A contract which derives its value from the prices, or index of prices, of underlying securities

Classifications of Derivatives

a) Forward Contract: A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future. In case of a forward contract the price which paid/received by the parties is decided at the time of entering into contract. It is the simplest form of derivative contract mostly entered by individuals in day today's life. Forward contract is a cash market transaction in which delivery of the instrument is deferred until the contract has been made. Although the delivery is made in the future, the price is determined on the initial trade date. The specified price is referred to as the delivery price.

b) Futures Contract: Futures is a standardized forward contact to buy (long) or sell (short) the underlying asset at a specified price at a specified future date through a specified exchange. Futures contracts are traded on exchanges that work as a buyer or seller for the counterparty. Exchange sets the standardized terms in term of quality, quantity, price quotation, date and delivery place (in case of commodity). The features of a futures contract may be specified as follows:

- These are traded on an organised exchange like IMM, LIFFE, NSE, BSE, CBOT etc.
- These involve standardized contract terms viz. the underlying asset, the time of maturity and the manner of maturity etc.
- These are associated with a clearing house to ensure smooth functioning of the market.
- There are margin requirements and daily settlement to act as further safeguard.
- These provide for supervision and monitoring of contract by a regulatory authority.

- Almost ninety percent future contracts are settled via cash settlement instead of actual delivery of underlying asset.

c) Options Contract: In case of futures contact, both parties are under obligation to perform their respective obligations out of a contract. But an options contract, as the name suggests, is in some sense, an optional contract. An option is the right, but not the obligation, to buy or sell something at a stated date at a stated price. Options contracts are of two types: 'call options' and 'put options'. A 'call option' gives one the right to buy; a 'put option' gives one the right to sell. Apart from this, options can also be classified as OTC (Over the Counter) options and exchange traded options. Options are the standardized financial contract that allows the buyer (holder) of the option, i.e. the right at the cost of option premium, not the obligation, to buy (call options) or sell (put options) a specified asset at a set price on or before a specified date through exchanges.

d) Swaps Contract: A swap can be defined as a barter or exchange. It is a contract whereby parties agree to exchange obligations that each of them have under their respective underlying contracts or we can say, a swap is an agreement between two or more parties to exchange stream of cash flows over a period of time in the future. The parties that agree to the swap are known as counter parties. The two commonly used swaps are: i) Interest rate swaps which entail swapping only the interest related cash flows between the parties in the same currency, and ii) Currency swaps: These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than the cash flows in the opposite direction.

3.6 PRIMARY MARKET / NEW ISSUE MARKET

The primary market is a market where new securities are issued to the public regularly. Basically the primary market is the place where the shares are issued for the first time. So when a company is getting listed for the first time at the stock exchange and issuing shares -this process is undertaken at the primary market.

The primary market is also known as the New Issue Market (NIM). Here, the transaction is conducted between the issuer and the buyer. In short, the primary market creates new securities and offers them to the public. For instance, Initial Public Offering (IPO) is an offering of the primary market where a private company decides to sell stocks to the public for the first time. An important point to remember here is that in the primary market, securities are directly purchased from the issuer. The primary market consists of arrangements, which facilitate the procurement of long term funds by companies by making fresh issue of shares and debentures.

3.7 FUNCTIONS OF NEW ISSUE MARKET

The main function of new issue market is to facilitate transfer of resources from savers to the users. The savers are individuals, commercial banks, insurance companies etc. The users are public limited companies and governments. The new issue market plays an important role of mobilizing funds from the savers and transfers them to borrowers for production purposes. The main functions of a new issue market can be divided into a triple service functions:

- **Origination:** Origination refers to the work of investigation, analysis and processing of new project proposals. Origination starts before an issue is actually floated in the market. The function of origination is done by merchant bankers who may be commercial banks, all India financial institutions or private firms.
- **Underwriting:** Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of shares issues remains unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for the marketability of shares.

- **Distribution:** Distribution is the function of sale of securities to ultimate investors. This service is performing by brokers and agents who maintain a regular and direct contact with the ultimate investors.

3.8 METHODS OF FLOATATION IN PRIMARY MARKET

There are various methods of floating new issues in the primary market:

3.8.1 Offer through Prospectus

Offer through prospectus is the most popular method of raising funds by public companies in the primary market. A prospectus makes a direct appeal to investors to raise capital, through an advertisement in newspapers and magazines. It provides such information as the reason for which the fund is being raised, the company's background and upcoming projection, it's a precedent financial performance, etc. After a prospectus is issued, the public subscribes to shares, debentures, etc. As per the response, shares are prearranged to the public.

3.8.2 Offer for Sale

Under this method, securities are not issued directly to the public but are offered for sale through intermediaries like issuing houses or stock brokers. Institutional investors like business enterprise funds, private equity funds, etc., invest in an unlisted company when it is very small or at an early stage. Consequently, when the company becomes big, these investors sell their shares to the public, through the issue of the offer document and the company's shares are listed in the stock exchange. This is called an offer for sale. The advantage of this technique is that the company need not be bothered about the printing and advertisement of the prospectus, allocation of shares, etc.

3.8.3 Private Placement

Public offers are an exclusive concern and its subsidiary cost is very high. This is why some companies favor not to go down this route. They go for private placement. A private placement is the allotment of securities by a company to institutional investors and some selected individuals. It helps to raise capital more quickly than a public issue. They offer investment opportunities to a select few individuals. Companies sell their shares to economic institutes,

banks, insurance companies, and some select individuals. This helps them raise the funds competently, rapidly and efficiently.

3.8.4 Rights Issue

Usually, when a company is looking to expand or are in need of supplementary funds, they first turn to their present investors. This is a privilege given to existing shareholders to subscribe to a new issue of shares according to the terms and conditions of the company. So the present shareholders are given a prospect to further invest in the company. They are given the 'right' to buy new shares before the public is offered the chance. Such shares are marketable in the market by the owners. The rights issue is advantageous to the company as the cost of issue is minimum.

3.8.5 e-IPOs

e-IPOs stands for Electronic Initial Public Offer. When a company wants to offer its shares to the public it can now also do so online. This is called an Initial Public Offer (IPO). A company proposing to issue capital to the public through the online system of the stock exchange has to enter into an agreement with the stock exchange. An agreement is signed between the company and the related stock exchange known as the e-IPO. Issuing company also require to assign registrar to have electronic connectivity with the exchange.

3.9 ABUSES IN NEW ISSUES MARKET

The term 'market abuse' is used to refer to a certain circumstance in which an unlawful behaviour is seen in the business through which mostly the financial investors of the markets are unreasonably disadvantaged. Market abuse includes insider dealing, market manipulation or attempted market manipulation and unlawful disclosure. Insider dealing and unlawful disclosure both involve misuse of insider information, whereas market manipulation involves dishonestly or artificially manipulating the market.

The market abuse is used to refer to those kinds of circumstances in which the laws are violated hence causing losses to the financial market investors. The market abuse may be caused by someone who may have used the data that was not initially available to the public. There can be one

more case in which some false or misleading information or data may have been disseminated in the market.

Market abuse is a civil offence, and the penalties can include an injunction, an unlimited fine, and/or being banned from carrying out any regulated activities in the future. The Reserve Bank of India (RBI) in March, 2019 came out with guidelines to prevent misuse of price-sensitive information by participants in markets for financial instruments. No market participant would carry out a transaction or initiate any action with the sole or dominant intention of influencing a benchmark rate or a reference rate.

3.10 PROBLEMS OF NEW ISSUES MARKET

- **Drawback for the New Company:** In primary markets, the funds can be raised in huge quantity by the companies. If the track record of a company is sound and the company has a good reputation in the market, it can further raise the funds by way of follow on public offer or rights issue. But a company which is totally new, which is newly registered and not much popular, finds it difficult to raise the funds. This fact underlines the reality that even though primary market is for new issues of capital, still the new companies have lot of problems while raising the funds from the market.
- **Timing of New Issues:** Due to the advantages of primary market, the companies are interested to raise the capital through primary market. But if number of companies queue up for raising the capital at a time, then the market gets crowded. When the secondary market performs well, primary market gets flooded with new issues by the companies. This is hazardous to the companies as well as the investors. Since a number of companies come up with the issue at a time, the investors get divided and the company may not get entire subscription. From investor's point of view also it is difficult for them to opt for a particular company. Investors may get confused.
- **Price Rigging:** This drawback is normally observed when companies come up with capital issue in the primary market. The prices of shares

are artificially pulled up before issue of securities by companies. This artificial increase in price is done by some buyers and sellers among themselves or among group which engages itself in such type of activities.

- **Lack of Professionalism:** With the quantitative increase in the number of stock exchanges, number of brokers, it was expected that some kind of professionalism would automatically get built into the system. Especially, highly competent and professional brokers were expected to emerge during this phase. But, many brokers lacked professional standards.
- **Speculative Influence:** Though the capital markets world over faced the evil of speculative motives in India speculative influence started along with other developments taking place. With increasing number of companies listed and increase in capital formation, some speculative motives started hitting the market.
- **Cost of Public Issues:** This problem continued to have impact on development of capital market in general and primary market in particular. Brokerage, underwriting commission, prospectus printing and distribution were some of the elements of cost involved during the public issue. Similarly, there was a time gap between announcement of the issue and actual generation of capital.
- **Isolated Stock Exchanges:** The stock exchanges in India have a presence only at particular locations. At the respective locations, normally trade takes place which is also characterized by regional features. But it must also be noted that stock brokers of one stock exchange were not allowed to operate on their own in any other stock exchanges.
- **Unethical Mergers of Companies:** The primary market is advantageous to the economy as it provides capital to the enterprises. But there are some unethical practices being developed in the primary market also. For example, a large unlisted company gets merged with small listed company through public offer and purchases shares of the small listed company in a big way. Such mergers are dangerous as the identity of the company may get changed.

- **Underdeveloped Debt Markets:** The shares issued in the primary market are later on traded in the secondary markets i.e. stock exchanges. But a part of primary market also involves debenture financing. The debentures are issued in the primary market. But in stock exchanges there is no room for trading in debentures. The secondary market in industrial debentures remained underdeveloped over the years.
- **Other Problems:** There are other problems prevailing in the Indian markets like inflating project costs and fixing unreasonable premium in the primary market, preferential and reserved allotment of substantial part of capital, benami traders, rackets and tampering with public issue application forms, badla finance etc. Some of these problems have been sorted out, but in general, this results into loss of confidence among small and retail investors.

3.11 INITIAL PUBLIC OFFERING (IPOs)

An initial public offering (IPO) refers to the process of offering shares of a private corporation to the public in a new stock issuance. It also allows public investors to participate in the offering. A company planning an IPO will typically select an underwriter or underwriters. An IPO is a big step for a company. It provides the company with access to raising a lot of money. This gives the company a greater ability to grow and expand.

Prior to an IPO, a company is considered private. As a private company, the business has grown with a relatively small number of shareholders including early investors like the founders, family, and friends along with professional investors such as venture capitalists or angel investors.

When a company reaches a stage in its growth process where it believes it is mature enough for the rigors of Securities and Exchange Commission (SEC) regulations along with the benefits and responsibilities to public shareholders, it will begin to advertise its interest in going public. Typically, this stage of growth will occur when a company has reached a private valuation of approximately $1 billion, also known as unicorn status. However, private com-

panies at various valuations with strong fundamentals and proven profitability potential can also qualify for an IPO, depending on the market competition and their ability to meet listing requirements.

3.12 ON-LINE IPOs

Initial Public Offer is the process by which a company sells its shares to the public and thereby raises money for growth and expansion. It allows investors to buy the shares in primary market. Once the stock gets listed on the exchange, shares can be bought through secondary market. This can be done online. Although investors can apply for IPOs online, they should remember that an IPO order cannot be placed directly through their broker. They need to place the order through their bank that provides them with ASBA facility. For online transaction investors should have Internet enabled accounts with a bank with transaction rights and have a Demat account with any Depository Participants (DPs). They need to be a resident Indian individual.

3.13 INVESTOR PROTECTION IN PRIMARY MARKET

Investors are the pillar of the financial and securities market. They determine the level of activity in the market as they put the money in funds, stocks, etc. to help grow the market and the economy. Hence, it is very important to protect the interests of the investors. Strong investor protection is essential for the healthy growth of financial markets. Investor protection involves various measures established to protect the interests of investors from malpractices.

a) Investor Protection Measures by SEBI

SEBI is a statutory regulatory body of capital market established on the 12th of April, 1992. Investor protection legislation is implemented under the Section 11(2) of the SEBI Act. It monitors and regulates the Indian capital and securities market. Investor protection measures by SEBI are in place to safeguard the investors from the malpractices in shares, the stock market, Mutual Fund, etc. The measures are as follows:

- Stock Exchange and other securities market business regulation;
- Registering and regulating the intermediaries of the business like brokers, transfer agents, bankers, trustees, registrars, portfolio managers, investment consultants, merchant bankers, etc.

CFA Investment

- Recording and monitoring the work of custodians, depositors, participants, foreign investors, credit rating agencies, etc.
- Registering investment schemes like Mutual fund & venture capital funds, and regulating their functioning;
- Promotion and controlling of self-regulatory companies;
- Keeping a check on frauds and unfair trading methods related to the securities market;
- Observing and regulating major transactions and take-over of the companies;
- Carry out investor awareness and education programme;
- Train the intermediaries of the business;
- Inspecting and auditing the security exchanges (SEs) and intermediaries; and
- Assessment of fees and other charges.

b) SEBI Guidelines for protecting interest of investors:

The main object of SEBI is not only to regulate stock markets but also to protect the interest of investors. For this purpose, SEBI has given following guidelines:

- SEBI has been encouraging investor-education. For this purpose, certain investors' associations have been registered.
- Companies raising public deposits as well as huge capital must undergo credit rating. Credit rating by an authorized authority gives a fair view about the financial strength of the organization. For this purpose, there are four credit rating agencies. They are:
  - CRISIL
  - ICRA
  - CARE and
  - Duff and Phelps Credit Rating India Pvt. Ltd.
- SEBI has taken the responsibility of disclosing fair and adequate information for investors for the purpose of investment decisions.
- For the benefit of the investors, company has to disclose its capacity utilization, adverse events and material changes of key personnel.

- Disclosure on market prices for listed company.
- Arrangement for disclosing investors grievances and redressal system.
- Compulsory disclosure in the prospectus.
- Contribution by promoters whose name figure in the prospectus.
- In case of over subscription of any company issue, SEBI representatives will be present there to look into the allotment process.
- Setting up of investors' grievances cell for handling complaints of investors.
- SEBI has right to cancel registration of any underwriter who fails to furnish business details to SEBI.
- SEBI has made it mandatory for Merchant bankers to attach diligence certificate with the prospectus for extending their accountability to the investors.
- There is an advertisement code by SEBI which has to be followed by companies or investors.
- To avoid any malpractice in allotment process, SEBI has appointed its representatives to look into allotment process which boosts the confidence of individual investors.
- Underwriters, registrar to issue and share transfer agent and portfolio managers have been brought under SEBI for the first time.
- Even the mutual funds have been brought under SEBI and they have to disclose NPV (Net present value) of units every day which benefits investors.
- For the benefit of the individual investors, a new scheme called stock invest account has been introduced in banks.
- In case of allotment, the company will inform the banker as per SEBI guidelines, and funds will be released from the stock invest account to the bank.

3.14 RECENT TRENDS IN PRIMARY MARKET

The new issues market in India has passed through both the phases of boom and depression. The new issue market in India is not fully

developed as compared to other advanced countries like U.S.A., U.K. and Germany. But there has been tremendous growth in the sphere of new issue activity in India. Further the relaxation of norms relating to foreign investments and incentives provided by the government helped to sustain the impetus of growth in the market.

In the recent years, a number of new instruments such as PCDs, FCDs, PSBs and CCPs, etc. have been introduced in the securities market resulting into and upsurge in the new issue market. But the new economic policy of the Narasimha Rao government and the setting up of Securities and Exchange Board of India to promote orderly and healthy growth of securities market providing investor protection has to be regarded as one of the most important developments on the securities market of India in recent years. As a result of these developments, the institutional investors and the mutual funds have gained importance, both in the primary as well as the secondary market. Another recent development that took place in the market is the setting up of the Over-the Counter Exchange of Indian (OTCEI) which began its operations in 1992 permitting smaller companies to raise capital.

During past decades, there have been remarkable reforms in the India Economic scenario. Consequently, NIM has made enormous progress in recent years, moving away from fixed- price offering to price discovery through a screen-based auction for IPOs. This has reflected a quest to discover the price through an open fair, competitive auction, which is done in a fully transparent way, where all investors participate in an equal setting, and the investment bankers' or other influences do not vitiate the allocation of shares. The increase in fund mobilization from NIM in India has been exceptionally well.

3.15 BOOK-BUILDING MECHANISM

Companies all over the world use either fixed pricing or book building as a mechanism to price their shares. Over the period of time, the fixed price mechanism has become obsolete and book building has become

the de-facto mechanism used in pricing shares while conducting an initial public offer (IPO).

Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time. When shares are being offered for sale in an IPO, it can either be done at a fixed price or it can be decided in a price range. This process of discovering the price by providing the investors with a price range and then asking them to bid on it is called the book building process. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market. This is the preferred method which is recommended by all major stock exchanges and as a result is followed in all major developed countries in the world.

3.16 SEBI MEASURES FOR PRIMARY MARKET

The primary market in India is the market where investors and companies trade stocks, options and other public financial instruments. All issues on the primary market are subject to strict regulation. Companies must file statements with the Securities and Exchange Commission (SEC) and other securities agencies and must wait until their filings are approved before they can go public. SEBI has regulated the primary market through

- The regulation of issuers' access to market
- Regulation of information production at the time of issue
- Regulation of processes and procedures relating to issuance of securities

In 2000 the Securities and Exchange Board of India, or SEBI, issued a set of guidelines for the primary market that covers 17 consumer and investor protection areas, including how new companies become active on the primary market and how they issue and price securities.

- **Initial Public Offerings:** Indian companies that want to open their operations to public funding must work through a broker who is licensed with SEBI to offer and accept applications for funding through India's e-IPO system, which is an online system for bringing private companies to the primary market. The broker must work with a registrar from the

company to negotiate all offers between the company and potential investors. The broker must keep all funds pertaining to the IPO in an escrow account and must report daily to the company's registrar.

- **Issuing and Pricing Securities:** A company must file a draft prospectus with SEBI at least three weeks before filing its final documentation with the Registrar of Companies on the primary market. The draft prospectus contains contact information for the company, an analysis of market risks and how the company will respond to them, as well as information about the company's leadership. After the company is registered and approved, it can freely determine the price at which it wants to list its shares on the primary market. If a bank is involved in listing a company, the pricing of its shares must be approved by SEBI. The company must make public the face value of all publicly traded shares.

- **Issuing Debt Instruments:** Companies and banks that include debt instruments as part of an investment offering must disclose credit ratings to SEBI before entering into any agreements with investors. Debt instruments are statements in which the issuer raises capital by selling debt to an investor. The issuer pays back the investor with interest according to the terms of a contract. SEBI requires that all companies issuing debt instruments keep their investors informed by providing cash flow and liquidity information. SEBI allows companies to choose to repay their debts by issuing stock or other financial instruments to those invested in the company's debt.

- **Banks Issuing Capital to a Company:** SEBI does not limit the amount of capital a financial institution can issue to a publicly traded company, though it does not permit institutions with a conflict of interest to issue capital to a company. Designated financial institutions, those that are approved by SEBI, reserve a percentage of the company in which they want to invest and are entitled to hold that percentage for three years. SEBI also allows institutional investors to evaluate their holdings in a

company as they see fit, providing the institution has shown a profit over the past three years.

3.17 REGULATORY MEASURES OF SEBI

SEBI has introduced various guidelines as regulatory measures for capital issues. They are as below:

- **Disclosure of All Material Facts is made Compulsory**: SEBI has made it compulsory for companies do disclose all the facts and risk factors regarding the projects undertaken by the company. The basis on which the premium amount is calculated should also be disclosed by the company as per SEBI norms. SEBI also advises the code of ethics for advertising in media regarding the public issue.
- **Encouragement to Initial Public 0ffers**: In order to encourage Initial Public Offers (IPO) in the primary market, SEBI has permitted companies to determine the par value of shares issued by them. SEBI has allowed issues of IPOs to go for "Book Building" – i.e. reserve and allot shares to individual investors. But the issuer will have to disclose the price, the issue size and the number of securities to be offered to the public.
- **Increase of Popularity to Private Placement Market**: In recent years, private placement market has become popular with issuers because of stringent entry and disclosure norms for public issues. Besides low cost of issuance, ease of structuring investments and saving of time lag in issuance are the other causes responsible for the rapid growth of private placement market.
- **Underwriting has made Optional**: To reduce the cost of issue in primary market, SEBI has made underwriting of issue optional. However, the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected would be refunded to the investor is still in force.

- **Issue of Due Diligence Certificate**: The lead managers have to issue due diligence certificate, which has now been made part of the offer document.

- **Conditions regarding Application Size etc.**: SEBI has raised the minimum application size and also the proportion of each issue allowed for firm allotment to institutions such as mutual funds.

- **Regulation of Merchant Banking**: SEBI has brought Merchant banking under its regulatory framework. The merchant bankers are now to be authorized by SEBI. Merchant bankers now have a greater degree of accountability in the offer document and issue process.

- **Imposition of Compulsory Deposit on Companies making Public Issues**: In order to induce companies to exercise greater care and diligence for timely action in matters relating to the public issues of capital, SEBI has advised stock exchanges to collect from companies making public issues, a deposit of one per cent of the issue amount which could be forfeited in case of non-compliance of the provisions of the listing agreement and, non-dispatch of refund orders and share certificates by registered post within the prescribed time.

- **Reforms as to Mutual Funds**: The Government has now permitted the setting up of private mutual funds and a few have already been set up. UTI has now been brought under the regulatory jurisdiction of SEBI. All mutual funds are allowed to apply for firm allotments in public issues. To improve the scope of investments by mutual funds, the latter are permitted to underwrite public issues. Further, SEBI has relaxed the guidelines for investment in money market instruments. Finally, SEBI has issued fresh guidelines for advertising by mutual funds.

- **Vetting of Offer Document**: SEBI vets offer documents to make sure that the company listing the shares has made all disclosures in it. All the guidelines and regulatory measures of capital issues are meant to

promote healthy and efficient functioning of the issue market (or the primary market).

Despite all these steps, there are flagrant breaches of issue procedures through collusion between unscrupulous promoters and corrupt officials in the lead banks and even of the top officials of SEBI.



CHECK YOUR PROGRESS

1. Answer as directed:

a) RBI is the regulator of Indian capital market. (Write True or False)

b) ———————— market is a market for new issues.

c) Gold is a financial asset. (Write True or False)



3.18 LET US SUMUP

We have discuss the following points in this unit:-

- The capital market refers to the institutional arrangements which facilitate the lending and borrowing of long-term and medium-term funds.
- Capital market is divided into two parts: a) The new securities market called New Issue Market which deals with the sale of new securities and shares and b) the secondary market or stock exchange which specialises in buying and selling of old securities, shares, stocks, bonds, debentures, etc.
- Capital market plays an important role in mobilising resources and diverting them in productive channels. It facilitates and promotes the process of economic growth in the country.
- There are sub-divisions of capital market namely debt market, equity market and derivative market.
- The primary market also known as the New Issue Market (NIM) is a market where new securities are issued to the public regularly.
- The main function of new issue market is to facilitate transfer of resources from savers to the users.

- Unlawful behaviour is seen in the business industry such as insider dealing or market manipulation is called market abuse.
- India is facing so many problems in new issue market.
- SEBI is the regulatory body of Indian capital market.



3.19 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services –By M. P. Tripathy
- Indian Financial System -By M Y Khan



3.20 ANSWERS TO CHECK YOUR PROGRESS

1. (a) False (b) Primary (c) False



3.21 POSSIBLE QUESTIONS

1. Write short notes on the following:
   a) Functions of New Issue Market
   a) Capital Market
   b) Venture capital funds in India
   c) Debt market
   d) Equity market
   e) Derivatives market
   f) Hedgers
   g) Speculators
   d) Arbitrageurs

1. What do you mean by capital market? Explain the players of Indian Capital market.
2. Bring out the salient features of Indian capital market.
3. What is secondary market? Distinguish between primary and secondary market.
4. What do you mean by New Issue Market (NIM)? Discuss the functions of NIM.
5. Critically examine the recent trends in secondary market in India.

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UNIT 4 : CAPITAL MARKET IN INDIA-II

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Meaning and Nature of Secondary Market

4.4 Stock Exchange

4.5 Functions of Secondary Market/Stock Exchange

4.6 Characteristics of a Stock Exchange

4.7 Advantages/Benefits of Stock Exchanges

4.8 Organisation and Working of Stock Exchange

4.9 Stock Exchanges in India

4.10 List of Indian Stock Exchanges

4.11 Major Weaknesses of Stock Exchange

4.12 Measures Suggested For Reform of Stock Exchange

4.13 Regulations of Stock Exchanges In India

4.14 Role of SEBI in Regulating Stock Exchanges

4.15 Internet Trading

4.16 Let Us Sum Up

4.17 Further Readings

4.18 Answers to Check Your Progress

4.19 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and characteristics of stock exchange
- describe the functions of stock exchange

- interpret advantages and disadvantages of stock exchange
- enumerate the evolution of stock exchanges in India
- discuss about its regulation with special relation to SEBI

4.2 INTRODUCTION

The existing companies accumulate their funds by selling of different types of securities such as shares, debentures and bonds. There should be common place where those securities can be bought and sold on a regular basis. This unit discusses about that common platform called secondary market or stock exchange. It discusses the meaning, nature, constituents and functions of secondary market.

4.3 MEANING AND NATURE OF SECONDARY MARKET

The secondary market is the stock market where existing stocks are bought and sold by the retail investors through the brokers. It is the secondary market that controls the price of the stocks. Generally when we speak about investing or trading at the stock market we mean trading at the secondary stock market. It is the secondary market where we can invest and trade in the stocks to get the profit from our stock market investment. In secondary market, the securities issued in the primary market are bought and sold. Here, you can buy a share directly from a seller and the stock exchange or broker acts as an intermediary between two parties. The secondary market is actually formed by another layer of investors who deal with primary market investor to buy and sell financial securities such as bonds and stocks. These dealings happen in the recognizable stock exchange.

The secondary market known as stock market or stock exchange plays an equally important role in mobilising long-term funds by providing the necessary liquidity to holdings in shares and debentures. It provides a place where these securities can be encashed without any difficulty and delay. It is an organised market where shares and debentures are traded regularly with high degree of transparency and security. In fact, an active secondary market facilitates the growth of primary market as the investors in the primary market are assured of a continuous market for liquidity of their holdings. The major play-

ers in the secondary market are the stockbrokers like merchant bankers, mutual funds, financial institutions, and the individual investors who are members of the stock exchange who facilitate the trading.

4.4 STOCK EXCHANGE

Stock exchange is the term commonly used for a secondary market, which provide a place where different types of existing securities such as shares, debentures and bonds, government securities can be bought and sold on a regular basis. A stock exchange is generally organised as an association, a society or a company with a limited number of members. It is open only to these members who act as brokers for the buyers and sellers. The Securities Contract (Regulation) Act has defined stock exchange as an "association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business of buying, selling and dealing in securities".

It may be noted that all securities are not permitted to be traded on a recognised stock exchange. It is allowed only in those securities (called listed securities) that have been duly approved for the purpose by the stock exchange authorities. The method of trading now-a-days, however, is quite simple on account of the availability of on-line trading facility with the help of computers. It is also quite fast as it takes just a few minutes to strike a deal through the brokers who may be available close by. Similarly, on account of the system of scrip-less trading and rolling settlement, the delivery of securities and the payment of amount involved also take very little time, say, two days.

4.5 FUNCTIONS OF SECONDARY MARKET/STOCK EXCHANGE

The functions of secondary market or stock exchange can be enumerated as follows:

1. Provides Ready and Continuous Market: By providing a place where listed securities can be bought and sold regularly and conveniently, a stock exchange ensures a ready and continuous market for various shares,

debentures, bonds and government securities. This lends a high degree of liquidity to holdings in these securities as the investor can encash their holdings as and when they want.

2. Provides Information about Prices and Sales: A stock exchange maintains complete record of all transactions taking place in different securities every day and supplies regular information on their prices and sales volumes to press and other media. This enables the investors in taking quick decisions on purchase and sale of securities in which they are interested.

3. Provides safety to dealings and investment: Transactions on the stock exchange are conducted only amongst its members with adequate transparency and in strict conformity to its rules and regulations which include the procedure and timings of delivery and payment to be followed. This provides a high degree of safety to dealings at the stock exchange. There is little risk of loss on account of non-payment or non delivery because, a stock exchange allows trading only in securities that have been listed with it. Securities and Exchange Board of India (SEBI) regulates the business in stock exchanges in India and the working of the stock brokers.

4. Helps in Mobilisation of Savings and Capital Formation: Efficient functioning of stock market creates conducive climate for an active and growing primary market. Good performance and outlook for shares in the stock exchanges imparts faxibility to the new issue market, which helps in mobilising savings for investment in industrial and commercial establishments. Not only that the stock exchanges provide liquidity and profitability to dealings and investments in shares and debentures. Thus it helps mobilising surplus savings for investment in corporate and government securities and contributes to capital formation.

5. Barometer of Economic and Business Conditions: Stock exchanges reflect the changing conditions of economic health of a country, as the shares prices are highly sensitive to changing economic, social and political conditions. The intensity of trading at stock exchanges and the corresponding rise on fall in the prices of securities reflects the investors' assessment of the

economic and business conditions in a country, and acts as the barometer which indicates the general conditions of the atmosphere of business.

6. Better Allocation of Funds: As a result of stock market transactions, funds flow from the less profitable to more profitable enterprises and they avail of the greater potential for growth. Financial resources of the economy are thus better allocated.

7. Contributes to Economic Growth: In stock exchange securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.

8. Spreading of Equity Cult: Stock exchange encourages people to invest in ownership securities by regulating new issues, better trading practices and by educating public about investment.

9. Providing Scope for Speculation: To ensure liquidity and demand of supply of securities the stock exchange permits healthy speculation of securities.

10. Liquidity: The main function of stock market is to provide ready market for sale and purchase of securities. The presence of stock exchange market gives assurance to investors that their investment can be converted into cash whenever they want.

11. Promotes the Habits of Savings and Investment: The stock market offers attractive opportunities of investment in various securities. These attractive opportunities encourage people to save more and invest in securities of corporate sector rather than investing in unproductive assets such as gold, silver, etc.

4.6 CHARACTERISTICS OF A STOCK EXCHANGE

The main characteristics of a stock exchange are:

- It is an organised market

- It provides a place where existing and approved securities can be bought and sold easily
- In a stock exchange, transactions take place between its members or their authorized agents
- All transactions are regulated by rules and by laws of the concerned stock exchange
- It makes complete information available to public in regard to prices and volume of transactions taking place every day

4.7 ADVANTAGES/BENEFITS OF STOCK EXCHANGES

The advantages of stock exchanges can be outlined from the point of view of (a) Companies, (b) Investors, and (c) the Society as a whole.

a) Towards the Companies

i) The companies whose securities have been listed on a stock exchange enjoy a better goodwill and credit-standing than other companies because they are supposed to be financially sound.

ii) The market for their securities is enlarged as the investors all over the world become aware of such securities and have an opportunity to invest.

iii) As a result of enhanced goodwill and higher demand, the value of their securities increases and their bargaining power in collective ventures, mergers, etc. is enhanced.

iv) The companies have the convenience to decide upon the size, price and timing of the issue.

b) Towards the Investors

i) The investors enjoy the ready availability of facility and convenience of buying and selling the securities at will and at an opportune time.

ii) Because of the assured safety in dealings at the stock exchange the investors are free from any anxiety about the delivery and payment problems.

iii) Availability of regular information on prices of securities traded at the stock exchanges helps them in deciding on the timing of their purchase and sale.

iv) It becomes easier for them to raise loans from banks against their holdings in securities traded at the stock exchange because banks prefer them as collateral on account of their liquidity and convenient valuation.

c) Towards the Society

i) The availability of lucrative avenues of investment and the liquidity thereof induces people to save and invest in long-term securities. This leads to increased capital formation in the country.

ii) The facility for convenient purchase and sale of securities at the stock exchange provides support to new issue market. This helps in promotion and expansion of industrial activity, which in turn contributes, to increase in the rate of industrial growth.

iii) The Stock exchanges facilitate realisation of financial resources to more profitable and growing industrial units where investors can easily increase their investment substantially.

iv) The volume of activity at the stock exchanges and the movement of share prices reflect the changing economic health.

v) Since government securities are also traded at the stock exchanges, the government borrowing is highly facilitated.

4.8 ORGANISATION AND WORKING OF A STOCK EXCHANGE

Practically, the organisation and working of a stock exchange differs from exchange to exchange in technical details although the general pattern of all exchanges is almost the same. The general pattern of a stock exchange is as follows:

(a) Constitution: It is an association of members which may be a voluntary and non--profit association or company limited by shares or guarantee.

(b) Membership: Membership is a 'must' for transacting business since non-members are not allowed to enter the stock-exchange. Membership is strictly limited, i.e., no one is allowed to be a member unless there is a va-

cancy. Membership is acquired outright by the payment of membership fees prescribed by the stock exchange.

(c) Management: The general administration of a stock exchange is administered by a committee of management and is called by different names in different exchanges. The selected Executive Committee of different stock exchanges carries on management of their day-to-day activities through sub-committees such as Listing Committee, Defaulters' Committee, Arbitration Committee, etc.

(d) Nature of Transactions: Two types of transactions — cash or forward — are made in a stock Transactions exchange. Cash transaction is one which reveals the delivery of securities within a short time which is settled by the payment of price. This type of transaction is also known as investment transaction since it is based on bona fide intention of purchase and sale of securities. On the contrary, a forward transaction is one which reveals forward delivery contracts and fixed settlement days. It is a speculative transaction and the settlement is made by the payment of price differences.

4.9 STOCK EXCHANGES IN INDIA

The first organised stock exchange in India was started in Mumbai known as Bombay Stock Exchange (BSE). It was followed by Ahmedabad Stock Exchange in 1894 and Kolkata Stock Exchange in 1908. The number of stock exchanges in India went up to 7 by 1939 and it increased to 21 by 1945 on account of heavy speculation activity during Second World War. A number of unorganised stock exchanges also functioned in the country without any formal set-up and were known as 'kerb' market. The Security Contracts (Regulation) Act was passed in 1956 for recognition and regulation of Stock Exchanges in India. At present we have 23 stock exchanges in the country. Of these, the most prominent stock exchange that came up is National Stock Exchange (NSE). In fact, as of now, BSE and NSE are the two Stock Exchanges, which enjoy nation-wide coverage and handle most of the business in securities in the country.

Another stock exchange that needs special mention is Over the Counter Exchange of India (OTCEI). It was promoted by the financial institutions like

UTI, ICICI, IDBI, IFCI, LIC etc. in September 1992 specially to cater to small and medium sized companies with equity capital of more than ₹ 30 lakh and less than 25 crore. It helps entrepreneurs in raising finances for their new projects in a cost effective manner. It provides for nationwide online ringless trading with 20 plus representative offices in all major cities of the country. On this stock exchange, securities of those companies can be traded which are exclusively listed on OTCEI only. In addition, certain shares and debentures listed with other stock exchanges in India and the units of UTI and other mutual funds are also allowed to be traded on OTCEI as permitted securities.

4.10 LIST OF INDIAN STOCK EXCHANGES

Following are the major stock exchanges in India:

4.10.1 Bombay Stock Exchange (BSE)

Bombay stock Exchange (BSE) was established in 1875 and it is located at Dalal Streat,Mumbai. It operates with a vision of to "*Emerge as the premier Indian stock exchange with best-in-class global practice in technology, products innovation, and customer service."* It is one of the two principal large stock exchanges of India and was founded by Mr. Premchand Roychand, famously known as the Cotton King, the Bullion King or the Big Bull. He was one of the most influential Indian businessmen of the 19th century and made a fortune in the stock-broking business.

Established in 1875, BSE is the oldest and first stock exchange of Asia and was formerly known by the name of –The Native Share & Stock Brokers Association. But the story of BSE starts back in the 1850s when 22 stockbrokers would gather under banyan trees in front of Mumbai's Town Hall. Location of these meetings changed multiple times to accommodate an increasing number of brokers. The group eventually moved to Dalal Street in the year 1874.

In the year 1986, Sensex was introduced, as the first equity index to provide a base for identifying the top 30 trading companies of the exchange, in more than 10 sectors. Apart from Sensex, other important indices of BSE are

BSE 100, BSE 200, BSE 500, BSE MIDCAP, BSE SMLCAP, BSE PSU, BSE Auto, BSE Pharma, BSE FMCG, BSE Metal, etc.

As of April 2018, BSE has an overall market capitalization of over $4.9 trillion, which makes it the 10th largest stock exchange marketplace in the world. It also offers varied services such as market data services, risk management, CDSL (Central Depository Services Limited) depository services, etc. (Unit 7 of this Block discuesses broadly about BSE)

4.10.2 National Stock Exchange (NSE)

National Stock Exchange (NSE) is the youngest stock exchange of India which came into picture in the year 1992. It operates with a vision, "*To continue to be a leader, establish a global presence, and facilitate the financial well-being of people.***"** In 1992, for the very first time in India, NSE introduced the advanced electronic trading system which removed the paper-based settlement system from trading and offered an easy trading facility. One year later, in the year 1993, NSE was set up as a tax paying company, which later on registered itself as a Stock Exchange under the Securities Contract Regulation Act. In the year 1995, National Securities Depository Limited (NSDL) was formed to provide depository services to the investors.

NSDL allows investors and traders to securely hold and transfer their stocks electronically along with this, it also allows investors to hold and trade in as few as one share or one bond. Nifty 50 the popular benchmark index in the Indian stock market, was introduced by NSE in the same year. Nifty lists out top 50 companies which traded on the NSE stock exchange market. (Unit 7 of this Block discuesses broadly about NSE)

4.10.3 Calcutta Stock Exchange (CSE)

Calcutta Stock Exchange (CSE) is a regional stock exchange (RSE) located at the Lyons Range, Kolkata and is the second oldest stock exchange in South East Asia. Incorporated in 1908, CSE is the second largest Stock Exchange in India. In the year 1980, it was granted permanent recognition by

the Government of India under the relevant provisions of the Securities Contracts (Regulation) Act, 1956. While nearly 20 regional stock exchanges have voluntarily exited in the face of SEBI's stringent regulations against RSEs, CSE continues to fight a lone battle.

4.10.4 Metropolitan Stock Exchange (MSE)

Metropolitan Stock Exchange (MSE) was recognized by SEBI on 16 September 2008 and is valid till 15 September 2019. MSE offers a hi-tech platform to trade in the capital market, futures & options, currency derivatives, and debt market segments of the Indian market. It was recognized by SEBI on 16th September 2008 and is valid till 15th September 2019. Shareholders of MSE include Indian public sector banks, private sector banks, investors and domestic financial institutions which are subjected to CAG Audit. It has come out with a "Manifesto of Change", which is a roadmap of what the stock exchange intends to achieve in terms of driving market development and inclusive growth over the next 10 years.

4.10.5. India International Exchange (India INX)

Opened in January 2017, India International Exchange (India INX) is India's first international stock exchange. It is a wholly owned subsidiary of the Bombay Stock Exchange (BSE) and is located at the International Financial Services Centre (IFSC), GIFT City in Gujarat. It is claimed to be the world's most advanced technological platform with a turn-around time of 4 microseconds which operates 22 hours a day and six days a week. Because of these timings, international investors and Non-Resident Indians (NRIs) can trade from anywhere across the globe at their preferred timings. Also, India INX launched Global Securities Market, India's first international primary market platform that connects global investors with Indian and foreign issuers.

4.10.6 NSE IFSC Ltd.

NSE IFSC Limited (NSE International Exchange) incorporated on 29th November 2016, is a wholly owned subsidiary of the National Stock Exchange (NSE) and is located at the International Financial Services Centre (IFSC), GIFT City in Gujarat. NSE IFSC Limited has been launched to grow the financial market as well as expected to bring capital into India. It is permitted to offer trading in securities in any currency other than the Indian rupee. NSE IFSC Limited conducts 16 hours of daily trading, which it intends to gradually expand in line with market feedback. Currently, there are two trading sessions, the first between 8 am and 5 pm and the second between 5.30 pm and 11.30 pm.

Former Stock Exchanges in India

There are 23 stock exchanges in India. Among them, two are national level stock exchanges namely BSE and NSE. The rest 21 are Regional Stock Exchanges (RSEs). Due to stringent norms introduced by SEBI, 20 RSEs in the country opted to exit the business. The list of stock exchanges which already closed their business are as follows:

S. No.	Former Stock Exchanges	Closed in
1	Ahmedabad Stock Exchange	2018
2	Delhi Stock Exchange	2017
3	Guwahati/Gauhati Stock Exchange	2015
4	Jaipur Stock Exchange	2015
5	Madhya Pradesh Stock Exchange	2015
6	Madras Stock Exchange	2015
7	OTC Exchange of India	2015
8	Pune Stock Exchange	2015
9	UP Stock Exchange	2015
10	Vadodara Stock Exchange	2015
11	Bangalore Stock Exchange	2014
12	Cochin Stock Exchange	2014
13	Inter-connected Stock Exchange of India	2014
14	Ludhiana Stock Exchange	2014

15	Trivandrum Stock Exchange	2010
16	Coimbatore Stock Exchange	2009
17	Hyderabad Stock Exchange	2007
18	Magadh Stock Exchange	2007
19	Bhubaneshwar Stock Exchange	2005
20	Mangalore Stock Exchange	2004



CHECK YOUR PROGRESS

1. Answer as directed:

a) A person appointed by a stock broker to assist to him in the business of securities trading at trading floor of stock exchanges is _____. (Fill in the gap)

b) An order for the purchase of securities at a fixed price is known as _____. (Fill in the gap)

c) In a stock exchange where the ownership, management and trading are concentrated in a single group, it is called _____. (Fill in the gap)

d) Stock Exchange provides a ready market for sale and purchase of gold and silver. (Write True or False)

e) In the stock exchange, transactions take place between companies and their shareholders directly. (Write True or False)

4.11 MAJOR WEAKNESSES OF STOCK EXCHANGE

The major weaknesses of stock exchange in India are:

1. **Lack of Professionalism:** The majority of stock brokers lack professionalism. They lack proper education, business skills, infra-structural facilities etc. which inhibits them to provide proper service to clients. They are not able to guide and counsel their clients in the manner expected of them.

2. **Domination of Financial Institutions:**Indian stock markets are dominated by a few financial institutions. The U.T.I., LIC, GIC are the main players in In-

dian stock markets. The buying and selling by these institutions sets the tone in the market. Moreover, Indian financial institutions indulge more in buying and less in selling. With the entry of more and more Indian and foreign institutions, their influence in stock markets will gradually decline.

3. Poor Liquidity: The Indian stock exchanges suffer from poor liquidity. A small number of scrips are regularly traded on stock exchanges. A seller has to wait for disposing off his holdings for a long time. When an investor is not sure of selling his shares whenever he needs money then he will be discouraged to invest in shares. There is huge backlog of pending deliveries also.

4. Domination by Big Operators: Some big operators influence the sentiment of stock exchanges in India. In Bombay Stock Exchange 3-4 operators used to call the shots. The case of Harshad Mehta is well known in India. He created bullish conditions in Indian stock exchanges in the first quarter of 1992 and BSE sensex nearly doubled in a very short period. This artificial increase in prices of shares adversely affected the investing public and people suffered huge losses.

5. Less Floating Stocks: There is a scarcity of floating stock in Indian stock exchanges. The shares and debentures offered for sale are a small portion of total stocks. The financial institutions and joint stock companies which control over 75 percent of the scrips do not offer them for sale. It creates scarcity of stocks for trading. The markets tend to be violative and amenable to manipulations in the absence of adequate floating stocks for trading.

6. Speculative Trading: The trading in stock exchanges is mainly speculative in nature. The operators try to derive benefit out of short-term price fluctuations. Hence, one of the common evils associated with stock exchange operations is the excessive speculation. Speculation implies buying or selling securities to take advantage of price differential at different times. The speculators generally do not take or give delivery and pay or receive full payment. They settle their transactions just by paying the difference in prices. Normally, speculation is considered a healthy practice and is necessary for successful operation of stock exchange activity. But, when it becomes excessive, it leads to

wide fluctuations in prices and various malpractices by the vested interests. In the process, genuine investors suffer and are driven out of the market.

7. Fluctuation of Prices: Another shortcoming of stock exchange operations is that security prices may fluctuate due to unpredictable political, social and economic factors as well as on account of rumours spread by interested parties. This makes it difficult to assess the movement of prices in future and build appropriate strategies for investment in securities. However, these days good amount of vigilance is exercised by stock exchange authorities and SEBI to control activities at the stock exchange and ensure their healthy functioning.

4.12 MEASURES SUGGESTED FOR REFORM OF STOCK EXCHANGE

Following are some of the important measures suggested by Dr. L.C. Gupta for making necessary changes in the current trade practices in Indian stock exchanges in his "Export study of Trading in shares in stock Exchanges":

(i) Uniform System of One-Week Settlement: In order to unify all stock exchanges in India on a national basis, all the stock exchanges should introduce a uniform system of one-week settlement. This uniform system will reduce the risk missing out of price movements in shares and also check the strong tendency towards over speculation and over-concentration of trading activity in a few shares.

(ii) Market Making: The system market makers should be introduced in stock exchanges in India at par with the all leading stock exchanges of London and New York. In this system the market makers usually take the responsibility of market making for specific shares, i.e., for buying and selling a specific share at definite prices. This system will provide protection to investors and also liquidity to all shares.

(iii) Margin Trading and Marking to the Market System: As the margin trading system adopted by Indian stock exchanges is defective and has failed to prevent the problem of default and over-speculation, Dr. Gupta suggested two alternatives against this system. The first one suggests adopting

the margin trading system of USA in which commercial banks provide financial support to the extent of 50 per cent to the buyer in the stock market trading after necessary pledging of shares with a bank. The second alternative i.e., the marking to the market system on a daily basis is a complete system to check bankruptcy and will provide guarantee towards financial integrity of the market at all times.

(iv) Abolishing the System of Carry Forward: The present practice of the system of carry forward adopted by the Indian SEs has led to over-speculation in the stock market. With the abolition of this system, the stock exchanges will be free from many problems.

(v) Formation of Governing Body (GB) and Management of Stock Exchange: The formation of GB should be done in a rational way. The Executive Director of a Stock Exchange must either be appointed by the Government or by SEBI as per the advice from the panel of independent experts, so that he can have indepen-dent control over stock brokers. The composition of GB of stock exchanges should also be changed between the broker-directors and non-broker directors in ratio of 50: 50 to make it more objective, direct and strong.

(vi) Introducing Management Information System: The stock exchanges in the country should introduce a well designed management information system (MIS) so as to feed the SEs with sufficient information relating to trading volume and prices, trading concentration in certain securities, trading concentration by some SE members, speculation etc. Such information will also help the authorities to restrict and regulate the stock markets properly.

4.13 REGULATIONS OF STOCK EXCHANGES IN INDIA

Indian Capital Markets are regulated and monitored by the Ministry of Finance, The Securities and Exchange Board of India and The Reserve Bank of India. The Ministry of Finance regulates through the Department of Economic Affairs - Capital Markets Division. The division is responsible for formulating the policies related to the orderly growth and development of the securi-

ties markets (i.e. share, debt and derivatives) as well as protecting the interest of the investors. In particular, it is responsible for-

- institutional reforms in the securities markets,
- building regulatory and market institutions,
- strengthening investor protection mechanism, and
- providing efficient legislative framework for securities markets

The Division administers legislations and rules made under:

- Depositories Act, 1996,
- Securities Contracts (Regulation) Act, 1956 and
- Securities and Exchange Board of India Act, 1992.

Regulators of Stock Exchanges in India:

The stock exchanges suffer from certain limitations and require strict control over their activities in order to ensure safety in dealings thereon. Hence, as early as 1956, the Securities Contracts (Regulation) Act was passed which provided for recognition of stock exchanges by the central Government. All stock exchanges are required submit information relating to its affairs as required by the Government from time to time. The Government was given wide powers relating to listing of securities, make or amend bylaws, withdraw recognition to, or supersede the governing bodies of stock exchange in extraordinary/abnormal situations. Under the Act, the Government promulgated the Securities Regulations (Rules) 1957. The main regulators of stock exchange in India are:

- **Securities & Exchange Board of India (SEBI):** The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act 1992 and is the principal regulator for Stock Exchanges in India. SEBI's primary functions include protecting investor interests, promoting and regulating the Indian securities markets. All financial intermediaries permitted by their respective regulators to participate in the Indian securities markets are governed by SEBI regulations, whether domestic or foreign. Foreign Portfolio Investors are required to register with DDPs in order to participate in the Indian securities markets.

- **Reserve Bank of India (RBI):** The Reserve Bank of India (RBI) is governed by the Reserve Bank of India Act, 1934. The RBI is responsible for implementing monetary and credit policies, issuing currency notes, being banker to the government, regulator of the banking system, manager of foreign exchange, and regulator of payment & settlement systems while continuously working towards the development of Indian financial markets. The RBI regulates financial markets and systems through different legislations. It regulates the foreign exchange markets through the Foreign Exchange Management Act, 1999.

4.14 ROLE OF SEBI IN REGULATING STOCK EXCHANGES

As for measures in the secondary market, all statutory powers to regulate stock exchanges under the Securities Contracts (Regulation) Act have been vested with SEBI through the passage of securities law (Amendment) Act in 1995. Naturally, the SEBI has duly notified rules and a code of conduct to regulate the activities of intermediaries in the securities market. The registration in the securities market and then registration with SEBI is made compulsory. It has issued guidelines for composition of the governing bodies of stock exchanges so as to include more public representatives. Corporate membership has also been introduced at the stock exchanges. It has notified the regulations on insider trading to protect and preserve the integrity of stock markets and issued guidelines for mergers and acquisitions. SEBI has constantly reviewed the traditional trading systems of Indian stock exchanges and tried to simplify the procedure, achieve transparency in transactions and reduce their costs. To prevent excessive speculations and volatility in the market, it has done away with badla system, and introduced rolling settlement and trading in derivatives. All stock exchanges have been advised to set-up clearing corporation/settlement guarantee fund to ensure timely settlements. SEBI organises training programmes for intermediaries in the securities market and conferences for investor education all over the country from time to time.

As part of its efforts to protect investors' interests, SEBI has initiated many primary market reforms, which include improved disclosure standards in public issue documents, introduction of prudential norms and simplification of issue procedures. Companies are now required to disclose all material facts and risk factors associated with their projects while making public issue. All issue documents are to be vetted by SEBI to ensure that the disclosures are not only adequate but also authentic and accurate. SEBI has also introduced a code of advertisement for public issues for ensuring fair and truthful disclosures. Merchant bankers and all mutual funds including UTI have been brought under the regulatory framework of SEBI.

As part of economic reforms programme started in June 1991, the Government of India initiated several capital market reforms, which included the abolition of the office of the Controller of Capital Issues (CCI) and granting statutory recognition to Securities Exchange Board of India (SEBI) in 1992 for:

- protecting the interest of investors in securities;
- promoting the development of securities market;
- regulating the securities market; and
- matters connected there with or incidental thereto.

SEBI has been vested with necessary powers concerning various aspects of capital market such as:

- regulating the business in stock exchanges and any other securities market;
- registering and regulating the working of various intermediaries and mutual funds;
- promoting and regulating self regulatory organisations;
- promoting investors education and training of intermediaries;
- prohibiting insider trading and unfair trade practices;
- regulating substantial acquisition of shares and takeover of companies;
- calling for information, undertaking inspection, conducting inquiries and audit of stock exchanges, and intermediaries and self regulation organisations in the stock market; and

- performing such functions and exercising such powers under the provisions of the Capital Issues (Control) Act, 1947 and the Securities Contracts (Regulation) Act, 1956 as may be delegated to it by the Central Government.

4.15 INTERNET TRADING

The Securities & Exchange Board of India (SEBI) approved the report on Internet Trading brought out by the SEBI Committee on Internet Based Trading and Services In January 2000. Internet trading can take place through order routing systems, which will route client orders to exchange trading systems for execution. Thus a client sitting in any part of the country would be able to trade using the Internet as a medium through brokers' Internet trading systems.

SEBI-registered brokers can introduce Internet based trading after obtaining permission from respective Stock Exchanges. SEBI has stipulated the minimum conditions to be fulfilled by trading members to start Internet based trading and services, vide their circular no.SMDRP/POLICY/CIR-06/2000 dated January 31, 2000.

NSE became the first exchange to grant approval to its members for providing Internet based trading services. In line with SEBI directives, NSE has issued circulars detailing the operational guidelines and procedures to be complied with by members desirous of providing Internet based trading and services in circular no. NSE/MSD/41332 dated June 17, 2019.

Members can procure the Internet trading software from software vendors who are empanelled with NSE or they may develop the software through their own in-house development team or may procure the software from other non-empanelled vendors.

Advantages of Online Tradingd

Following are the advantages of online trading :

- **It is simple:** It enables a trader to have a hassle free trading experience. Anyone can use these platforms as specific skill is not required to carry out trading online.
- **It is less expensive:** It is less expensive as compared to traditional mode of trading. Brokers also promote online trading as it reduces maintenance and other costs incurred by the broker.
- **Quick and less time consuming:** Trading can be done in a seamless manner and in less time. One can carry out trading even through a smartphone in the simplest way.
- **Complete control:** It allows investors to have complete control over their portfolios. They can place trade orders from anywhere anytime.
- **Chances of error are less:** In case of traditional offline trading, there were more chances of errors due to miscommunication between the traders and brokers. But in online trading, investors can place trade orders or cancel without broker's interference and hence can manage trade transactions by themselves.
- **Monitor investment at all times:** Investors can monitor their investments anytime. Various mobile trading apps help them stay in touch with the markets and also monitor their investment anytime and take proper strategic moves accordingly.
- **Access to research reports:** Investors can get access to top research recommendations, reports, analysis on stock price based on various charts available in various brokerage websites.

Safety measures that have to be taken in case of online trading:

- Trade orders should not be placed from shared PCs or cyber cafes.
- Always log out after carrying out trade in order to avoid any misuse of your account.

- Personal computers have to be protected against viruses by installing anti-virus solution.
- Do not click on “remember me” option when you sign in to your trading account from a different location.



CHECK YOUR PROGRESS

2. Answer as directed:

a) The full form of OTCEI is _____. (Fill in the gap)

b) SENSEX is the index of _____. (Fill in the gaps)

c) NIFTY is the index of _____. (Fill in the gaps)

d) The first Indian equity index is _____. (Fill in the gaps)

e) Full form of STRIPS is _____. (Fill in the gaps)

f) Gilt Edged Securities are _____. (Fill in the gaps)

g) Zero interest bonds are sold at discount. (Write True or False)



4.16 Let Us Sum Up

We have discuses the following points in the unit :-

- The secondary market is the stock market where existing stocks are bought and sold by the retail investors through the brokers.
- The secondary market known as stock market or stock exchange plays an equally important role in mobilising long-term funds. Stock exchanges provide a place where different types of existing securities such as shares, debentures and bonds, government securities can be bought and sold on a regular basis.
- The major players in the secondary market are the stockbrokers like merchant bankers, mutual funds, financial institutions, and the individual

investors who are members of the stock exchange who facilitate the trading.

- Indian stock exchanges have various weaknesses.
- The Securities and Exchange Board of India (SEBI) is the regulatory authority of Stock Exchanges in India.



4.17 FURTHER READINGS

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services –By M. P. Tripathy
- Indian Financial System -By M Y Khan



4.18 ANSWERS TO CHECK YOUR PROGRESS

1. (a) Authorised clerk (b) Limit order (c) Mutual exchange (d) False (e) False

2. (a) Over the Counter Exchange of India (b) BSE (c) NSE (d) SENSEX (e) Separate Trading of Registered Interest and Principal of Securities (f) Govt. Securities (g) True



4.19 MODEL QUESTIONS

1. Write short notes on the following:
   a) Advantages of stock exchanges
   b) Limitations of stock exchanges
   c) Over the Counter Exchange of India
2. What is Stock Exchange? Explain its significance in the development of Indian capital market.
3. Enumerate the main characteristics of a stock exchange and also state its limitations.

4. Critically examine the role and functions of stock exchanges in the financial system of country.
5. What do mean by listing of securities? Describe the listing and point out its merits and demerits.
6. Explain the role played by SEBI in protecting investors' interests and controlling the business at stock exchange.
7. Give explanatory notes on (a) stock exchange in India; and (b) Regulations of stock exchanges.

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UNIT-5 : LISTING OF SECURITIES

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Meaning of Listing

5.4 Types of Listing of Securities

5.5 Listing Requirements

5.6 Formalities for Listing

5.7 Listing Procedure at the Stock Exchange

5.8 Conditions for Listing

5.9 Criteria for Listing of Securities

5.10 Advantages of Listing

5.11 Disadvantages of Listing

5.12 Listing Fee

5.13 Listing of Right Issue

5.14 Listing of Bonus Issue

5.15 Differences between Right Issue and Bonus Issue

5.16 Listing of Further Issues

5.17 Delisting Of Securities

5.18 Listing Conditions in BSE

5.19 Listing Requirements for NSE

5.20 Let Us Sum Up

5.21 Further Readings

5.22 Answers to Check Your Progress

5.23 Model Questions

5.1 LEARNING OBJECTIVES

After reading this unit you will able to know–

- meaning of Listing of Securities
- formalities for Listing
- advantages and disadvantages of Listing on Stock Exchange
- rules for Listing of Securities

5.2 INTRODUCTION

For trading in the stock market, a company has to list its securities in the stock exchange. It means that the name of the company is registered in the stock exchange. The company has to fulfill certain conditions according to Companies Act. In this unit we will discuss about the meaning and advantages of listing of securities.

5.3 MEANING OF LISTING

Listing forms the very basis of the operations of stock exchange. A stock exchange deals only in the listed securities of certain selected companies. Listing here means an act of inclusion of securities in the official list of a stock exchange for the purpose of trading. The company issuing securities for public subscription has to apply to a recognised stock exchange to get its securities listed. If the permission is granted, then the securities are said to have been listed.

Listing, therefore, is a sort of sanction of the stock exchange permitting dealings in the specific securities. Listing means admission of securities to dealings on a recognized stock exchanges of any incorporated company, Central and State Governments, quasi governmental and other financial institutions/ corporations, municipalities, electricity, housing boards etc. In technical language, listed securities are also called 'scrips'. Securities are bought and sold in recognized stock exchanges through members who are known as 'brokers'. The prices at which the securities are bought and sold on a recognized stock exchange are known as 'official quotation'.

5.4 TYPES OF LISTING OF SECURITIES

1. Initial listing: Here, the shares of the company are listed for the first time on a stock exchange.

2. Listing for public Issue: When a company which has listed its shares on a stock exchange comes out with a public issue.

3. Listing for Rights Issue: When the company which has already listed its shares in the stock exchange issues securities to the existing shareholders on rights basis.

4. Listing of Bonus shares: When a listed company in a stock exchange is capitalizing its profit by issuing bonus shares to the existing shareholders.

5. Listing for merger or amalgamation: When the amalgamated company issues new shares to the shareholders of amalgamated company, such shares are listed.

5.5 LISTING REQUIREMENTS

The company has to offer its shares or debentures to the public for subscription. Only then, the company will be allowed to list its security in the stock exchange. Exchanges have listing requirements to ensure that only high quality securities are traded on them and to uphold the exchange's reputation among investors. For listing shares in the stock exchange, a company must have minimum of Rs. 5 crores as its equity capital and 60% of this i.e., Rs. 3 crores is offered to the public.

5.6 FORMALITIES FOR LISTING

A company wishing to have its securities listed has to apply in the prescribed form supported by following documents and particulars:

- Copies of Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus and agreements with underwriters
- Specimen copies of shares' and debentures' certificates, letters of allotment, etc.
- Particulars of bonuses and dividends declared during the last 10 years
- Particulars of shares or debentures for which permission is sought
- Details of shares and debentures issued for consideration other than cash

- Statement showing distribution of shares and particulars of commission, brokerage, discounts or special terms towards the issue of shares
- A brief history of the company's activities since its incorporation with reference to its assets, liabilities and capital structure
- All particulars regarding capital structure
- Copies of advertisements offering securities for sale during the last 5 years
- Copies of Balance sheet, audited accounts and auditors' report for the last 5 years
- Any agreement with financial institutions
- Particulars of shares forfeited
- Certified copy of consent from SEBI

5.7 LISTING PROCEDURE AT THE STOCK EXCHANGE

After the application is made the listing committee of the stock exchange will scrutinize the application form of the company. After a careful examination of the application, the stock exchange authorities may call upon the company to execute a listing agreement. This contains the obligations and restrictions on the part of the company. The stock exchange reserves the right to cancel or suspend the permission granted following any breach of the obligations mentioned above. Here, the stock exchange will ensure the following:

- The financial position of the company is sound
- Solvency and liquidity positions are good
- The issue is large and broad based to generate public interest.

If the application for listing is accepted, the listed company will be called to execute listing agreement with the stock exchange.

The company must follow certain obligations which are:

- The company will treat all the applications with equal fairness
- In case of over subscription, the allotment will be decided in consultation with stock exchanges; and

- The company will notify to the stock exchange any change in its management, business, capital structure or bonus or rights issue of shares

The listed company undertakes:

- That it would offer not less than 49 per cent of its issued capital for public subscription;
- That it would be fair to all applicants for shares while making allotments;
- That it would keep the stock exchange fully informed about vital matters affecting the company
- That it would ensure equitable voting rights and dividend rights

5.8 CONDITIONS FOR LISTING

Before listing securities, a company has to fulfill the following conditions:

- Shares of the company must be offered to the public through a prospectus and 25% of each class of securities must be offered.
- The prospectus should clearly mention opening of subscription, receipt of application, etc.
- The capital structure of the company should be broad-based and there should-be public interest in securities.
- The minimum issued capital must be Rs. 3 crores of which Rs. 1.80 crores must be offered to the public.
- There must be at least five public shareholders for every Rs. 1 lakh of fresh issue of capital and 10 shareholders for every Rs. 1 lakh of offer for sale of existing capital. On the excess application money, the company will have to pay interest from 4% to 15%, if there is delay in refund and delay should not be more than 10 weeks from the date of closure of subscription list.
- A company with paid up capital of more than Rs. 5 crores should get itself listed in more than one stock exchange, it includes the compulsory listing on regional stock exchange.

- The auditor or secretary of the company applying for listing should declare that the share certificates have been stamped so that shares belonging to the promoter's quota cannot be sold or hypothecated or transferred for a period of 5 years.
- Articles of Association of the company must have the following provisions:
    - o A common form of transfer shall be used
    - o Fully paid shares shall be used
    - o No lien on fully paid shares
    - o Calls paid in advance will not carry a right to dividend and will not be forfeited before the claim becomes time-barred.
    - o Option to call off shares shall be given only after sanction by the general meeting.
- Letter of allotment, Letter of regret and letter of rights shall be issued simu1taneously.
- Receipts for all the securities deposited, whether for registration or split and no charges will be made for the services.
- The company will issue consolidation and renewal certificates for split certificate, letter of allotment, letter of rights and transfer, etc. when required.
- The stock exchange should be notified by the company regarding the date of board meeting, change in the composition of board of directors, and any new issue of securities, in place of reissue of forfeited shares.
- Closing the transfer books for the purpose of declaration of dividend, rights issue or bonus issue. And for this purpose, due notice should be given to stock exchange.
- Annual return of the company to be filed soon after the annual general body meeting.
- The company will have to comply with conditions imposed by the stock exchange now and then for 1istmg of security.

5.9 CRITERIA FOR LISTING OF SECURITIES

The Stock Exchange has to direct special attention to the following particulars while scrutinizing the application:

5.9.1 Articles:

(a) Whether the Articles contain the following provisions:

- A common form of transfer shall be used.
- Fully paid shares will be free from lien.
- Calls paid in advance may carry interest, but shall not confer a right to dividend.
- Unclaimed dividends shall not be forfeited before the claim becomes time barred.
- Option to call on shares shall be given only after sanction by the general meeting.
- Whether at least 49% of each class of securities issued was offered to the public for subscription through newspapers for not less than three days.
- Whether the company is of a fair size, has a broad based capital structure and there is sufficient public interest in its securities.

5.9.2 Listing Agreement:

A listing agreement contains the obligations and restrictions which listing will entail. This agreement contains 39 clauses with a number of sub-clauses. These cover various aspects of the issue of letters of allotment, share certificates, transfer of shares, information to be given to the stock exchanges regarding closure of register of members for the purpose of payment of dividend, issue of bonus and right shares and convertible debentures, holding of meetings of the board of directors for recommendation or declaration of dividend or issue of right or bonus shares or convertible debentures, submission of cop-

ies of directors' report, annual accounts and other notices, resolutions and so on to the shareholders.

The basic purpose behind making these provisions in the listing agreement is to keep the shareholders and investors informed about the various activities which are likely to affect the share prices of such companies so that equal opportunity is provided to all concerned for buying or selling of the securities. On the basis of these details, investors are able to make investment decisions based on correct information.

A company whose securities are listed with a stock exchange must keep the stock exchange fully informed about matters affecting the company, e.g.,

- To notify the stock exchange promptly of the date of the Board Meeting at which dividend will be declared;
- To forward immediately to the stock exchange copies of its annual audited accounts after they are issued;
- To notify the stock exchange of any material change in the general nature or character of the company's business;
- To notify the stock exchange of any change in the company's capital; and
- To notify the stock exchange (even before shareholders) of the issue of any new shares (right shares or otherwise) as the issue of any privileges or bonus to members.

The company must also undertake:

- Not to commit a breach of any condition on the basis of which listing has been obtained;
- To notify the exchange of any occasion which will result in the redemption, cancellation or retirement of any listed securities;
- Avoid as far as possible the establishment of a false market for the company's shares;

- To intimate the stock exchange of any other information necessary to enable the shareholders to appraise the company's position.

The Securities Contracts (Regulation) Act, 1956, gives the Central Government power to compel an incorporated company to get its securities with a recognized stock exchange in accordance with the rules and regulations prescribed for the purpose. If a recognized exchange refuses to list the securities of a company, the company can file an appeal against such a decision with the government. The Act empowers the government to set aside or change the decision after giving proper opportunity to both the parties to explain their position in this regard.

5.9.3 Guidelines for Listing Securities:

To ensure the effective working of the recognized stock exchange in the public interest, Government framed Securities Contracts (Regulation) Rules, 1957. These Rules have been revised time-to-time whenever it has been necessary to do so depending on the environmental requirements through guidelines issued by the government in this regard. In November 1982, certain administrative guidelines governing the listing of securities on recognized stock exchanges, in relaxation of Rule-19 (2) (b) if these Rules were issued. These guidelines broadly cover the following:

5.9.4 Established Non-FERA Companies:

According to the Act, 'Non-FERA Companies' mean (1) those companies which are incorporated in India at least ten years prior to the date of applying for the listing regulation; or companies which have a profit earning record for a continuous period of at least five years prior to the date of the listing application; and (2) in which foreign equity does not exceed 40 per cent. The rule provides that in relation to these non-FERA companies, public offer should ordinarily be at least 49% of the issued capital of the company. But in certain cases, where there is already a considerable public shareholding in the company, a further reduction in the public offer may also be considered if the following conditions are satisfied:

- The shares are held by persons not connected with the management, their associates and associate companies.
- The shares have remained widely distributed, without undue concentration of large holdings in the hands of the shareholders on record (or their predecessors in title) for a period of at least 3 years prior to the date of the listing application.
- The number of such shareholders is at least 20 for every Rs. 1 lakh of capital held by them.

5.9.5 Other Established or New Non-FERA Companies:

In respect of **(i)** Other established Non-FERA companies, that is, companies incorporated in India within ten years of the date of the listing application and in which foreign equity does not exceed 40 per cent, and (ii) New companies without any foreign equity participation, the provisions of Rule 19 (2) (b) of the Securities Contracts (Regulation) Rules will apply. In other words, the public offer should be at least 60 per cent of the issued capital of the company in such cases.

Subscriptions by the Central Government, State Government and their agencies and public financial institutions will be counted as a part of the public offer up to a maximum extent of 11 per cent of the issued capital of the company.

5.9.6 New Companies with Foreign Equity Participation:

In respect of new companies with approved foreign equity participation, the public offer should be the balance of the issued capital after deduction of the capital subscribed by the foreign participants and the Indian promoters.

The following conditions should, however, be fulfilled:

- The public offer should in no case be less than 33 per cent of the issued capital of the company.
- The share of the Indian promoters should not be more than 40 per cent of the issued capital of the company.

5.9.7 New Companies with Non-Resident Indian Equity Participation:

Where non-residents of Indian nationally or origin of overseas companies, partnership firms, trusts, societies and other corporate bodies, owned predominant ownership is that at least 60 per cent of the ownership of these entitles should be with non-residents of Indian nationality or origin (the criterion for determining such predominant ownership is that at least 60 per cent of the ownership of these entities should be with non-residents of Indian nationality or origin) are themselves the promoters of the company after deduction of the capital subscribed by them.

However, public offer in such a case should not be less than 26% of the issued capital of the company.

- If the non-resident Indian equity is 74 per cent, the public offer should be 26 percent of the issued capital of the company.
- If the non-resident Indian equity is 40 per cent, the public offer should be 60 per cent of the issued capital of the company. [There is no relaxation of Rule 19(2) (b) in this case].
- If the non-resident Indian equity is 30 per cent, the public offer need not exceed 60 per cent and the balance of 10 per cent can be allotted to friends, relatives and associates of the promoters. [Here again, there is no relaxation of Rule 19(2) (b)].

5.9.8 Joint Sector Companies:

In a Joint sector company, the principal promoter will be a State Government and/or its agencies and the co- promoter will be a private party. The shareholding of the State Government and/or its agencies will not ordinarily be less than that of the co-promoter.

In such cases, the public offer should be the balance of the issued capital of the company after deduction of the capital subscribed by the promoters and the co-promoters subject to the condition that the public offer should not normally be less than 33-1/3 per cent of the issued capital of the company. To illustrate, if the State Government and/or its agencies take up 26 per cent

and the co-promoter takes up 25 per cent of the issued capital of the company, the balance of 49 per cent should be offered to the public.

5.9.9 Offer for the Sale of Existing Issued Capital:

Companies can have their shares listed on recognized Stock Exchange by arranging for an offer for sale of their existing issued capital. Such an offer for sale can be combined with a fresh issue of capital also. The extent of public offer in these cases should be in conformity with the provisions detailed above.

In addition, the following conditions should also be fulfilled:

- The net worth (i.e., existing paid up equity capital plus free reserves, excluding reserves created out of revaluation of fixed assets) of the company should not be less than its existing paid up capital and the company should not have incurred a loss in each of the three years preceding the listing application.
- The offer should result in a wide distribution of shares among the general public without undue concentration of large holdings, and the number of public shareholders should be at least 20 for every Rs. 1 lakh of the public offer.
- If the share is offered at a price above its par value, the price should have been approved by the Central Government.
- The offer should set out all material particulars relating to the company and the shares offered to the public. It must be in a form approved by the Stock Exchange concerned and must comply with all conditions pertaining to public advertisement, opening and closing of subscription lists, payment of application money, disposal of applications, basis of allotment, etc., as are applicable to a company offering fresh shares for public subscription in accordance with the listing regulations and instructions issued by the government from time-to-time.

5.10 ADVANTAGES OF LISTING

Listing of securities on the stock exchanges is advantageous to the company as well as to the investors as will be seen hereunder:

To the Company:

- The company enjoys concessions under direct tax laws as such companies are known as companies in which public are substantially interested resulting in lower rate of income-tax payable by them.
- The company gains national and international importance by its share value quoted on the stock exchanges.
- Financial institutions and banks extend term loan facilities in the form of rupee currency and foreign currency loan.
- It helps the company to mobilize resources from the shareholders through 'Rights Issue' for programs of expansion and modernization without depending on the financial institutions in line with the Government policies.
- It ensures wide distributions of shareholding thus avoiding fears of easy takeover of the organization by others.
- Listing provides effective publicity and wide marketability of the securities.
- It enhances the reputation of the concern which brightens its image in the investment market.
- It provides price continuity for securities.
- It facilitates the correct evaluation of securities in terms of their real worth.

To the Investors:

- Since the securities are officially traded, liquidity of investment by the investors is well ensured.

- Rights entitlement in respect of further issues can be disposed of in the market.
- Listed securities are well preferred by bankers for extending loan facility.
- Official quotations of the securities on the stock exchanges corroborate the valuation taken by the investors for purposes of tax assessments under Income-tax Act, Wealth- tax Act etc.
- Since securities are quoted, there is no secrecy of the price realization of securities sold by the investors.
- The rules of the stock exchange protect the interest of the investors in respect of their holdings.
- Listed companies are obliged to furnish unaudited financial results on the quarterly basis. The said details enable the investing public to appreciate the financial results of the company in between the financial periods.
- Takeover offers concerning the listed companies are to be announced to the public. This will enable the investing public to exercise their discretion on such matters.
- It protects investors' interests through the enforcement of set rules and regulations.

5.11 DISADVANTAGES OF LISTING

- Listing encroaches upon the freedom and secrecy of the activities of concerned companies.
- Listed securities may fall victim to erratic fluctuations in values.
- Unscrupulous speculators often manipulate the values of listed securities to the disadvantage of the company.
- Gambling may thrive under the garb of genuine speculation.

5.12 LISTING FEE

All listed companies are required to pay an Annual Listing Fees to the respective stock exchange. At the time of listing the companies will be required to pay an initial listing fee and a pro-rata annual fee for the remainder of the financial year. From there on the annual fee will apply. Fees are calculated on the value of the securities that are quoted. Fees also apply if the companies raise additional capital following the IPO.

5.13 LISTING OF RIGHT ISSUE

A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. This type of issue gives existing shareholders securities called rights. With the rights, the shareholder can purchase new shares at a discount to the market price on a stated future date. The company is giving shareholders a chance to increase their exposure to the stock at a discount price.

A rights issue is a way by which a listed company can raise additional capital. However, instead of going to the public, the company gives its existing shareholders the right to subscribe to newly issued shares in proportion to their existing holdings. For example, 1:4 rights issue means an existing investor can buy one extra share for every four shares already held by him/her. Usually the price at which the new shares are issued by way of rights issue is less than the prevailing market.

Until the date at which the new shares can be purchased, shareholders may trade the rights on the market the same way that they would trade ordinary shares. The rights issued to a shareholder have value, thus compensating current shareholders for the future dilution of their existing shares' value. Dilution occurs because a rights offering spreads a company's net profit over a larger number of shares. Thus, the company's earnings per share, or EPS, decreases as the allocated earnings result in share dilution.

The benefits of the rights issue:

- Increased control of the existing shareholders

- Enhancement in the value of shares and thus there is no loss on the existing shareholders
- It increases the goodwill of the firm and brand perception
- No cost involved with the issuance of shares

Drawbacks of rights issue:

- There tends to be a dilution in the value of shares due to an increase in its numbers
- It does offer a temporary solution to management issues but may not necessarily guide in the long run.

5.14 LISTING OF BONUS ISSUE

A bonus issue, also known as a scrip issue or a capitalization issue, is an offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increasing the dividend payout. Bonus issues are given to shareholders when companies are short of cash and shareholders expect a regular income. Shareholders may sell the bonus shares and meet their liquidity needs. Bonus shares may also be issued to restructure company reserves. Issuing bonus shares does not involve cash flow. It increases the company's share capital but not its net assets.

Advantages and Disadvantages of Issuing Bonus Shares

Companies low on cash may issue bonus shares rather than cash dividends as a method of providing income to shareholders. Because issuing bonus shares increases the issued share capital of the company, the company is perceived as being bigger than it really is, making it more attractive to investors. In addition, increasing the number of outstanding shares decreases the stock price, making the stock more affordable for retail investors.

However, issuing bonus shares takes more money from the cash reserve than issuing dividends does. Also, because issuing bonus shares does not generate cash for the company, it could result in a decline in the dividends per share in the future, which shareholders may not view favorably. In addition, shareholders selling bonus shares to meet liquidity needs lowers sharehold-

ers' percentage stake in the company, giving them less control over how the company is managed.

5.15 DIFFERENCES BETWEEN RIGHT ISSUE AND BONUS ISSUE

1. The rights issue is an additional issue of shares by a company for its existing shareholders. The existing shareholders have their right to subscribe to these shares unless some special rights reserve them for any other individuals.

On the other hand, when a firm earns the supernormal amount of prof its, these are converted into Capital and divided amongst the shareholders free of cost in a proportion of their respective holdings.

2. Rights shares are offered to the existing shareholders by the company for raising additional capital from the market. Rights shares are offered at a discounted price compared to the market price.

Whereas, bonus shares are issued to the shareholders free of cost.

5.16 LISTING OF FURTHER ISSUES

A company (including Private company) having a share capital can increase its subscribed capital by issue of further shares to persons who are holders of equity shares of the company in proportion to the paid up share capital on those shares, by sending a letter of offer.

In some situations, a company would consider it economically viable to increase its subscribed capital after its incorporation. This is because such a further issue would substantially increase its financial reserve and incentivize the shareholders of the company, thereby ensuring the healthy functioning of the company. Such a company which is desirous of increasing its subscribed capital by the further issue of shares is required to comply with the procedure laid down in section 62 of the Companies Act, 2013.

Further shares shall be offered-

- to persons who, at the date of the offer, are holders of equity shares of the company in proportion, as nearly as circumstances admit, to the paid-up share capital on those shares by sending a letter of offer subject to the following conditions, namely:—
    - the offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;
    - unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice referred to in clause (*i*) shall contain a statement of this right;
    - after the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company;
- to employees under a scheme of employees' stock option, subject to [special resolution] passed by company and subject to such conditions

5.17 DELISTING OF SECURITIES

Delisting of securities means permanent removal of securities of a listed company from the stock exchange where it was registered. As a result of this, the company would no longer be traded at that stock exchange. It may happen either when the company does not comply with the guidelines of the stock exchange, or that the company has not witnessed trading for years, or that it voluntary wants to get delisted or in case of merger or acquisition of a com-

pany with/by some other company. So, broadly it can be classified under two headings:

1. **Compulsory delisting:** Compulsory delisting refers to permanent removal securities of a listed company from a stock exchange as a penalizing measure at the behest of the stock exchange for not making submission/comply with various requirements set out in the listing agreement within the time frames prescribed.

   A stock exchange may compulsorily delist the share of a listed company under certain circumstances like:

   - Non-compliance with the listing agreement for a minimum period of six months
   - Failure to maintain the minimum trading level of shares on the exchange
   - Promoters' 'Directors' track record especially with regard to insider trading, manipulation share prices, unfair market practices (e.g. returning of share transfer documents under objection on frivolous grounds with a view to creating scarcity of floating stock, in the market causing unjust aberrations in the share prices, auctions, close-out, etc. depending upon the trading position of directors or the firm)
   - The company has become sick and unable to meet current debt obligations or to adequately finance operations, or has not paid interests on debentures for the last 2-3 years, or has become defunct, or there are no employees, or liquidator appointed etc.

2. **Voluntary delisting:** In voluntary delisting, a listed company decides on its own to permanently remove its securities from a stock exchange. This happens mainly due to merger or amalgamation of one company

with the other or due to the non-performance of the shares on the particular exchange in the market.

5.18 LISTING CONDITIONS IN BSE

Listing requirement**s** are a set of conditions which a firm must meet before listing a security on one of the organized stock exchanges. A company intending to have its securities listed on BSE has to comply with the listing requirements prescribed by it. Some of the requirements are as under:

- Minimum Listing Requirements for New Companies
- Minimum Listing Requirements for Companies already Listed on other Stock Exchanges
- Minimum Requirements for Companies Delisted by BSE seeking relisting on BSE
- Permission to Use the Name of BSE in an Issuer Company's Prospectus
- Submission of Letter of Application
- Allotment of Securities
- Trading Permission
- Requirement of 1% Security
- Payment of Listing Fees
- Compliance with the Listing Agreement
- Cash Management Services (CMS) - Collection of Listing Fees

The listing norms for companies already listed on other stock exchanges and seeking listing at BSE, made effective from August 6, 2002, are that (i) the company shall have a minimum issued and paid up equity capital of Rs. 3 crore and (ii) the company shall have a profit making track record for the preceding last three years.

5.19 LISTING REQUIREMENTS FOR NSE

A company intending to have its securities listed on NSE has to comply with the following listing requirements:

- Company must be registered as a public company under Companies act 1956 or Companies act 2013.

- Company should be at least 3 years old and 2 years should be positive net worth.
- Post issue paid-up capital should not be more than 25 Cr.



CHECK YOUR PROGRESS

1. Write True or False

a) Securities listed in a stock exchange are marketable forever.

b) All listed companies are required to pay an Annual Listing Fees to the respective stock exchange.

c) A rights issue is an invitation to existing shareholders to purchase additional new shares in the company.

d) A bonus issue is also known as a scrip issue or a capitalization issue.

e) Bonus is offered to the existing shareholders against additional charges.



5.20 LET US SUM UP

We have discuses the following points in the unit :-

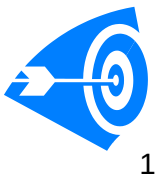
- A stock exchange deals only in the listed securities of certain selected companies.
- Listing means an act of inclusion of securities in the official list of a stock exchange for the purpose of trading.
- All listed companies are required to pay an Annual Listing Fees to the respective stock exchange.
- Every recognized stock exchange has the power to make byelaws for the listing of securities on the stock exchange.
- Central Government has the power to make or amend byelaws of recognized stock exchanges either on a request by the governing body of a stock exchange or on its own motion.

- Exchanges have listing requirements to ensure that only high quality securities are traded on them and to uphold the exchange's reputation among investors.
- The stock exchange reserves the right to cancel or suspend the permission granted following any breach of the obligations mentioned above.
- Listing of securities on the stock exchanges is advantageous to the company as well as to the investors.
- A rights issue is an invitation to existing shareholders to purchase additional new shares in the company.
- A bonus issue, also known as a scrip issue or a capitalization issue, is an offer of free additional shares to existing shareholders.



5.21 FURTHER READINGS

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services –By M. P. Tripathy
- Indian Financial System -By M Y Khan
- Website of the SEBI, NSE Ltd. and BSE Ltd.



5.22 ANSWERS TO CHECK YOUR PROGRESS

1. a) False b) True c) True d) True e) False



5.23 POSSIBLE QUESTIONS

1. Write short notes on the following:
   a) Need for listing of securities
   b) Listing procedures
   c) Listing of rights issue

d) Listing of bonus issue
e) Listing of further issue
f) Listing fee
g) Delisting

2. What do you mean by listing of securities? What are the procedures to be followed by a company for listing its securities in a stock exchange?
3. Enumerate the advantages and disadvantages of listing of securities.
4. Describe the listing conditions for listing in BSE and NSE.

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UNIT-6 : MERCHANT BANKING

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Nature and Characteristics of Merchant Banking

6.4 Classification of Merchant Banks

6.5 Functions/Services Offered by Merchant Bankers

6.6 Qualities Required of Merchant Bankers

6.7 Merchant Banking in India

6.8 SEBI Guidelines for Merchant Banking in India

6.9 Regulation of Merchant Banking in India

6.10 Registration/Pre-requisites for Merchant Bankers

6.11 Scope for Merchant Banking in India

6.12 Let Us Sum Up

6.13 Further Readings

6.14 Answers to Check Your Progress

6.15 Model Questions

6.1 LEARNING OBJECTIVES

After reading this unit you will able to:

- state the meaning and characteristics of merchant bank
- classify the merchant banks in India
- explain the functions and services provided by merchant banks
- enumerate the present structure of merchant banking in India
- explain the regulation of merchant banks in India
- discuss the scope of merchant banking in India

6.2 INTRODUCTION

Merchant banking is an essential part of financial sector of a country. Originally, the merchant banking business was established in Italy and Franch in the medieval period. A merchant banker in those days was a trader-cum-entrepreneur who added banking business with trading. In U.K. merchant bank-

ers came into existence by the end of the 18th century. In USA, a kind of merchant banking activity emerged through investment bankers in the early twentieth century. In India, merchant banking activities were initiated by the Grindlays Bank in 1967.

The term merchant banking is used differently in different countries and so there is no precise definition for it. In London, merchant banker refers to those who are members of British Merchant banking Securities House Association who carry on consultation, leasing, portfolio services, asset management, euro credit, loan syndication etc. In America, merchant banking is concerned with mobilizing savings of people and directing the funds to business enterprise.

In the Indian context, the notification of the Ministry of Finance defines merchant banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager-consultant, advisor or rendering corporate advisory services in relation to such issue management" The Amendment Regulation specifies that issue management consist of prospectus and other information relating to issue, determining financial structure, tie-up of financiers and final allotment and refund of the subscriptions, underwriting and portfolio management services.

6.3 NATURE AND CHARACTERISTICS OF MERCHANT BANKING

Merchant banking is skill based activities and involves serving every financial need of every client. It requires focused skill-base to provide for the requirements of the client. SEBI has made the quality of man-power as one of the criteria for registration as merchant banker. These skills should not be concentrated in issue management and underwriting alone, which may have an adverse impact on business. Merchant bankers can turn to any of the activities mentioned above depending upon resources, such as capital, foreign tie-ups for overseas activities and skills. The depth and sophistication in merchant banking business are improving since the avenues for participating in capital market activities have widened from issue management and underwrit-

ing to private placement, bought out deals (BODs), buy-back of shares, mergers and takeovers.

The services of merchant bank cover project counseling, pre investment activities, feasibility studies, project reports, design of capital structure, issue management, underwriting, loan syndication, mobilization of funds from non-resident Indians, foreign currency finance, mergers, amalgamation, takeover, venture capital, buy back and public deposits.

Characteristics of Merchant Banking

- High proportion of decision makers as a percentage of total staff
- Quick decision process
- High density of information
- Intense contact with the environment
- Loose organizational structure
- Concentration of short and medium term engagements
- Emphasis on fee and commission income
- Innovative instead of repetitive operations
- Sophisticated services on a national and international level
- Low rate of profit distribution
- High liquidity ratio

6.4 CLASSIFICATION OF MERCHANT BANKS

1. Public Sector Merchant Banks

- Commercial Banks (public)
- National Financial Institutions
- State Financial Institutions

2. Private Sector Merchant Banks

- Foreign Banks
- Indian Private Banks
- Leasing Banks
- Finance and Investment Companies

6.5 FUNCTIONS/SERVICES OFFERED BY MERCHANT BANKERS

Merchant banks in India are rendering varieties of financial, consultancy and allied services. The basic function of merchant banker or investment banker is marketing of corporate and other securities. In the process, it performs a number of services concerning various aspects of marketing, viz., origination, underwriting, and distribution, of securities. Earlier in India, when new issues were priced at a significant discount to their market prices, the merchant banker's job was limited to ensuring press coverage and dispatching subscription forms to every corner of the country. Now, merchant bankers are designing innovative instruments and perform a number of other services both for the issuing companies as well as the investors. The activities or services performed by merchant bankers, in India, today include:

- Project promotion services
- Project finance
- Management and marketing of new issues
- Underwriting of new issues
- Syndication of credit
- Leasing services
- Corporate advisory services
- Providing venture capital
- Operating mutual funds and off shore funds
- Investment management or portfolio management services
- Bought out deals
- Providing assistance for technical and financial collaborations and joint ventures
- Management of and dealing in commercial paper
- Investment services for non-resident Indians
- Public deposits
- Corporate counseling
- Project counseling and feasibility studies
- Mergers and amalgamations
- Debenture trusteeship

- Acceptance house business
- Issue management
- Export financing for capital goods
- Hire-purchasing financing
- Investment trusts
- Valuation of assets
- Financial management, etc.

1. Project Appraisal

This service helps corporates in analyze the soundness of a project, which may be setting up a new unit/expansion/modernization etc. It is a process of examining the technical, commercial, financial and economic viability of a project to ensure that it generates sufficient returns on the resources invested in it. The study of viability involves detached verification of project's ability to stand the tests of technical, financial and commercial feasibilities and management's capabilities to successfully implement and run the project. A service project report will be prepared for the company, including finalization of capital structure. Project appraisal includes:

- Financial appraisal (liquidity analysis, capital structure analysis, profitability analysis etc
- Technical appraisal (factors of production, technology, civil works, site location etc)
- Economic appraisal (also known as cost-benefit analysis, social cost, impact on employment, impact of the economy)

2. Syndication of Loan

Merchant Bankers arrange short, medium and long term loans for their clients. They analyze the pattern of clients cash flows, based on which the terms of borrowing can be defined. It then prepares a detailed loan memorandum which is circulated to various banks and financial institutions and they are invited to participate in the syndicate. The merchant banks then negotiate the terms of lending based on which the final allotment is done. It also arranges for

raising foreign exchange loans and external commercial borrowings for import of capital.

3. Issue Management

This is the primary function of merchant bankers. It refers to the management of securities offering of corporates to the general public and existing shareholders on rights basis. Merchant bankers act as lead managers and assists companies in arriving at quantum and nature of issue and obtaining consent/clearance from various statutory authorities, preparing draft prospectus, obtaining approval from appropriate authorities etc. it also assists companies in tying up with underwriters for the issue, appoint other intermediaries like brokers, bankers, advertising agents, registrar to the issue and co-ordinates the activities of these agencies and institutions from the successful flotation of the issue. It also helps in listing the securities in stock exchange, finalizing basis of allotment, arranging for refund, handling investor complaints etc. Merchant banks help companies raise funds by selling shares to the public by issuing prospectus. Shares may be issued at par, premium or discount.

4. Underwriting of Issues

In order to ensure full subscription or the stipulated minimum subscription of 90% of the issue; companies enter into an agreement with financial institutions, banks, brokers and bankers to underwrite the issue amount. Merchant bankers can underwrite issues and assist companies in tying up with other underwriters.

Underwriting is an agreement whereby the underwriter promises to subscribe to a specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of shares issues remains unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for the marketability of shares.

In the securities industry an underwriter is a company, usually an investment bank that helps companies introduce their new securities to the market. In the insurance business, an underwriter is a company liable for insured losses in return for a fee (premium). Underwriting is the process by which investment bankers raise investment capital from investors on behalf of

corporations and governments that are issuing securities (both equity and debt). It is also the process of issuing insurance policies.

5. Corporate Counseling

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

6. Bankers to the Issue

Collection of subscription money/application money for an issue from the investors, acknowledgement, proper accounting of the money received, sending reports/certificates, informing collection details are the services provided in the banker to the issue role.

7. Investment Counseling

This activity involved assisting firms, companies, trusts, funds and associations in the choice of shares and stocks for investment depending upon the needs and the risk-return trade-off, as well as taxation and time considerations.

8. Portfolio Management Services

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and securities issued by the government. It is not merely a collection of unrelated assets but a carefully blended asset combination within a unified framework. Hence, a portfolio is a collection of different kinds of investments. Portfolio management refers to maintaining proper combination of securities in a manner that they give maximum return within minimum risk. Merchant bankers provide portfolio management services to their clients. Today the investors are very prudent. Every investor is very interested in safety, liquidity and profitability of his investment. But investors cannot study and choose the appropriate securities. They need expert guidance. Merchant bankers have a role to play in this regard.

9. Registrar and Transfer Agent

Transfer agency work involves carrying out transfer work in respect of securities after complying with stipulated formalities/procedures. Preparation and printing of dividend warrants and dispatching them to share holders is also covered here. Other services include attending to complaints of applicants/investors, coding and verification of applications, allotment, processing and dispatching allotment letters, providing various documents and certificates etc.

10. Mergers, Amalgamations and Acquisitions

Some companies desire to restructure themselves in order to effectively meet competition. Merchant bankers provide all requisite guidance and services for restructuring, to prepare due diligence, necessary clearance from statutory bodies like SEBI, ROC etc. as per the statutory stipulations, for the process of mergers, acquisitions and amalgamations.

11. Venture Capital

Merchant bankers help the companies obtaining venture capital for financing their new and innovative strategies. Venture capital is a type of funding for a new or growing business. It usually comes from venture capital firms that specialize in building high risk financial portfolios. With venture capital, the venture capital firm gives funding to the startup company in exchange for equity in the startup.

12. Leasing Finance

Merchant bankers also help in leasing services. Lease is a contract between the lessor and lessee, whereby the lessor allows the issue of his specific asset such as equiptment by the lessee for a certain period. The lessor charges a fee called rentals.

13. Non-resident Investment

Merchant bankers provide investment advisory services to attract NRI investment in primary and secondary markets, undertake buying and selling of securities on their behalf, secure clearances from RBI under FEMA for repatriation of interest and dividends etc.

14. Joint Ventures

Merchant bankers help corporate bodies with joint ventures in India and abroad.

6.6 QUALITIES REQUIRED OF MERCHANT BANKERS

Merchant bankers play a significant role as a catalyst to transform the project ideas into industrial ventures. They help promotion of the enterprise by undertaking various activities such as market surveys, choice of suitable location and its size, preparation of documents and obtaining consent from various authorities. They help in taking important decisions such as financing mix, management of public issues, credit syndication etc. the success of the merchant bankers depends on the quality of service and soundness of advice to clients. To perform these services effectively the merchant bankers are expected to process certain qualities which are described bellow:

- Ability to analyse various aspects such as technical, financial and economic aspects concerning the formation of an industrial project.
- Knowledge about the various aspects of capital markets, trends in stock exchange, psychology of investing public, change in economic and technological environment in the country.
- Ability to build up the bank-client relationship and live up to the clients' expectations with total involvement in the project assigned to them.
- Innovative approach in developing capital market instruments to satisfy the ever changing needs of investing public.
- Integrity and maintenance of high professional standards are the essential requisites for the success of merchant bankers' present scenario.

CHECK YOUR PROGRESS

1. Answer as directed:

a)_____ is the regulatory body of merchant banking in India. (Fill in the gap)

b) Merchant banks in India started in _____. (Fill in the gap)

6.7 MERCHANT BANKING IN INDIA

The Banking Commission Report in 1972, in view of the widening industrial base of the country, stressed the need for merchant banking in India. As a matter of fact, the Grindlays Bank initiated the merchant banking activity in Indian capital market in 1967. Their business form was on the management of public issues and financial consultancy. Citibank introduced its merchant banking division in 1970. Following the recommendations of the Banking Companies (1072), the State Bank of India established its merchant banking division in 1973. The more was followed by the ICICI in starting merchant banking services in 1974. The mid-seventies onwards there was a mushroom growth of merchant banking sector as several banks including Bank of Baroda, Canara Bank, Mercantile Bank, United Bank of India, among others and well as IFCI and IDBI, besides many NBFCs started providing merchant banking services.

By 1995, there were 934 merchant banks registered with the SEBI which include 34 commercial banks with subsidiaries institutions, 21 states institutions, 10 international banks with subsidiaries, 8 financial institutions banks, 7 foreign financial investments, 4 leasing, 16 private banks, and 834 financial and investment companies. The SEBI has categorized them into four groups. Category I contained over 40 percent of merchant bankers. In 1997, however this classification was discontinued and only category I remained. The minimum net worth for this category is ₹ 5 crores and the registration fee was 2.5 lakhs for two initial years and 1 lakh in the third year.

6.8 SEBI GUIDELINES FOR MERCHANT BANKING IN INDIA

The guidelines set by the Securities and Exchange Board of India (SEBI) for the merchant banking are:

- **Recognition:** To start merchant banking activities in India merchant bankers must get recognition from the SEBI. The SEBI grants recognition based on their professional competence, capital adequacy, experience, reputation, and the quality of their employees and infrastructure.
- **Application process:** While applying for recognition, the applicants must provide:
  - An undertaking
  - A declaration from at least two directors

- Details of businesses handled in the last three years
- A detailed report from principal bankers
- Details of associated registered intermediaries
- A reference to the object clause of the company's Memorandum and Article of Association
- The UIN obtained under MAPIN

· **Capital adequacy:** High capital adequacy norms set for authorization by the SEBI (Merchant Bankers) Regulations, 1992.

· **Activities to be focused on:** Merchant banking companies must focus solely on securities market activities. Proposed regulations restrict merchant banker activities to:

- Issue management
- Buyback
- Delisting
- Underwriting
- Private placement of listed or proposed to be listed securities
- Advisory services related to these activities

6.9 REGULATION OF MERCHANT BANKING IN INDIA

The Securities and Exchange Board of India (SEBI) is the regulatory body of merchant banking in India. The SEBI has laid down code of conduct for the merchant bankers to follow and they are also required to submit their annual balance sheet, profit & loss account, etc. along with their working result. The SEBI is also authorized to inspect the books of accounts, records and other documents of the merchant banks. In the case of defaulters, the SEBI can suspend or cancel their registration.

In essence, merchant bankers are basically identifiable as issue houses. They undertake pre-issue and post-issue management. The SEBI's guidelines in this context are to be adhered to by the merchant bankers. The merchant bankers are required to ensure that the prospectus of the client companies must provide the necessary information as per the Companies Act, 1956 and the SEBI's guidelines. For underwriting activity they need to obtain a certified copy of registration from the SEBI.

The main objective of the merchant banking regulation is to control the raising of funds in the primary market and ensure cost-effectiveness. The SEBI is striving a fair, efficient and flexible primary market with such regulations. The merchant banking activity in India is govern by:

- Guidelines given by the Securities and Exchange Board of India (SEBI) and Ministry of Finance
- Companies Act, 1956
- Securities guidelines of Stock Exchange

Licensed merchant bankers have to register with the SEBI. The registration of merchant banking is compulsory for the activities such as:

- Debenture trusteeship
- Authorisation
- Portfolio management
- Capital issues pre and post
- Takeover by acquisition of shares

6.10 REGISTRATION/PRE-REQUISITES FOR MERCHANT BANKERS

Registration with SEBI is mandatory to carry out the business of merchant banking in India. An applicant should comply with the following norms:

- Applicant should be a body corporate.
- Applicant should have minimum net worth of 5 crore.
- Applicant must have at least 2 employees with prior experience of merchant banking.
- Applicant should have necessary infrastructure like office space, equipment, manpower etc.
- Applicant should not carry on any business other than those connected with the securities market and must have necessary experience in the same.
- Applicant should not have been involved in any securities scam, proved guilty for any offense or been accused of moral turpitude.
- Any associate co, group co, subsidiary or inter-connected co of applicant should not have been a registered merchant banker.

6.11 SCOPE FOR MERCHANT BANKING IN INDIA

1. Growth of New Issues Market: The growth of new issue market is unprecedented since 1990-1991. Merchant banking can help with the further sophistication and penetration of the new issues market.

2. Entry of Foreign Investors: Foreign institutional investors were allowed to invest in the primary and secondary market in 1992 and also, Indian companies were allowed to directly tap foreign capital through euro issues. Further, foreign direct investment by NRIs has risen considerably due to number of incentives offered to them. They need the services of merchant bankers to advise them for their investment in India. The increasing number of joint ventures abroad by Indian companies also requires expert services of merchant bankers.

3. Hanging Policy of Financial Institutions: The policy of decentralization, increase in demand for technical and financial services and encouragement of small and medium industries, requires the services of merchant bankers.

4. Development of Debt Market: The development of debt market will offer tremendous opportunity to Merchant Bankers.

5. Innovations in Financial Instruments: The Indian capital market has witnessed innovations in the introduction of financial instruments. This has further extended the role of merchant bankers as market makers for these instruments.

6. Corporate Restructuring: Due to liberalization and globalization, competition in the corporate sector is becoming intense. To survive and thrive, companies need new strategies, structures and methods of functioning. This has led to corporate restructuring including mergers, acquisitions, etc. These developments offer a good opportunity to merchant bankers to extend their area of operations.

7. Disinvestment: The government of India has raised ₹ 2000 crores through disinvestment of equity shares of selected public sector undertakings in 93-94. Merchant Bankers can help in the disinvestment process.



CHECK YOUR PROGRESS

2. Answer as directed:

a) Merchant banks concept in India introduced by _____. (Fill in the gap)

b) Credit card is a prepaid card. (Write True or False)



6.12 LET US SUMUP

In this unit we have discuss the following:

- The services of merchant bank cover project counseling, pre investment activities, feasibility studies, project reports, design of capital structure, issue management, underwriting, loan syndication, mobilization of funds from non-resident Indians, foreign currency finance, mergers, amalgamation, takeover, venture capital, buy back and public deposits.
- Merchant banking is skill based activities and involves serving every financial need of every client.
- Merchant bankers play a significant role as a catalyst to transform the project ideas into industrial ventures.
- Grindlays Bank initiated the merchant banking activity in Indian capital market in 1967.
- The Securities and Exchange Board of India (SEBI) is the regulatory body of merchant banking in India.



6.13 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services –By M. P. Tripathy
- Indian Financial System -By M Y Khan

6.14 ANSWERS TO CHECK YOUR PROGRESS

1. (a) SEBI (b) 1969
2. (a) ANZ Grindlays (b) False

6.15 MODEL QUESTIONS

1. Write short notes on the following:
   a) Portfolio management
   b) Project counseling
   c) Traveller's Cheques
2. Define Merchant Banking? Explain its Nature and characteristics.
3. What are Merchant Bankers? Discuss briefly the financial services provided by merchant bankers in Indian capital market?
4. Put a light on the scope for Merchant Banking in India.
5. Write an essay on Classification of Merchant Banking.

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UNIT 7 : TRADING AND SETTLEMENT SYSTEM IN STOCK EXCHANGES

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Meaning of Stock Exchange

7.4 Functions of Stock Exchange

7.5 Features of Stock Exchange

7.6 Bombay Stock Exchange (BSE)

7.7 BSE-BOLT System

7.8 Bad Delivery

7.9 Short Delivery

7.10 Auction of Shares

7.11 National Stock Exchange (NSE)

7.12 Order Types and Books

7.13 Demat Settlement

7.14 Physical Settlement

7.15Funds Settlement

7.16 Valuation Debit

7.17 Valuation Price

7.18 Let Us Sum Up

7.19 Further Readings

7.20 Answers to Check Your Progress

7.21 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning, features and functions of stock exchange
- know about the stock exchanges in India
- understand the BSE and NSE
- to learn about the trading procedure on a Stock Exchanges

- know different types of settlements
- enumerate the meaning of pay-in and pay-out, bad delivery, short delivery, NEAT system, Demat settlement, funds settlement, valuation debit, valuation price etc.

7.2 INTRODUCTION

It is essential for the success of a recognised stock exchange that there must be written and codified rules, bye-laws and regulations to ensure smooth conduct of business in the stock exchange. Rules of trading, clearing and settlement of transactions should be very clear to avoid misunderstandings, to ensure rapid dealings and prompt settlements, to prevent artificial price fluctuations, to encourage a large volume of trade by building confidence in the investors, to educate the investors regarding the malpractice followed by companies and speculators etc. This unit deals with trading, clearing and settlement mechanism followed by various stock exchanges.

7.3 MEANING OF STOCK EXCHANGE

Stock exchange is an important institution in the capital market. It is a secure place where trading is done in a systematic way. Here, the secored how securities are bought and sold as per well-structured rules and regulations. Securities mentioned here include debenture and share issued by a public company, debenture and bonds issued by the government bodies, municipal and public bodies.

7.4 FUNCTIONS OF STOCK EXCHANGE

Some of the significant functions of the Stock Exchange are listed below:

- **Economic Barometer:** A stock exchange is a solid barometer to gauge the economic circumstance of a country. A stock exchange is also known as a pulse of the economy or economic mirror which reflects the economic conditions of a country.
- **Pricing of Securities:** The stock market helps to assess the securities on the basis of demand and supply factors. The securities of effective and growth-oriented organisations are estimated higher as there is more demand for such securities.

- **Safety of Transactions:** In the stock market only the indexed securities are traded and stock exchange authorities include the corporations named in the trade list only after verifying the soundness of the organisation. The organisations which are listed also have to function within the stringent rules and regulations. This guarantees the security of dealing through the stock exchange.
- **Contributes to Economic Growth:** In stock exchange securities of various organisations are traded. This method of disinvestment and reinvestment helps to invest in the most productive investment proposal and this leads to capital structure and economic growth.
- **Spreading of Equity Cult:** Stock exchange urges people to invest in ownership securities by managing new issues, better trading practices and by educating the people about investment.
- **Providing Scope for Speculation:** To assure liquidity and demand of supply of securities the stock exchange allows healthy consideration of securities.
- **Liquidity:** The principal purpose of the stock market is to present a ready market for sale and purchase of securities. The presence of the stock exchange market gives certainty to investors that their investment can be transformed into cash whenever they want.
- **Better Allocation of Capital:** The shares of profit-making organisations are valued at higher prices and are actively traded so such organisations can efficiently raise capital from the stock market.
- **Promotes the Habits of Savings and Investment:** The stock market gives attractive chances for investment in different securities. These attractive opportunities inspire people to save more and invest in securities of the corporate sector rather than investing in unfruitful assets such as gold, silver, etc.

7.5 FEATURES OF STOCK EXCHANGE

- **A market for securities:** It is a wholesome market where securities of government, corporate companies, semi-government companies are bought and sold.
- **Second-hand securities:** It associates with bonds, shares that have already been announced by the company once previously.
- **Regulate trade in securities:** The exchange does not sell and buy bonds and shares on its own account. The broker or exchange members do the trade on the company's behalf.
- **Dealings only in registered securities:** Only listed securities recorded in the exchange office can be traded.
- **Transaction:** Only through authorised brokers and members the transaction for securities can be made.
- **Recognition:** It requires to be recognized by the central government.
- **Measuring device:** It develops and indicates the growth and security of a business in the index of a stock exchange.
- **Operates as per rules**: All the security dealings at the stock exchange are controlled by exchange rules and regulations and SEBI guidelines.

7.6 BOMBAY STOCK EXCHANGE (BSE)

BSE is an Indian stock exchange located at Dalal Street, Mumbai and operates with a vision of to "*Emerge as the premier Indian stock exchange with best-in-class global practice in technology, products innovation, and customer service."* It is one of the two principal large stock exchanges of India and was founded by Mr. Premchand Roychand, famously known as the Cotton King, the Bullion King or the Big Bull. He was one of the most influential Indian businessmen of the 19th century and made a fortune in the stock-broking business.

Established in 1875, BSE is the oldest and first stock exchange of Asia and was formerly known by the name of -The Native Share & Stock Brokers Association. But the story of BSE starts back in the 1850s when 22 stockbrokers would gather under banyan trees in front of Mumbai's Town Hall. Location

of these meetings changed multiple times to accommodate an increasing number of brokers. The group eventually moved to Dalal Street in the year 1874. BSE is an integral component of the "$1 trillion" club, having the 11th largest market capitalisation value at $2.2 trillion.

In the year 1986, Sensex was introduced, as the first equity index to provide a base for identifying the top 30 trading companies of the exchange, in more than 10 sectors. Apart from Sensex, other important indices of BSE are BSE 100, BSE 200, BSE 500, BSE MIDCAP, BSE SMLCAP, BSE PSU, BSE Auto, BSE Pharma, BSE FMCG, BSE Metal, etc.

a) Working of Bombay Stock Exchange (BSE):

In 1995, the BSE switched from an open-floor to an electronic trading system. Today electronic systems dominate the financial industry overall, offering fewer errors, faster execution, and better efficiency than traditional open-outcry trading systems. Securities that the BSE lists include stocks, stock futures, stock options, index futures, index options, and weekly options. The BSE's overall performance is measured by the Sensex, an index of 30 of the BSE's largest stocks covering 12 sectors.

Financial transactions in BSE are done online through an electronic trading system. Market orders can be directly placed in BSE online, without the requirement of external specialists through direct market access. Due to the absence of such limit orders, focus is shifted from buyers/sellers to the total value of transactions in a day.

Trading in the BSE share market has to be done through a brokerage agency, against a stipulated charge. However, direct investment access is given to certain preferential investors making large transactions in the BSE stock market. BOLT-Bombay Online trading platform is used by this stock exchange for efficient trading.

Transactions made in BSE online are done through T+2 rolling settlement, wherein all transactions are processed within two days. Securities and Exchange Board of India (SEBI) is responsible for the regulation of this stock exchange, continuously updating rules for its smooth operation.

Recently BSE has launched new software for trading called BEST (BSE Electronic Smart Trader). It can be downloaded directly from Android play store and an investor can enjoy zero transaction charges for 6 months on cross currency derivatives.

b) Trading/Settlement Process at BSE:

i) Step 1: Finding a Broker

A broker acts as an intermediary or a mediator between the investor and the stock exchange. The work of a broker is transfer of order electronically from the investor to the exchange. The brokers should be selected on the following basis:

- Watching out for fees taken for opening an online trading account
- Having a proper look at ratings and customer service.
- Brokerage charge for intraday trading
- Brokerage charge on selling a long held share
- Margin provided by the broker on intraday trading
- The broker must provide information regarding investment opportunities on a regular basis.

ii) Step 2: Opening Account with the Broker

Having selected a broker it is time to open an online trading account with the broker. A broker always opens a trading account in the name of the investor/ client only if he/she is satisfied about the credit worthiness of the client. If the broker feels satisfied with the client he/she will open the account by writing the client's name in the broker's book. The minimum requirement for opening a trading account is PAN card, and bank account failing to which the account cannot be opened.

iii) Step 3: Placing the Order

After the account is opened successfully a notification will be provided via email or message. Then the investor can begin the trading as per his/her

wish. The trading or investment is done by purchasing a specified number of shares of a particular company. Different online trading platforms follow different symbols to mark the order placing. Order can also be placed via a telephonic call with the broker. There are different types of orders:

c) Share Groups on BSE

Stock classification is the process of grouping stocks for ease of understanding**.** In India both BSE (Bombay Stock Exchange) and NSE (National Stock Exchange) classifies stocks. More or less the classification of stocks is similar on both platforms. Mainly there are seven grades of stocks namely, A, B, T, S, TS & Z. All other stocks which fail the characteristics of any one of these grades were kept in others. These grades are scores of stocks on the basis of their size, liquidity and exchange compliance.

i) A Group stocks - highly liquid stocks

- The stocks fall in the category of A Group, are the most liquid counters among all the stocks listed on the BSE.
- The market rates A Group stocks as excellent in all aspects and they also show comparatively high traded volume during trading.
- Settlement of A Group stocks trades is done under the normal rolling settlement process.

ii) T Group stocks - the stocks in trade-to-trade

- The stocks fall under T group follows trade-to-trade settlement system of the exchange.
- Each trade in this group is seen as a separate transaction and there is no netting-out of trades as in the rolling system
- The traders, who buy shares of this category or sell the script of this group, have to pay the amount or deliver the shares by T+2 days.
- For example, you bought 100 shares of T Group and sold another 100 shares on the same day. Then, the shares you have bought, you will have to pay the price of those shares in two days. And for the shares you have sold, you will have to make the delivery of shares by T+2 days, so that Exchange can make the settlement on time.

- Stocks of T group are regularly moved in and out of trade-to-trade settlement depending on the speculative interest that governs them.

iii) S Group stocks - small and medium stocks

- The stocks of 'S Group' fall under the BSE's Indonext segment.
- The BSE Indonext comprises small and medium companies that have a listing in the regional Stock Exchange.
- Generally, the turnover of S grade companies is rupees 5 crore and tangible assets of rupees 3 crore.
- Apart from the small size of the company, the other risk that comes with investing in them is low liquidity.

iv) TS Group stocks - it is a mix of T & S groups

- TS group is the combination of T & S group of shares.
- It consists of stocks in the "BSE-Indonext" segments also.
- These category stocks settle on a trade-to-trade basis as a surveillance measure.

v) Z Group stocks – caution to retail investors

- The companies of Z grade stocks have not complied with the exchange's listing requirements that have failed to redress investor's complaints.
- This grade also includes stocks of companies that have dematerialization arrangement with only one of the two depositories – CDSL and NSDL.
- The stocks of Z category are the riskiest scripts. Not much information is available to such companies in the public domain.
- These companies have low media coverage that keeps them relatively hidden from public scrutiny that makes such scripts more vulnerable to insider trading.
- Z Group companies already have a poor score in redressing investor complaints.

vi) B Group stocks - stocks that are left behind

- B Group comprises stocks that don't fall in any of the other groups.
- These counters see normal volumes and settle under the rolling system.

vii) Other classification

- Tradable financial instruments which are other than companies' stocks, form "Others". Group G & F falls under "others".
- The exchange also facilitates trading in fixed income securities, like company deposits. These instruments form F Group.
- Retail investors trade in government securities like long-dated GOI bonds on the exchange. Instruments of government securities come in Group G.

7.7 BSE-BOLT SYSTEM

Online trading in India has changed the meaning of trading in the country. With no requirement for a broker, trading has become easier, faster and far more convenient than earlier days. There is no need for any paperwork through online investing and the need for a middleman is eliminated. All the stock accounts are stored in Demat account where they can be viewed. The Bombay Stock exchange (BSE) provides an efficient and transparent market for trading in debt instruments, equity and derivatives. BSE online trading was established in 1995 and is the first exchange to be set up in Asia. This is performed through a system known as BOLT (BSE's Online Trading System).

Now all scrips on BSE are being traded through BOLT. The brokers and their agents conduct trading under the BOLT system from their Trading Work Stations (TWS). At every TWS, the BOLT system displays 'touchline' which will share the best bid and offer prices presently available in the market. The BOLT system also displays at every TWS 'market view' which will provide detailed market information on each listed stock.

7.8 BAD DELIVERY

A stock that cannot be transferred, especially because of improperly filed paperwork or another fairly innocuous reason, is called bad delivery. One of the biggest problems faced by the investors in the secondary market is that of bad delivery which arises out of rejection of physical shares sent it to the companies by the buyers for getting them transferred in their names.

In order to help the buyers BSE has set up a Bad Delivery Cell (BDC) based upon the Uniform Norms for Good/Bad Deliveries formulated by SEBI.

BDC follows a weekly cycle for acceptance of objections and rectifications. The cycle commences every Tuesday, on which the objections are accepted in the clearing house. The members have a facility of directly uploading the bad delivery claims in the BDC backend software and can download the various reports issued by the BDC, by using the BDC upload-download software. The physical/objection documents are accepted in the clearing house only if the data has been successfully loaded in the BDC backend software.

7.9 SHORT DELIVERY

In the equity segment whenever a share is bought or sold, and not squared off on the same day (i.e. non-intraday trades), such transactions result into delivery transactions. This means that if the shares are bought, the client needs to pay the full amount and take the delivery of shares in his Demat account. Similarly, if the shares are sold for delivery, the client has to give the shares to the exchanges to be transferred to the corresponding buyer. If the seller fails to deliver the shares (whether partially or fully), it is known as 'Short Delivery of Shares'.

Stock markets in India operate on T+2 rolling settlement cycles. Simply put, shares bought on Monday (T day) are settled on Wednesday (T + 2 day). Shares sold on Monday (T day) are to be settled/delivered on Wednesday (T + 2 day).

7.10 AUCTION OF SHARES

In the equity segment, shares can be sold for delivery only if the shares are available in the Demat account of the client. The client needs to transfer the shares to the exchanges on T+2 days. If the client fails to transfer the shares within the stipulated time, such transaction results into default of pay-in obligation and short delivery of shares.

The buyer of the shares is the rightful acquirer of the shares and the shares needs to be transferred to his account. Since the seller has defaulted in delivery of the shares, the exchange would put the undelivered shares for 'Auction'. This Auction will happen on the T+2 day itself. In the auction session, people who already have shares in the Demat account can offer their shares.

The auction window time is between 2.00 p.m. to 2.45 p.m. Clients of the broker where the default has happened cannot participate for the auction in the same script. The auction price is taken at the lowest price offered in the auction. The highest price would be not more than 20% and not less than 20% of the closing price of the T+1 day i.e. the previous day prior to settlement day. If the shares are offered, the shares are given to the buyer of the shares on T+3 day. The seller has to pay the price for the shares offered in the auction, which is generally higher than the market price prevailing on the day.

7.11 NATIONAL STOCK EXCHANGE (NSE)

NSE is the youngest stock exchange of India which came into picture in the year 1992 and operates with a vision, "*To continue to be a leader, establish a global presence, and facilitate the financial well-being of people.***"**

In 1992, for the very first time in India, NSE introduced the advanced electronic trading system which removed the paper-based settlement system from trading and offered an easy trading facility. One year later, in the year 1993, NSE was set up as a tax paying company, which later on registered itself as a Stock Exchange under the Securities Contract Regulation Act. In the year 1995, National Securities Depository Limited (NSDL) was formed to provide depository services to the investors.

NSDL allows investors and traders to securely hold and transfer their stocks electronically along with this, it also allows investors to hold and trade in as few as one share or one bond. Nifty 50 the popular benchmark index in the Indian stock market, was introduced by NSE in the same year. Nifty lists out top 50 companies which traded on the NSE stock exchange market.

a) Market Segments in NSE:

The NSE operates the following sub-segments in the equities segment:

- **Rolling Settlement:** In a rolling settlement, each trading day is considered as a trading period and trades executed during the day are settled based on the net obligations for the day. At NSE, trades in rolling

settlement are settled on a T+2 basis i.e. on the 2nd working day. For arriving at the settlement day all intervening holidays, which include bank holidays, NSE holidays, Saturdays and Sundays are excluded. Typically trades taking place on Monday are settled on Wednesday, Tuesday's trades settled on Thursday and so on.

- **Limited Physical Market:** Pursuant to the directive of SEBI to provide an exit route for small investors holding physical shares in securities mandated for compulsory dematerialised settlement, the Exchange has provided a facility for such trading in physical shares not exceeding 500 shares. This market segment is referred to as 'Limited Physical Market' (small window). The Limited Physical Market was introduced on June 7, 1999.
- **Institutional Segment:** The Reserve Bank of India had vide a press release on October 21, 1999, clarified that inter-foreign-institutional-investor (inter-FII) transactions do not require prior approval or post-facto confirmation of RBI, since such transactions do not affect the percentage of overall FII holdings in Indian companies. To facilitate execution of such Inter-Institutional deals in companies where the cut-off limit of FII investment has been reached, the Exchange introduced a new market segment on December 27, 1999.
- **Qualified Foreign Investor (QFI) Segment:** SEBI vide circulars CIR/ IMD/FII&C/3/2012 dated January 13, 2012, CIR/ IMD/ FII&C/ 4/ 2012 dated January 25, 2012 provide guideline for Investment by Qualified Foreign Investors (QFI) in Indian Equity Shares. As per the SEBI circular, when the aggregate shareholding of all the QFIs in a company reaches 8% of the equity paid up capital, the company's name along with ISIN shall be published in caution list by the depositories and no fresh purchases shall be allowed without prior approval of the depositories.
- **Trade for Trade Segment:** The scrips in Trade for Trade segment are made available for trading under BE series. The settlement of scrips available in this segment is done on a trade for trade basis and no

netting off is allowed. The criteria for shifting scrips to/from Trade for Trade segment are decided jointly by the Stock Exchanges in consultation with SEBI and reviewed periodically.

- **Block trading Session:** The SEBI vide letter MRD/DoP/SE/Cir - 19/05 dated September 02, 2005 and CIR/MRD/DP/118/2017 dated October 26, 2017 guidelines outlining a facility of allowing Stock Exchanges to provide separate trading window to facilitate execution of large trades. The Exchange has introduced new block window mechanism for the block trades from January 01, 2018.
- **Post Close Session:** In accordance with SEBI letter SMD/Policy/9916/2003 dated May 20, 2003 notifying scheme / guidelines outlining a facility of providing Trading Session after normal market hours in Capital Market Segment, 'Closing Session' has been introduced by the Exchange from June 16, 2003.

b) NEAT System Operation in NSE:

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NEAT is a screen-based trading system. NSE also offers 'NEAT Plus' package that provides members trading in multiple markets on the exchange with a unified trading interface. NSE consciously opted in favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs. The NEAT system has four types of market. They are:

- **Normal Market:** All orders which are of regular lot size or multiples thereof are traded in the Normal Market. For shares that are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as Regular lot orders, Special Term orders, Negotiated Trade Orders and Stop Loss orders depending on their order attributes.
- **Odd Lot Market:** All orders whose order size is less than the regular lot size are traded in the odd-lot market. An order is called an odd lot order if the order size is less than regular lot size. These orders do not

have any special terms attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place. Currently the odd lot market facility is used for the Limited Physical Market as per the SEBI directives.

- **Auction Market:** In the Auction Market, auctions are initiated by the Exchange on behalf of trading members for settlement related reasons. There are 3 participants in this market.
    i) Initiator -the party who initiates the auction process is called an initiator
    ii) Competitor -the party who enters orders on the same side as of the initiator
    iii) Solicitor -the party who enters orders on the opposite side as of the initiator

7.12 ORDER TYPES AND BOOKS

The NSE trading system provides complete flexibility to members in the kinds of orders that can be placed by them. Orders are first numbered and time-stamped on receipt and then immediately processed for potential match. Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different 'books'. Orders are stored in price-time priority in various books. Price priority means that if two orders are entered into the system, the order having the best price gets the higher priority. Time priority means if two orders having the same price are entered, the order that is entered first gets the higher priority.

The Equities segment has following types of books:

- **Regular Lot Book:** The Regular Lot Book contains all regular lot orders that have none of the following attributes attached to them.
    - All or None (AON)
    - Minimum Fill (MF)
    - Stop Loss (SL)

- **Special Terms Book:** The Special Terms book contains all orders that have either of the following terms attached:
    - All or None (AON)
    - Minimum Fill (MF)
- **Stop-Loss Book:** Stop Loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the Regular lot book. The stop loss condition is met under the following circumstances:
    - Sell order: A sell order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order.
    - Buy order: A buy order in the Stop Loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.
- **Odd Lot Book:** The Odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot order against passive orders in the book. Currently, pursuant to a SEBI directive, the Odd Lot Market is being used for orders that have quantity less than or equal to 500 viz. the Limited Physical Market.
- **Auction Book:** This book contains orders that are entered for all auctions. The matching process for auction orders in this book is initiated only at the end of the solicitor period.

7.13 DEMAT SETTLEMENT

Investing in equity shares in physical form entails a lengthy procedure, lot of paperwork and risk of getting fake shares. In order to keep the entire experience easy and streamlined, a Demat account is required. While trading online, Demat account is used to hold shares and securities in dematerialised/

electronic format. Under dematerialisation, share certificates are converted from physical form to electronic form so as to increase their accessibility.

Settlement of securities is a business process whereby securities or interests in securities are delivered. Settlement involves the delivery of securities from one party to another. Delivery usually takes place against payment known as delivery versus payment. It is mandatory to have a Demat account in order to purchase shares since trading equity involves delivery of shares. Demat accounts allow for electronic transactions when shares of stock are bought and sold.

It is similar to a bank account with the bank where the record of debit/ credit balances are maintained in a bank passbook. In the same way, when the Demat account holder purchases or sells shares, it will be credited or debited to/from the Demat Account respectively. One can open a Demat Account without possessing any shares and can maintain a zero balance in your account.

7.14 PHYSICAL SETTLEMENT

Settlement by physical delivery is carried out by clearing brokers or their agents. Immediately, after the last day of trading, the regulated exchange's clearing organization shall report a sale and a purchase of the underlying asset at the prior day's settlement price (normally the closing price). Traders who hold a short position in the physical settlement of futures contract to expiration are required to deliver the underlying asset. Traders not owning them are obligated to buy them at the current price and those who already own the assets have to hand it over to the requisite clearing organization.

As stated by SEBI, starting from July 2018 expiry, Future and Option (F&O) positions are being moved from cash settlement mode to compulsory physical delivery settlement in a phased manner. Starting from October 2019 expiry, all stock F&O contracts will be compulsorily physically settled. If you hold a position in any Stock F&O contract, at expiry, you will be required to give/take delivery of stocks.

7.15 FUNDS SETTLEMENT

Funds settlement refers to the transfer of funds from buyer to seller and the transfer of an asset's title from seller to buyer. When an investor sends an order to his or her broker, that trade information is sent to a clearing house. The clearing house processes and records the trade, and then issues a report to the broker/dealers involved that includes their net securities positions and the money to be settled among the parties. Funds settlement also occurs for dividend payments.

7.16 VALUATION DEBIT

On the settlement day NSE Clearing accepts pay-in of securities made by members through depositories and identifies the shortages. The members are debited by an amount equivalent to the securities not delivered and valued at a valuation price. This is known as valuation debit. For all such short deliveries NSE Clearing conducts a buying-in auction on the T+2 day, after completion of the pay-out, through the NSE trading system. If the buy-in auction price is more than the valuation price, the Cash market (CM) is required to make good the difference. All shortages not bought-in are deemed closed out.

7.17 VALUATION PRICE

Valuation Price means the value of each restricted stock unit or performance stock unit based on the average of the closing prices on the stock exchange for shares for the 10 trading days preceding the valuation date. A trading day is any day that the shares are traded on the stock exchange. Valuation price is the price per unit as determined by dividing the agreed value by the aggregate number of units issued and outstanding as of the end of the fiscal period utilized in calculating the agreed value.



CHECK YOUR PROGRESS

Write the full form of the following:

a) CDSL

b) BOLT

c) BEST

d) TWS

e) BDC

f) QF

Ig) NEAT

h) F&O

i) DTCC

j) NSDL



7.18 LET US SUM UP

In this unit we have discuss the following:

- Stock exchange is an important factor in the capital market where the securities are bought and sold as per well-structured rules and regulations.
- The first organised stock exchange in India was started in Mumbai known as Bombay Stock Exchange (BSE).
- At present we have 23 stock exchanges in the country.
- Established in 1875, BSE is the oldest and first stock exchange of Asia and was formerly known by the name of -The Native Share & Stock Brokers Association.
- In the year 1986, Sensex was introduced, as the first equity index to provide a base for identifying the top 30 trading companies of the exchange, in more than 10 sectors.
- BSE is performed through a system known as BOLT (BSE's Online Trading System).
- A stock that cannot be transferred, especially because of improperly filed paperwork or another fairly innocuous reason, is called bad delivery.

- If the seller fails to deliver the shares (whether partially or fully), it is known as 'Short Delivery of Shares'.
- NSE is the youngest stock exchange of India which came into picture in the year 1992 and operates with a vision, '*To continue to be a leader, establish a global presence, and facilitate the financial well-being of people.*'
- NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NEAT is a screen-based trading system.
- While trading online, Demat account is used to hold shares and securities in dematerialised/electronic format.
- Funds settlement refers to the transfer of funds from buyer to seller and the transfer of an asset's title from seller to buyer.



7.19 FURTHER READINGS

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathywebsites of BSE and NSE



7.20 ANSWERS TO CHECK YOUR PROGRESS

a) Central Depository Services Limited
b) Bombay On-line Trading
c) BSE Electronic Smart Trader
d) Trading Work Stations
e) Bad Delivery Cell
f) Qualified Foreign Investors
g) National Exchange for Automated Trading

h) Future and Option

i) Depository Trust & Clearing Corporation

j) National Securities Depository Limited



7.21 MODEL QUESTIONS

1. Write short notes on the following:
   a) Bombay On-line Trading (BOLT)
   b) National Exchange for Automated Trading (NEAT) System
   c) Pay-in and pay-out
   d) Bad delivery
   e) Short delivery
   f) Demat settlement
   g) Physical settlement
2. Write an overview on Indian Stock Exchange.
3. Enumerate the features and functions of stock exchange.
4. Discuss about the settlement procedures in BSE.
5. Write a note on NSE. Explain the market segments of NSE.
6. What do you mean by institutional segment? Mention the salient features of Institutional segment.

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UNIT 8 : OVER THE COUNTER STOCK EXCHANGES AND FOREIGN STOCK EXCHANGES

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning and Definition of OTCEI

8.4 Need for Starting OTCEI

8.5 Features of OTCEI

8.6 Constituents of OTCEI

8.7 Advantages of OTCEI

8.8 Listing Requirements in OTCEI

8.9 Trading Process on OTCEI

8.10 Market Making

8.11 New York Stock Exchange (NYSE)

8.12 Trading Floor

8.13 NYSE Trading Floor

8.14 Players on Trading Floor

8.15 Role of Specialist

8.16 Role of Depositories and Depository Participants (DPS)

8.17 Electronic Communication Networks (ECNs)

8.18 Let Us Sum Up

8.19 Further Reading

8.20 Answers to Check Your Progress

8.21 Possible Questions

8.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and structure of OTCEI
- know the need, features and participants of OTCSI
- describe the advantages and disadvantages of OTCEI
- explain the rules for listing procedures, trading and settlement in OTCEI

- state the meaning of foreign exchange
- interpret the trading norms, players and role of NYSE
- state the meaning and composition of NASDAQ
- enumerate composition of foreign exchange markets

8.2 INTRODUCTION

The Indian capital market has witnessed sweeping changes over the last few years. There were new instruments and new institutions. The existing stock exchanges were insufficient in infrastructure facilities to cope up with the new situation. In order to overcome the pitfalls and loop-holes of the existing system, a new institution came into existence in 1990 and started functioning in 1992. This unit discusses about the various aspects of that particular new institution i.e. Over the Counter Exchange of India (OTCEI).

8.3 MEANING AND DEFINITION OF OTCEI

The over-the-counter exchange of India (OTCEI) concept is a great innovation in the Indian Stock market. It is a recognized stock exchange under the Securities Contract (Regulations) Act, 1965 as well as the Indian Companies Act. OTCEI is a computer based screen system exhibiting the quotations of the scrips of the companies of different industries of the nation. It has a national network and there is no geographical barrier for listing. Dealers and Investors can take decisions on the spot more quickly than on the regular stock exchanges. It is a great boom to the small and marginal investors who are greatly neglected till today.

The over-the-counter exchange of India (OTCEI) is an electronic stock exchange based in India that consists of small and medium sized firms aiming to gain access to the capital markets like electronic exchanges in the U.S. such as the NASDAQ. he first electronic OTC stock exchange in India was established in 1990. There is no central place of exchange, and all trading occurs through electronic networks. Over-the-counter (OTC) or off-exchange trading is done directly between two parties, without the supervision of an exchange. It is contrasted with exchange trading, which occurs via exchanges.

Over the Counter Exchange of India (OTCEI) can be defined as a stock exchange without a proper trading floor. All stock exchanges have a specific place for trading their securities through counters. But the OTCEI is connected through a computer network and the transactions are taking place through computer operations.

8.4 NEED FOR STARTING OTCEI

Many small companies in India are finding it difficult to raise adequate capital through stock exchanges as the conditions stipulated by them could not be fulfilled. The companies must have run for minimum three years and they must have earned profit and the minimum capital requirement for listing is also quite high. Hence by promoting a new stock exchange with flexible conditions, the small and medium companies in India will be able to raise sufficient capital. Once these companies enlarge their resources, they can list themselves in the regular stock exchanges. The need for OTCSI in India is to facilitate the following services:

- Hybrid Trading System
- Sponsorship of Companies
- Cost Effective
- Ideal for Start-up Companies
- Enhanced Visibility and Recognition
- Assist in Forging Partnership
- Specialist exchange for technology and growth companies

8.5 FEATURES OF OTCEI

Following are the features of OTCEI due to which it has an edge over other stock exchanges in the country:

- **Ring less Trading:** For greater accessibility to the investor, the OTC Exchange has eliminated the trading ring. Trading will take place through a network of computers of OTC dealers located at several places within the same city and even across cities. The exchange allows dealers to

quote, query and transact through a central OTC computer using telecommunication links.

- **National Reach:** Unlike other stock exchanges, the OTC Exchange has a nationwide reach. This enables widely dispersed trading across cities, resulting in greater liquidity. Companies thus, have the unique benefit of nationwide listing and trading of their scrips by listing at just one exchange, the OTC exchange.
- **Computerized:** All the activities of the OTC trading process are computerized. This facilitates a more transparent, quick and disciplined market. The trading mechanism brings out these features of the system.
- **Exclusive List of Companies:** The OTC Exchange will not list and trade in companies listed on any other exchange. It will list an entirely new set of companies, sponsored by members of the OTC Exchange.
- **Authorized Dealers:** All members and dealers are authorized and approved by the OTCEI
- **Liquidity through Market Making:** The sponsor-member requires day quotes (buy and sell) for the 12 months from the date of commencement of trading. Besides compulsory market maker, there are additional market maker and voluntary market maker who give two way quotes for the scrip.
- **Efficient Market Pricing:** Competition among market makers produces efficient pricing. This reduces spreads between buy and sell quotations. It also increases the capacity to absorb larger volumes, to the benefit of investors'.The market makers continually analyze companies and provide information about them to their investors, thus helping investors to make an informed investment decision.
- **Transfer of Securities:** Investors are required to be submittd transfer deeds to any of the OTCEI counters for transferring the shares in their names. Shares are automatically transferred in the name of the investors.

- **Investor Registration:** For buying and selling of shares on the OTCEI, investor needs "INVESTOTC Card". Application for "INVESTOTC Card" can be made at any of the counters of OTCEI and also at the time of applying for new issues on the OTCEI.
- **Transparency of Transactions:** At the OTC Exchange, the investor can see the available quotations on the computer screen at the dealer's office before placing the order. The confirmation slip/trading document generated through the computer gives the exact price of the transaction and the brokerage charge. So the investor's interest is totally safeguarded.
- **Faster Delivery and Payment:** On the OTC Exchange, the transaction is settled within a period of 7 days.
- **Sponsorship:** The companies that seek listing on the OTC Exchange have to approach one of the members appointed by the OTC for acting as a sponsor to the issue. The sponsor makes thorough appraisal of the project, resulting in investors getting a choice of quality companies.
- **Listing of Small and Medium Sized Companies:** In the past, many small and medium sized companies were not able to enter the capital market, due to the listing requirement of the Securities Contract (Regulation) Act, 1956. The Act specified that a minimum issued equity capital of Rs. 3 crores and maximum 25 crores for issuing. The OTC Exchange provides an ideal opportunity to these companies to enter the Capital market.
- **Bought-Out Deals:** Through the concept of bought-out deals, OTCEI allows companies to place their equity meant to be offered to the public with the sponsor -member at a mutually agreed price. This ensures swifter availability of funds to companies for timely completion of projects and a listed status at a later date.

8.6 CONSTITUENTS OF OTCEI

OTCEI commenced its operations in 1992. In OTCEI, we have the following parties taking part in various transactions. They are:

- Companies

- Dealers
- Members
- Investors
- Custodian or Settlers
- Transfer agents
- OTCEI
- Government
- SEBI

There are three types of intermediaries exist in OTCEI:

- Members
- Dealers
- Sponsors

8.7 ADVANTAGES OF OTCEI

The Advantages of OTCEI towards the companies, the investors, and the economy at large are described below:

a) To Companies:

- Provides method of raising funds through capital market instruments which are priced fairly. In OTCEI the company will be able to negotiate the issue price with the sponsors who will market the issue.
- Saves unnecessary issue expenses on raising funds from capital markets. The method of sponsors pricing the scrips with members of OTCEI who will in turn, off – load the scrips to public will obviate the need for a public issue as we know them today. Therefore, almost all associated costs will be eliminated.
- Offer documents of companies seeking listing on OTCEI will not be vetted by SEBI. Such companies shall only file their offer documents with SEBI and SEBI will communicate its comments to the issuer company and lead manager within 21 days.

- Retains greater degree of management stability. The OTC Exchange will list scrips even with 40% of the capital made available for public trading.
- Provides greater accessibility to large pool of captive investor base. This enhances fund raising power substantially. OTC Exchange will create a nationwide network, where investors will be serviced who will form the captive investor base for companies.

b) To Investor:

- Investment in stocks becomes easier. OTC Exchange's wide network will bring the stock exchange to the street corner.
- Provides greater confidence and fidelity of trade. Investor can look up the prices displayed at each OTC counter. He knows he is trading scrips at the right market price.
- Enables transactions to be completed quickly. Investors can settle the deals across the counter and the money or scrip proceeds from the deal will be settled in a matter of days if not earlier.
- Provides definite liquidity to investors. The market making system will have two way prices which are quoted regularly to provide sufficient opportunity for investors to exit.
- Investors may get a greater sense of security because researchers have been researched and members to get their considered opinion.

c) To Economy:

- OTC Exchange will help spread the stock exchange operations geographically and integrate capital market investment into a forum.
- Encourages closely held companies to go public,
- Encourages venture capital activities to boost entrepreneurs.

8.8 LISTING REQUIREMENTS IN OTCEI

The members of the OTCEI will invite companies to list on the exchange for raising capital. There are dealers who perform the dual role of a broker and

market maker. A broker acts on behalf of buyer or seller, while a market maker has a responsibility to make available the particular share in the maker for transactions and to maintain reasonable price through supply and demand forces. For any company to list its shares in OTCEI it requires sponsorship by members of the OTCEI and it must also have two market makers. The OTCEI has also laid down rules regarding listing requirements.

- Once a company lists its securities in the market, it cannot delist its securities for a minimum period of 3 years.
- There are certain norms to be fulfilled by companies for sale of equity shares or any other securities under bought out deal (i.e., a company at its early stage may issue shares with an understanding that it will buy back after 5 years at the market price from out of its profits.)
- 20% of the issued capital should be retained by the promoters for a period of not less than 3 years.
- There should be two market makers as per the guidelines of OTCEI.

8.9 TRADING PROCESS ON OTCEI

The trading mechanism on OTCEI is quite different to other stock exchanges. It is based on a created tradable document called Counter Receipt (CR). Share certificates have to be converted to CR to begin trading. A Sale Confirmation Slip (SCS) is given to an investor when he sells the CR and the transaction is completed.

A listed company may either make a direct sale to the public or offer for sale and bought out offer. If an investor purchases a security at a public offer he is issued a counter receipt which gives information about the investor as well as the company, share price, date of transaction, brokerage and total value of transactions. When an investor wishes to sell the security, he has to produce the counter receipt (CR).

One can trade in securities by going to any counter of the OTCEI. All the counters are linked with the central computer at the OTCEI headquarter. This office is in Mumbai. There can be three types of trading on the OTCEI (i) Initial Allotment (ii) Buying in Secondary Market (iii) Selling in Secondary Market

- **Initial Allotment**

When an investor is allotted shares through the medium of OTCEI, he is given a receipt which is called Counter Receipt - CR. This receipt is just like the share certificate. Selling and buying can be done through the medium of this receipt.

- **Buying in the Secondary Market:**

For the purpose of buying shares listed on the OTCEI. a person has to get himself registered. After this, he informs the counter operator about the number of the shares to be purchased. The counter operator displays the rates on the screen. After getting himself satisfied with the rate, the investor hands over the cheque to the operator. On the encashment of the cheque, the CR is handed over to the investor. This procedure normally takes about a week.

- **Selling in the Secondary Market:**

Any investor who has purchased shares from the OTCEI can sell his shares at any counter of the OTCEI. After getting himself satisfied with the rate displayed on the screen, the investor hands over the Counter Receipt and the Transfer Deed to the Operator. The operator prepares the Sales Confirmation Slip (SCS) and a copy of it is handed over to the seller. The operator sends the CR, TD and SCS to the Registrar for confirmation. After confirming every detail the Registrar sends them back to the counter operator. In the end the operator issues a cheque to the seller and receives back the SCS from the seller.

8.10 MARKET MAKING

Market making is the process of giving two way (buy/sell) quotes for securities, for a specific period as defined under the Exchange rules. The market makers generate investor's interest by quoting the buying and selling rates and creating a competitive environment. Market makers provide liquidity by buying and selling securities. They analyse companies and provide information to investors.

There are three kinds of market makers. These are compulsory market maker, additional market maker and voluntary market maker. The principal and

additional market makers offer buy and sell quotes in the securities of a company for the first 18 months and 12 months from listing respectively. The principal and additional market makers subscribe to such percentage of the total offer to the public as decided by OTCEI, for the purpose of market making. Minimum net worth to undertake principal/additional market making assignments should be Rs.1 crore. Maximum permissible spread between buy and sell quotes is 5% except for securities whose market price is below Rs.10/-, where the maximum spread between buy and sell quotes is Rs.1.00.

Advantages of market making:

To Companies:

- Continuous source of liquidity for the company's scrips
- Provides valuation for the company's scrips
- Company benefits from the analysis and information dissemination function of the market makers

To Investors:

- Continuous source of liquidity, which means he can liquidate his investment any time he chooses
- Competition among market makers reduces spreads and produces efficient pricing
- Source of company information

Types of Market Makers:

- **Principal Market Makers (PMM):** These market makers have to offer buy and sell quotes for a period of at least 18 months from the commencement of initial trading in the company's scrip.
- **Additional Market Maker (AMM):** Such market makers will offer buy & sell quotes for a period of at least one year from the commencement of initial trading.

8.11 NEW YORK STOCK EXCHANGE (NYSE)

The New York Stock Exchange (NYSE) is a stock exchange located in New York City that is the largest equities-based exchange in the world, based on the total market capitalization of its listed securities. Formerly run as a private organization, the NYSE became a public entity in 2005 following the acqui-

sition of electronic trading exchange Archipelago. In 2007 a merger with Euronext, the largest stock exchange in Europe, led to the creation of NYSE Euronext, which was later acquired by Intercontinental Exchange, the current parent of the New York Stock Exchange.

It is an American stock exchange. It was founded on 17th may 1972. It is located at 11 Wall Street, Lower Manhatten, New York City, United States. Its trading floor is located at 11 Wall Street and is composed of 21 rooms used for the facilitation of trading.

a) Features of NYSE

- It is the world's largest stock exchange by market capitalization of its listed companies at US$ 19233 billion as of 31th January 2015.
- The average daily trading value was approximately US$ 19 billion in 2013.
- The number of listings as on may, 2015 were 1868.
- The NYSE is owned by Intercontinental Exchange, an American holding company.
- The New York stock exchange also referred to as "the BIG BOARD".
- THE NYSE is open for trading Monday through Friday with the exception of holidays declared by the Exchange in advance.
- The NYSE trades in a continuous auction format where traders can execute stock transactions on behalf of investors.
- The NYSE opening bell in rung at 9.30 AM ET to mark the start of the day's trading session. At 4 PM ET the closing bell id rung and trading for the day stops.
- The major indices are Dow Jones Industrial average, standard & poor 500, and NYSE composite.
- Its official website is NYSE.com

Key Players of the NYSE

- **Specialists:** Specialists are brokers dealing in a particular stock who remain at one location on the trading floor. They help level out the sup-

ply and demand of stocks available in the market. According to the U.S. Securities and Exchange Commission, “They do this by stepping in with their own capital to help reduce market volatility when there are not sufficient buyers or sellers.” Most specialists are in charge of trading 5-10 stocks. They track their trades and quotation changes in an ‘order book.’

- **Floor Traders:** They trade exclusively from their own accounts but can also act on behalf of others and receive commission for their services. Like their name indicates, these are the people seen on the floor of the stock exchange.

8.12 TRADING FLOOR

Trading floor refers to an area where trading activities in financial instruments, such as equities, fixed income, futures etc., takes place. Trading floors sit in the buildings of various exchanges, such as the New York Stock Exchange (NYSE) and the Chicago Board of Trade (CBOT) etc.

The trading floor is also referred to as the pit of an exchange. This is due to the fact that, initially, the trading floor was circular in design, and traders had to step into the arena to conduct their desired transactions. Factor in the hectic, frenzied nature that accompanies this type of activity, and one can see that the moniker is quite descriptive. However, with the advent of electronic trading platforms, many of the trading floors that once dominated market exchanges have disappeared as trading has become more electronically based.

8.13 NYSE TRADING FLOOR

The NYSE trading floor is located at 11 Wall Street in New York City and has been in its current location since 1865. The exchange installed telephones in 1878, which provided investors with direct access to traders on the NYSE trading floor. Today, most of the transactions that take place on the trading floor are automated and execute in less than a second. A bell is rung on the trading floor to signal the opening and closing of each day’s trading.

In an era where trading floors are becoming a relic of the past, the NYSE announced in 2017 that it would allow all U.S. stocks and exchange–traded funds to trade on its trading floor, increasing the number of securities that could be traded on the trading floor from roughly 3,500 to about 8,600. This expansion was completed in the first half of 2018.

Trading floors aren't unique to the New York Stock Exchange. In fact, you'll find trading floors at the Chicago Board of Trade and in investment banks and brokerage houses. The general purpose of a trading floor is to give traders a specific place where they can buy and sell stocks and options. Before the electronic era, trading relied heavily on these trading floors. However, today's automation has replaced the need to trade in person and, in fact, much of the activity that happens each day on the New York Stock Exchange takes place at a data centre located in the suburbs of New Jersey. The Nasdaq **doesn't have a trading floor at all**, with all trading taking place electronically.

8.14 PLAYERS ON TRADING FLOOR

Brokerages, investment banks and other companies involved in trading activities can also have trading floors. In this case, it refers to the physical office location that houses the trading division, which can complete transactions over the internet or telephone. There are many different types of traders that can be found on trading floors. The most common are the floor brokers, who are tasked with trading on behalf of clients. Other types of traders include hedgers, scalpers, spreaders, and position traders.

8.15 ROLE OF SPECIALIST

A specialist is a member of a stock exchange who acts as the market maker to facilitate the trading of a given stock. A specialist holds an inventory of the particular stock, posts the bid, and asks prices, manages limit orders and executes trades. If there is a large shift in demand on the buy or sell side, the specialist steps in and sells off his own inventory as a way to manage large movements and to meet the demand until the gap between supply and demand narrows.

Most specialists trade 5 to 10 stocks at a time on any given trading day. There is usually one specialist per stock who stands ready to step in and buy or sell as many shares as needed to ensure a fair and orderly market in that security. Each specialist has a particular spot on the floor of the exchange, called a trading post, where the buying and selling of stock occurs. Floor traders, who act on behalf of customers and buy and sell the stock, gather around a specialist's trading post to learn the best bid and ask offers for security or stock. Specialists execute a trade when bid and ask orders match.

Specialists also buy or sell the stock when it reaches a certain price. If a floor trader's bid is above the ask price, but then the ask price rises to match the bid price later, the specialist then fills the order. Before the stock market opens for the trading day, specialists attempt to find a fair opening price for a stock. If a specialist can't find a fair opening price, he may delay trading on a particular stock as part of his overall role.

A specialist has four major roles to fill. He acts as an auctioneer to show brokers the best bids and offers. A specialist also continually updates floor brokers to act as a catalyst for buying and selling. He places an order on behalf of brokers and places orders for customers ahead of his own. Despite all of these duties, the number of specialists has declined, thanks to electronic trading.

It is the specialist's job to act in a way that benefits the public above all. Every specialist accomplishes this by filling the four vital roles of (1) auctioneer, (2) catalyst, (3) agent and (4) principal. Let's take a closer look at what a specialist does in fulfilling each of these roles:

- **Auctioneer -**Shows best bids and offers, becoming a market maker.
- ***Catalyst*** -Keeps track of the interests of different buyers and sellers and continually updates them.
- ***Agent*** -Places electronically routed orders on behalf of clients. Floor brokers can leave an order with a specialist, freeing themselves up to take on other orders. Specialists then take on the responsibilities of a broker.

- **Principal** -Acts as the major party to a transaction. Since specialists are responsible for keeping the market in equilibrium, they are required to execute all customer orders ahead of their own.

8.16 ROLE OF DEPOSITORIES AND DEPOSITORY PARTICIPANTS (DPS)

In the entire settlement process, there is another important intermediary known as the depository. A depository is an institution that holds and facilitates the exchanges of securities. In India, the two depositories are the National Securities Depository Limited (NSDL) and the Central Depository Service (India) Limited (CDSL). These depositories allow brokers to deposit securities so that activities such as book entry and record keeping services can be performed.

In order to trade in the secondary market, the security should be held in electronic form by the investor. DPs or Depository Participants (usually your broker firm) act as intermediaries between the depository and the investor. They are involved in the dematerialisation and transfer of securities. In addition, the settlement of securities is done through the demat account that the investor holds with the DP.

8.17 ELECTRONIC COMMUNICATION NETWORKS (ECNs)

An electronic communication network (ECN) is a computerized system that automatically matches buy and sell orders for securities in the market. It connects major brokerages and individual traders so they can trade directly between themselves without going through a middleman and make it possible for investors in different geographic locations to quickly and easily trade with each other. The U.S. Securities and Exchange Commission (SEC) requires ECNs to register as broker-dealers.

An ECN makes money by charging a fee for each transaction to meet financial obligations. It attempts to eliminate the third party's role in executing orders entered by an exchange market maker or an over-the-counter market

maker and permits such orders to be entirely or partly executed. Orders placed through ECNs are usually limit order.

The use of the ECN allows investors a way to trade outside traditional trading hours, providing a mechanism for those who either can't be actively involved during normal market times or who prefer the flexibility offered by wider availability. It also avoids the wider spreads that are common when using a traditional broker and provides overall lower commissions and fees. For those concerned about privacy, the ECN can provide a level of anonymity to those who desire it. This can be particularly attractive to investors interested in making larger transactions.

One of the biggest drawbacks to using an ECN is the price to pay for using one. Access fees and commission charges can be costly and are difficult to avoid. Per-trade-based commissions can be costly and can affect your bottom line and your profitability.



CHECK YOUR PROGRESS

Write the full form of the following:

a) OTCEI

b) OTC

c) CR

d) SCS

e) OASIS

f) PMM

g) AMM

h) NYSE

j) ECNs

j) SEC

k) CBOT



8.18 LET US SUM UP

In this unit, we have discuss the following :-

- OTCEI is a recognized stock exchange under the Securities Contract (Regulations) Act, 1965 as well as the Indian Companies Act.
- It has a national network and there is no geographical barrier for listing.
- Dealers and Investors can take decisions on the spot more quickly than on the regular stock exchanges.
- The first electronic OTC stock exchange in India was established in 1990.
- Over the Counter Exchange of India (OTCEI) can be defined as a stock exchange without a proper trading floor.
- OTC Exchange of India introduced several new concepts in the Indian trading system.
- The need for OTCSI in Indian financial system is enormous.
- There are dealers who perform the dual role of a broker and market maker.
- A broker acts on behalf of buyer or seller, while a market maker has a responsibility to make available the particular share in the maker for transactions and to maintain reasonable price through supply and demand forces.
- Market making is the process of giving two way (buy/sell) quotes for securities, for a specific period as defined under the Exchange rules.
- The New York Stock Exchange (NYSE) is the largest equities-based exchange in the world, based on the total market capitalization of its listed securities.
- An electronic communication network (ECN) is a computerized system that automatically matches buy and sell orders for securities in the market.



8.19 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- OTCEI Website



8.20 ANSWERS TO CHECK YOUR PROGRESS

a) Over the Counter Exchange of India

b) Over-the-counter

c) Counter Receipt

d) Sale Confirmation Slip

e) Automated Securities Integrated System

f) Principal Market Makers

g) Additional Market Maker

h) New York Stock Exchange

i) Electronic Communications Networks

j) Securities and Exchange Commission

k) Chicago Board of Trade



8.21 MODEL QUESTIONS

1. Write short notes on the following:

   a) OTCEI

   b) Listing procedures in OTCEI

   c) Market making

   d) Foreign stock exchange

e) New York Stock Exchange

2. Give the meaning of OTCEI. Enumerate its role in Indian financial system.

3. Discuss about the listing requirements and procedures in OTCEI. Mention the advantages of OTCEI.

4. Write an explanatory note on New York Stock Exchange.

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UNIT 9 : STOCK MARKET INDICES

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Meaning of Stock Market Indices

9.4 Purposes of Calculating Stock Index

9.5 Need for Indices

9.6 Usefulness of Indices

9.7 Consideration in Developing Indices

9.8 Methods for Calculating Stock Market Index

9.9 Stock Indices in India

9.10 Scrip Selection Criteria

9.11 Guidelines for Selection of 'A' Group Companies At BSE

9.12 Overview of Stock Market Indices in Foreign Countries

9.13 Let Us Sum Up

9.14 Further Reading

9.15 Answers to Check Your Progress

9.16 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and need of stock market indices
- know the purposes of stock market indices
- describe the advantages and disadvantages of stock market indices
- explain the methods of calculating stock market indices
- know about the stock market indices in India
- understand about the stock market indices in foreign countries

9.2 INTRODUCTION

People often speak about that the stock market fell one day, or that the market jumped another day. What does it mean? It is so because of up and down of stock indices. Stock index reflects overall market sentiment and direction of price movements of products in the financial, commodities or any other markets. Any change taking place in the underlying stock prices impact the overall value of the index. If the prices of most of the underlying securities rise, then the index is said to be risen, and vice-versa. This unit discusses about the meaning, purposes, methods of calculate stock market indices India.

9.3 MEANING OF STOCK MARKET INDICES

A market index is a hypothetical portfolio of investment holdings which represents a segment of the financial market. The calculation of the index value comes from the prices of the underlying holdings. Some indices have values based on market-cap weighting, revenue-weighting, float-weighting, and fundamental-weighting. Weighting is a method of adjusting the individual impact of items in an index.

A Stock Market Index is a statistical measure of the relative value of a group of stocks in numerical terms. A stock market index shows changes taking place in the stock market. An index is important to measure the performance of investments against a relevant market index. It is used to give information about the price movements of products in the financial, commodities or any other markets. Stock market indexes are meant to capture the overall behaviour of equity markets. Financial indexes are constructed to measure price movements of stocks, bonds, T-bills and other forms of investments.

A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market. To create an index, a few similar kinds of stocks are chosen from amongst the securities already listed on the exchange and grouped together. The criteria of stock selection could be the type of industry, market capitalisation or the size

of the company. An Index is calculated with reference to a base period and a base index value. The value of the stock market index is computed using values of the underlying stocks.

Some of the notable indices in India are as follows:

- Benchmark indices like NSE Nifty and BSE Sensex
- Broad-based indices like Nifty 50 and BSE 100
- Indices based on market capitalization like the BSE Smallcap and BSE Midcap
- Sectoral indices like Nifty FMCG Index and CNX IT

9.4 PURPOSES OF CALCULATING STOCK INDEX

There are thousands of companies listed on stock markets, making it almost impossible to monitor each company. This is why stock market indices are created. Market indices bring together a select group of company stocks and regularly measure them to show the performance of the overall market or a certain segment of the market.

In short, an index helps investors understand the health of the stock market enables them to study the market sentiment and makes it easy to compare the performance of an individual stock. The Sensex and Nifty-50 are two popular benchmark indices that largely reflect the performance of Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). To understand how each sector of the stock market is doing, there are sectoral indices such as Nifty Bank, Nifty Auto etc.

Stock market indexes can be useful to follow for a few key reasons:

- Tracking the most-followed stock market indexes can give you a general sense of the health of the overall stock market.
- Tracking lesser-known indexes can help you see how a particular segment of the market is performing compared to the market as a whole.

- If you don't want to invest in individual stocks but rather simply want to match the performance of the overall market, then a cost-effective way to earn solid returns over time is by investing in index funds that track the stock market indexes you're most interested in.
- Stock market indexes make it easier to know how the market is performing without having to follow the ups and downs of every individual stock. They also open up simple investment opportunities that even novice investors can use to participate in the long-term success of the stock market.

9.5 NEED FOR INDICES

Indices are an important part of the stock market and therefore of investments. Here's why we need stock indices for:

a) **Sorting:** In a share market, there are thousands of companies listed. It is very difficult for an investor to differentiate between all of those and pick one or two to buy. And then sort them out. This is where indices come into the picture. Companies and their shares are classified into indices based on key characteristics like size of company, sector or industry they belong to.

b) **Representation:** An Index act as a representative of the entire market or a certain segment of the market. In India, the BSE Sensex and the NSE Nifty are considered the benchmark indices. They are considered to represent the overall market performance.

c) **Comparison:** An index makes it easy for an investor to compare performance. Indices can be used as a benchmark to compare against performance. If a equity has outperformed the market, you simply compare the price trends of the index and the stock. An index can also be used to compare a set of stocks against a benchmark or another index. This also helps investors identify market trends easily.

d) Reflection: Investor sentiment is a very important aspect of stock market movements. This is because, if sentiment is positive, there will be demand for a stock. This will then lead to a increase in prices. It is very difficult to gauge investor sentiment correctly. Indices help reflect investor's mood, not just for the overall market, but even sector wise and across company sizes. You can simply compare an index with a benchmark to see if has underperformed or outperformed. This will, in turn, reflect investor sentiment.

e) Passive investment: Many investors prefer to invest in a portfolio of securities that closely comparable to an index. This process of investment is called passive investment. An index portfolio helps investors cut down cost of research and equity selection process. They rely on the index for stock selection for their investment. As a result, portfolio returns will match that of the index. For example, if Sensex gave 9 % returns in 6 month, an investor's portfolio that resembles the Sensex is also likely to give the same amount of returns. Indices are also used to construct mutual funds and exchange-traded funds.

9.6 USEFULNESS OF INDICES

An Index is used to give information about the price movements of products in the financial, commodities or any other markets. Financial indexes are constructed to measure price movements of stocks, bonds, T-bills and other forms of investments. Stock market indexes are meant to capture the overall behaviour of equity markets. A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market. Stock market indexes are useful for a variety of reasons. Some of them are:

- They provide a historical comparison of returns on money invested in the stock market against other forms of investments such as gold or debt.

- They can be used as a standard against which to compare the performance of an equity fund.
- It is a lead indicator of the performance of the overall economy or a sector of the economy.
- Stock indexes reflect highly up to date information.

9.7 CONSIDERATION IN DEVELOPING INDICES

An index is made up of similar stocks based on market capitalization, industry or company size. Upon selection of stocks, the index value is computed. Each stock will have a different price and price change in one stock would not be proportionately equal to the price change in another. So, the value of the index value cannot be arrived at as a simple sum of the prices of all the stocks. Each stock in the index is assigned a particular weightage based on its market capitalization or price. The weight represents the extent of the impact that the stock's price change has on the value of the index.

The two most commonly used stock market indices are as follows:

- **Market-cap weightage:** Market capitalization refers to the total market value of the stock of a company. It is calculated by multiplying the total number of outstanding stocks floated by the company with the share price of a stock. It, therefore, considers both the price as well as the size of the stock. In an index which uses market-cap weightage, the stocks are assigned weightage based on their market capitalization as compared to the total market capitalization of the index.

  Suppose a stock has a market capitalization of Rs. 50,000 whereas the underlying index has a total market-cap of Rs. 1,00,000. Thus, the weightage given to the stock will be 50%. It is important to note that market capitalization of a stock changes every day with the fluctuations in its price. Due to this reason, weightage of the stock would change daily. But usually such a change is marginal in nature. Moreover, the companies with higher market-caps get more importance in this method.

  In India, free-float market capitalization is used by most of the indices. Here, the total number of shares listed by a company is not

used to compute market capitalization. Instead, use only the amount of shares available for trading publicly. Consequently, it gives a smaller number than the market capitalization.

- **Price weightage:** In this method, the value of an index value is computed based on the stock price of a company rather than the market capitalization. Thus, the stocks which have higher prices receive greater weightages in the index as compared to the stocks which have lower prices. This method has been used in The Dow Jones Industrial Average in the US and the Nikkei 225 in Japan.

9.8 METHODS FOR CALCULATING STOCK MARKET INDEX

There are various methods for calculating the stock market index. In this post, we will discuss some of the major methods to calculate stock market index.

1. **Full Market Capitalisation method:** In this method, to determine the scrips weighted in the index, the number of shares outstanding is multiplied by the market price of companies' shares. The share with the highest market capitalisation would have a higher weighted in the index and would be most influential in the index. In the end, Market capitalisation of all companies will be added and it will be the final value of that index.

   The number of shares outstanding means the total number of shares currently held by all its shareholders, including shares held by institutional investors and restricted shares owned by the company's officers and insiders. S&P 500 index in the USA uses this method.
2. **Free Float Market Capitalisation method:** Free Float is the percentage of shares available in the market for trading. It excludes restricted shares held by the government in the form of strategic investment, shares held by companies' officers and insiders, shares locked under employee stock option plan etc. Companies in the index are provided with the free float factors based on its percentage of shares in free

float. Free float ranges from 0.05 to 1.0 Value of index through this method is calculated using following steps.

3. **Modified Capitalisation Weighted:** This method seeks to reduce the effect of largest stock in the index which would otherwise dominate the value of the index. This method sets a limit on percentage weight of the largest stock in the group of stocks. NASDAQ 100 uses this method.
4. **Price weighted Index:** In price-weighted index calculation method, each stock influences the index in proportion to its price per share. The value of the index is calculated by adding the prices of each stock in the index and dividing them by the total number of stocks. Stocks with a higher price are given more weight which has a greater influence on the performance of the index. Dow Johns Industrial Average uses this method.
5. **Equal Weighing:** In this method, percentage weight of every stock in the index is equal. So, all the stocks have equal influence on the index value. Kansas City Board of Trade (KCBT) uses this method.

9.9 STOCK INDICES IN INDIA

Stocks are sold and bought in Indian stock market as a group. The mix of various stocks has a number of indexes. These are used to benchmark the performance in terms of the economy. The groups are on the basis of the segment or industry. It can also be on the basis of the company size or some other.

Most of the trading in the Indian stock market takes place on its two stock exchanges, i.e. the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). The BSE has been in existence since 1875. The NSE, on the other hand, was founded in 1992 and started trading in 1994. However, both exchanges follow the same trading mechanism, trading hours, settlement process, etc. The BSE has about 4,700 listed firms, whereas the rival NSE has about 1,200. Out of all the listed firms on the BSE, only about 500 firms constitute more than 90% of its market capitalization. Following are the different Indices India:

9.9.1. Broad Market Indices

These indices are broad-market indices, consisting of the large, liquid stocks listed on the Exchange. They serve as a benchmark for measuring the performance of the stocks or portfolios such as mutual fund investments.

a) Bombay Stock Exchange (BSE) Indices - SENSEX

SENSEX stands for Stock Exchange Sensitive Index. The BSE Sensex (S&P Bombay Stock Exchange Sensitive Index), also-called the BSE 30 or simply the Sensex, is a free float market weighted stock market index of 30 well established and financially sound companies listed on Bombay Stock Exchange. The 30 component companies which are some of the largest and most actively traded stocks are representative of various industrial of the Indian economy. Sensex is the stock market index indicator for the BSE. It was first published in 1986.

How is Sensex calculated?

The calculation of Sensex is done by a Free-Float method that came into existence from September 1, 2003. The level of Sensex is a direct indication of the performance of 30 stocks in the market. The free-float method takes into account the proportion of the shares that can be readily traded in the market. This does not include the ones held by various shareholders and promoters or other locked-in shares not available in the market.

First, the market capitalization is taken into account. This is done by multiplying all the shares issued by the company with the price of its stock. Then BSE determines a Free-float factor that is a multiple of the market capitalization of the company. This helps in determining the free-float market capitalization based on the details submitted by the company. Then, Ratio and Proportion are used based on the base index of 100. This helps to determine the Sensex.

b) National Stock Exchange (NSE) Index - NIFTY

Full form of NIFTY is ‘National Stock Exchange Fifty’. The NIFTY 50 index is National Stock Exchange of India’s benchmark stock market index for

Indian equity market. Nifty is owned and managed by India Index Service and Products (IISL). The NIFTY 50 covers 13 sectors of the Indian economy and offers investment managers exposure to the Indian market in one portfolio. Nifty is the market indicator of NSE. It ideally is a collection of 50 stocks but presently has 51 listed in it. It is also referred to as Nifty 50 and CNX Nifty by some as it is owned.

How is Nifty calculated?

Nifty is also calculated through the free-float market capitalization weighted method. Just like Sensex, Nifty also follows a mathematical formula based to know the market capitalization. The equity capital is multiply with a price to derive the market capitalization. To determine the Free-float market capitalization, equity capital is multiplied by a price which is further multiplied with IWF, which is the factor for determining the number of shares available for trading freely in the market. The Index is determined on a daily basis by taking into consideration the current market value divided by base market capital and then multiplied by the Base Index Value of 1000.

9.9.2. Sectoral Indices

The Market Sector Indices summarizes the performance of stocks grouped by specific market sectors. This allows investors to benchmark the performance of a particular stock market sector or industry.

Sectoral Indices in NSE

- **Nifty Auto Index**: The Nifty Auto Index is designed to reflect the behavior and performance of the Automobiles sector which includes manufacturer of cars & motorcycles, heavy vehicles, auto ancillaries, tyres, etc. The Nifty Auto Index comprises of 15 stocks that are listed on the National Stock Exchange.
- **Nifty Bank Index**: Nifty Bank Index is an index comprised of the most liquid and large capitalized Indian Banking stocks. It provides investors and market intermediaries with a benchmark that captures the capital market performance of Indian Banks. The index has 12 stocks from the banking sector which trade on the National Stock Exchange.

- **Nifty Financial Services Index:** The Nifty Financial Services Index is designed to reflect the behavior and performance of the Indian financial market which includes banks, financial institutions and housing finance and other financial services companies. The Nifty Finance Index comprises of 15 stocks that are listed on the National Stock Exchange (NSE).
- **Nifty FMCG Index:** FMCGs (Fast Moving Consumer Goods) are those goods and products, which are non-durable, mass consumption products and available off the shelf. The Nifty FMCG Index comprises of maximum of 15 companies who manufacture such products which are listed on the National Stock Exchange (NSE).
- **Nifty IT Index:** In order to have a good benchmark of the Indian IT sector, IISL has developed the Nifty IT sector index. Nifty IT provides investors and market intermediaries with an appropriate benchmark that captures the performance of the IT segment of the market.
- **Nifty Media Index:** The Nifty Media Index is designed to reflect the behavior and performance of the Media & Entertainment sector including printing and publishing. The Nifty Media Index comprises of stocks that are listed on the National Stock Exchange (NSE).
- **Nifty Metal Index:** The Nifty Metal Index is designed to reflect the behavior and performance of the Metals sector including mining. The Nifty Metal Index comprises of maximum of 15 stocks that are listed on the National Stock Exchange.
- **Nifty Pharma Index:** Pharmaceuticals sector is one of the key sectors where Indian companies have created a global brand for themselves besides software. IISL has developed Nifty Pharma Index to capture the performance of the companies in this sector. Indian companies have taken advantage of the opportunities in the regulated generics market in the western countries and made deep inroads especially in providing low cost equivalents of expensive drugs.
- **Nifty Private Bank Index:** The Nifty Private Bank Index is designed to reflect the performance of the banks from private sector. The Nifty Private Bank Index comprises of 10 stocks that are listed on the National Stock Exchange (NSE).

- **Nifty PSU Bank Index:** Recognizing these changing dynamics of Indian banking industry, IISL has developed Nifty PSU Bank Index to capture the performance of the PSU banks.
- **Nifty Realty Index:** Real estate sector in India is witnessing significant growth. Recent dynamics of the market reflected the opportunity of creating wealth across real estate companies, as proven by recent listings of real estate companies resulting into prominent growth in public funds and private equity.

9.9.3. Thematic Indices

Our Thematic Indexes reflect the performance of various broad investment themes. Thematic investing seeks to identify specific social, economic, industrial, environmental or demographic trends and their long-term secular, cyclical and structural influences on the world's economies and markets.

Thematic Indices in NSE:

- Nifty Commodities Index
- Nifty CPSE Index
- Nifty Corporate Group Indices
- Nifty Energy Index
- Nifty India Consumption Index
- Nifty Infrastructure Index
- Nifty MNC Index
- Nifty PSE Index
- Nifty Services Sector Index
- Nifty100 Liquid 15 Index
- Nifty Midcap Liquid 15 Index
- Nifty Shariah 25 Index
- Nifty 50 Shariah
- Nifty 500 Shariah Index

Thematic Indices in BSE:

- S&P BSE GREENEX

- S&P BSE CARBONEX

4. Strategy Indices

Strategy indices are designed on the basis of quantitative models / investment strategies to provide a single value for the aggregate performance of a number of companies.

9.10 SCRIP SELECTION CRITERIA

a) SENSEX

The general guidelines for selection of constituents in SENSEX are as follows:

- **Listing History:** The scrip should have a listing history of at least 3 months at BSE. Minimum requirement of 3 months is reduced to one month, if full market capitalization of a newly listed company ranks among top 10 in the list of BSE universe. In case, a company is listed on account of merger/ demerger/amalgamation, minimum listing history would not be required.
- **Trading Frequency:** The scrip should have been traded on each and every trading day in the last three months. Exceptions can be made for extreme reasons like scrip suspension etc.
- **Final Rank:** The scrip should figure in the top 100 companies listed by final rank. The final rank is arrived at by assigning 75% weightage to the rank on the basis of three-month average full market capitalization and 25% weightage to the liquidity rank based on three-month average daily turnover & three-month average impact cost.
- **Market Capitalization Weightage:** The weightage of each scrips in SENSEX based on three- month average free-float market capitalization should be at least 0.5% of the Index.
- **Industry/Sector Representation:** Scrip selection would generally take into account a balanced representation of the listed companies in the universe of BSE.

- **Track Record:** In the opinion of the Index Committee, the company should have an acceptable track record.

b) NIFTY

Usually, it is based on the liquidity and other factors such as out of IPO period, replacement, among others. NSE explains that "For inclusion in the index, the security should have traded at an average impact cost of 0.50 percent or less during the last six months for 90 percent of the observations for a basket size of Rs 2 crore."

Other factors:

- A stock could come under consideration once it has come out of an IPO, if it fulfills the parameters such as impact cost, market capitalisation and floating stock, for a 3- month period than 6-month period.
- Availability for trading in the derivatives segment.
- Replacement of stock

9.11 GUIDELINES FOR SELECTION OF 'A' GROUP COMPANIES AT BSE

A) Company Selection Criteria for Analysis:

(i) Companies classified under group 'A' & 'B' group shall be considered for the purpose of review. Further, companies traded under permitted category at BSE, listed mutual funds and scrips traded under physical mode shall be kept out of the ambit of classification in Group 'A'.

(ii) Company must have been listed for minimum period of 3 months. However, exception to this criterion would be granted to:

a) A company, which is permitted for trading in F&O segment from date of its listing

b) A company listed subsequent to any corporate action involving scheme of arrangement for merger/ demerger/ capital restructuring etc.

(iii) Companies traded for minimum 98% of the trading days in last quarter shall be considered eligible.

(iv) The list of companies is further screened for investigation & compliance by Dept. of Surveillance & Supervision (DOSS). The companies with negative investigation observation are considered ineligible for this review. v. While selecting top 300 companies in Group 'A', following hierarchy shall be followed:

a) Companies with the final rank within top 300 continuously for preceding three rolling quarters shall be included.

b) In case, a list derived from v (a) above, comprises of less than 300 companies, the companies with final rank within top 300 in preceding two rolling quarters shall be included.

c) In case, a list derived from v (a) and v (b) above, comprises of less than 300 companies, the companies with final rank within top 300 in the current quarter shall be included.

d) 'A' Group company which is not included in the final 300 companies but is a part of S&P BSE 500 will continue to be in the 'A' Group.

B) Scoring Mechanism for Group 'A' Companies:

1. Last quarter average free float Market Capitalisation of the company (50%)

2. Last quarter average Turnover of the company (25%)

3. Corporate Governance (10%) (Source of Information – Latest Annual Report Submitted by the company)

4. Compliance Monitoring (10%)

5. Responsible/Sustainable Investment (Source of Information – Latest Annual Report Submitted by the company and Company Website) (5%)

9.12 OVERVIEW OF STOCK MARKET INDICES IN FOREIGN COUNTRIES

Stock market indexes measure the value of a section of a country's stock market via a weighted average of selected stocks. These indexes help investors and analysts describe the market and compare different investments. Many mutual funds and exchange-traded funds (ETFs) attempt to track these indexes to provide investors with exposure to a given market. The three most common types of indexes are 'global' indexes, 'regional' indexes, and 'national' indexes.

a) Global Stock Market Indexes

Global stock market indexes track equities from all around the world. For example, the MSCI World Index tracks large and mid-cap equities across 23 developed countries covering approximately 85% of the free float-adjusted market capitalization in each country. It's worth noting that global stock market indexes weighted by market capitalization don't offer exposure to emerging markets or frontier markets since they're too small for inclusion.

Along with the MSCI, some of the most popular global stock market indexes include:

- FTSE All-World Index
- S&P Global 100 Index
- S&P Global 1200 Index
- Dow Jones Global Titans 50
- Russell Global Index

b) Regional Stock Market Indexes

Regional stock market indexes track equities from specific regions around the world. For instance, these indexes may cover Asian, European, or Latin American equities. They help investors and analysts compare the performance of specific countries to a general region to highlight what assets are

over and under-performing. The funds tied to these indexes may also be helpful in building exposure to specific regions of the world.

Some of the most popular regional stock market indexes are listed below.

Asia

- S&P Asia 50 Index
- Dow Jones Asian Titan 50 Index
- FTSE ASEAN 40 Index

Europe

- Euro Stoxx 50 Index
- FTSE Euro 100 Index
- S&P Europe 350 Index

Latin America

- S&P Latin America 40 Index

c) National Stock Market Indexes

National stock market indexes provide exposure to individual countries. In some cases, the equities in these indexes will consist entirely of large-cap stocks, similar to the Dow Jones Industrial Average in the United States. In other cases, the equities may be considered small-cap since the country may not have many large companies. This is often the case in emerging market and frontier market economies. Here are some of the top global and national stock market indexes.

China

- SSE Composite Index
- SZSE Component Index
- CSI 300 Index

Japan

- Nikkei 225 Index
- Topic Index
- JPX-Nikkei 400 Index

Germany

- DAX 30 Index
- TecDAX Index
- MDAX Index

United Kingdom

- FTSE 100 Index
- FTSE All-Share Index
- FTSE techMark Index

France

- CAC 40 Index
- CAC Next 20 Index
- CAC Mid 60 Index

India

- Bombay Stock Market Index
- National Stock Exchange of India Index
- MCX Stock Exchange Index

Italy

- FTSE MIB Index
- FTSE Italia Mid Cap Index
- MIBTel Index

Brazil

- Bovespa Stock Index

- IBrX Stock Index
- ITEL Stock Index

Canada

- S&P TSX 60 Index
- S&P TSX Composite Index
- S&P TSX Venture Composite Index

South Korea

- KOSPI Index
- KOSDAQ Index

d) Other Stock Market Indexes

There are many other types of specialized stock market indexes for certain demographics. For example, the S&P Islamic Index and Shariah indexes are geared toward investors adhering to Islamic laws, while other indexes cater towards goals like Environmental-Social-Government (or ESG) investments. Investors may want to consider these types of indexes, which may also provide exposure to global stocks with certain restraints.

Some popular alternative stock market indexes include:

- S&P Global BMI Shariah Index
- Stoxx Global ESG Leaders Index



CHECK YOUR PROGRESS

Write the full form of the following:

a) BSE

b) NSE

c) SENSEX

d) NIFTY

e) KCBT

f) IISL



9.13 LET US SUM UP

In this unit, we have discuss the following :-

- A market index is a hypothetical portfolio of investment holdings which represents a segment of the financial market. A stock market index shows changes taking place in the stock market.
- A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market.
- An index is important to measure the performance of investments against a relevant market index. It is used to give information about the price movements of products in the financial, commodities or any other markets.
- Stock market indexes are meant to capture the overall behaviour of equity markets.
- Stock index helps investors understand the health of the stock market enables them to study the market sentiment and makes it easy to compare the performance of an individual stock.
- There are various methods for calculating the stock market index.
- Most of the trading in the Indian stock market takes place on its two stock exchanges, i.e. the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).
- The BSE index is SENSEX, also called the BSE 30. SENSEX stands for Stock Exchange Sensitive Index.
- The NSE index is NIFTY, also called NIFTY 50. Full form of NIFTY is ‘National Stock Exchange Fifty’.

- There are three most common types of indexes in world's market; they are 'global' indexes, 'regional' indexes, and 'national' indexes.



9.14 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- BSE Website
- NSE Website



9.15 ANSWERS TO CHECK YOUR PROGRESS

a) Bombay Stock Exchange

b) National Stock Exchange

c) Stock Exchange Sensitive Index.

d) National Stock Exchange Fifty

e) Kansas City Board of Trade

f) India Index Service and Products



9.16 POSSIBLE QUESTIONS

1. Write short notes on the following:

   a) Stock market index

b) Bombay Stock Exchange

c) National Stock Exchange

d) Stock Exchange Sensitive Index

e) National Stock Exchange Fifty

f) Scrip Selection Criteria

2. Give the meaning of stock market index. Enumerate the purposes needs of calculating stock indices.
3. Describe the methods for calculating stock market index.
4. Write a detail note on stock indices in India.
5. What are the main indices used by the national level stock exchanges in India, and what is their significance?

UNIT 10 : SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Meaning of SEBI

10.4 Preamble of SEBI

10.5 Reasons for Establishment of SEBI

10.6 Present Members of the Board

10.7 Constitution of SEBI

10.8 Various Departments of SEBI

10.9 Organisational Structure of SEBI

10.10 Management of SEBI

10.11 Objectives of SEBI

10.12 Role of SEBI

10.13 Role of SEBI in Regulating Insider Trading

10.14 Powers of SEBI

10.15 Functions of SEBI

10.16 Responsibilities of SEBI

10.17 SEBI in India's Capital Market

10.18 Investor Protection Measures by SEBI

10.19 Let Us Sum Up

10.20 Further Reading

10.21 Answers to Check Your Progress

10.22 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the historical perspective of the securities market reforms in India
- describe the reasons for establishment of SEBI
- interpret the management, organizational structure, objectives, powers and role of SEBI in India
- enumerate the role of SEBI in Indian capital market
- explain the functions of SEBI
- discuss the functions of various departments of SEBI

10.2 INTRODUCTION

The buying and selling of long term securities namely stock, shares, bonds and debentures are held in stock market or securities market. Stock market is the mirror of the economy of any country. Therefore in India, for the orderly development and to regulate the functions of securities market the Securities and Exchange Board of India (SEBI) was set. The main idea of the establishment of SEBI was to keep a check on malpractices and protect the interest of investors. This unit will discuss about the meaning, role, functions and various aspects of SEBI in India.

10.3 MEANING OF SEBI

Securities and Exchange Board of India, popularly known as SEBI is the apex body of Indian Stock Market. It is the regulator, controller and promoter for securities market in India. The Securities and Exchange Board of India was enacted on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992. However, SEBI was first established in the year 1988 as a non-statutory body for regulating the securities market. It became an autonomous body in 1992 and more powers were given through an ordinance. Since then it regulates the market through its independent powers. Its head quarter is in Mumbai.

Establishment of SEBI was one of the greatest reforms that took place in Indian economy. It protects the interest of Investors and regulates the functioning of Indian Financial System. The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as **"...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto".**

10.4 PREAMBLE OF SEBI

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

10.5 REASONS FOR ESTABLISHMENT OF SEBI

During 1980s, there was tremendous growth in the capital market due to increasing participation of public. With the growth in the dealings of stock markets led to lot of malpractices like rigging of prices, unofficial premium on new issues, delay in delivery of shares, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. by the brokers, merchant bankers, companies, investment consultants and others involved in the securities market. Due to these malpractices the customers started losing confidence and faith in the stock exchange. This resulted in many investor grievances. Because of lack of proper penal provision and legislation, the government and the stock exchanges were not able to redress these grievances of the investors. This necessitated a need for a separate regulatory body, and hence Securities and Exchange Board of India was established. Its main objective was to promote orderly and healthy growth of securities and to provide protection to the investors.

10.6 PRESENT MEMBERS OF THE BOARD

At present one chairperson, four whole time members and three part-time members constitute the board.

i) Madhabi Puri Buch, Chairperson

ii) Amarjeet Singh, Whole-Time Member

iii) Ananth Narayan G, Whole-Time Member

iv) Ashwini Bhatia, Whole-Time Member

v) Kamlesh Chandra Varshney, Whole-Time Member

vi) Ajay Seth, Part-Time Member

vii) M. Rajeshwar Rao, Part-Time Member

vii) Deepti Gaur Mukerjee, Part-Time Member

10.7 CONSTITUTION OF SEBI

The SEBI is body of six members comprising the chairman, two members from the official of the ministry of central bank dealing with finance and law, two members who are professionals and have experience or special knowledge relating to securities market, and one member from RBI. All the member except the RBI member are appointed by government who also lays down their terms of office, tenure and conditions of services, and who also removes any member from the office under any circumstances. The central government is empowered to supersede the SEBI in public interest or if, on account of grave emergency and some other circumstances.

The work of SEBI has been organized into five operational department each of which is headed by an executive director who report to Chairman. Besides, there is a legal Department and Investigation Department. The department is further divided into division. The SEBI has regional offices at Calcutta, Chennai and Delhi. It has also formed two non statutory advisory committees namely Primary Market Advisory Committee and Secondary Market Advisory Committee with members from market player, recognized investor association and other eminent person. SEBI has a corporate framework

comprising various departments each managed by a department head. There are about 20 departments under SEBI.

The hierarchical structure of SEBI consists of the following members:

- The chairman of SEBI is nominated by the Union Government of India.
- Two officers from the Union Finance Ministry will be a part of this structure.
- One member will be appointed from the Reserve Bank of India.
- Five other members will be nominated by the Union Government of India.

10.8 VARIOUS DEPARTMENTS OF SEBI

- Market Intermediaries Regulation and Supervision Department (MIRSD)
- Market Regulation Department (MRD)
- Commodity Derivatives Market Regulation Department (CDMRD)
- Corporation Finance Department (CFD)
- Investment Management Department (IMD)
- Integrated Surveillance Department (ISD)
- Investigations Department (IVD)
- Enforcement Of Department (EFD)
- Legal Affairs Department (LAD)
- Enquiries and Adjudication Department (EAD)
- Office of Investor Assistance and Education (OIAE)
- General Services Department (GSD)
- Department of Economic and Policy Analysis (DEPA)
- Office of the Chairman (OCH)
- Information Technology Department
- The Regional Offices (RO's)

10.9 ORGANISATIONAL STRUCTURE OF SEBI

i) SEBI a Statutory body

ii) Its activities are divided into five departments. Each department is headed by an executive director.

iii) The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.

iv) SEBI has formed two advisory committees to deal with primary and secondary markets.

These committees consist of market players, investors associations and eminent persons.

The Ministry of Finance of the Government of India has overall administrative control over its functions. On 30th January 1992, it was given a statutory status through an ordinance, which later on was replaced by Act of Parliament known as Securities and Exchange Board of India Act, 1992. SEBI is considered as watchdog of the securities market. The SEBI is managed by its members, which consists of following:

i) The chairman who is nominated by Union Government of India

ii) Two members, i.e., officers from Union Finance Ministry

iii) One member from the Reserve Bank of India

iv) The remaining five members are nominated by Union Government of India out of them at least three shall be whole-time members.

The office of SEBI is situated at Mumbai with its regional offices at Kolkata, Delhi and Chennai.

10.10 MANAGEMENT OF SEBI

The Ministry of Finance of the Government of India has overall administrative control over its functions. On 30th January 1992, it was given a statutory status through an ordinance, which later on was replaced by Act of Parliament known as Securities and Exchange Board of India Act, 1992.

SEBI is considered as watchdog of the securities market. The SEBI is managed by its members, which consists of following:

i) The chairman who is nominated by Union Government of India

ii) Two members, i.e., officers from Union Finance Ministry

iii) One member from the Reserve Bank of India

iv) The remaining five members are nominated by Union Government of India out of them at least three shall be whole-time members. The office of SEBI is situated at Mumbai with its regional offices at Kolkata, Delhi and Chennai.

10.11 OBJECTIVES OF SEBI

As an important entity in the market it works with following objectives:

i) It tries to develop the securities market

ii) Promotes investors interest

iii) Makes rules and regulations for the securities market

Following are the overall objectives of SEBI:

i) Protection: To guide, educate, and to protect the rights and interests of the investors

ii) *Competitive and Professional*: To make the intermediaries like merchant bankers, brokers etc. competitive and professional by regulating their activities and developing a code of conduct

iii) *Prevention of Malpractices*: To prevent trading malpractices

iv) *Balancing:* To establish a balance between statutory regulation and self regulation by the securities industry

v) *Orderly Functioning*: To promote orderly functioning of stock exchange and securities industry by regulating them

10.12 ROLE OF SEBI

The SEBI plays an important role to create an environment which facilitates efficient mobilization and allocation of resources through the securities

market. This environment consists of rules and regulations, policy framework, practices and infrastructures to meet the needs of three groups which mainly constitute the market i.e. issuers of securities (companies), the investors and the market intermediaries.

(i) To the Issuers: SEBI aims to provide a market place to the issuers where they can confidently look forward to raise the required amount of funds in an easy and efficient manner.

(ii) To the Investors: SEBI aims to protect the right and interest of the investors by providing adequate, accurate and authentic information on a regular basis.

(iii) To the Intermediaries: In order to enable the intermediaries to provide better service to the investors and the issuers, SEBI provides a competitive, professionalised and expanding market to them having adequate and efficient infrastructure.

10.13 ROLE OF SEBI IN REGULATING INSIDER TRADING

Company insiders have information unavailable to the public. These individuals have firsthand knowledge of what the company is doing and better information concerning what the future might hold. If there are likely problems for the company in the future, such as poor earnings, slow growth, or lawsuits, then insiders can sell their stock before these events happen. When this information becomes public, the stock's price should decrease. However, this price decrease occurs after the insider has sold his or her shares, thus avoiding the loss. In this case the insider beats the market. On the other hand, insiders know when their company has a bright future, high potential earnings, innovative products being developed, etc. When the future looks bright, insiders can buy shares before the public becomes aware of these facts. The price, later, fully increases to represent the positive information. In both cases, insiders use private information to beat the market.

Earlier, the concept of insider trading was limited to the aspect of a company insider tipping of an outsider and the outsider using the tip and trad-

ing in the company's shares, this constitutes a breach of fiduciary duty owed by the insider to the company's shareholders; it was called the classical theory of insider trading.

10.14 POWERS OF SEBI

- Power to call periodical returns from recognized stock exchanges
- Power to compel listing of securities by public companies
- Power to levy fees or other charges for carrying out the purposes of regulation
- Power to call information or explanation from recognized stock exchanges or their members
- Power to grant approval to byelaws of recognized stock exchanges
- Power to control and regulate stock exchanges
- Power to direct enquiries and conduct investigations to be made in relation to affairs of stock exchanges or their members
- Power to suspect company's finances, accounts and audit and conducting a check on the same
- Power for levying penalties and adjudication
- Power of central government to issue directions
- Power of central government to supersede the Board
- Power to grant immunity
- Power to exempt from tax on wealth and income or in any other manner as it thinks fit
- Power to make rules and regulations
- Power to lay rules and regulations before Parliament

10.15 FUNCTIONS OF SEBI

The functions of SEBI can be divided into three parts viz:

- Regulatory function,
- Development function, and

- Protective function.

1. Regulatory Functions

Regulatory functions of SEBI are as follows:

*a) Registration of Brokers and Agents***:** SEBI registers brokers, sub-brokers, transfer agents, merchant banks etc.

*b) Notifications of Rules and Regulations***:** It notifies rules and regulations for the smooth functioning of all intermediaries in the securities' market.

*c) Levying of Fees***:** It levies fees, penalties and other charges for contravening its directions and orders.

*d) Regulator of Investment Schemes***:** It registers and regulates collective investment schemes and mutual funds.

*e) Prohibits Unfair Trade Practices***:** SEBI prohibits fraudulent and unfair trade practices.

*f) Inspection and Enquiries***:** It undertakes inspection and conducts enquiries and audit of stock exchange

*g) Performing and Exercising Powers***:** It performs and exercises such powers under Securities Contracts (Regulation) Act 1956, as have been delegated to it by the Government of India.

2. Development Functions

Development functions of SEBI are as under:

*a) Training to Intermediaries***:** It promotes training of intermediaries of the securities.

*b) Promotion of Fair Trade***:** It promotes fair trade practices by making underwriting optional.

c) Research: It publishes information useful to all market participants for conducting research.

3. Protective Functions

Protective Functions of SEBI are as under:

*a) Prevents Insider Trading***:** Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available

to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading. It does so by prohibiting insiders such as directors, promoters etc. to make profit through trading of securities using confidential price sensitive information.

b) Prohibits Fraudulent and Unfair Trade Practices: It prohibits fraudulent and unfair trade practices in the security market, such as price rigging and sale or purchase of securities through misleading statements. Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

*c) Promotes Fair Practices***:** It promotes fair practices and code of conduct in the securities market e.g. it looks after the interests of the debenture holders in terms of any mid-term revision of interest rates etc.

*d) Educates Investors***:** It educates the investors through campaigns.

10.16 RESPONSIBILITIES OF SEBI

SEBI basically has only three responsibilities areas which are as follows:

i) For the *issuer* of securities

ii) For the *investors* of securities

iii) For the market *intermediaries*

Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors, to promote the development of, and to regulate the securities market, by such measures as it thinks fit.

- regulating the business in stock exchanges and any other securities markets

- registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner
- registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds
- promoting and regulating self-regulatory organisations
- prohibiting fraudulent and unfair trade practices relating to securities markets
- promoting investors' education and training of intermediaries of securities markets
- prohibiting insider trading in securities
- regulating substantial acquisition of shares and take-over of companies
- calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market
- levying fees or other charges for carrying out the purposes of this Act
- conducting research for the above purposes
- issuing commissions for the examination of witnesses or documents
- the discovery and production of books of account and other documents, at such place and such time as may be specified by the Board
- suspend the trading of any security in a recognized stock exchange
- restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities
- to regulate or prohibit issue of prospectus, offer document or advertisement soliciting money for issue of securities

10.17 SEBI IN INDIA'S CAPITAL MARKET

The Securities and Exchange Board of India, is the national regulatory body for the securities market, set up under the securities and Exchange Board

of India Act, 1992, to protect the interest of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith and incidental too. As per the SEBI act, 1992, the power and functions of the Board encompass the regulation of stock exchanges and other securities markets; registration and regulation of the working stock brokers, sub-brokers, bankers to an issue (a public offer of capital), trustees of trust deeds, registrars to an issues, merchant bankers, under writers, portfolio managers, investment advisors and such other intermediaries who may be associated with the stock market in any way; registration and regulations of mutual funds; promotion and regulation of self-regulatory organizations; prohibiting fraudulent and unfair trade practices and insider trading in securities markets; regulating substantial acquisition of shares and takeover of companies; calling for information from, undertaking inspection, conducting inquiries and audits of stock exchanges, intermediaries and self-regulatory organizations of the securities market; performing such functions and exercising such powers as contained in the provisions of the Capital Issues(Control) Act,1947 and the Securities Contracts (Regulation) Act, 1956, levying various fees and other charges, conducting necessary research for above purposes and performing such other functions as may be prescribes from time to time.

SEBI as the watchdog of the industry has an important and crucial role in the market in ensuring that the market participants perform their duties in accordance with the regulatory norms. The stock exchange as a responsible Self Regulatory Organization (SRO) functions to regulate the market and its prices as per the prevalent regulations. SEBI play complimentary roles to enhance the investor protection and the overall quality of the market. SEBI from time to time have adopted many rules and regulations for enhancing the Indian capital market. The recent initiatives undertaken are as follows:

i) **Sole Control on Brokers:** Under this rule every brokers and sub brokers have to get registration with SEBI and any stock exchange in India.

ii) **For Underwriters:** For working as an underwriter an asset limit of 20 lakhs has been fixed.

iii) **For Share Prices:** According to this law all Indian companies are free to determine their respective share prices and premiums on the share prices.

iv) **For Mutual Funds:** SEBI's introduction of SEBI (Mutual Funds) Regulation in 1993 is to have direct control on all mutual funds of both public and private sector.

10.18 INVESTOR PROTECTION MEASURES BY SEBI

Investors are the pillar of the financial and securities market. They determine the level of activity in the market. They put the money in funds, stocks, etc. to help grow the market and thus, the economy. It is very important to protect the interest of the investors. Investor protection involves various measures established to protect the interests of investors from malpractices. Securities and Exchange Board of India (SEBI) is responsible for regulations of the Mutual Funds too and safeguard the interests of the investors. Investor protection measures by SEBI are in place to safeguard the investors from the malpractices in shares, the stock market, Mutual Fund, etc. The Role of SEBI in Investor Protection SEBI has given out various methods and measures to ensure the investor protection from time to time. It has published various directives, driven many investor awareness programmes, set up Investor Protection Fund (IPF) to compensate the investors.

Investor protection legislation is implemented under the Section 11(2) of the SEBI Act. The measures are as follows:

- Stock Exchange and other securities market business regulation.
- Registering and regulating the intermediaries of the business like brokers, transfer agents, bankers, trustees, registrars, portfolio managers, investment consultants, merchant bankers, etc.
- Recording and monitoring the work of custodians, depositors, participants, foreign investors, credit rating agencies, etc.
- Registering investment schemes like Mutual fund & venture capital funds, and regulating their functioning,
- Promotion and controlling of self-regulatory companies.

- Keeping a check on frauds and unfair trading methods related to the securities market.
- Observing and regulating major transactions and take-over of the companies.
- Carry out investor awareness and education programme.
- Train the intermediaries of the business.
- Inspecting and auditing the security exchanges (SEs) and intermediaries.
- Assessment of fees and other charges.



CHECK YOUR PROGRESS

Answer as directed:

a) SEBI was established in _____. (Fill in the gap)

b) A new company which has not completed 12 months' commercial production has to issue shares only _____. (Fill in the gap)

c) Registration of brokers is compulsory. (Write True or False)

d) Investors' protection is the major responsibility of SEBI. (Write True or False)

e) The two national level stock exchanges in India are ..... and ..... of India. (Fill in the gap)

f) SEBI is the ..... for the Securities Market in India. (Fill in the gap)



10.19 LET US SUM UP

In this unit, we have discuss the following :-

- Securities and Exchange Board of India, popularly known as SEBI is the apex body of Indian Stock Market.
- It is the regulator, controller and promoter for securities market in India.
- The Securities and Exchange Board of India was enacted on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.

- The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.
- The Ministry of Finance of the Government of India has overall administrative control over its functions.
- The SEBI is body of six members comprising the chairman, two members from the official of the ministry of central bank dealing with finance and law, two members who are professionals and have experience or special knowledge relating to securities market, and one member from RBI.
- SEBI has a corporate framework comprising various departments each managed by a department head. There are about 20 departments under SEBI.
- The functions of SEBI can be divided into three parts viz: regulatory function, development function, and protective function.



10.20 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- SEBI (Disclosure & Investor Protection) Guidelines 2000
- SEBI (Stock Brokers & Sub Brokers) Regulations 1992
- SEBI (FII) Regulations
- SEBI (Insider Trading) Regulations



10.21 ANSWERS TO CHECK YOUR PROGRESS

(a) April 12, 1992 (b) at par (c) True (d) True (e) Bombay Stock Exchange, National Stock Exchange (f) Regulator



10.22 MODEL QUESTIONS

1. Write short notes on the following:

b) Organisational structure of SEBI

c) Book building

d) Insider trading

e) Stock invest

2. What is SEBI? What are its objectives? Discuss the role of SEBI in the development of Indian capital market.

3. Discuss about the functions of Securities Exchange Board of India (SEBI). Explain how does SEBI protect the interest of investors?

4. Has SEBI succeeded so far in being the regulator of securities market?

5. Is it necessary for India to have a separate Securities and Exchange Board of India? If yes, elaborate.

6. “Stock trading is a boon as well as bane.” Discuss.

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UNIT 11 : NEW INSTRUMENTS AND PARTICIPANTS IN INDIAN STOCK MARKETS

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Concept of Depository Receipts

11.4 American Depositary Receipts (ADRs)

11.5 Global Depositary Receipt (GDRs)

11.6 Difference between ADR and GDR

11.7 Euro Issues

11.8 Other International Issues (Foreign Euro-Bonds):

11.9 Indian Depository Receipts (IDRs)

11.10 Foreign Institutional Investor (FII)

11.11 Foreign Direct Investment

11.12 Foreign Direct Investment (FDI) in India

11.13 Regional Stock Exchanges

11.14 Demutualization

11.15 Let Us Sum Up

11.16 Further Reading

11.17 Answers to Check Your Progress

11.18 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning of depository receipts
- understand the meaning, definition and working of American Depository Receipts (ADRs)

- know the meaning, definition and trading of Global Depository Receipts (GDRs)
- kind the differences between ADRs and GDRs
- describe the meaning, advantages, disadvantages and sources of Euro Issues
- explain the effect of GDRs in Indian capital market
- state the meaning of IDRs and FIIs
- interpret the SEBI guidelines for FIIs
- enumerate meaning and trends of FDIs in India
- state the meaning of Regional Stock Exchange
- know about Demutualisation

11.2 INTRODUCTION

In India, many families save money on a monthly basis from their income mainly to secure their future. Putting one's money in savings account or locker will not help the money to multiply. One can multiply their money by Investing. An individual can invest money in various financial instruments which are available in India. In this unit we will discuss about some capital instruments.

11.3 CONCEPT OF DEPOSITORY RECEIPTS

Many publicly listed companies in India, trades their shares through Bombay Stock Exchange or National Stock Exchange. A lot of companies also want to trade their shares in overseas stock exchange, although the companies need to comply with some policies. In such a situation companies get itself listed through ADR or GDR. For this purpose, the company deposits its shares to the Overseas Depository Bank (ODB) and the bank issues Depository Receipts in exchange for shares. These receipts are then listed on the stock exchange and offered for sale to the foreign investors. Depository Receipts help the Non-Resident Indian's or foreign investors to invest in Indian companies by using their regular equity trading account. Market regulator SEBI

sets the ball rolling to give Indian companies increased access to foreign funds through the American Depository Receipts (ADR) and Global Depository Receipts (GDR) route.

Depository Receipt is a mechanism through which a domestic company can raise finance from the international equity market. In this system, the shares of the company domiciled in one country are held by the depository i.e. Overseas Depository Bank, and issues claim against these shares. Such claims are known as Depository Receipts that are denominated in the convertible currency, mostly US$, but these can also be denominated in Euros. Now, these receipts are listed on the stock exchanges.

11.4 AMERICAN DEPOSITARY RECEIPTS (ADRs)

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

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

Definition of ADR:

American Depository Receipt (ADR) is a negotiable certificate, issued by a US bank, denominated in US$ representing securities of a foreign company trading in the United States stock market. The receipts are a claim against the number of shares underlying. ADR's are offered for sale to American investors. By way of ADR, the US investors can invest in non-US companies. The dividend is paid to the ADR holders, is in US dollars. ADR's are easily transferable, without any stamp duty. The transfer of ADR automatically transfers the number of shares underlying.

Working of American Depositary Receipts:

ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas. ADR holders do not have to transact the trade in the foreign currency or worry about exchanging currency on the forex market. These securities clear through U.S. settlement systems. To offer ADRs a U.S. bank will purchase shares on a foreign exchange. The bank will hold the stock as inventory and issue an ADR for domestic trading. ADRs list either on the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or the NASDAQ, but they are also sold over-the-counter (OTC). U.S. banks require that foreign companies provide them with detailed financial information. This requirement makes it easier for American investors to assess a company's financial health.

Types of ADRs:

American depositary receipts come in two basic categories:

- A bank issues a sponsored ADR on behalf of the foreign company. The bank and the business enter into a legal arrangement. Usually, the foreign company will pay the costs of issuing an ADR and retaining control over it. While the bank will handle the transactions with investors. Sponsored ADRs are categorized by what degree the foreign company complies with U.S. Securities and Exchange Commission (SEC) regulations and American accounting procedures.
- A bank also issues an unsponsored ADR. However, this certificate has no direct involvement, participation or even permission from the foreign company. Theoretically, there could be several unsponsored ADRs for the same foreign company, issued by different U.S. banks. These different offerings may also offer varying dividends. With sponsored programs, there is only one ADR, issued by the bank working with the foreign company.

One primary difference between the two types of ADRs is where investors can buy them. All except the lowest level of sponsored ADRs register with the SEC and trade on major U.S. stock exchanges. Unsponsored ADRs will trade only over-the-counter. Also, unsponsored ADRs never include voting rights.

11.5 GLOBAL DEPOSITARY RECEIPT (GDRs)

A Global Depositary Receipt (GDR) is a bank certificate issued in more than one country for shares in a foreign company. A Global Depository Receipt is very similar to an American Depository Receipt (ADR). It is a type of bank certificate that represents shares in a foreign company, such that a foreign branch of an international bank then holds the shares. The shares themselves trade as domestic shares, but, globally, various bank branches offer the shares for sale. Private markets use GDRs to raise capital denominated in either U.S. dollars or Euros. When private markets attempt to obtain Euros instead of U.S. dollars, GDRs are referred to as European Depositary Receipts (EDRs).

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

Shares per Global Depositary Receipt:

Each GDR represents a particular number of shares in a specific company. A single GDR can represent anywhere from a fraction of a share to multiple shares, depending on its design. In a situation that involves multiple shares, the receipt value shows an amount higher than the price for a single share. Depository banks manage and distribute various GDRs and function in an international context.

Definition of GDR:

GDR or Global Depository Receipt is a negotiable instrument used to tap the financial markets of various countries with a single instrument. The receipts are issued by the depository bank, in more than one country representing a fixed number of shares in a foreign company. The holders of GDR can convert them into shares by surrendering the receipts to the bank. Prior approval of Ministry of Finance and FIPB (Foreign Investment Promotion Board) is taken by the company planning for the issue of GDR.

Trading of Global Depositary Receipt Shares:

Companies issue GDRs to attract interest by foreign investors. GDRs provide a lower-cost mechanism in which these investors can participate. These shares trade as though they are domestic shares, but investors can purchase the shares in an international marketplace. A custodian bank often takes possession of the shares while the transaction processes, ensuring both parties a level of protection while facilitating participation.

Brokers who represent the buyer manage the purchase and sale of GDRs. Generally, the brokers are from the home country and are sellers within the foreign market. The actual purchase of the assets is multi-staged, involving a broker in the investor's homeland, a broker located within the market associated with the company that has issued the shares, a bank representing the buyer, and the custodian bank.

If an investor desires, brokers can also sell GDRs on their behalf. An investor can sell them as-is on the proper exchanges, or the investor can convert them into regular stock for the company. Additionally, they can be canceled and returned to the issuing company.

Effect of GDRs in Indian Capital Market:

Indian capital markets are largely affected by GDRs from its very inception having the following characteristics:

- Transactions from Indian stock market are shifted from domestic to foreign market.
- Since the Indian stock markets depend on the World-wide market, investors are now acquainted with the up to-date economic affairs of the world as well
- Retail investors of India are practically outlined from the investment point of view.

11.6 DIFFERENCE BETWEEN ADR AND GDR

ADR and GDR are commonly used by the Indian companies to raise funds from the foreign capital market. The principal difference between ADR and GDR is in the market; they are issued and in the exchange, they are listed. While ADR is traded on US stock exchanges, GDR is traded on European stock exchanges. ADR and GDR are two depository receipts that are traded in local stock exchange but represent a security issued by a foreign public listed company.

Basis For Comparison	**ADR**	**GDR**
Acronym	American Depository Receipt	Global Depository Receipt
Meaning	ADR is a negotiable instrument issued by a US bank, representing non-US company stock, trading in the US stock exchange.	GDR is a negotiable instrument issued by the international depository bank, representing foreign company's stock trading globally.
Relevance	Foreign companies can trade in US stock market.	Foreign companies can trade in any country's stock market other than the US stock market.
Issued in	United States domestic capital market.	European capital market.
Listed in	American Stock Exchange such as NYSE or NASDAQ	Non-US Stock Exchange such as London Stock Exchange or Luxemberg Stock Exchange.
Negotiation	In America only.	All over the world.
Disclosure Requirement	Onerous	Less onerous
Market	Retail investor market	Institutional market.

11.7 EURO ISSUES

Euro-issues mean the issue which is listed on European Stock Exchange although the subscriptions for the same may come from any corner of the world other than India. Euro issue is a name given to sources of finance or capital available to raise money outside the home country in foreign currency.

The most commonly used sources of funds that fall under Euro issues are American Depository Receipts (ADRs), Global Depository Receipts (GDRs), and Foreign Currency Convertible Bonds (FCCB) among others.

Advantage of Euro Issues:

Some of the major advantages and limitations of Euro issues to enable the better understanding of the concept and understand why companies find it attractive to raise money through this route are as follows:

- Raising funds by way of euro issue acts as a cheap source of foreign currency funds for the company without exchange risks especially for companies that have foreign currency receivables.
- In a case of funding by way of equity, debt to equity ratios and debt service coverage ratio wouldn't be an issue.
- Euro issues provide a larger market and international access to funds and may lead to easy larger volume funding which may be difficult from domestic sources. It opens up many new opportunities for the companies in new markets.
- Companies gain international exposure and can enhance liquidity for its shares.

Disadvantage of Euro Issues:

Despite many advantages of euro issues making it an attractive source of finance for companies; there are few limitations of euro issues which need to be evaluated before choosing the right option. The limitations are given below:

- Though euro issues are usually available at lower costs, companies which do not have adequate receivables may run currency exchange risk and may have to incur hedging costs which may turn out to be higher than the cost saved.
- Not all companies can avail funds via euro issues. The companies have to follow the guidelines issued by Reserve Bank of India and meet the criterions to avail funding through this route.
- Companies may have to undergo stake dilution if raised by way of equity or convertible bonds.

Sources of Euro Issues:

- **Foreign Currency Convertible Bonds (FCCB):** Foreign Currency Convertible Bonds (FCCB) is an equity linked foreign currency debt security subscribed by non-residents which can be converted into shares. The Bond has a fixed interest or coupon rate. The interest of the bond may be opted for conversion into equity. The company must have to pay interest in dollars till the conversion takes place. Needless to mention that if the conversion option is not exercised, the redemption of such bonds must be made in dollars.

- **Global Depository Receipts (GDRs)**: Global Depository Receipts (GDR) is a negotiable certificate dominated, in US dollars, issued by the overseas depository bank outside India against issue of equity shares Each GDR contains one or more shares of the issuing company. These depository receipts may be traded freely either in any international stock exchange or over the counter exchange outside India, or among the restricted groups.

11.8 OTHER INTERNATIONAL ISSUES (FOREIGN EURO-BONDS):

Needless to say that, GDRs is not the single source of investment for receiving foreign currency finance. There is one additional method by which foreign currency finance offered by companies from the International Capital Market the Euro-Bonds. It is interesting to note that domestic capital market of different countries use different names for such bonds issue e.g. Bull Dogs' in U K. Swiss Frances in Switzerland etc. similarly, each domestic market of a country maintains its own rules and regulations. That is why, borrower from one country may borrow in some other country's currency of course according to the rules and regulations prevailed in that country.

The different types of foreign bonds:

- **Euro – Convertible Bonds:** We know that a convertible bond is a debt instrument that provides the holder of the bond an option to convert the bond into equity shares of the company. Normally, at the time of conversion, the price of the equity shares is inclusive of certain premium money although the bonds carry fixed percentage of interest.

- **Euro-Convertible Zero-Bonds**: These bonds also are similar to convertible bonds. Interest is not paid on the bonds. At the same time conversion of bonds is made on marketing at pre-determined price. Normally the period of maturity is taken for 5 years.

- **Euro-Bonds with Equity Warrants**: These bonds contain a coupon rate/prices which has been determined by the market rate/ price. Pure bonds are transacted at a discount. The investors who prefer to create a fixed income funds may use these bonus for their purposes.

- **General Euro-Bonds**: It has already been explained that bonds are debt instruments. Thus a plain Euro-Bond is also a debt instrument. Investor who wants to invest his investment for the purpose of adding/ increasing his investments do not prefer it.

11.9 INDIAN DEPOSITORY RECEIPTS (IDRs)

An Indian Depository Receipt (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India) against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian Securities Markets. The IDR is a specific Indian version of the similar global depository receipts. A foreign company can access Indian securities market for raising funds through issue of Indian Depository Receipts (IDRs). The foreign company IDRs will deposit shares to an Indian depository. The depository would issue receipts to Indian investors against these shares. The benefit of the underlying shares (like bonus, dividends etc.) would accrue to the depository receipt holders in India.

IDR's are based on the original American Depository Receipts that were first introduced in 1927 in the US.

The Ministry of Corporate Affairs of the Government of India, using section 642 read with section 605A had prescribed the Companies (Issue of Indian Depository Receipts) Rules, 2004 (IDR Rules) vide notification number GSR 131(E) dated February 23, 2004. The rules for IDRs were operationalized by the SEBI, the Indian markets regulator in 2006. Operation instructions under the Foreign Exchange Management Act were issued by the Reserve bank of India on July 22, 2009. The SEBI has been notifying amendments to these guidelines from time to time. The Standard Chartered PLC became the first global company to file for an issue of Indian depository receipts in India in 2010.

Eligibility to Issue IDRs:

The regulations relating to the issue of IDRs is contained in Securities and Exchange Board of India (Issue of capital and disclosure requirements) Regulations, 2009, as revised from time to time. According to Clause 26 in Chapter III ("Provisions as to public issue"), the following are required of any company intending to make a public issue in India:

- It has net tangible assets of at least Indian Rupee three crore in each of the preceding three full years (of twelve months each), of which not more than fifty per cent are held in monetary assets: Provided that if more than fifty percent of the net tangible assets are held in monetary assets, the issuer has made firm commitments to use such excess monetary assets in its business or project;
- It has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least three out of the immediately preceding five years: Provided that extraordinary items shall not be considered for calculating distributable profits;
- It has a net worth of at least INR one crore in each of the preceding three full years (of twelve months each);
- The aggregate of the proposed issue and all previous issues made in the same financial year in terms of issue size does not exceed five times its

pre-issue net worth as per the audited balance sheet of the preceding financial year;

- If it has changed its name within the last one year, at least fifty per cent. of the revenue for the preceding one full year has been earned by it from the activity indicated by the new name.

Further, Clause 97 in Chapter X stipulates additional requirements from a foreign company intending to make an issue of IDRs, an issuing company making an issue of IDR shall also satisfy the following:

- The issuing company is listed in its home country;
- The issuing company is not prohibited to issue securities by any regulatory body;
- The issuing company has track record of compliance with securities market regulations in its home country.

Issue Process:

According to SEBI guidelines, IDRs will be issued to Indian residents in the same way as domestic shares are issued. The issuer company will make a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares. The issue process is exactly the same: the company will file a draft Red Herring Prospectus (DRHP), which will be examined by SEBI. The general body of investors will get a chance to read and review the DRHP as it is a public document, available on the websites of SEBI and the book running lead managers. After SEBI gives its clearance, the company sets the issue dates and files the document with the Registrar of Companies.

In the next step, after getting the Registrar's registration ticket, the company can go ahead with marketing the issue. The issue will be kept open for a fixed number of days, and investors can submit their application forms at the bidding centers. The investors will bid within the price band and the final price will be decided post the closure of the Issue. The receipts will be allotted to the investors in their demat account as is done for equity shares in any public issue. On 26 October 2010, SEBI notified the framework for rights issue of

Indian Depository Receipts (IDRs). Disclosure requirement for IDR rights would more or less be in line with the reduced requirement applicable for domestic rights issue.

11.10 FOREIGN INSTITUTIONAL INVESTOR (FII)

A foreign institutional investor (FII) is an investor or investment fund registered in a country outside of the one in which it is investing. Institutional investors most notably include hedge funds, insurance companies, pension funds, and mutual funds. The term is used most commonly in India and refers to outside companies investing in the financial markets of India.

A foreign institutional investor (FII) is any type of large investor who does business in a country other than the one in which the investment instrument is being purchased. In addition to the types of investors above, others include banks, large corporate buyers or representatives of large institutions. All FIIs take a position in a foreign financial market on behalf of the home country in which they are registered.

Definition of Foreign Institutional Investors:

Foreign institutional investors (FIIs) are those institutional investors which invest in the assets belonging to a different country other than that where these organizations are based. Foreign institutional investors play a very important role in any economy. These are the big companies such as investment banks, mutual funds etc, who invest considerable amount of money in the Indian markets. With the buying of securities by these big players, markets trend to move upward and vice-versa. They exert strong influence on the total inflows coming into the economy.

Market regulator SEBI has over 1450 foreign institutional investors registered with it. The FIIs are considered as both a trigger and a catalyst for the market performance by encouraging investment from all classes of investors which further leads to growth in financial market trends under a self-organized system.

Foreign Institutional Investors (FII) in India:

Countries with the highest volume of foreign institutional investments are those that have developing economies. These types of economies provide investors with higher growth potential than in mature economies. This is why these investors are most commonly found in India, all of which must register with the SEBI to participate in the market.

Foreign Portfolio/Institutional Investors (FPI/FII) have been one of the biggest drivers of India's financial markets and have invested around Rs 13.39 trillion (US$ 191.60 billion) in India between FY02-20 (till December 4, 2019). Highly developed primary and secondary markets have attracted FIIs/FPIs to the country. Investments by FIIs/FPIs in India are regulated by the Securities and Exchange Board of India (SEBI) while the ceilings on such investments are maintained by the Reserve Bank of India (RBI). Following are the few types of FIIs investing in India:

- Hedge Funds
- Foreign Mutual Funds
- Sovereign Wealth Funds
- Pension Funds
- Trusts
- Asset management Companies
- Endowments, University Funds, etc.

The total market capitalisation (M-cap) of all the companies listed on Bombay Stock Exchange (BSE) rose to a record high level of Rs 151.08 trillion (US$ 2.16 trillion) in 2018-19 and reached Rs 154.12 trillion (US$ 2.20 trillion) in 2019-20.

Government/Regulatory Initiatives:

- In May 2019, SEBI proposed reducing the overall time taken for rights issue from 55-58 days to around 31 days. This will make the application and allotment process more efficient.
- In September 2018, SEBI has reduced the time to list shares on stock exchange after initial public offerings to three days from previous six days.

- A report filed by a panel appointed by the Securities and Exchange Board of India on December 04, 2018 has proposed direct overseas listing of Indian companies and other regulatory changes.
- In September 2018, the Securities and Exchange Board of India relaxed the Know-Your-Client (KYC) requirement for Foreign Portfolio Investors (FPIs).
- In September 2018, SEBI allowed Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) to start commodity derivate segments.
- SEBI has also allowed foreign entities to participate in the commodity derivatives segment of Indian stock exchanges, to help them hedge their exposures. It has also proposed to allow Non Resident Indians (NRIs) to invest through FPI route after meeting specific KYC norms.
- In August 2018, SEBI reduced the timeline for public issue of debt securities from 12 days to six days.
- Foreign Portfolio Investors are also allowed to invest up to 25 per cent in Category III Alternative Investment Funds (AIF) in India. Different types of funds such as hedge funds, Private Investment in Public Equity (PIPE) funds, etc. are operating in India as Category III AIFs.
- Investments by FPIs have also been allowed in Real Estate Investment Trusts (REITs) and Infrastructure Investment Trust (InvITs).

Example of a Foreign Institutional Investor (FII):

If a mutual fund in the United States sees an investment opportunity in an Indian-based company, it can purchase the equity on the Indian public exchange and take a long position in a high-growth stock. This also benefits domestic private investors who may not be able to register with the Securities and Exchange Board of India. Instead, they can invest in the mutual fund and take part in the high growth potential.

Regulations for Investing in Indian Companies:

All FIIs are allowed to invest in India's primary and secondary capital markets only through the country's Portfolio Investment Scheme (PIS). This scheme allows FIIs to purchase shares and debentures of Indian companies on the normal public exchanges in India.

However, there are many regulations included in the scheme. There is a ceiling for all FIIs that states the max investment amount can only be 24% of the paid-up capital of the Indian company receiving the investment. The maximum investment can be increased above 24% through board approval and the passing of a special resolution. The ceiling is reduced to 20% of the paid-up capital for investments in public sector banks.

The RBI monitors daily compliance with these ceilings for all foreign institutional investments. It checks compliance by implementing cutoff points 2% below the max investment amounts. This gives it a chance to caution the Indian company receiving the investment before allowing the final 2% to be invested.

11.11 FOREIGN DIRECT INVESTMENT

A Foreign Direct Investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. It is thus distinguished from a foreign portfolio investment by a notion of direct control. In simple words, foreign direct investments are investments made by one company into another located in another country. FDIs are actively utilized in open markets rather than closed markets for investors.

A foreign direct investment is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets, including establishing ownership or controlling interest in a foreign company. However, FDIs are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies.

Foreign direct investments are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies. Foreign direct investment frequently involves more than just a capital investment. It may include provisions of management or technology as well. The key feature of foreign direct investment is that it establishes either effective control of or at least substan-

tial influence over the decision-making of a foreign business. FDIs not only bring money with them but also skills, technology and knowledge.

11.12 FOREIGN DIRECT INVESTMENT (FDI) IN INDIA

Apart from being a critical driver of economic growth, foreign direct investment (FDI) is a major source of non-debt financial resource for the economic development of India. Foreign companies invest in India to take advantage of relatively lower wages, special investment privileges such as tax exemptions, etc. For a country where foreign investments are being made, it also means achieving technical know-how and generating employment.

The Indian government's favourable policy regime and robust business environment have ensured that foreign capital keeps flowing into the country. The government has taken many initiatives in recent years such as relaxing FDI norms across sectors such as defence, PSU oil refineries, telecom, power exchanges, and stock exchanges, among others.

FDI is an important monetary source for India's economic development. Economic liberalisation started in India in the wake of the 1991 crisis and since then, FDI has steadily increased in the country. Today, India is a part of top 100-club on Ease of Doing Business (EoDB) and globally ranks number one in the greenfield FDI ranking.

Government Initiatives on FDI:

In August 2019, government permitted 100 per cent FDI under the automatic route in coal mining for open sale (as well as in developing allied infrastructure like washeries). In Union Budget 2019-20, the government of India proposed opening of FDI in aviation, media (animation, AVGC) and insurance sectors in consultation with all stakeholders. 100 per cent FDI is permitted for insurance intermediaries.

As of February 2019, the Government of India is working on a road map to achieve its goal of US$ 100 billion worth of FDI inflows. In February 2019, the Government of India released the Draft National E-Commerce Policy which encourages FDI in the marketplace model of e-commerce. Further, it states that

the FDI policy for e-commerce sector has been developed to ensure a level playing field for all participants.

Government of India is planning to consider 100 per cent FDI in Insurance intermediaries in India to give a boost to the sector and attracting more funds. In December 2018, the Government of India revised FDI rules related to e-commerce. As per the rules 100 per cent FDI is allowed in the marketplace-based model of e-commerce. Also, sales of any vendor through an e-commerce marketplace entity or its group companies have been limited to 25 per cent of the total sales of such vendor. In September 2018, the Government of India released the National Digital Communications Policy, 2018 which envisages increasing FDI inflows in the telecommunications sector to US$ 100 billion by 2022.

In January 2018, Government of India allowed foreign airlines to invest in Air India up to 49 per cent with government approval. The investment cannot exceed 49 per cent directly or indirectly. No government approval will be required for FDI up to an extent of 100 per cent in Real Estate Broking Services. The Government of India is in talks with stakeholders to further ease foreign direct investment (FDI) in defence under the automatic route to 51 per cent from the current 49 per cent, in order to give a boost to the Make in India initiative and to generate employment.

11.13 REGIONAL STOCK EXCHANGE

A regional stock exchange is a term used to describe stock exchanges that operates outside of the country's main financial center. It is a stock exchange not located in that country's primary financial centers. Often, regional companies who cannot meet the strict listing requirements of a national exchange may qualify for a listing on a regional exchange. However, a company that qualifies to be on a national exchange may also register for a listing on one or more regional exchanges.

There are 23 stock exchanges in India. Among them two are national level stock exchanges namely Bombay Stock Exchange (BSE) and National Stock Exchange of India (NSE). The rest 21 are Regional Stock Exchanges (RSE). The share of the RSEs, which was as much as 45.6 per cent of the total all-India turnover of Rs. 2.39 lakh crore in 1995-96, declined progressively year after year and in 2001-02, it was just 8.4 per cent of the total volume of Rs. 8.96 lakh crore. At present, there is virtually no trading at any of the RSEs.

The Regional Stock Exchanges started clustering from the year 1894, when the first RSE, the Ahmedabad Stock Exchange (ASE) was established. In the year 1908, the second in the series, Calcutta Stock Exchange (CSE) came into existence. During the early sixties, there were only few recognized RSEs in India namely Calcutta, Madras, Ahmedabad, Delhi, Hyderabad and Indore. The number remained unchanged for the next two decades. 1980s was the turning point and many RSEs were incorporated. The latest is Coimbatore Stock Exchange and Meerut Stock Exchange.

11.14 DEMUTUALIZATION

Demutualization refers to the conversion of an existing non-profit organization into a profits-oriented company. In other words, an association that is mutually owned by members converts itself into an organization that is owned by shareholders. The company can take different shapes and forms, that is, it could be either a listed or unlisted company which may be closely held or publicly held. This process involves the segregation of members' right into distinct segments, viz. ownership rights and trading rights. It changes the relationship between members and the stock exchange. Members while retaining their trading rights acquire ownership rights in the stock exchange, which have a market value, and they also acquire the benefits of limited liability.

Demutualization involves the complex process of transitioning a company's financial structure, from a mutual company into a shareholder-driven model. Mutual companies (not to be confused with mutual funds) are entities seeded by private investors who are also customers or members of these operations. Businesses such as insurance companies, savings and loan associations, banking trusts, and credit unions are commonly structured as

mutual companies. Thus demutualization refers to the transition process of an exchange from a "mutually-owned" association to a company "owned by shareholders". In other words, transforming the legal structure of an exchange from a mutual form to a business corporation form is referred to as demutualization.

The first exchange to get demutualized was the Stockholm Stock Exchange in 1993. After that many exchanges have demutualized. This includes the major stock exchanges like New York Stock Exchange, Chicago Mercantile Exchange, London Stock Exchange, Australian stock Exchange, Deutsche Börse, Toronto Stock Exchange, Singapore Stock Exchange to name a few.

Demutualization of Stock Exchanges in India:

SEBI had formed a Group on Corporatisation and Demutualization of Stock Exchanges under the Chairmanship of Justice M H Kania, former Chief Justice of India, for advising SEBI on corporatization and demutualization of exchanges and to recommend the steps that need to be taken to implement the same. The Group submitted its Report to SEBI on August 28, 2002. The process of demutualising all the broker-run exchanges in India actually started with the Bombay Stock Exchange which was demutualised in August 2005. In the UK, the London Stock Exchange got demutualised in March 2000.

In India, demutualisation was mandated by the government as a regulatory measure directed at ending the brokers' control over the exchanges. By contrast, the London SE's demutualisation was entirely its own voluntary decision, aimed at developing its business in the fast changing and globalising world. This step was expected to improve its international competitiveness, provide greater flexibility, facilitate speedier decision-making, and enable it to form international alliances, as and when necessary.

Process of Demutualization:

Corporatisation of Stock Exchanges is the process of converting the organizational structure of the stock exchange from a non-corporate structure to a corporate structure. Traditionally, some of the stock exchanges in India were established as "Association of persons", like BSE, ASE and MPSE. Corporatisation of these exchanges is the process of converting them into incorporated Companies.

Forces behind the Demutualization:

Demutualization as a concept is neither a very new concept nor very sophisticated. The essence lies with the separation of ownership and management. Thus it is well driven by the good intentions of proper governance, which has taken a new turn after the collapse of many large corporations in the year 2002.

Advantages of Demutualization:

The advantages of demutualized stock exchange are as follows.

- Demutualization results in more flexible governance structure fostering decisive action in response to changes in the business environment.
- It leads to greater investor participation in the governance of the exchange.
- It yields an improved platform in response to potential competitors in the form of alternative trading systems.
- Demutualization allows greater flexibility and access to global markets.
- It also facilitates faster and more complete consolidation of stock exchanges to enhance available synergies.
- It ensures increased access to resources for capital investment raised by way of equity offerings or private investment.



CHECK YOUR PROGRESS

Write the full form of the following:

a) ADRs

b) GDRs

c) ODB

d) IDRs

e) FIIs

f) RSEs

g) FDI

h) NRIs

i) FCCB



11.15 LET US SUM UP

In this unit, we have discuss the following :-

- Companies want to trade their shares in overseas stock exchange need to get them listed through ADR or GDR.
- For this purpose, the company deposits its shares to the Overseas Depository Bank (ODB) and the bank issues Depository Receipts in exchange for shares.
- Depository Receipt is a mechanism through which a domestic company can raise finance from the international equity market.
- An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares-or as little as one share-investment in a foreign company's stock.
- A Global Depositary Receipt (GDR) is a bank certificate issued in more than one country for shares in a foreign company.
- Euro-issues mean the issue which is listed on European Stock Exchange although the subscriptions for the same may come from any corner of the world other than India.
- An Indian Depository Receipt (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian securities Markets.
- A foreign institutional investor (FII) is any type of large investor who does business in a country other than the one in which the investment instrument is being purchased.
- A Foreign Direct Investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country.

- FDI is a major source of non-debt financial resource for the economic development of India.
- A regional stock exchange is a stock exchange not located in that country's primary financial centers, and where regional companies are listed.
- Demutualization is a process by which a private, member-owned company, such as a co-operative, or a mutual life insurance company, legally changes its structure, in order to become a public-traded company owned by shareholders.



11.16 FURTHER READINGS

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- India Financial System –By M Y Khan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy



11.17ANSWERS TO CHECK YOUR PROGRESS

a) American Depository Receipts

b) Global Depository Receipts

c) Overseas Depository Bank

d) Indian Depository Receipts

e) Foreign Institutional Investor

f) Regional Stock Exchanges

g) Foreign Direct Investment

h) Non Resident Indians

i) Foreign Currency Convertible Bonds



11.18 MODEL QUESTIONS

1. Write short notes on the following:
   a) American Depository Receipts (ADRs)
   b) Global Depository Receipts (GDRs)
   c) Indian Depository Receipts (IDRs)
   d) Euro Issues
   e) Foreign Institutional Investor (FIIs)
   f) Regional Stock Exchanges (RSEs)
   a) Foreign Direct Investment (FDI)
2. Distinguish between ADRs and GDRs.
3. Give the meaning of ADRs. Write a detail note on types and working procedure of ADRs.
4. What do you mean by GDRs? Describe the effects of GDRs in Indian capital market.
5. What is FDI? Enumerate the need for FDIs in India.

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Unit 12 : DERIVATIVES MARKETS

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Meaning and Definition of Derivatives

12.4 Classifications of Derivatives

12.5 Participants in the Derivatives Market

12.6 Characteristics of Derivatives

12.7 Functions of Derivatives

12.8 Benefits of Derivatives

12.9 Exchange Traded Derivatives

12.10 Development of Exchange-Traded Derivatives

12.11 Exchange Traded Vs. OTC Derivatives Markets

12.12 Global Derivatives Market

12.13 Derivatives Market in India

12.14 L. C. Gupta Committee on Derivatives

12.15 Recommendations of Prof. J. R. Varma Committee Report

12.16 Let Us Sum Up

12.17 Further Reading

12.18 Answers to Check Your Progress

12.19 Model Questions

12.1 LEARNING OBJECTIVES

After reading this unit you will able to:

- know the Meaning of Derivatives
- discusse the Characteristics of Derivatives
- functions of derivatives know the
- users of derivatives know the
- salient Points of derivatives explain

12.2 INTRODUCTION

In the present state of the economy, there is an imperative need for the corporate clients to protect their operating profits by shifting some of the uncountable financial risks to those who are able to bear and manage them. In this context, derivatives occupy an important place as a risk reducing machinery. This unit discusses about the meaning, types, functions and many other aspects of derivatives in Indian context.

12.3 MEANING AND DEFINITION OF DERIVATIVES

A derivative is a financial instrument that derives its value from an underlying asset. The underlying asset can be equity, currency, commodities, or interest rate. Thus, a change in the underlying asset leads to an equivalent change in the derivative. Derivative markets are investment markets where derivative trading takes place. The derivatives market refers to the financial markets for financial instruments such as underlying assets and financial derivatives. Derivatives are contracts which derive their value from the underlying assets. These are widely used to speculate and make money. Some use them as a risk transfer vehicle as well.

The term derivatives refer to a broad class of financial instruments which mainly include options and futures. These instruments derive their value from the price and other related variables of the underlying asset. They do not have worth of their own and derive their value from the claim they give to their owners to own some other financial assets or security. A simple example of derivative is butter, which is derivative of milk. The price of butter depends upon price of milk, which in turn depends upon the demand and supply of milk. The general definition of derivatives means to derive something from something else.

Derivatives are financial contracts whose value is dependent on an underlying asset or group of assets. The commonly used assets are stocks, bonds, currencies, commodities and market indices. The value of the underlying assets keeps changing according to market conditions. The basic principle behind entering into derivative contracts is to earn profits by speculating

on the value of the underlying asset in future. Imagine that the market price of an equity share may go up or down. You may suffer a loss owing to a fall in the stock value. In this situation, you may enter a derivative contract either to make gains by placing accurate bet. Or simply cushion yourself from the losses in the spot market where the stock is being traded.

According to Securities Contract Regulation Act (SCRA) 1956, derivatives may be defined as:

a) 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;

b) A contract which derives its value from the prices, or index of prices, of underlying securities.

D.G. Gardener defined the derivatives as "A derivative is a financial product which has been derived from market for another product."

The above definition conveys that the derivatives are financial products. Derivative is derived from another financial instrument/ contract called the underlying. A derivative derives its value from underlying assets.

12.4 CLASSIFICATIONS OF DERIVATIVES

Derivative contracts can be classified into the following four types:

a) Forward Contract: A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future. In case of a forward contract the price which paid/received by the parties is decided at the time of entering into contract. It is the simplest form of derivative contract mostly entered by individuals in day to day's life. Forward contract is a cash market transaction in which delivery of the instrument is deferred until the contract has been made. Although the delivery is made in the future, the price is determined on the initial trade date. One of the parties to a forward contract assumes a long position (buyer) and agrees to buy the underlying asset at a certain future date for a certain price. The other party to the contract known as seller assumes a short position and agrees to sell the asset on the same date for the same price. The specified price is referred to as the delivery price. The

contract terms like delivery price and quantity are mutually agreed upon by the parties to the contract. No margins are generally payable by any of the parties to the other. Forwards contracts are traded over-the-counter and are not dealt with on an exchange unlike futures contract. Lack of liquidity and counter party default risks are the main drawbacks of a forward contract.

b) Futures Contract: Futures is a standardized forward contact to buy (long) or sell (short) the underlying asset at a specified price at a specified future date through a specified exchange. Futures contracts are traded on exchanges that work as a buyer or seller for the counterparty. Exchange sets the standardized terms in term of quality, quantity, price quotation, date and delivery place (in case of commodity).The features of a futures contract may be specified as follows:

- These are traded on an organised exchange like IMM, LIFFE, NSE, BSE, CBOT etc.
- These involve standardized contract terms viz. the underlying asset, the time of maturity and the manner of maturity etc.
- These are associated with a clearing house to ensure smooth functioning of the market.
- There are margin requirements and daily settlement to act as further safeguard.
- These provide for supervision and monitoring of contract by a regulatory authority.
- Almost ninety percent future contracts are settled via cash settlement instead of actual delivery of underlying asset.

c) Options Contract: Options are financial derivative contracts that give the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price (referred to as the strike price) during a specific period of time. In case of futures contact, both parties are under obligation to perform their respective obligations out of a contract. But an options contract, as the name suggests, is in some sense, an optional contract. Options contracts are of two types: call options and put options. A 'call option' gives one the right to buy; a 'put option' gives one the right to sell. Apart from this, options can also be

classified as OTC (Over the Counter) options and exchange traded options. In case of exchange traded options contract, contracts are standardized and traded on recognized exchanges, whereas OTC options are customized contracts traded privately between the parties.

d) Swaps Contract: A swap can be defined as a barter or exchange. It is a contract whereby parties agree to exchange obligations that each of them have under their respective underlying contracts or we can say, a swap is an agreement between two or more parties to exchange stream of cash flows over a period of time in the future. The parties that agree to the swap are known as counter parties. The two commonly used swaps are: i) Interest rate swaps which entail swapping only the interest related cash flows between the parties in the same currency, and ii) Currency swaps: These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than the cash flows in the opposite direction.

12.5 PARTICIPANTS IN THE DERIVATIVES MARKET

Derivatives contracts are being bought and sold by a large number of individuals, business organizations, governments and others for a variety of purposes. The participants in the derivatives market can be broadly categorized into the following four groups:

i) Hedgers: Hedging is when a person invests in financial markets to reduce the risk of price volatility in exchange markets, i.e., eliminate the risk of future price movements. Derivatives are the most popular instruments in the sphere of hedging. It is because derivatives are effective hedges in correspondence with their respective underlying assets.

ii) Speculators:

Speculation is the most common market activity that participants of a financial market take part in. It is a risky activity that investors engage in. It involves the purchase of any financial instrument or an asset that an investor speculates to become significantly valuable in the future. Speculation is driven by the motive of potentially earning lucrative profits in the future. The risk reduced by hedging is transferred to the counterparty to the trade, who may be

another hedger with opposite requirements or a speculator. Speculators expose themselves to risk by buying or selling in futures market in order to profit from the future price fluctuations (buy an asset when the price is low and sell it when it is high) and thus, provide liquidity to the market.

iii) Arbitrageurs:

Arbitrage is a very common profit-making activity in financial markets that comes into effect by taking advantage of or profiting from the price volatility of the market. Arbitrageurs make a profit from the price difference arising in an investment of a financial instrument such as bonds, stocks, derivatives, etc. Arbitrageurs are investors who exploit price discrepancies between markets by entering into transactions in two or more markets. When the opportunity emerges, an arbitrageur tries to take advantage of it by buying in one market at a particular 'price and simultaneously selling in the other market at a higher price.

iv) Margin traders:

In the finance industry, the margin is the collateral deposited by an investor investing in a financial instrument to the counterparty to cover the credit risk associated with the investment. A margin refers to the minimum amount that you need to deposit with the broker to participate in the derivative market. It is used to reflect your losses and gains on a daily basis as per market movements. It enables to get leverage in derivative trades and maintain a large outstanding position.

12.6 CHARACTERISTICS OF DERIVATIVES

- Derivatives have the characteristic of Leverage or Gearing. With a small initial outlay of funds (a small percentage of the entire contract value) one can deal big volumes.

- Pricing and trading in derivatives are complex and a through understanding of the price behaviour and product structure of the underlying is an essential pre-requisite before one can venture into dealing in these products.

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

12.7 FUNCTIONS OF DERIVATIVES

- **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 a future 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. You 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.

12.8 BENEFITS OF DERIVATIVES

Derivatives provide a range of benefits by enabling the exchange of future risks. Not only can businesses around the world effectively use deriva-

tives to hedge risks by reducing uncertainty about future prices, derivatives also foster investments, since investors can achieve better returns at a lower cost. In this way, derivatives fulfill an important function in the price discovery of assets.

- **Protection against risks**

The most important benefit of derivatives is the ability to manage market risk, i.e. to lower the actual market risk level to the desired one. This task of minimizing or eliminating risk, often called hedging, means that derivatives can safeguard corporate and financial institutions against unwanted price movements. For example, an airline can today lock in the price for fuel needed at a future point in time using kerosene forward. Even with a minimum upfront investment, derivatives serve to limit the volatility of companies' cash flows. This in turn gives rise to more reliable forecasting, lower capital costs, and higher capital productivity -all of which contribute to economic growth.

- **Possibility of trading on future price expectations**

A second essential function fulfilled by derivatives is price discovery, allowing investors to trade on future price expectations. By trading in derivatives, investors effectively disclose their beliefs on future prices and increase the amount of information available to all market participants. In this way, derivatives enhance valuation and thereby allocation efficiency.

For example, investors can take positions against the market if they expect an asset to drop in value (e.g. a derivatives contract to sell a single stock). Alternatively, they can take the market position (e.g. a futures contract on a commodity) if they perceive an asset to be undervalued and expect its value to rise again in the future. Adopting such strategies is important to reduce the risk of assets being subject to under- or overvaluation and allows a consistent valuation over time.10) Derivatives have further benefits. They can be employed for hedging and investment purposes at very low transaction costs, especially in comparison to investing directly in the underlying.11) In

addition, derivatives enable rapid innovation of products that can be easily customized to the needs of any user.

12.9 EXCHANGE TRADED DERIVATIVES

An exchange traded derivative is a financial instrument that trades on a regulated exchange and whose value is based on the value of another asset. Exchange traded derivatives have become increasingly popular because of the advantages they have such as standardization, liquidity, and elimination of default risk. Futures and options are two of the most popular exchange traded derivatives. These derivatives can be used to hedge exposure or speculate on a wide range of financial assets like commodities, equities, currencies, and even interest rates.

One of the defining characteristic of exchange traded derivatives is their mark-to-market feature, wherein gains and losses on every derivative contract are calculated on a daily basis. If the client has incurred losses that have eroded the margin put up, he or she will have to replenish the required capital in a timely manner or risk the derivative position being sold off by the firm.

Exchange traded derivatives are well suited for the retail investor, unlike their over-the-counter cousins. In the OTC market, it is easy to get lost in the complexity of the instrument and the exact nature of what is being traded. In that regard, exchange traded derivatives have two big advantages:

- **Standardization**: The exchange has standardized terms and specifications for each derivative contract, making it easy for the investor to determine how many contracts can be bought or sold. Each individual contract is also of a size that is not daunting for the small investor.
- **Elimination of default risk**: The derivatives exchange itself acts as the counterparty for each transaction involving an exchange traded derivative, effectively becoming the seller for every buyer, and the buyer for every seller. This eliminates the risk that the counterparty to the derivative transaction may default on its obligations.

12.10 DVELOPMENT OF EXCHANGE-TRADED DERIVATIVES

Derivatives have probably been around for as long as people have been trading with one another. Forward contracting dates back at least to the 12th century, and may well have been around before then. Merchants entered into contracts with one another for future delivery of specified amount of commodities at specified price. A primary motivation for pre-arranging a buyer or seller for a stock of commodities in early forward contracts was to lessen the possibility that large swings would inhibit marketing the commodity after a harvest. The following factors have been driving the growth of financial derivatives:

- Increased volatility in asset prices in financial markets,
- Increased integration of national financial markets with the international markets,
- Marked improvement in communication facilities and sharp decline in their costs,
- Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and
- Innovations in the derivatives markets, which optimally combine the risks and returns over a large number of financial assets leading to higher returns, have reduced risk as well as transactions costs as compared to individual financial assets.

12.11 EXCHANGE TRADED VS. OTC DERIVATIVES MARKETS

The OTC derivatives markets have witnessed rather sharp growth over the last few years, which have accompanied the modernization of commercial and investment banking and globalization of financial activities. The recent developments in information technology have contributed to a great extent to these developments.

Exchange refers to the formally established stock exchange wherein securities are traded and they have a defined set of rules for the participants. When the trading is performed through the exchange, it is under the supervision of the exchange and so it ensures that all the rules and regulations are duly complied with. Whereas, Over the Counter (OTC) is a dealer oriented

market of securities, which is a decentralized and unorganized market where trading happens by way of phone, emails, etc.

While both exchange-traded and OTC derivative contracts offer many benefits, the former have rigid structures compared to the latter. The highly leveraged institutions and their OTC derivative positions were the main cause of turbulence in financial markets in 1998. The OTC derivatives markets have the following features compared to exchange traded derivatives:

- The management of counter-party (credit) risk is decentralized and located within individual institutions.
- There are no formal centralized limits on individual positions, leverage, or margining.
- There are no formal rules for risk and burden-sharing.
- There are no formal rules or mechanisms for ensuring market stability and integrity, and for Safeguarding the collective interests of market participants, and
- The OTC contracts are generally not regulated by a regulatory authority and the exchange's self regulatory organization, although they are affected indirectly by national legal systems, banking supervision and market surveillance.

Basis for Comparison	**OTC (Over The Counter)**	**Exchange**
Meaning	Over the Counter or OTC is a decentralized dealer market wherein brokers and dealers transact directly via computer networks and phone.	Exchange is an organized and regulated market, wherein trading of stocks takes place between buyers and sellers in a safe, transparent and systematic manner.
Market maker	Dealer	Exchange itself
Used by	Small companies	Well established companies
Physical Location	No	Yes
Trading hours	24×7	Exchange hours
Stocks	Unlisted Stocks	Listed Stocks
Transparency	Low	Comparatively high
Contracts	Customized	Standardized

12.12 GLOBAL DERIVATIVES MARKET

Over the past 25 years, the financial market has seen strong growth and innovation, and derivatives have contributed substantially to this impressive development. Today, the global derivatives market is a main pillar of the international financial system and the economy as a whole. Businesses around the world today use derivatives to effectively hedge risks and reduce uncertainty about future prices. Derivatives contribute to economic growth and increase the efficiency of markets by improving price discovery for assets.

Derivatives are financial instruments that are traded among market participants over the counter (OTC) or via regulated markets (on-exchange), whereby the former comprises the majority of the market. Derivatives are used to protect against and manage risks, offering their users various benefits compared to other financial instruments. Considering the key role played by the global derivatives market in the global economy, it is not at all surprising that the market has seen such strong growth over the past decades.

Derivatives are an important class of financial instruments that are central to today's financial and trade markets. They offer various types of risk protection and allow innovative investment strategies. Around 25 years ago, the derivatives market was small and domestic. Since then it has grown impressively. No other class of financial instruments has experienced as much innovation. Product and technology innovation together with competition have fuelled the impressive growth that has created many new jobs both at exchanges and intermediaries as well as at related service providers. As global leaders driving the market's development, European derivatives players today account for more than 20 percent of the European wholesale financial services sector's revenues and contribute 0.4 percent to total European GDP.

Given the derivatives market's global nature, users can trade around the clock and make use of derivatives that offer exposure to almost any 'underlying' across all markets and asset classes. The derivatives market is predominantly a professional wholesale market with banks, investment firms, insurance companies and corporate as its main participants.

The global derivatives market is a main pillar of the international financial system and economy. As an indispensible tool for risk management and investment purposes, derivatives are used by more than 94 percent of the world's largest companies. Benefits of derivatives that make them indispensable to the global financial system and the economy are:

- Provide risk protection with a minimum upfront investment and capital consumption.
- Allow investors to trade on future price expectations thus improving efficiency of price discovery.
- Have very low overall transaction costs compared with investing directly in the underlying asset.
- Allow fast product innovation because new contracts can be introduced rapidly.
- Can be customized to the specific needs of any user.

12.13 DERIVATIVES MARKET IN INDIA

At present the Indian stock markets are not having any risk hedged instruments that would allow the investors to manage and minimize the risk. In industrialized countries apart from money market and capital market securities, a variety of other securities known as 'derivatives' have now become available for investment and trading. The derivatives originate in mathematics and refer to a variable which has been derived from another variable. A derivative is a financial product which has been derived from another financial product or commodity. The derivatives do not have independent existence without underlying product and market. Derivatives are contracts which are written between two parties for easily marketable assets. Derivatives are also known as deferred delivery or deferred payment instruments.

In India, the emergence and growth of derivatives market is relatively a recent phenomenon. Since its inception in June 2000, derivatives market has exhibited exponential growth both in terms of volume and number of contract traded. The market turnover has grown from Rs.2365 Cr. in 2000-2001 to Rs. 26444804.86 Cr. in 2013-14. Within a short span of time, derivatives trading in

India has surpassed cash segment in terms of turnover and number of traded contracts.

12.14 L. C. GUPTA COMMITTEE ON DERIVATIVES

SEBI appointed the L. C. Gupta Committee on 18th November 1996 to develop appropriate regulatory framework for derivatives trading and to recommend suggestive bye-laws for Regulation and Control of Trading and Settlement of Derivatives Contracts. The Committee was also to focus on financial derivatives and in particular, equity derivatives. The Committee submitted its report in March 1998.

The Board of SEBI in its meeting held on May 11, 1998 accepted the recommendations of the Dr. L.C. Gupta Committee and approved the phased introduction of derivatives trading in India beginning with Stock Index Futures. The Board also approved the 'Suggestive Bye-laws' recommended by the committee for Regulation and Control of Trading and Settlement of Derivatives Contracts. SEBI circulated the contents of the Report in June 1998.

The important recommendations of L. C. Gupta Committee are:

1. Need for coordinated development

The Committee feels that the attempt should be to develop an integrated market structure. SEBI-RBI coordination mechanism as all the three types of financial derivatives are set to emerge in India in the near future, it is desirable that such development be coordinated. The Committee recommends that a formal mechanism be established for such coordination between SEBI and RBI in respect of all financial derivatives markets. This will help to avoid the problem of overlapping jurisdictions.

2. Cash and Futures Market Relationship

The Committee felt that the operations of the cash market, on which the derivatives market will be based, needed improvement in many respects. It therefore suggested improvements to the Cash Market.

3. Derivatives Exchanges

The Committee strongly favoured the introduction of financial derivatives to facilitate hedging in a most cost-efficient way against market risk. There is a need for equity derivatives, interest rate derivatives and currency deriva-

tives. There should be phased introduction of derivatives produces. To start with, index futures to be introduced, which should be followed by options on index and later options on stocks. The derivative trading should take place on a separate segment of the existing stock exchanges with an independent governing council where the number of trading members should be limited to 40 percent of the total number.

4. Regulatory framework

Regulatory control should envisage modern systems for fool-proof and fail-proof regulation. Regulatory framework for derivatives trading envisaged two-level regulation i.e. exchange-level and SEBI-level, with considerable emphasis on self-regulatory competence of derivative exchanges under the overall supervision and guidance of SEBI. There will be complete segregation of client money at the level of trading /clearing member and even at the level of clearing corporation.

5. Regulatory Role of SEBI

SEBI will approve rules, bye-laws and regulations. New derivative contracts to be approved by SEBI. Derivative exchanges to provide full details of proposed contract, like - economic purposes of the contract; likely contribution to the market's development; safeguards incorporated for investor protection and fair trading.

6. Specifications Regarding Trading

Stock Exchanges are to stipulate in advance trading days and hours. Each contract is to have pre-determined expiration date and time. Contract expiration period may not exceed 12 months. The last trading day of the trading cycle is to be stipulated in advance.

7. Membership Eligibility Criteria

The trading and clearing member will have stringent eligibility conditions. The Committee recommended for separate clearing and non-clearing members. There should be separate registration with SEBI in addition to registration with the stock exchange. At least two persons should have passed the certification program approved by SEBI.

8. Clearing Corporation (CC)

The Clearing System to be totally restructured. There should be no trading interests on board of the Clearing Corporation (CC). The maximum exposure limit to be liked the deposit limit. To make the clearing system effective the Committee stressed stipulation of Initial and mark-to-market margins.

9. Mark to Market and Settlement:

There should the system of daily settlement of futures contracts. Similarly the closing price of futures is to be settled on daily basis. The final settlement price is to be as per the closing price of underlying security.

10. Sales Practices:

- Risk disclosure document with each client mandatory
- Sales personnel to pass certification exam
- Specific authorisation from client's board of directors/trustees

11. Trading Parameters

- Each order - buy/sell and open/close
- Unique order identification number
- Regular market lot size, tick size
- Gross exposure limits to be specified
- Price bands for each derivative contract
- Maximum permissible open position
- Off line order entry permitted

12. Brokerage

- Prices on the system shall be exclusive of brokerage
- Maximum brokerage rates shall be prescribed by the exchange
- Brokerage to be separately indicated in the contract note

13. Margins From Clients

- Margins to be collected from all clients/trading members
- Daily margins to be further collected
- Right of clearing member to close out positions of clients/TMs not paying daily margins
- Losses if any to be charged to clients/TMs and adjusted against margins

14. Other Recommendations

- Removal of the regulatory prohibition on the use of derivatives by mutual funds while making the trustees responsible to restrict the use of derivatives by mutual funds only to hedging and portfolio balancing and not for speculation.
- Creation of derivatives Cell, a derivatives Advisory Committee, and Economic Research Wing by SEBI.
- Declaration of derivatives as securities under section 2(h)(iia) of the SCRA and suitable amendment in the notification issued by the Central Government in June 1969 under section 16 of the SCRA.

12.15 RECOMMENDATIONS OF PROF. J. R. VARMA COMMITTEE REPORT

SEBI, while accepting the recommendations of Dr L C Gupta Committee, appointed a Committee under Prof. J R Varma to recommend measures for risk containment for derivatives market in India. This Committee focused on ways of making operational the broad recommendations of the Dr. L.C. Gupta Committee to maintain the initial margin to cover 99% Value at Risk (VaR).

With regard to margining system, Prof. J R Varma Committee report suggested that SEBI should authorise the use of a particular VaR estimation methodology but should not mandate a specific minimum margin level.

The Committee also recommended that the volatility estimated at the end of the day's trading should be used in calculating margin calls at the end of the same day. Further, the volatility estimation and margin fixation methodology was also required to be clearly made known to all market participants so that they can compute what the margin would be for any given closing level of the index. The trading software for this purpose should itself provide this information on a real time basis on the trading workstation screen.

The Committee took note of the international practice of levying very low margins on calendar spreads. The Committee suggested that:

- The margin on calendar spreads should be levied at a flat rate of 0.5% per month of spread on the far month contract of the spread subject to a minimum margin of 1% and a maximum margin of 3% on the far side

of the spread for spreads with legs upto 1 year apart. A spread with the two legs three months apart would thus attract a margin of 1.5% on the far month contract.

- The margining of calendar spreads should be reviewed at the end of six months of index futures trading.
- A calendar spread should be treated as a naked position in the far month contract as the near month contract approaches expiry. This change should be affected in gradual steps over the last few days of trading of the near month contract. Specifically, during the last five days of trading of the near month contract, the following percentages of a calendar spread shall be treated as a naked position in the far month contract: 100% on day of expiry, 80% one day before expiry, 60% two days before expiry, 40% three days before expiry, 20% four days before expiry. The balance of the spread shall continue to be treated as a spread. This phasing in will apply both to margining and to the computation of exposure limits.
- If the closing out of one leg of a calendar spread causes the members liquid net worth to fall below the minimum levels specified by Exchanges/ SEBI, his terminal shall be disabled and the clearing corporation shall take steps to liquidate sufficient positions to restore the members liquid net worth to the levels mandated.
- The derivatives exchange should explore the possibility that the trading system could incorporate the ability to place a single order to buy or sell spreads without placing two separate orders for the two legs.
- For the purposes of the exposure limit, a calendar spread shall be regarded as an open position of one third of the mark to market value of the far month contract.

The Committee also recommended laying down of operational guidelines by clearing corporation on collection of margin and standard guidelines for back office accounting at the clearing member and trading member level to facilitate the detection of non-compliance at each level. The Committee felt the

need to have another level of defence in the form of the broker's net worth to avoid any crisis from time to time.



CHECK YOUR PROGRESS

Write the full form of the following:

i) SCRA

ii) SEBI

iii) OTC

iv) NSE

v) BSE

vi) EFT

vii) CC



12.16 LET US SUM UP

In this unit, we have discuss the following :-

- The derivatives market refers to the financial markets for financial instruments such as underlying assets and financial derivatives.
- The term derivatives refer to a broad class of financial instruments which mainly include options and futures.
- A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future.
- Futures contracts are traded on exchanges that work as a buyer or seller for the counterparty.
- Options are financial derivative contracts that give the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price during a specific period of time.

- Swap is an agreement between two or more parties to exchange stream of cash flows over a period of time in the future.
- An exchange traded derivative is a financial instrument that trades on a regulated exchange and whose value is based on the value of another asset.
- Today, the global derivatives market is a main pillar of the international financial system and the economy as a whole. Businesses around the world today use derivatives to effectively hedge risks and reduce uncertainty about future prices.



12.17 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- Financial Derivatives in India – By Jagadish R. Raiyani



12.18 ANSWERS TO CHECK YOUR PROGRESS

i) Securities Contract Regulation Act
ii) Securities and Exchange Board of India
iii) Over the Counter
iv) National Stock Exchange
v) Bombay Stock Exchange
vi) Electronic Funds Transfer
vii) Clearing Corporation



12.19 MODEL QUESTIONS

1. Define derivatives.
2. Distinguish between forward and futures markets.
3. List any four points related to regulation of derivatives in India.
4. What are credit derivative instruments?
5. Differentiate Badla from a Forward trade.
6. Distinguish between swap and option.
7. Explain the various functions of derivatives market and types of players.
8. Explain the measures specified by SEBI to enhance protection of rights of investors in derivatives market.
9. Give any the recommendations of L. C. Gupta Committee.
10. Mention any the recommendations of J. R. Varma Committee.
11. “Trading in derivatives encouraged investors to speculate”. Comment.

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UNIT 13 : NON-BANKING FINANCIAL INSTITUTIONS

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Meaning and Concept of Non-Banking Financial Institutions

13.4 Definition of Non-Banking Financial Company

13.5 Difference between NBFIs and Banks

13.6 Registration of NBFIs/NBFCs

13.7 Supervisory Framework for NBFIs/NBFCs

13.8 Role of NBFIs/NBFCs

13.9 Different Types of NBFIs/NBFCs in India

13.10 Functions/ Services Provided by NBFCs/NBFIs

13.11 Sources of Funds of NBFIS

13.12 RBI Regulations for Funding in NBFCs

13.13 Investment Strategies of NBFIs

13.14 Let Us Sum Up

13.15 Further Reading

13.16 Answers to Chek Your Progress

13.17 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and role of non-banking financial institutions
- differentiate between banking and non-banking financial companies
- interpret the guidelines for regulating non-banking financial companies
- identify the types of non-banking financial companies
- explain the various types of services provided by non-banking financial companies
- discuss the evolution of non-banking financial companies in India

13.2 INTRODUCTION

There are so many financial institutions exist in the financial system, that provide banking like services. But they are not actual banks. These institutions are specialized in some particular sectors or groups. These institutions are not allowed to take deposits from the public. This unit discusses about the role of such non-banking financial institutions in the financial system of the country.

13.3 MEANING AND CONCEPT OF NON-BANKING FINANCIAL INSTITUTIONS

The terms Non-Bank Financial Institutions or Non-Bank Financial Intermediaries (NBFIs) also termed as Non-Bank Financial Companies (NBFCs), supplement banks by providing the infrastructure to allocate surplus resources to individuals and companies with deficits. Non-Banking Financial Institutions (NBFIs) refer to those companies that offer financial services, but do not hold banking licenses and cannot accept deposits. Insurance companies, brokerage firms, and companies offering microloans are examples of Non-Banking Financial Institutions. Non-bank financial intermediaries play an important role in promoting savings in the country. These institutions provide a wide range of financial assets as store of value and make available expert financial services to the savers.

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license and cannot accept deposits from the public. However, NBFIs do facilitate alternative financial services, such as investment (both collective and individual), risk pooling, financial consulting, brokering, money transmission, and check cashing. Examples of non-bank financial institutions include insurance firms, venture capitalists, currency exchanges, some microloan organizations, and pawn shops. These non-banking financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups.

13.4 DEFINITION OF NON-BANKING FINANCIAL COMPANY

Reserve Bank of India defines NBFC as 'A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme of arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).'

According to the Reserve Bank of India Amendment Act, 1997 the Non Banking Finance Company was defined as under:

- A financial institution which is a company,
- A non banking institution which is a company and whose principal business is to receiving of deposits under any scheme/arrangement/in any other manner or lending in any manner and
- Other non banking institutions/class of institutions as the RBI may specify

This definition excludes financial institutions besides institutions which carry on agricultural operations as their principal business. Non-banking finance companies consist mainly of finance companies which carry on hire purchase finance, housing finance, investment, loan, equipment leasing or mutual benefit financial companies but do not include insurance companies or stock exchanges or stock-broking companies.

13.5 DIFFERENCE BETWEEN NBFIs AND BANKS

The difference between banks and NBFIs is mainly in the nature of the liabilities of the two and, to some extent, in the structure of their assets. While the liabilities of commercial banks usually consist of demand and time deposits, those of NBFIs do not ordinarily include demand deposits, the mutual benefit financial companies, commonly known as Nidhis, being notable exceptions. From the point of view of assets held, it may be said that commercial banks hold a wide variety ranging from short-term and medium-term to long term credits and they also use various credit instruments like overdrafts, cash credits, bills, etc. On the other hand, the assets of NBFCs are more specialized. For instance, hire purchase finance companies confine their operations mainly to the financing of transport operations and consumer credit while housing finance companies make loans for housing purpose.

Many activities and functions of NBFI's are similar to those of banks. The distinction between them has become considerably indistinct. It is true that NBFIs, unlike banks, are still not a part of payments mechanism. They cannot create money but in many other respects, they are substitution and complementary with banks.

NBFIs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:

- NBFI cannot accept demand deposits;
- NBFIs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
- Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFIs, unlike in case of banks.

Difference between Banks and NBFCs in table form

Features/Indicators	Banks	NBFCs
Regulated By	RBI-Banking Act	Companies Act and the direction of RBI
The process of Loan sanction	Moderately Stringent	Easier and faster
Product Offering	all types of loans	Majorly property loans
Interest Rate Benchmark	Base rate + Margin	Retail Prime Lending Rate(RPLR)-Spread
Overdraft Facility	Available	Not Available
Passing interest rate benefit to existing borrowers	No much room more existing borrowers	High chance for existing and new borrowers to get benefited from discounts and offers
Pre-payment convenience through NEFT	Available at banks for all customers	Usually prefers cheque payments to process Electronic Clearing Service(ECS)
Interest Rates	Rate of interest will be comparatively lower	Depends on the property and applicant and most of the times will be higher than banks

13.6 REGISTRATION OF NBFIs/NBFCs

In terms of Section 45-IA of the RBI Act, 1934, no Non-banking Financial Company can commence or carry on business of a non-banking financial institution without a) obtaining a certificate of registration from the bank and without having a Net Owned Funds of ₹ 25 lakhs (Two crore since April 1999). However, in terms of the powers given to the Bank, to prevent dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982, Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit Company.

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should comply with the following:

- It should be a company registered under Section 3 of the companies Act, 1956.

- It should have a minimum net owned fund of 200 lakh. (The minimum net owned fund (NOF) required for specialized NBFCs like NBFC-MFIs, NBFC-Factors, CICs is indicated separately in the FAQs on specialized NBFCs).

13.7 SUPERVISORY FRAMEWORK FOR NBFIs/NBFCs

The Supervisory framework for NBFCs is based on three aspects—(a) the size of NBFC, (b) type of activity (c) the acceptance or otherwise of public deposits. Towards this end, a four-pronged supervisory strategy comprising

(a) On-site inspection based on CAMELS (Capital, Assets, Management, Earnings, Liquidity, Systems and Procedures) methodology.

(b) Computerized off-site surveillance through periodic control returns,

(c) An effective market intelligence network, and

(d) A system of submission of exception reports by auditors of 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 NBFCs but they have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

Housing Finance Companies are regulated by National Housing Bank, Merchant Banker/Venture Capital Fund Company/stock-exchanges/stock brokers/sub-brokers are regulated by Securities and Exchange Board of India, and Insurance companies are regulated by Insurance Regulatory and Development Authority. Similarly, Chit Fund Companies are regulated by the respective State Governments and Nidhi Companies are regulated by Ministry of Corporate Affairs, Government of India. Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation.

It may also be mentioned that Mortgage Guarantee Companies have been notified as Non-Banking Financial Companies under Section 45 I (f) (iii) of the RBI Act, 1934. Core Investment Companies with asset size of less than 100 crore, and those with asset size of 100 crore and above but not accessing public funds are exempted from registration with the RBI.

13.8 ROLE OF NBFIs/NBFCs

Non-Banking Financial Companies play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. There are different types of institutions involved in financial services in India. These include commercial banks, financial institutions and non-banking finance companies. Due to the financial sector reforms, NBFCs have been emerged as an integral part of the Indian financial system. Non-banking finance companies frequently act as suppliers of loans & credit facilities and accept deposits, operating mutual funds and similar other functions. They are competitive and complimentary to banks and financial institutions.

13.9 DIFFERENT TYPES OF NBFIs/NBFCs IN INDIA

RBI has identified as many as 12 categories of NBFCs. Five of them are regulated by the RBI, Chit funds jointly by the RBI and the Registrar of Chits and two (mutual benefit funds including Nidhis and micro finance companies) by the Department of Company Affairs, Government of India. The National Housing Bank (NHB) regulates housing finance companies. Stock Broking and Merchant Banking Companies are regulated by the Securities and Exchange Board of India and insurance companies come under the Insurance Regulatory and Development Authority. The different categories of NBFCs operating in India under the supervisory control of RBI are:

- Residuary Non-banking Finance Companies (RNBCs)
- Miscellaneous Non-Banking Finance Companies (MNBCs)

1. **Residuary Non-Banking Company:** Residuary Non-Banking Company is a class of NBFC, which is a company and has as its principal business the receiving of deposits, under any scheme of arrangement or in any other

manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

2. **Miscellaneous Non-Banking Financial Companies**: Miscellaneous Non-Banking Financial Companies are another type of NBFCs and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above.

13.10 FUNCTIONS/ SERVICES PROVIDED BY NBFCs/NBFIs

NBFCs provide range of financial services to their clients. Types of services under non-banking finance services include the following:

- Hire Purchase Services
- Leasing Services
- Housing Finance Services
- Asset Management Services
- Venture Capital Services
- Mutual Benefit Finance Services (Nidhi)

Now we take a look at each type of service that an NBFI could undertake.

1. Hire Purchase Services

Hire purchase is the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the installments, the owner can repossess the goods. Hire purchase is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor Finance Co., Bajaj Auto Finance Company is some of the hire purchase financing companies.

2. Leasing Services

A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFI may obtain license to commence leasing services subject to, they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. is some of the Leasing companies in India.

3. Housing Finance Services

Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may undertake the services /activities such as Providing long term finance for the purpose of constructing, purchasing or renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing Finance Co. Ltd., HDFC is some of the housing finance companies in our country.

4. Asset Management Services

Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.

5. Venture Capital Services

Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise

to venture projects. In India, venture capital concentrates on seed capital finance for high technology and for research & development. ICICI ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, IDBI and others also promoting venture capital finance activities.

6. Mutual Funds Services

A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification.

13.12 SOURCES OF FUNDS OF NBFIS

A Non-Banking Financial Company (NBFC) is a company which carries on the business of loans and advances, acquisition of shares, bonds, stock, insurance business or hire-purchase, but does not include any institution whose principal business objective is agriculture or agriculture allied activity, purchase or sale of any goods (other than securities) ordinary business activity or providing any services and sale/purchase/construction of immovable property. As these financial institutions lack the ability to raise money supply at a low rate like banks, they end up raising funds at a higher interest rate, thereby causing the hurdle rate on their funds to increase proportionately in order to maintain Net Interest Margins between 1-3%. This causes NBFCs to seek alternative strategies for deployment of funds in order to generate a higher return (thereby taking on a higher risk pattern). Funding source of NBFCs comprises debentures, borrowings from banks and FIs, public deposits, commercial papers, and inter-corporate loans.

1. Sources of Funds

There are three primary sources of funds looking to raise money without deposits:

a) Long Term: These are through term loans obtained from banks in a single quantum, after deciding on the amount of funds to be deployed in the

normal course of operations of the NBFC. The advantage of doing so is that banks can usually lend at much lower rates owing to the nature of the CASA deposits, which favours the business model of NBFCs that have a more aggressive risk-return profile. These kind of loans can be unsecured or secured through Government Securities (which again is monitored by the Treasury Department), and repayment can be done in bullet or a structured schedule. This repayment should ideally be mirrored with the repayment schedules of the assets on the balance-sheet. A good credit rating is mandatory for raising large sums at a competitive interest rate.

b) Medium Term: Bonds are used as a common route to reduce the interest rate on the sources of funds. The coupon rate on the bond is selected in order to reflect the rating profile of the NBFC as well as a return better than the Government Securities. In some cases, tax-free bonds are also issued for priority sectors such as infrastructure and roads. The maturity profile of these bonds coincides with the repayment/interest schedules of the investments made by the NBFCs (and displayed as assets on the balance sheet). Bonds can be issued to retail investors as well, which is a primary advantage for NBFCs during bond placement.

c) Short Term: Short term loans offered by an NBFC can be issued by raising funds through Commercial Paper (CPs). CP is short term unsecured promissory notes issued by companies, with tenure of 3 months to 12 months.

13.12 RBI REGULATIONS FOR FUNDING IN NBFCs

NBFCs (Non-Banking Financial Companies) as the name suggests, are not banking companies. They do not rely on CASA (Current Account Savings Account) deposits for raising funds. As CASA deposits are only meant for banks, wherein the banks are provided with licenses by the RBI in order to accept monies from the public. NBFCs do not have those luxuries, it means, the NBFCs needs to look for alternate sources of the money supply, which are higher than the deposits taken by banks, where the interest rate offered is between 4-6 percent.

The financial institutions capable of raising money supply at a low rate like banks and end up raising funds at a higher interest rate. This causes NBFCs

to seek for alternative strategies for raising funds in order to generate a higher return. The Key Points to keep in mind while raising funds in NBFC are:

- Evaluating the mismatch between assets & liabilities; and
- Minimizing the mismatch in assets and Liabilities.

NBFCs can raise funds from various sources. One of the best options to raise fund is from foreign investment. After the liberalization of the Indian economy in 1991, there have been witnessed a significant interest of foreign investors in the Indian NBFC sectors.

Foreign investment in NBFC sector is permitted under the automatic route as per the FDI policy.

- The automatic route is one where no approval from Foreign Investment Promotion Board (FIPB) or RBI approval is needed before making the proposed investment. Up to 100%, foreign investment is permitted without the approval of FIPB under the automatic.
- All foreign transactions are required to rout only through entities licensed by the RBI as per the regulations framed under FEMA.
- A Foreign investment which is allowed under automatic route only in the non-banking financial service activities are as follows:
    - Merchant Banking, Underwriting, Portfolio Management Services, Stock Broking, Asset Management, Venture Capital, Custodian Services, Factoring
    - Leasing & Finance, Housing Finance, Credit Card Business, Micro Credit, Rural Credit, Non-fund based activities, Investment Advisory Services, Financial Consultancy, Forex Broking, Credit Rating Agencies, Money Changing Business, etc.
- FDI in such NBFC's is allowed without any minimum capitalization norms after 2016.

13.13 INVESTMENT STRATEGIES OF NBFIs

Debt Strategy: The fixed income portfolio will be invested in debt securities maturing in line with the maturity of scheme. The fixed income strategy would to buy and hold. The debt portfolio is largely run as an accrual income product and will be passively managed. The Fixed income portion is

intended to be invested across sectors and in AA and AAA & Equivalent rated debt securities. The investment philosophy for fixed income investments follows from the objective to deliver optimal risk-adjusted returns across the products.

A combination of top, down and bottom up approaches are used to construct portfolios. Global and local macro-economic variables such as growth indicators, inflation outlook, currency changes, liquidity, etc. are analyzed to determine the long-term and short-term trends. Short-term, cyclical economic considerations are used to fine-tune the duration of the portfolios.

The investment universe includes government securities, corporate bonds, mortgages backed securities, and asset backed securities and money market instruments. They make asset allocation changes within this universe depending upon changes in relative valuations / spreads and the forward outlook for them. They maintain high credit quality portfolios across the board. Normally, portfolios have more than 85% in AA or higher rated assets. Credit risks are assumed after internal due diligence. The investment strategy of individual funds follows from the investment philosophy enunciated above and is fine tuned to suit the respective investment objectives of the funds.

Equity Strategy: The equity exposure would be in equity & equity-related instruments, primarily through long call options on Nifty, with expiry near to the maturity of the scheme. The equity derivative strategy would endeavor to provide exposure to equities by buying call options. The participation rate would depend on the prevailing prices of the option contract. The total Equity exposure of the fund will be in the range of 5%-20%. The Fund intends to buy call options with December 2014 expiry, and may invest some portion into large cap stocks for the remaining tenor of the fund.

Investment Philosophy: The overall investment philosophy stems from our objective of delivering superior risk adjusted returns to investors over an extended time frame. The investment philosophy is rooted in a set of well established but flexible principles that relies extensively on fundamental research. It is driven by the belief that over time stock prices reflect a business' underlying intrinsic values and its long-term prospects. As a result, the research pro-

cess aims to arrive at a comprehensive understanding of a company's business including the nature of its interactions with customers, suppliers, competitors and regulators. The idea is to identify superior businesses with growing and predictable cash flows run by competent management. When valuing businesses, they take the perspective of a co-owner of the business and thus lean heavily on the concept of cash flows and economic earning power. In addition, they rely on various earnings multiples besides analyzing private market value and appropriate regional and global comparisons.

The basic principles that serve as the foundation for the above investment approach are:

Managing risk: Their aim is to purchase stocks at a price that represents a material discount to their long-term intrinsic value or at a price that is attractive from a relative value standpoint. Doing so explicitly recognizes the importance of capital preservation and provides a supportable underlying value that provides some insulation if actual outcomes are milder than initially forecast. This is consistent with a long-term, business-like approach to investing and allows for the challenges that companies will possibly face in a competitive and fast-changing market. Besides looking at risk of an individual investment decision, we also thoroughly analyze and aim to manage overall portfolio risk.

Maintain a balanced outlook on the market: Downside risks to financial stability persist. In a number of markets, including several emerging markets, asset valuations could come under pressure if interest rates rose more than expected and adversely affected investor sentiment. They do not believe in taking a call on the near term direction of the market indices. They avoid market timing and as a result, except for extenuating circumstances, our funds do not make substantial cash allocations. The same market mechanism that creates the opportunity for successful long-term returns also presents volatility and accompanying anxieties in the short term. As long-term investors, they feel it is appropriate to maintain the patience and discipline that is demanded at such times and to the extent possible take advantage of such

uncertainty. Through the active management process, they aim to achieve higher risk-adjusted returns over time across all their products.

Focus on the long term: There is substantive empirical evidence to suggest that equities as an asset class have provided superior risk adjusted returns over the long term. However, over short periods of time equity returns can be quite volatile influenced by fluctuating investor emotions and temporary fads. Additionally, different investment styles, sectors and approaches come in and out of favor distorting short-term performance. Longer-term returns are driven by economic fundamentals. As a result prices and fundamentals do decouple over shorter periods but tend to converge over time.



CHECK YOUR PROGRESS

Answer as directed:

a) Non- banking financial institutions (NBFIs) are registered under _____. (Fill in the blanks)

b) A Non - Banking Financial Institution cannot accept demand deposit and cannot issue cheques. (Write True or False)

c) UTI, LIC etc, are examples of NBFIs. (Write True or False)



13.14 LET US SUM UP

In this unit, we have discuss the following :-

- A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license and cannot accept deposits from the public.
- Insurance companies, brokerage firms, and companies offering microloans are examples of non-bank financial institutions.
- Non-Bank Financial Institutions (NBFIs) or Non-Bank Financial Intermediaries (NBFIs) are also termed as Non-Bank Financial Companies (NBFCs).

- Non-Banking Financial Company (NBFC) is registered under the Companies Act, 1956.
- Many activities and functions of NBFI's are similar to those of banks.
- Non-Banking Financial Companies play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector.
- RBI has identified as many as 12 categories of NBFCs.
- NBFCs provide range of financial services to their clients.
- Funding source of NBFCs comprises debentures, borrowings from banks and FIs, public deposits, commercial papers, and inter-corporate loans.



13.15 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services –By M. P. Tripathy
- Indian Financial System -By M Y Khan



13.16 ANSWERS TO CHECK YOUR PROGRESS

(a) Companies Act (b) True (c) False



13.17 MODEL QUESTIONS

1. Write short notes on the following:

a) Residuary Non-banking Companies (RNBCs)

b) Miscellaneous Non-banking Companies (MNBCs)

c) Asset Finance Company (AFC)

2. Define Non-Banking Financial Companies. Discuss various services provided by NBFCs.
3. Analyse the structure and growth of NBFCs in India.
4. Enumerate the features of the RBI Regulations governing NBFCs.
5. Briefly discuss the features of Prudential Norms for NBFCs.
6. What are the features of regulations for Accepting Public Deposits by NBFCs?
7. What are the recent trend and changes in NBFCs?
8. What are the problems faced by the NBFCs today? What are the suggestions you can make to the government for promotion of NBFC sector?

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UNIT-14 : INSURANCE SECTOR IN INDIA

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Meaning of Insurance

14.4 Need for Insurance

14.5 Objectives of Insurance

14.6 Role of Insurance

14.7 Characteristics of Insurance

14.8 Principles of Insurance

14.9 Types of Insurance

14.10 Life Insurance

14.11 General Insurance

14.12 Crop Insurance

14.13 Micro Insurance

14.14 Entry of Private Players in Insurance Sector in India

14.15 Insurance Regulatory and Development Authority (IRDA)

14.16 Duties, Powers and Functions of IRDA

14.17 Let Us Sum Up

14.18 Further Reading

14.19 Answers to Check Your Progress

14.20 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and need of insurance
- understand the need for insurance
- explain the objectives of insurance
- differentiate between general insurance and life insurance
- understand the meaning of crop insurance and micro insurance
- study the role and functions of IRDA

- interpret the guidelines for regulating insurance sector by IRDA
- identify the types life various insurance policies in India

14.2 INTRODUCTION

All of us wish to achieve financial freedom at some point in our life, and when it comes to doing that, we tend to believe that savings are enough to be financially stable. But, if we look at life from a practical perspective, we would understand that savings alone are not enough to achieve financial freedom; protection from any unforeseen losses and contingencies by insuring our assets is equally important. This unit will discuss about the need and importance of various insurance.

14.3 MEANING OF INSURANCE

Insurance is a means of protection from any unforeseen losses and contingencies. It is a contractual agreement between two parties in which one party promise to protect another party from uncertainties and losses. Insurance is a risk-management technique used for hedging against various uncertain losses. The first party is insurance company or insurer who agrees to protect and compensate the other party for losses suffered by it. Another party is insured or insurance policy holder who gets protection under insurance policy in return for premium which he is required to pay regularly to insurer. In simple terms, insurance is just the protection against the losses.

Insurance helps in economic development of a country by mobilising people's saving by attracting them for investment in insurance policies. Insurance companies reinvest the collected amount in different investment avenues for earning profit. There are generally three steps in insurance process: Firstly, select the insurance policy as per your needs, then you need to pay the premium amount regularly and at last claim your insured amount with the help of supporting documents in case if any unfortunate event occurs.

14.4 NEED FOR INSURANCE

1. **Financially Security:** The best way to become financially secure from unexpected events is to cover with insurance. One can buy insurance

and receive a payout for financial support, in case there happens to be an unforeseen event.

2. **Transfer of Risk:** The contract of insurance works on the 'principle of transfer of financial risk from the insured to the insurer'. Having insurance reduces the financial burden.

3. **Complete Protection for You and Your Family:** Family is the most important asset that you have and your family also depends on you for financial support. This is why it is important to make sure that you and your family are completely secure to face any emergency.

4. **No More Stress or Tension During Difficult Times:** None of us can see the future or predetermine the future events. Any unforeseen tragedy can leave us physically, mentally, and financially strained. So, if we have insurance to take care of the outcomes of such tragedies such as illness, injury or permanent disability, even death- we save ourselves and our family from tension and stress.

5. **Some Insurances are Compulsory:** Insurance is necessary because sometimes it is mandatory as per the law. An example of this is motor insurance. As per the Motor Vehicle Act of 1988, it is compulsory to have at least a third-party motor insurance for every motor vehicle plying on road in India.

6. **Peace of Mind:** Insurance offers us financial security and also peace of mind. Insurance gives us security against any unforeseen events in life, and this gives us complete peace of mind.

14.5 OBJECTIVES OF INSURANCE

Though the primary objective of insurance is to financially guard against unpredictable life occurrences there are also some other important objectives. The overall objectives of insurance are as follows:

1. **Granting Security to People**

Insurance primarily serves the purpose of granting security against losses and damages to people. Insurance companies guarantee the insured of compensation in case of any unfavourable contingencies. Insured need to pay premium to insurance companies in return for guarantee of compensation.

2. Minimisation of Losses

Insurance aims at minimisation of losses arising from future risks and uncertainties. It adds certainty of payments to people for happening of uncertain events. It minimises the risk through proper planning and administration. Insurance companies suggest people for taking safety measures like installation of fire detection devices, alarm and cameras system etc. They also join hands with various organisations like fire brigade, health and various organisations which work for reducing losses and damages.

3. Diversifying the Risk

Insurance works towards diversifying the risk among large number of people. It aims at reducing the adverse effects of any future contingency by spreading the overall risk associated with it. The loss incurred by single individual is diversified among large peoples by insurance companies by utilising the collected premium amount for paying compensations.

4. Reduces the Anxiety and Fear

Insurance policies relieve the individuals of any tension and fear regarding the future risks and uncertainties. It guarantees them of compensation in occurrence of any unfavourable contingencies. It makes them confident and they focus on their activities with full attention.

5. Mobilises the Saving

Mobilisation of savings is another important objective of insurance. It attracts people for investments by presenting them with numerous insurance policies guarantying of compensation for losses. Insurance companies are able to generate large amount of funds in the form of premium that they charged from their policy holders regularly. These funds are then invested by these companies into securities and stock in market and earn incomes.

6. Generation of Capital

Insurance companies leads to capital generation by collecting large amount of funds from public. The funds collected as premium are invested for industrial development by subscribing to shares of companies. This boosts the industry performance and economic growth of country.

7. Tax Relief to the Insure

Another important objective of insurance is to provide tax benefit to the insured in life insurance and some health related insurances. Under Section

80C and 10D of the Income Tax Act, there are provisions of getting income tax benefits on life insurance.

14.6 ROLE OF INSURANCE

1. Provides Protection

The primary function of insurance is to provide protection to insured in case of any uncertain event. Insurance guarantees the person to protect him from sufferings in case of damages and losses. Insurance policies help a person to recover back to its original position after incurring losses by compensating them.

2. Sharing of Risk

Sharing of risk is an important function played by insurance. It is a means of pooling risk of one person among a large number of persons. Compensation for losses suffered by one individual is paid out of premium paid by different policyholders. Risk is diversified and shared among different persons.

3. Provides Certainty

Insurance provides reliability and certainty of payments to business. Happening of unexpected events is uncertain and cannot be determined. The uncertainties of these events can be minimized through proper planning and administration. Insurance helps in adding certainty to these uncertain events.

4. Improves the Efficiency

Insurance has an effective role in improving the efficiency of the business. By providing the guarantee for compensation in case of any mishaps, it relieves the businessmen of worries and tension of risk. It boosts their confidence level and they work with full attention towards their roles and thus leads to better productivity of the organisation thereby increasing the overall efficiency.

5. Prevention of losses

Insurance acts as a cover against the losses. It guides business in taking appropriate corrective measures for reducing damages and losses. Insurance company's joins hand with institutions which help in avoiding losses like fire brigade, health organisations and other intuitions. It helps in reducing losses.

6. Helps in Earning Foreign Exchange

Insurance is an important means of earning foreign exchange. Several companies operate internationally with many branches in different countries. Several countries earn foreign exchange by issue of insurance policies like marine insurance and many other different policies.

7. Promotes Economic Development

Insurance leads to generation of large amount of funds by insurance companies through the premium collected by them from insured. It utilises the ideal lying money with people by attracting them for investment in various investment policies. All collected money by insurance companies is invested in shares of various companies and other investment avenues for earning profit. This leads to industrial development in the country thereby accelerating the rate of economic growth.

14.7 CHARACTERISTICS OF INSURANCE

1. Personal Contract

Insurance contracts are generally personal in nature. It is an agreement between the insurance company and insured and such agreement is bound by certain obligations. Both the party is required to fulfill their obligation to keep the contract legal. Insured is required to pay premium to insurer regularly as his part of obligation. Whereas insurer need to compensate insured in case of any losses as his part of obligation.

2. Pooling of Risk

Insurance are meant for pooling the risk of various policy holders. Premium paid by different policy holders is used for recovering the losses incurred by insured individuals. This way risk of single individual is pooled among different individuals and its effect is minimized

3. Unilateral

Insurance contracts are unilateral. This means that both the parties (insurer and insured) who enter into insurance contracts are equally bound to perform their respective obligations. Insured need to pay the decided policy

premium without any default. Similarly, insurer has the right to compensate the insured for losses and damages arising out of contingency. It is their legal duty in exchange for the premium they are charging.

4. Cost of Risk

The cost of risk in insurance contract is the value of insurance object. Insurance companies before entering into contract properly evaluate the value of subject matter of insurance contract. Higher the risk associated with insurance object, higher will be premium charged. On the other hand, lower risk invited low premium by insurer from insured.

5. Assures of Compensation

Insurance policies assure the policy holder of compensation in occurrence of losses and damages. These policies are taken by insured to seek protection from future risks and uncertainties. Insurance companies guarantee the people for compensating them for losses. They assure to bring them back in their original position in which they were before occurrence of such losses. Assurance for compensation by insurer motivates people for investment in insurance policies.

6. Executor

Insurance contacts are executory which means compensation is paid only on occurrence of the contingency. It is included in agreement done that insured is liable to claim for compensation from insurer only if he incurs losses. Insured cannot profit from the insurance policies and can be compensated for losses only. If any contingency do not occur then insurer is not liable to pay any compensation.

7. No misrepresentation or concealment

Insurance contract is assumed to be free from any misrepresentation and concealment of information. Any misrepresentation or concealment of facts from both insurer and insured side will make the insurance contract void. Insured is required to disclose full information regarding insurance object fairly to insurer. Similarly, insurance companies are required to explain clearly the terms and conditions of insurance contract to insured.

14.8 PRINCIPLES OF INSURANCE

1. Principle of Utmost Good Faith

It states that both the parties to contract must enter into a contract in good faith. They both should reveal all material information and facts regarding

contract to each other accurately and honestly. Insured should tell the insurer all details truly so that insurance companies are able to calculate the right premium amount. Also, the insurer should provide all information regarding insurance contract with fairness to insured. Any misrepresentation of facts and figures will make insurance policy legally revoked or cancelled.

2. Principle of Indemnity

Principle of indemnity means insurance contracts are done to provide protection and compensate against uncertain losses, damages or injuries. Indemnity simply means protection, security and compensation for damages or losses. Insured cannot enter into an insurance contract for earning profit but it is meant for recovery of losses only. Insurance are meant to bring back the insured into the original position in which he was before happening of uncertainties. Principle of indemnity does not apply to the life insurance contract.

3. Principle of Insurable Interest

This principle states that insurance policy holder must have insurable interest in the subject matter of insurance. He must have some vested interest in it and must be affected by existence and non-existence of object of insurance. It is not necessarily required by insured to be the owner of insurance object. Existence of an object should provide him some benefits and gains. Any damage to an insurance object should adversely affect the insured and provides him heavy losses.

4. Principle of Subrogation

Principle of subrogation states that after paying compensation, the ownership right of property will transfer from insured to insurer. This principle gives insurer right to recover amount from third party who is responsible for happening of uncertainties and losses to insurer. Principle of subrogation allows insurer to pursue legal methods against that third party to recover the amount of losses. However, insurer can claim amount only to the extent of amount paid by him to insured as compensation.

5. Principle of Loss Minimization

This principle states that insured should always take all necessary steps to avoid losses and damages to insured property. It is his obligation to mini-

mize the losses to insured property in case of any uncertainties like blast or fire outbreak. Insured should not be negligible or act irresponsible towards the property only because it is insured for losses. Therefore, insured should try to protect insured property and avoid any losses.

6. Principle of Contribution

Principle of contribution states that insured cannot make profit by insuring the property with more than one insurance company. The insured in case of any uncertainties can claim only the actual amount of loss. Insurance companies will compensate to insured on basis on 'principle of contribution'. All Insurance companies will share the losses to extent of sum insured with them. In case if only one insurance company pays the full amount of loss it can demand contribution from other insurance companies.

7. Principle of Causa Proxima

Causa proxima means the 'direct cause' or 'nearest cause'. The principles of Causa proxima are applicable when there are series of causes for losses or damages to insured property. According to this, the most nearest and dominant cause for losses and damages is considered for calculating the liability of insurer.

14.9 TYPES OF INSURANCE

The Indian Insurance Sector is basically divided into two categories - Life Insurance and Non-life Insurance. The Non-life Insurance sector is also termed as General Insurance. Both the Life Insurance and the General Insurance are governed by the Insurance Regulatory and Development Authority of India (IRDAI).

The Insurance sector in India consists of total 57 insurance companies. Out of which 24 companies are the life insurance providers and the remaining 33 are non-life insurers. Out which there are seven public sector companies. Life insurance companies offer coverage to the life of the individuals, whereas the non-life insurance companies offer coverage with our day-to-day living like travel, health, our car and bikes, and home insurance. Not only this, but the non-life insurance companies provide coverage for our industrial equipment's as well.

Crop insurance for our farmers, gadget insurance for mobiles, pet insurance etc. are some more insurance products being made available by the general insurance companies in India.

14.10 LIFE INSURANCE

Life insurance is a contract between an individual and an insurance company, in which the insurance company provides financial security in return for regular payments of premiums to the insurance company. In case of the policyholder's death or if the policy matures, the insurance company shall pay a prescribed amount to the individual after a period of time or to their family, on basis of the contract.

Types of Life Insurance

Broadly, there are five basic types of life insurance plans:

1. **Term insurance**

Term plans are the most basic form of life insurance. They provide life cover with no savings / profits component. They are the most affordable form of life insurance as premiums are cheaper compared to other life insurance plans.

2. **Endowment plans**

Endowment plans differ from term plans in one important aspect i.e. maturity benefit. Unlike term plans which pay out the sum assured, along with profits, only in case of an eventuality over the policy term, endowment plans pay out the sum assured under both scenarios- death and survival.

3. **Unit linked insurance plans (ULIPs)**

Unit linked insurance plans (ULIPs) are a variant of the traditional endowment plan. They pay out the sum assured (or the investment portfolio if it's higher) on death/maturity. Since ULIPs invest in stock markets they are well-suited for individuals with appetite for risk.

4. Whole life policy

A whole life insurance policy covers a policyholder over his life. The main feature of a whole life policy is that the validity of the policy is not defined so the individual enjoys the life cover throughout his life.

5. Money back policy

This is a variant of the endowment plan. A money back policy gives periodic payments over the policy term. To that end, a portion of the sum assured is paid out at regular intervals. If the policy holder survives the term, he gets the balance sum assured.

14.11 GENERAL INSURANCE

General insurance covers non-life assets such as your home, vehicle, health, damage property from floods, fire, thefts, accidents and man-made disasters etc.

Types of general insurance

1. Health insurance:

Health Insurance is an essential risk mitigating tool. Health insurance prevents out-of-pocket expenses while dealing with a medical emergency. A general health insurance plan is an indemnity plan that pays for hospitalisation expenses up to the sum insured. While one can avail a standalone health policy, family floater plans provide coverage to all the members of the family. On the other hand, critical illness plans are fixed-benefit plans which provide a lump sum upon diagnosis of a critical ailment, taking care of pre and post-hospitalisation costs.

2. Marine insurance:

Marine insurance was the earliest well-developed kind of insurance, with origins in the Greek and Roman marine loan. It was the oldest risk hedging instruments to mitigate risk in medieval times. Marine insurance covers the loss or damage of ships, cargo, terminals, and any transport by which the property is transferred, acquired, or held between the points of origin and the final destination.

3. Fire Insurance:

Fire insurance is property insurance that provides coverage for loss or damage to a structure damaged or destroyed in a fire. Fire insurance policies provide payment for the loss of use of the property as a result of a fire, or for additional living expenses that were necessitated by uninhabitable conditions as well as damage to personal property and nearby structures. A fire insurance policy is usually effective for one year. However, it is usually renewable. Fire insurance was started after marine insurance.

4. Motor vehicle insurance:

Motor insurance covers our vehicles against accidents, damage, theft, vandalism, and so on. This form of insurance comes in two forms - comprehensive and third-party. A comprehensive motor insurance policy provides a 360-degree cushion to our vehicle against damages caused due to flood, fire, riot, etc. Along with this, it also offers us the rider, personal accident coverage along with third-party liability. On the other hand, a third-party motor insurance takes care of the damages suffered by a third-party in case of an accident caused by your vehicle. As per the Motor Vehicles Act, 1988, it's mandatory for every vehicle running on the road to have a third-party insurance.

5. Home insurance:

As the name suggests, a home insurance policy protects your home and its belongings from the damages suffered due to man-made or natural disasters. Some home insurance policies also provide coverage for temporary living expenses in case you are living on rent, due to your home undergoing renovation.

6. Travel insurance:

In case you are travelling abroad, a travel insurance policy protects you against losses suffered due to loss of baggage, delays in flight and trip cancellation. In some cases, if you are hospitalised while travelling, travel insurance may also offer cashless hospitalisation.

Difference between life and general insurance

1. Meaning and Coverage: Life insurance covers your life and also has provisions to provide a savings and investment avenue. Savings here mean the benefit on maturity. For example, if the policyholder outlives the policy period, he or she can get back the premium paid over the years. General insurance is a contract of indemnity covering non-life assets. It is a promise to make good on your losses, but with no savings or investment avenue i.e. if the claim is not made, no part of the premium can be got back.
2. **Purpose:** Life insurance gives a payout in case the policyholder dies, whereas in case of a general insurance, payouts is made in the event of an unexpected loss such as an accident or a theft or a sudden liability.
3. **Term of contract and payment:** Life insurance is a long-term contract and requires you to pay the premiums in monthly installments. General insurance meanwhile is a short-term contract, to be renewed every year, and requires you to pay the entire premium on renewal.
4. **Insurable interest:** With life insurance, the policyholder must be present during the issuing of a life insurance policy. With general insurance however, the policyholder must be present during the time of contract and at the time of loss.
5. **Payment of claim:** In case of life insurance, the insurable amount is paid on the occurrence of the event or on maturity of the policy. For general insurance, losses are reimbursed when the uncertain event occurs.
6. **Policy value:** Life insurance can be done for any value based on the premium the policy holder willing to pay. In case of general insurance, the amount payable is restricted to the liability incurred or actual loss suffered, irrespective of the policy amount.

Both life and general insurance are needed to comprehensively cover all aspects of our life. Life insurance and general insurance are two different forms of insurances. General insurance covers any other risk except for life-risk of the person injured. Life Insurance covers only the life-risk of the person insured. In the table below, all the key points between Life Insurance and general Insurance have covered:

Parameters	**Life insurance**	**General insurance**
Meaning	Covers life	Covers non-life assets
Contract term	Long-contract that requires paying premiums for several years	Generally, annual contracts which need to be renewed every year
Payment of claim	Is payable in case of the death of the policyholder during the policy term or on policy maturity	Reimbursed during an eventuality
Savings component	Present	Absent

Key Points	**Life Insurance**	**General Insurance**
Meaning	It is an insurance contract, which covers the life-risk of the person insured	It is an insurance that is not covered under Life insurance
Form	It is a form of investment	It is a contract of indemnity
Term of Contract	It's a long term contract	It's a short term contract
Premium	Premium has to be paid over the year	Premium has to be paid lump sum
Insurance claim	Insurable amount is paid either on the occurrence of the event, or on maturity	Loss is reimbursed, or liability will be repaid on the occurrence of uncertain event
Insurable Interest	Must be present at the time of contract	Must be present, at the time of contract and loss both
Policy Value	It can be done for any value based on the premium policy	The amount payable under life insurance is confined to the actual loss suffered

14.12 CROP INSURANCE

Crop insurance is a vital component of agriculture, especially in a country like India, where the majority of farmers are small and marginal with low

savings that reduces their ability to weather agricultural risks and fluctuations. Crop insurance is purchased by agricultural producers to protect against loss of their crops caused by natural disasters, such as hail, drought, floods, storms and other natural calamities, or the loss of revenue due to declines in the prices of agricultural commodities. Programmes extending insurance cover for crops in India have long been in operation, but have not been able to include the majority of the agricultural sector within their ambit.

In India a multiperil crop insurance called National Agriculture Insurance Scheme (NAIS) was implemented by Agriculture Insurance Company of India, an Indian government owned company. The scheme is compulsory for all farmers who take agricultural loans from any financial institution. It is voluntary for all other farmers. The premium is subsidized for farmers who own less than two hectares of land. This insurance follows the area approach. This means that instead of individual farmers, a specific area is insured. The area may vary from gram panchayat or block or district from crop to crop or state to state. The claim is calculated on the basis of crop cutting experiments carried out by agricultural departments of respective states. Any shortfall in yield compared to past 5 years average yield is compensated.

Agriculture in India is highly susceptible to risks like droughts and floods. It is necessary to protect the farmers from natural calamities and ensure their credit eligibility for the next season. For this purpose, the Government of India introduced many agricultural schemes throughout the country. The recent scheme was Pradhan Mantri Fasal Bima Yojana (PMFBY). The PMFBY was launched in 2016 and replaces all the prevailing yield insurance schemes in India. The scheme has extended coverage under localized risks, post-harvest losses etc. and aims at adoption of technology for the purpose of yield estimation. Through increased farmer awareness and low farmer premium rates the scheme aims at increasing the crop insurance penetration in India.

14.13 MICRO INSURANCE

Insurance Regulatory and Development Authority of India (IRDAI) created a special category of insurance policies called micro-insurance policies to promote insurance coverage among economically vulnerable sections of

society. The IRDA Micro-insurance Regulations, 2005 defines micro-insurance as 'a general or life insurance policy with a sum assured of Rs. 50,000 or less'.

The micro-insurance portfolio has made steady progress. More life insurers have commenced their micro-insurance operations and many new products are being introduced every year. The distribution infrastructure has also been considerably strengthened and the new business has shown a decent growth, though the volumes are still small. Life Insurance Corporation of India (LIC) contributed the most both in terms of policies sold and number of micro-insurance agents.

With the notification of the IRDA (Micro-insurance) Regulations 2005, by the Authority, there has been a steady growth in the design of products catering to the needs of the poor. The flexibilities provided in the Regulations allow the insurers to offer composite covers or package products. Insurance companies are now offering already approved general insurance products as micro-insurance products with the approval of the Authority, if the sum assured for the product is within the range prescribed for micro-insurance.

Intermediaries of Micro Insurance:

Micro- insurance business is done through the following intermediaries:

- Non-Government Organisations
- Self-Help Groups
- Micro-Finance Institutions

14.14 ENTRY OF PRIVATE PLAYERS IN INSURANCE SECTOR IN INDIA

Insurance was the only sector which had been fully nationalized and change in it was started only when the country completed its first decade of economic reform. The Indian insurance industry was revolved around two public sector players, viz., Life Insurance Corporation (LIC) of India and General Insurance Corporation (GIC) of India. LIC has been operated in the life segment lodge in the people brain by providing wide range of services, building an extensive network of branches and offering employment to a large number of agents. The non-life insurance sector was overwhelmingly dominated by GIC.

The Malhotra Committee observed that both life and non life insurance sector is facing some serious problem due to mismanagement and poor structure. Therefore, committee proposed restructuring of LIC and GIC.

Until 1999, there were no private insurance companies in India. The government then introduced the Insurance Regulatory and Development Authority Act in 1999, thereby de-regulating the insurance sector and allowing private companies. Furthermore, foreign investment was also allowed and capped at 26% holding in the Indian insurance companies. The entry of private companies was allowed in both life and non-life sector. The sector was opened in August 2000 for registration of the companies. However, a single company cannot transact business in both sectors.

India allowed private companies in insurance sector in 2000, setting a limit on FDI to 26%, which was increased to 49% in 2014. Insurance Laws (Amendment) Act, 2015 provides for enhancement of the foreign investment cap in an Indian insurance company from 26% to an explicitly composite limit of 49% with the safeguard of Indian ownership and control. The collaboration with the foreign markets has made the Insurance Sector in India grow tremendously with a high current market share. Private insurers like HDFC, ICICI and SBI have been some tough competitors for providing life as well as non-life products to the insurance sector in India.

14.15 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

Based on the recommendation of Malhotra committee regarding establishment of a strong, effective and independent regulatory body to protect interest of policyholders and development of insurance industry, the Government of India had established interim regulatory authority in January 1996 through an exclusive order. Later on, this Interim Regulatory Authority becomes Insurance Regulatory and Development Authority of India (IRDAI).

The constitution of IRDA is a landmark in landscape of financial sector. The Insurance Regulatory and Development Authority of India Act, 1999 provides for composition, tenure of office chairperson and other members, re-

moval from office, salary and allowances of chairperson and members, duties, power and function of IRDA. Insurance Regulatory and Development Authority of India Act made several amendments to the Insurance Act 1938, LIC Act 1956 and GIC Act 1972 which revoked the monopoly conferred to the Life Insurance Corporation of India and General Insurance Corporation of India.

As per the provisions of IRDA Act, 1999, Insurance Regulatory and Development Authority (IRDA) was established on 19th April 1999 as an autonomous body to protect the interests of holder of insurance policy and to regulate, promote and ensure orderly growth of the insurance industry in India. IRDA started its functioning on April 19, 2000 headed by N. Rangachary as its first Chairperson with 4 full-time directors, 2 part-time directors and 25-members in Insurance Advisory Council. The members of the council represent various industries and professions.

IRDA as a regulatory authority has heavy responsibilities and difficult roles to play. On the one side, it has to protect against malpractices and secure fair treatment to policyholders. On the other side, it has to impose restrictions in such a manner that growth of insurance industry is not hampered. IRDA regulations cover minimum requirements for best practices in the area of licensing, prudential regulations and requirements, supervisory powers, managing asset qualities and enhancing corporate governance.

Objectives of IRDA

- To protect the interest of policyholders of insurance policies;
- To bring about speedy and orderly growth of the insurance industry and to provide long term funds for accelerating growth of the economy;
- To set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence of those it regulates;
- To ensure speedy settlement of genuine claims, to prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery;
- To promote fairness, transparency and orderly conduct in financial markets dealing with insurance and build a reliable management infor-

mation system to enforce high standards of financial soundness amongst market players;

- To take action where such standards are inadequate or ineffectively enforced;
- To bring about optimum amount of self-regulation in day-to-day working of the industry consistent with the requirements of prudential regulation.

14.16 DUTIES, POWERS AND FUNCTIONS OF IRDA

Section 14 of IRDA Act, 1999 lays down the duties, powers and functions of IRDA. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include:

i) Issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;

ii) Protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

iii) Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents

iv) Specifying the code of conduct for surveyors and loss assessors;

v) Promoting efficiency in the conduct of insurance business;

vi) Promoting and regulating professional organisations connected with the insurance and re-insurance business;

vii) Levying fees and other charges for carrying out the purposes of this Act;

viii) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, in-

termediaries, insurance intermediaries and other organisations connected with the insurance business;

ix) Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);

x) Specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

xi) Regulating investment of funds by insurance companies;

xii) Regulating maintenance of margin of solvency;

xiii) Adjudication of disputes between insurers and intermediaries or insurance intermediaries;

xiv) Supervising the functioning of the Tariff Advisory Committee;

xv) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);

xvi) Specifying the percentage of life insurance business



CHECK YOUR PROGRESS

Fill in the blanks:

a) _____ is the regulator of insurance sector in India?

b) A fixed amount of money collect by insurance companies from their clients is called _____.

c) IRDA Act was passed in _____.

d) The Insurance that provides protection against loss by fire is called _____ Insurance.

e) Mediclaim is an example of _____ insurance.



14.17 LET US SUM UP

In this unit, we have discuss the following :-

- Insurance is a contractual agreement between two parties in which one party promise to protect another party from uncertainties and losses. The first party is insurance company or insurer who agrees to protect and compensate the other party for losses suffered by it.
- Insurance helps in economic development of country by mobilising people's saving by attracting them for investment in insurance policies.
- The Indian Insurance Sector is basically divided into two categories - Life Insurance and Non-life Insurance. The Non-life Insurance sector is also termed as General Insurance.
- Both the Life Insurance and the Non-life Insurance is governed by the Insurance Regulatory and Development Authority of India (IRDAI).
- Life insurance is a contract between an individual and an insurance company, in which the insurance company provides financial security in return for regular payments of premiums to the insurance company.
- General insurance covers non-life assets such as your home, vehicle, health, damage property from floods, fire, thefts, accidents and man-made disasters etc.
- Crop insurance is the insurance of agricultural producers against loss of crops caused by natural disasters, such as hail, drought, floods, storms and other natural calamities.
- Micro-insurance is a general or life insurance policy with a sum assured of Rs. 50,000 or less.
- Insurance Regulatory and Development Authority (IRDA) protects the interests of holder of insurance policy and to regulate, promote and ensure orderly growth of the insurance industry in India.



14.18 FURTHER READING

- Principles & Practice of Insurance -By M Motihar
- Insurance: Principles and Practice -By M.N. Mishra & S B Mishra



14.19 ANSWERS TO CHECK YOUR PROGRESS

a) IRDA b) premium c) 1999 d) fire e) general



14.20 MODEL QUESTIONS

1. Write short notes on the following:
   a) Life insurance
   b) General insurance
   c) Crop insurance
   d) Micro insurance
   e) Entry of private sectors in insurance in India
2. What are the different types of Insurance Coverage?
3. What do you mean by term 'Insurer' and 'Insured'?
4. What is General Insurance policy? What does it cover?
5. What is life insurance? What are the different types of Life Insurance?
6. Distinguish between General Insurance from life insurance.
7. Mention the powers and duties of IRDA.

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UNIT 15 : MICRO FINANCE

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Meaning and Origin of Micro Finance

15.4 Definition of Micro Finance

15.5 Need for Micro Finance

15.6 Role of Micro Finance

15.7 Micro Finance in India

15.8 Micro Finance Institutions

15.9 Model of Micro Finance

15.10 Role of Micro Finance in Economic Development

15.11 Role of NABARD in Promoting Micro Finance

15.12 Problems of Micro Finance

15.13 Let Us Sum Up

15.14 Further Reading

15.15 Answers to Check Your Progress

15.16 Possible Questions

15.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and definition of micro finance
- describe needs of micro finance
- interpret the functions of micro finance
- discuss about micro finance in India
- enumerate the role of micro finance in Indian economy
- explain the role of NABARD in the field of micro finance
- discuss various models of micro finance
- identify the problems of micro finance

15.2 INTRODUCTION

The money lenders, who used to provide small amount of loans to the poor and needy people of India and around the world, are the oldest informal and unorganized form of microcredit. The interest rate charged by them is so high that the poor people. Gradually, this type of credit attained the shape of microcredit and was further supplemented by many credit associations, co-operatives and banks. Here the concept of micro finance arises. This unit discusses about the various aspects of micro finance especially in India.

15.3 MEANING AND ORIGIN OF MICRO FINANCE

Micro Finance refers to the provision of affordable financial services such as small loans, small savings, micro insurance and funds transfer facilities extended to socially and economically poor and disadvantaged segments of the society to enable them to increase their income levels and improve standard of living. The main aim of micro finance is to provide small loans to poor people particularly living below poverty line, who are not able to raise loan for productive purposes from other sources and to improve their standard of living by increasing their earning and saving covering associated risks.

The poor people need minimum financial services. They need to open saving bank account in the bank to keep and multiply their small savings by carrying out productive activities and getting small loans from banks to purchase the assets and increase the level of their activities. In order to cover the life and activities risks, they require micro insurance facilities. They also require funds deposit and transfer facilities at their nearby places. The provision of these minimum financial services is covered in microfinance.

The concept of microfinance initiated as an introduction of Muhammad Yunus (2006) in the form of Grameen Bank in Bangladesh. Mr. Mohammad Yunus and Grameen Bank Bangladesh were given Noble Prize in the year 2006 for their efforts to create economic and social development through microfinance.

15.4 DEFINITION OF MICRO FINANCE

Micro-finance refers to small savings, credit and insurance services extended to socially and economically disadvantaged segments of society. In the Indian context terms like 'small and marginal farmers', 'rural artisans' and 'economically weaker sections' have been used to broadly define micro-finance customers.

The recent Task Force on Micro Finance has defined micro finance as "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas, for enabling them to raise their income levels and improve living standards".

According to International Labour Organization, "Microfinance is an economic development approach that involves providing financial services through institutions to low income clients"

Microfinance has been defined by the National Microfinance Taskforce, 1999 in India as "Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban and urban areas for enabling them to raise their income levels and improve living standards."

15.5 NEED FOR MICRO FINANCE

The banks have been more or less hesitant in providing small finance to the poor people with little or no cash income. The poor people have no or few assets to offer as collateral security for the loans to the banks. Thus bank fear having little recourse against the defaulting borrowers. The majority of the poor people does not have saving bank account in the bank and bank need proper identity and address proof before providing microcredit to them. The lack of knowledge, initiatives and collateral securities are the hindrances in getting the credit from banks. The people need microfinance to carry out their economic activities in commercial manner. The needs of microfinance are as follows:

- For the economic growth and transformation of the nation
- To eradicate poverty and record development of the nation

- To meet the life cycle needs, emergency needs and investment needs of the people
- For economic and social upliftment of the people
- For women empowerment through development

15.6 ROLE OF MICRO FINANCE

- Microfinance provides finance to the poor people for carrying out their economic activities and helps them to meet the basic needs of life.
- Microfinance helps the poor people to increase their income, savings and standard of living.
- Microfinance provides employment to the poor people by providing self employment opportunities in various sectors and activities.
- Microfinance protects the poor people against the risks by providing life insurance and assets insurance.
- Microfinance helps in alleviating poverty by providing affordable financial services.
- Microfinance helps in increasing economic growth and development in the country.
- Microfinance promotes gender equity by supporting women empowerment and their economic participation and hence improving well being of the poor households.
- Microfinance provides improvements in household economic welfare and enterprise stability and growth.
- Micro finance helps in increasing savings, investments and developments.
- Micro finance provides employment opportunities to unemployed people and full employment to the under employed people

15.7 MICRO FINANCE IN INDIA

In India, NABARD initiated the concept of microfinance as per this idea and established link between Self Help Group (SHGs), Non Government Organizations (NGOs) and Banks. The SHGs are formed and nurtured by NGOs.

On attaining maturity the SHGs get credit from banks and extend to members. By 2006 in India more than 22 lakh SHGs were financed by Commercial Banks, RRBs and Cooperative Banks. The microfinance movement has multiplied and large number of SHGs, NGOs, Microfinance Institutions (MFIs), and Non Banking Financial Companies (NBFCs) has emerged to provide microfinance to the poor and needy rural people. Thus the microfinance has emerged as a movement and established an industry.

Indian microfinance continues to grow rapidly towards extending outreach to a growing share of poor households, which are yet to be reached directly by the banks. The Self Help Groups Bank linkage (SHGBLP) programme which started simply as a bank outreach programme, has through the passage of time slowly metamorphosed into a holistic programme for financial, economic, social and of late, technological capital building in rural areas. Thus the SHG-Bank Linkage Programme has expanded at a fast pace in India to evolve into the largest microfinance programme in the world, and undoubtedly, it is the main microfinance programme in India.

The important milestones in the journey so far of the SHG Bank Linkage movement spearheaded by NABARD with the support of Reserve Bank of India and the G.O.I. are as follows:

- 1987: NABARD takes the lead in partnering with NGOs, particularly MYRADA, to pilot the SHG Bank linkage model due to poor performance of formal institutions in providing finance to the rural areas, informal sector and the “unbankable” poor.
- 1991: RBI advised all scheduled Banks about NABARD‘s proposed pilot and sought active participation from the Banks.
- 1992: NABARD launches the SHG Bank Linkage Programme initially to cover 500 SHGs which was an innovation for harnessing the flexibility of the Informal system with the strength and affordability of the formal system.
- 1996: Financing to SHGs was mainstreamed into the normal operations of the banks by the Reserve Bank of India in April 1996.

- 1998: In the Union Budget of 1998-99, Government announced that NABARD would endeavor to ensure credit linkage of 2 lakh SHGs in a period of 5 years.
- 1999: Swarna Gram Swarojgar Yojana (SGSY), an amalgamation of government programmes like Integrated Rural Development Program (IRDP) etc. was launched as a holistic programme to eradicate poverty by using the vehicle of SHGs for purveying microcredit for all rural poor especially the BPL families.
- 2000: A dedicated Fund viz. Micro Finance Development Fund was created in NABARD with a sizeable corpus of Rs. 100 Crore for various initiatives and interventions for the ascent of SHGBLP movement
- 2006: RBI issues guidelines for Branchless banking initiative in the rural areas through use of Business Correspondents and Business Facilitators.
- 2008: NABARD establishes NABFINS, a subsidiary of NABARD to provide financial services in two broad areas of Agriculture and Microfinance. Based on the recommendations of the "Committee on Financial Inclusion" two Funds, namely the "Financial Inclusion Fund (FIF)" and the "Financial Inclusion Technology Fund (FITF)", were set up at NABARD with an overall corpus of Rs. 500 crore each.
- 2011: NRLM, a flagship poverty alleviation programme, was launched by the Ministry of Rural Development, Govt. of India.
- 2012: The SHG-Bank Linkage Programme was given a renewed thrust with the launch of SHG-2.
- 2012: Women SHG programme (WSHG) for intensifying SHGs in the 150 Left Wing Extremism affected and backward districts of India implemented by NABARD in association with the Department of Financial Services, Ministry of Finance, G.O.I.
- 2015: Based on the impact evaluation studies on MEDPs, Livelihood and Enterprise Development Programme (LEDP) for creating sustainable livelihoods amongst SHG members was introduced on pilot basis in select states.

- 2015: The SHG BLP Strategic Advisory Board was constituted in NABARD with various stakeholders as well as representatives of DFS, NRLM, RBI, Bankers and Domain Experts to focus on strategic action plan on SHG BLP, digitization, livelihood promotion and a proper eco system to facilitate greater credit flow to the SHGs.
- 2015: Eshakti Pilot Project initiated by NABARD for digitisation of SHG records to bring transparency and accuracy in SHG's transactions in Ramgarh and Dhule districts of Jharkhand and Maharashtra respectively.
- 2016: EShakti pilot project extended to additional 23 districts in India.
- 2017: EShakti pilot project extended to 75 more districts thus covering 100 districts.

15.8 MICRO FINANCE INSTITUTIONS (MFIS)

The important channel for growth of microfinance in India is through Micro Finance Institutions (MFIs) l. They emerged in India in the late 1980s in response to the gap in availability of banking service for the un-served and under-served rural population. These institutions operating in the country follow a variety of credit methodologies. The work of MFIs commenced around the same time when the SHG-Bank Linkage Programme was evolving. Many of them were inspired by the Grameen Bank in Bangladesh and the innovations taking place in Latin America. Voluntary agencies and Non-Governmental Organisations (NGOs) undertook financial intermediation as a part of larger social good. Majority of these NGOs were registered as a Trust or a Society. The Micro Units Development & Refinance Agency Ltd (MUDRA), NBFC set up by the Government of India (GoI) in 2015 with its total focus on microenterprise, has to hand-hold and facilitate the development process of smaller MFIs and not for profit MFIs as they are the ones who operate in remote locations and with the underserved populations. As per MFIN, microfinance loan portfolio stands at INR 4,33,697 Crores as on Mar 31, 2024, serving 7.8 crore unique borrowers with 14.9 crore loan accounts (Source: MFIN Micrometer Q4 FY 23-24).

15.9 MODEL OF MICRO FINANCE

The various models currently being used by microfinance institutions throughout the world. A total of 14 models are existing in India. Different institutions in formal and informal sector have successfully tried out these models. Though these models have their own specific strengths and weaknesses, they have demonstrated to provide financial services to the unorganized sector with effective outreach. There is also a range of other methodologies that MFIs follow. Some MFIs start with one methodology and later on move or diversify to another methodology so that they do not exclude certain socio-economic categories of clients. So it becomes important to have a basic understanding of methodologies and activity of Credit Lending Models.

A. Association or Group Model

An association is formed by the poor in the target community to offer microfinance services (micro savings, microcredit, micro-insurance, etc.) to themselves. Associations or groups can be composed of youth, or women; they can form around political/religious/cultural issues; can create support structures for microenterprises and other work-based issues. It gathers capital and intermediates between banks, MFIs and its members. Example: Self Help Groups. An example of a Group Model is Self Help Groups.

In this method, 10-20 members are organized to form a group. These group members make regular savings of fixed amount in a common fund. The amount and frequency of savings is mutually decided by the group members. After the successful working of such a group for some months the group is linked to a financial institution for getting credit. The financial institutions issue loan in the name of group and whole group is considered responsible for repayment. The amount of loan depends upon the total accumulated amount of saving of the group. The group itself selects its members before acquiring a loan. Loans are granted to selected member(s) of the group first and then to the rest of the members. Group members themselves decide about the criteria of dividing the loan among the group members. With this loan the whole group may jointly start a micro-enterprise or the members may start their individual businesses.

Group members are jointly accountable for the repayment of each other's loans and usually meet weekly to collect repayments. The entire group will be disqualified and will not be eligible for further loans, even if one member of the group becomes a defaulter. These type of group based credit delivery methods help to empower the group members because they remain involved in various group activities.

B. Community Banking Model

Community Banking Model essentially treats the whole community as one unit, and establishes semi-formal or formal institutions through which microfinance is dispensed. Such institutions are usually formed by extensive help from NGOs and other organizations, who also train the community members in various financial activities of the community bank, closely related to the village banking model. These institutions may have savings components and other income-generating projects included in their structure. In many cases, community banks are also part of larger community development programmes which use finance as an inducement for action. Village banks are community-based credit and savings associations. They typically consist of 25 to 50 low-income individuals who are seeking to improve their lives through self-employment activities.

The primary function of Community-based organizations (CBO) is to develop internal financial management capacity of the group in order to create a mini-bank, independent of the lending institution, owned and managed entirely by the poor. The subcategories of the CBOs are community managed loan funds (CMLF) and village savings and loan associations (VSLA). The former is more widely known as a village banking model and it was developed by John Hatch of FINCA.

Advantages of Community Banking Model

- It is 'micro' enterprise with 'macro' impact. A small loan can make the difference between abject poverty and survival.
- It helps people help themselves. Loans to start or expand small businesses help the poor raise their standard of living under their own management and initiative.

- Community banks borrow a lump sum during fixed cycles and distribute smaller increments to each bank member. In the case that one member defaults, the others members must cover the deficit to ensure access to another loan cycle.
- Small loans are direct deposits against hunger. When mothers earn, whole family gets benefits. This increased capacity to buy more food improves the family's diet, making them less vulnerable to disease and death.
- It breaks the cycle of poverty. Access to credit enables the poor to transform their own communities.
- It doesn't create dependency. Bank members don't need to receive loans for a lifetime.
- Members learn while they earn. Bank members learn skills that improve their businesses and personal lives.
- It provides a safe way to save. Savings plans in community banks often give people the opportunity to save for the first time in their lives.
- It builds more than small businesses. By providing mutual support and encouraging individual empowerment, community banks build stronger families and strengthen civil society.
- It pays for itself. Community bank programs have the potential and goal of becoming self-sustaining. The interest charged on loans helps finance program operations and provides continued capital to make loans available to new communities.

C. Co-Operative Model

Cooperatives are very much like 'associations and Community Banks' except that their ownership structure does not include the poor. A co-operative is an autonomous association of persons belonging to the same local or professional community united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise. Some cooperatives include member-financing and savings activities in their mandate. Members participate in all the major decisions and democratically elect officers from among themselves to moni-

tor the administration of the co-operative. Creditworthiness and loan security are a function of cooperative membership

The leading organization that has been successful in using the co-operative form in rural micro finance in India has been the Cooperative Development Forum (CDF), Hyderabad, which has relied upon a 'credit union' involving the saving first strategy. It has built up a network of Women Thrift Groups (WTGs) and Men Thrift Groups (MTGs). They are registered under Mutually Aided Cooperated Society Act (MACs) and mobilize savings resources from the members and access outside/supplementary resources from the individual system. The WTG or MTG are divided into small groups (10 to 15 members) to facilitate better monitoring of thrift and repayment of loans.

Advantages of the Model

- Most of the WTG/MTGs decided to register themselves under the New Generation Cooperative Act, which allows for greater flexibility and autonomy in operations.
- The Associations provides training, management of the loan insurance fund and inter-lending. It also plays a support role by helping the member cooperative in handling accounting, auditing and other administrative matters.
- Cooperatives can access various types of savings from its members besides providing credit like other MFOs. It can also easily get its stakeholders in the governance structure by the use of democratic processes.
- Cooperatives can grow organically by setting up federations as and when they have a need to wield clout and negotiate on matters of policy.

Contribution of Cooperative Models for Economic Development

Financial cooperatives contribute to social development and improved living conditions in communities. They contribute to socio-economic development by:

- Creating sustainable local prosperity;
- Making it possible for all individuals to become self-sufficient;
- Helping to safeguard against excesses, risks and overly aggressive practices;

- Making members more resilient to external shocks;
- Participating in the creation of quality jobs;
- Being major drivers of economic growth;
- Encouraging innovation and sustainable development.
- Potential to scale-up their coverage of poor.
- Bringing good dividends in terms of increased lending and assured recovery.

Drawback of the Model

- The macro level studies indicate that the cooperatives at large have not been able to fully tap the potential of SBLP for reviving their business position.
- Lack of appreciation of the potential involved under SBLP and inadequate professional and other abilities to pursue a programme of SBLP type are some of the constraints faced by the cooperatives.
- Cooperatives also experience problems in accessing mainstream finance, because of their poor image.
- The greatest challenge on the governance front is the fact that so many cooperatives are not part of an organized network, but function as standalone organizations. Their area of operations is demarcated; this weakens their capacity for good governance.

D. The Grameen Model

Grameen model is based on the concept of joint liability. It is the invention of Prof Muhammad Yunus, founder of Grameen Bank in Bangladesh. Grameen model is the most accepted and prevalent micro-finance delivery model in the world today. Many MFIs have accepted the model as it has high focus on standardization and discipline. It has been highly successful in its banking service to the poor as well as in its poverty alleviation programmes. The most significant aspect of the Grameen Bank Model has been its high loan recovery rate.

Grameen model is being followed by India by Association for Sarva Seva Farms (ASSEFA), Activities for Social Alternatives (ASA), SHARE

Microfinance. Lt CASHPOR Financial and Technical Services Ltd have adopted this methodology with little variations.

The Objectives of the Grameen Bank Model:

- To extend banking facilities to poor men and women
- Eliminate the exploitation of the poor by moneylenders
- Create opportunities for self-employment for the vast multitude of unemployed in rural area
- Bring the disadvantaged, mostly women from the poorest households, within the fold of an organizational format which they could understand and manage by themselves
- Reverse the age-old vicious circle of 'low income, low saving and low investment' into a virtuous circle of 'low income, injection of credit, investment, more income, more savings, more investment, more income'.

Features of Grameen Model:

'Grameen credit' according to Muhammad Yunus, is based on the premise that the poor have skills which remain unutilised or under-utilised. 'Grameen credit' promotes credit as a human right and is targeted at the poor, particularly poor women. The most distinctive feature is that it is not based on any collateral, or legally enforceable contracts, but on trust. It provides service at the doorstep of the poor based on the principle that the bank should go to the people.

Another unique feature of 'Grameen credit' is that it gives high priority to building social capital through the formation of groups and centers, develops leadership qualities and undertakes a process of discussion among borrowers. It lays special emphasis on protection of the environment and children's education, and provides scholarships and student loans for higher education. For the formation of human capital it attempts to increase people's access to technology, like mobile phones and solar power.

Working of Grameen Model:

- **Operating Unit:** A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers start by visiting villages to familiarise themselves with the local environment in which they will be operating and identify

prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local population.

- **Eligibility for Loan:** In the first stage, out of Group of five prospective borrowers; only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks, other members of the group become eligible themselves for a loan.
- **Group Meetings:** Meetings take place only at the Central level and individual groups do not meet. Group meetings take place only in front of the Field staff of the MFI. The model suggests weekly meeting for frequent interaction with the clients to reduce credit risk. These groups of five meet together weekly, with seven other groups, so that bank staff meets with forty clients at a time. The meetings are conducted for carrying out the financial transactions only and other social issues are not discussed.
- **Terms and Conditions of Loan:** Flat interest is charged for making the system standardized. In flat rate system, installment size of repayment remains small for all weeks and hence is convenient and easier to explain. Also, it is easy to break the loan installment into the principal and interest component. The group leader collects the loan repayments and savings prior to the meeting and hands it over to the Centre leader who gives it to the field worker during the meeting. This collected amount is deposited in the branch on the same day.
- **Joint Liability:** The Group and Center are Joint liability Groups, which means that all members are jointly responsible for the repayment. MFI recovers full money from Center, if any member has defaulted; the group members have to pool in money to repay to the MFI. If Group members are unable to do it, Center as whole has to contribute and share the responsibility. According to the rules, if one member ever defaults, all in the group are denied subsequent loans. Because of these restrictions, there is substantial group pressure to keep individual

records clear. In this sense, collective responsibility of Group/Peer pressure replaces the collateral.

E. Intermediary Model

Intermediary model of credit lending position is a 'go-between' organization between the lenders and borrowers. The intermediary plays a critical role of generating credit awareness and education among the borrowers (including, in some cases, starting savings programmes. These activities are geared towards raising the 'credit worthiness' of the borrowers to a level sufficient enough to make them attractive to the lenders. The links developed by the intermediaries could cover funding, programme links, training and education, and research. Such activities can take place at various levels from international and national to regional, local and individual level.

Intermediaries could be individual lenders, NGOs, microenterprise/ microcredit programmes, and commercial banks (for government financed programmes). Lenders could be government agencies, commercial banks, international donors, etc.

From a policy perspective this approach resembles the recent policy recommendation by the Reserve Bank of India to set up a network of banking correspondents (BCs) and banking facilitators (BFs) in order to expand financial services to rural areas, remote locations and uncovered households. The agents in our framework could be viewed as BFs.

Advantages of the Model:

- The loans involve several dynamic features to encourage borrower repayment incentives: future eligibility for loans is linked to repayment of current loans, and loan sizes grow progressively with successful repayment. Safe borrowers would make a positive contribution to social surplus.
- The loans are designed to finance cultivation and marketing of agriculture produce. Borrowers can repay in the form of producer's cold store receipts at harvest time, so they do not have to sell the crop at that time in order to repay the loans.

- An insurance aspect is included in the loan: repayment obligations are reduced following adverse village level covariate shocks to crop yields or revenues (which are verified by post-harvest surveys).
- Intermediated loans experience higher take up (controlling for land-holding) as these clients do not have to bear the burden of making up for the repayment burdens of their group members if the latter default. Nor do they have to incur the costs of attending group meetings, achieving savings targets, or all the problems of free-riding and social tensions.
- Some additional features reduce transactions costs for borrowers: loans are made directly by the MFI, with MFI officials visiting each borrower in their homes. Borrowers do not have to open bank accounts, with all transactions taking place at their door-step. There are no savings requirements or mandated meetings with agents or MFI officials.
- The administrative costs of lenders are substantially lower owing to the elimination of these requirements, since MFIs do not have to hire officials who conduct weekly meetings and collect savings deposits from borrowers.

Drawbacks of the Model:

- The success of this program will crucially depend on the agent recommending good clients. So the obvious question is: what are the agent's incentives to recommend good clients. Therefore handsome share of commission has to be given to agents.
- With the higher provision of incentives for intermediaries, cost of borrower will rise, which will further deteriorate the situation.
- Agents can refer clients, pursue the client's proposal and facilitate the MFIs to carry out its transactions; however the final decision on whether to actually provide the loan to the recommended household rests with the actual lender.
- Finally agents might be politically motivated and might view this as an extension of the government anti-poverty programs and use this to increase the political dominance of the party in power within the village.

F. Individual Banking Model

Many MFIs have begun to recognize that the traditional group based lending (GBL) model is too restrictive and not universally applicable. As a result, many institutions have started to shift towards various alternative models including group based loans with individual liabilities where repayment is still weekly during a group meeting, or by simply shifting to a model that extends an individual liability loan. The shift towards individual loans has been remarkable over the past few years.

It is not accurate to denote that microfinance is solely based on a group lending methodology. The individual model is, in many cases, a part of a larger 'credit plus' programme, where other socio-economic services such as skill development, education, and other outreach services are provided. This is a straight forward credit lending model where micro loans are given directly to the borrower. It does not include the formation of groups, or generating peer pressures to ensure repayment.

Advantages of the Model:

There are many reasons why individual loans are better in some instances than group loans.

- Specifically, these loans may attract new clients who did not participate previously in microfinance programs because the group atmosphere did not suit their needs. In turn, this allows an MFI to increase its reach.
- Individual loans also permit MFIs to tailor the loan specifically for its clients' needs. This is especially attractive for agricultural financing, which needs more flexibility in its repayment cycles.
- Individual loans also give a client more privacy. By taking away the group atmosphere, individuals do not have to disclose their financials to anyone other than the MFI.
- Finally, individual loans give MFI an opportunity to monitor the uses of the loan more closely to ensure that it is going to the assumed purpose.

Drawbacks of the Model:

Individual lending also comes with some reservations. They are:

- Few MFIs provide individual loans to low-income people because poorer clients are considered higher risk clients due to their lack of collateral, plus the labor intensive nature of the credits and hence the lack of profitability of small-credits.
- Group peer pressure is absent and therefore programme management, client appraisal poses specific challenges. Here clients have to be monitored and deeper field research is necessary in order to choose the right clientele, especially because these people have no tangible collateral or credit history and in most cases are illiterate.
- With this model, the loan is given directly to the borrower and it is his/her sole duty to pay back the full amount plus interest rates without financial support from a group in case he/she defaults.
- Technical assistance as well as payment schedules and business management training is generally provided by the MFI for recovery of loans. More monitoring might lead to increased costs of servicing a loan, as mentioned previously. Screening potential clients might end up being costly as well.

15.10 ROLE OF MICRO FINANCE IN ECONOMIC DEVELOPMENT

Microfinance play an important role in beginning and expanding the small business by offering small loans to lower income groups which generate income and employment to local communities. Microfinance has been treated as an important tool for economic development. Microfinance plays vital role in economic development through following ways:

- **Poverty Alleviation:** According to World Bank report 1.4 billion population in developing countries is living on less than 1.25 US dollar a day. That's why to alleviate poverty is one of the major millennium development goal announced by UNO in 2008. To eradicate poverty most of the nations including India have been pursuing various policies and programmes.

- **Women Empowerment:** Microfinance is an important tool not only reducing poverty but also empowering women as normally more than 50% SHGs are formed by women. SHGs has proved to be strategic tool for organizing women in groups and promoting their saving habits to gain greater access to financial and economical resources. Poor women use small loans to start a long chain of economic activity and raise their socio-economic status in the society.
- **Financial Inclusion:** Microfinance has been recognized as an important tool in connectivity the unbanked population to mainstream institutional banking services. It has contributed to reduce their dependency on informal money lenders and non-institutional sources.
- **Mobilization of Savings:** Microfinance develops the saving habits among the people. Now poor people with meager income also save money and are bankable. The financial resources generated through saving of group members and micro credits obtained from banks are utilized to provide loans to its members.
- **Financial Stability:** Microfinance has also played a greatest in providing financial stability to people which contributed to local economies in substantial extent. Small loans have offered opportunities to earn extra income, so that people can pay for their extreme necessities.
- **Development of Skills:** Microfinance has helped in identifying the potential rural entrepreneurs. SHGs encourage its members to set up their businesses jointly or individually. They receive training from their supporting institutions and learn leadership qualities. Thus, microfinance helps indirectly in the Development of Skills.

15.11 ROLE OF NABARD IN PROMOTING MICRO FINANCE IN INDIA

- **The SHG-Bank Linkage Program:** NABARD conceptualised and launched Self-Help-Group-Bank Linkage Program (SBLP) in 1992, which attempts to link the rural poor in large numbers to the formal banking sector in a sustainable and cost effective manner. This has emerged as the predominant micro finance model in the country and is now a proven method of financial inclusion, providing unbanked rural

clientele access to formal financial services from the existing banking system.

- **Supporting Grant to Agencies:** NABARD continued to extend grant support to NGOs, RRBs, DCCBs, Farmer Clubs (FCs) and Individual Rural Volunteers (IRVs) for promoting and nurturing quality SHGs. Efforts continued towards roping in new Self-Help Promoting Institutions (SHPIs) and supporting the existing ones.
- **Capacity Building:** Capacity building of stakeholders is crucial for up-scaling the SHG movement and maintaining the quality & sustainability of SHGs. NABARD supports capacity building programs for SHG members, officers of commercial banks, cooperative banks, RRBs, PRIs, and Government departments including IAS officers.
- **Micro-enterprise Promotion:** In 2008-09 NABARD launched a scheme for supporting small-scale activity based groups (ABGs) under which NABARD provides support for capacity building, production and investment credit and market related aspects. NABARD support is in the form of grant for group formation, training, extension services, and market linkage.
- **Micro-Enterprise Development Program:** NABARD in 2005-06 had launched a pilot program 'Micro-Enterprise Development Program' (MEDP) to motivate and assist members of matured SHGs to take up income generating activities on a sustainable basis. MEDP is being implemented in nine districts in nine States, involving 14 NGOs, which act as 'Micro-Enterprise Promotion Agency' (MEPA).
- **Support to SHG-Federations:** NABARD, recognizing the emerging role of the SHG Federations and their value addition to functioning of SHGs, enhancing the bargaining powers of group members and livelihood promotion, introduced in 2008-09, a flexible scheme to support SHG-Federations, on a model neutral basis.
- **Support to Joint Liability Groups (JIG):** NABARD had launched pilot project on financing Joint Liability Groups (JLGs) through select RRBs and PCARDB, which proved success.

- **Support to MFIs:** Recognizing the role of MFIs in supplementing the efforts of the formal banking network in providing credit support to unreached clients for inclusive growth, NABARD supports them through grant and loan-based assistance from the Micro-Finance Development and Equity Fund (MFDEF).
- **Revolving Fund Assistance:** NABARD has been selectively supporting MFIs by providing revolving financial assistance (RFA) for on lending to the unreached poor as also experimenting with various MF models to innovate alternative, sustainable and replicable credit delivery systems.
- **Support for Rating of MFIs:** NABARD provides financial assistance to commercial banks and RRBs to avail the services of credit rating agencies (such as CRISIL, M-CRIL, ICRA, CARE and Planet Finance) for the purpose of rating of MFIs and empowering them to intermediate between the lending banks and the clients.
- **Capital/Equity Support:** NABARD, under its Capital/Equity Support scheme, provides financial assistance to MFIs to leverage capital/equity for accessing funds from banks, providing financial services at an affordable cost to the poor, and achieve sustainability in credit operations over 3 to 5 years.
- **Rajiv Gandhi Mahila Vikas Pariyojana:** NABARD in collaboration with the Rajiv Gandhi Cheritable Trust (RGCT) has designed the Rajiv Gandhi Mahila Vikas Pariyojana to promote, credit link and form SHG Federations in selected districts of Uttar Pradesh.
- **SHG-Post Office Program:** The project aimed at utilizing the vast network of Post Offices in rural areas in disbursement of credit to rural poor, on an agency basis.
- **Financial Assistance for Developing Software:** NABARD had sanctioned Rs.10.29 lakh to MYRADA for developing software for NGOs to help them understand the functioning and performance of SHGs.
- **NABARD-KfW program:** The NABARD-KfW program being implemented in Gujarat aims at improving access of poor women

to micro-credit on a sustainable basis, both in rural and urban areas.

- **NABARD-GTZ Rural Finance Program:** Under the 'NABARD-GTZ Rural Finance Program' training modules were developed to sensitize bank branch managers and SHG members for minimizing risks in lending through early warning system and provided to training institutes involved in MF.

15.12 PROBLEMS OF MICRO FINANCE

- **Financial illiteracy:** One the major problems in India towards the growth of the microfinance sector is illiteracy of the people. This makes it difficult in creating awareness of microfinance and even more difficult to serve them as microfinance clients.
- **Lack of information:** There are various sources of credit information in India, but none of these focuses on small, rural borrowers. Credit information on such borrowers is difficult to obtain because the majority of the rural poor rely on money lenders and other informal lenders, and it is not in the interest of such lenders to pass on a borrower's good credit repayment record to other providers of finance.
- Inability to generate funds: MFIs have inability to raise sufficient fund in the microfinance sector which is again an important concerning challenge.
- Heavy dependence on banks & FIS: MIF's are dependent on borrowing from banks & FIS. For most of the MFI's funding sources are restricted to private banks & apex MFI's.
- Weak governance: Many MFI's are not willing to convert to a corporate structure; hence they trend to remain closed to transparency and improved governance, thus unable to attract capital. MFI's also facing a challenge to strike a balance between social and business goals.
- High Interest Rate: MFIs are charging very high interest rates, which the poor find difficult to pay. MFIs are private institutions and therefore require being economically sustainable.

- Regional Imbalances: There is unequal geographical growth of Microfinance institutions and SHGs in India. About 60% of the total SHG credit linkages in the country are concentrated in the Southern States.



CHECK YOUR PROGRESS

Write the full form of the following:

1) SHGs _____

2) NGOs _____

3) MFIs _____

4) MUDRA Bank _____

5) NABARD _____

6) RRBs _____

7) SBLP _____



15.13 LET US SUM UP

In this unit, we have discuss the following :-

- Micro Finance refers to the provision of affordable financial services extended to socially and economically poor and disadvantaged segments of the society.
- The main aim of micro finance is to provide small loans to poor people particularly living below poverty line.
- The concept of microfinance initiated as an introduction of Muhammad Yunus (2006) in the form of Grameen Bank in Bangladesh.
- In India, NABARD initiated the concept of microfinance.
- Microfinance aims at removal of poverty, empowering poor, mostly women.

- The important channel for growth of microfinance in India is through Microfinance Institutions (MFIs).
- The various models currently being used by microfinance institutions throughout the world are: Associations, Bank Guarantees, Community Banking, Cooperatives, Credit Unions, Grameen, Group, Individual, Intermediaries, NGOs, Peer Pressure, ROSCAs, Small Business, and Village Banking models.
- Microfinance has been treated as an important tool for economic development.



15.14 FURTHER READING

- Microfinance in India: Approaches, Outcomes, Challenges –By by Tara S Nair (Editor)
- Indian Microfinance: The Challenges of Rapid Growth -By Prabhu Ghate
- Microfinance in India: A Performance Evaluation –By Anil Kumar Chauhan and S. M. Feroze
- Website of NABARD & RBI



15.15 ANSWERS TO CHECK YOUR PROGRESS

1) Self-Help Groups
2) Non-government Organizations
3) Microfinance Institutions
4) Micro Units Development Refinance Agency Bank
5) National Bank for Agriculture and Development
6) Regional Rural Banks
7) Self-Help-Group-Bank Linkage Program



15.16 MODEL QUESTIONS

1. Write short notes on:
   - Micro Insurance
   - Micro Credit
   - MUDRA Bank
2. Define and explain Microcredit?
3. Define and explain Microfinance?
4. Why Microfinance is needed?
5. What is the role of Microfinance?
6. What are the general characteristics of Microfinance clients?
7. What is meant by Microfinance? Differentiate between Microcredit and Microfinance?
8. Explain the role of Microfinance? What are the benefits of Microfinance?
9. Define and explain Microfinance? How the Microcredit emerged and turned into Microfinance?
10. How Microfinance provides economic and social upliftment of the poor people who are in the grip of vicious cycle of poverty?

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