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ECONOMICS

BLOCK- 2

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BLOCK INTRODUCTION

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

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

UNIT 9: MUTUAL FUND

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Origin of Mutual Fund

9.4 Meaning and Concept of Mutual Fund

9.5 Function and Features of Mutual Fund

9.6 Classification and Types of Mutual Fund

9.7 Mutual Fund Fees

9.8 Advantages of Mutual Fund

9.9 Disadvantages of Mutual Fund

9.10 Net Asset Value

9.10.1 Meaning of High and Low NAV

9.10.2 Importance of NAV in Mutual Fund

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9.12 Let Us Sum Up

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9.1 LEARNING OBJECTIVES

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

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

9.2 INTRODUCTION

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

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

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

9.3 ORIGIN OF MUTUAL FUND

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

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

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

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

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

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

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

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

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

9.4 MEANING AND CONCEPT OF MUTUAL FUND

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

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

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

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

Mutual fund generate income in following ways

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

9.5 FUNCTIONS AND FEATURES OF MUTUAL FUND

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

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

Features of Mutual Fund

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

9.6 CLASSIFICATION AND TYPES OF MUTUAL FUND

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

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

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

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

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

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

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

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

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

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

9.7 MUTUAL FUND FEES

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

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

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



CHECK YOUR PROGRESS

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

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

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

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9.8 ADVANTAGES OF MUTUAL FUND

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

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

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

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

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

9.9 DISADVANTAGES OF MUTUAL FUND

The mutual funds have the following drawbacks-

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

9.10 NET ASSET VALUE

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

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

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

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

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

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

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

NAV = (10000 – 2000) / 200

NAV = 8000/200

NAV = Rs 40/

9.10.1 Meaning of High and Low NAV

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

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

So, the investor received

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

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

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

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

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

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

9.10.2 Importance of NAV in Mutual Fund

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

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

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

9.11 FACTORS THAT HELP TO CHOOSE MUTUAL FUND

Following are the factors that help to choose mutual fund :

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



CHECK YOUR PROGRESS

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

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

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9.12 LET US SUM UP

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



9.13 FURTHER READING

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

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9.14 ANSWERS TO THE CHECK YOUR PROGRESS

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

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

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

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

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

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



9.15 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by mutual fund?

Q 2: Briefly explain the features of mutual fund.

Q 3: What is meant by Mutual Fund Fees?

Q 4: How NAV is calculated?

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

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

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

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

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

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UNIT 10 : THE DEBT MARKET

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Participants in the Debt Market

10.4 Instruments traded in the Debt Market

10.5 The Government Security Market

10.5.1 Market Segments of Government Securities Market

10.6 Let Us Sum Up

10.7 Further Reading

10.8 Answers to Check Your Progress

10.9 Model Questions

10.1 LEARNING OBJECTIVES

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

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

10.2 INTRODUCTION

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

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

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

10.3 PARTICIPANTS IN THE DEBT MARKET

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

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

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



LET US KNOW

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

10.4 INSTRUMENTS TRADED IN THE DEBT MARKET

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

- Government Securities
- Public Sector Bonds
- Private Sector Bonds

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

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

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

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



LET US KNOW

Segments of Debt Market:

There are two segments of the debt Market:

- the primary market
- the secondary market

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



CHECK YOUR PROGRESS

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

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

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

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10.5 THE GOVERNMENT SECURITY MARKET

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

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

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

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

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



LET US KNOW

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

There are three segments of investors in government securities

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

10.5.1 Market Segments of Government Securities Market

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

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

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



CHECK YOUR PROGRESS

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

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

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

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10.6 LET US SUM UP

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



10.7 FURTHER READING

- Pathak, B. V. (2012). *The Indian Financial Sysytem*. Singapore: Pearson
- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.
- P.F Smith (1971). Economics of Financial Institutions & Markets. Prentice Hall
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10.8 ANSWERS TO CHECK YOUR PROGRESS

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

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

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

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

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

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

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



10.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

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

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

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

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

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

Q 1: Discuss the participants of the debt market.

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

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

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

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

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UNIT 11: THE INSURANCE SECTOR

UNIT STRUCTURE

11.1 Learning objectives

11.2 Introduction

11.3 Concept of Insurance

11.4 Nature of Insurance

11.5 Role of Insurance

11.6 Types and Methods of Insurance

11.6.1 Types of Insurance

11.6.2 Methods of Insurance

11.7 Need for Insurance

11.8 Functions of Insurance

11.9 Shortcomings of Insurance

11.10 Lets Us Sum Up

11.11 Further Reading

11.12 Answer to Check Your Progress

11.13 Model Questions

11.1 LEARNING OBJECTIVES

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

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

11.2 INTRODUCTION

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

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

11.3 CONCEPT OF INSURANCE

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

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

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

Illustration:

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

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

Definition of Insurance

The definition of insurance can be classified under two categories:

- *Functional Definitions* - According to Allen C. Mayerson, " Insurance is a device for the transfer of certain risks of economic loss to an insured, that would otherwise be borne by the insured."

  As per Disnadle, " Insurance is an instrument of distributing the loss of few among many."
- *Contractual definition*- According to E.W.Patterson, " Insuance is a contract by which one party, for a considertion called premium, assumes a particular risk of the other party and promises to pay to him or his nominee a certain or ascertainable sum of amount on a specified contingency."

According to MacLean "Insurance is a method of spreading over a large number of persons a possible financial loss too serious to be conveniently borne by an individual."

11.4 NATURE OF INSURANCE

The nature of insurance is as follows:

- Insurance is a mechanism of sharing risk by large number of people among the few who are exposed to risk by one or the other reason.
- If a large number of subscribers to insurance serve the purpose of compensation to few among them exposed to uncertain risks appears as a co-operative look.
- Valuation of risk is determined as per predefined terms and conditions of the insurance policies.
- Insurance provides facility of financial help in case of contingency.
- Financial help depends on the value of insurance for which payment is made in case of contingency. This provides basis of the amount to be paid.
- Insurance is a policy regulated under laws and therefore the amount of insurance can neither be paid as gambling nor as charity.

11.5 ROLE OF INSURANCE

Human beings, his/her family and properties are always exposed to different kinds of risks. Risk involve the losses. Insurance is a tool which reduces the cost of loss or effect of loss caused by variety of risk. It accumulates funds to meet individual losses. It is not device to prevent unwanted event of happening or cause of loss but protects them against that loss by compensating which is lost. The role and importance of insurance are discussed as follows:

- **Insurance provides security:** Insurance provides safety and security against the loss on a particular event. Life insurance provides security against death and old age sufferings. Fire insurance protects against loss due to fire while Marine insurance provides protection and safety against loss of ship and cargo. For personal accident and sickness insurance financial protection is given when the individual is unable to earn. In other insurance too, this security is provided against the loss at a given contingency.
- **Insurance reduces business risk or losses:**In Business, commerce and industry, huge properties are employed. Because of slight negligence, the property may be turned in to ashes. A person may not be sure of his life, health and cannot continue the business up to the longer period to support his dependents. With the help of insurance, he can be sure of his earning, because the insurance company will pay a fixed amount at the time of death, damage by fire, theft, accident and other perils.
- **Insurance provides peace of mind:** Insurance removes the tensions, fears, anxiety, frustration and weakness of the human mind associated with the future uncertainty. By providing financial support and promise to compensate losses arising out from various risk, it provides peace of mind and stimulates more and better work performance of an individual.
- **Life insurance encourages saving:** In some specified life insurance policies, the insured has an obligation to pay premium

regularly and cannot be withdrawn easily before the expiry of the term of policy. Life insurance encourages the habit of regular and systematic saving through premium and after a certain period, it would be a part of necessary saving of the insured person.

- **Insurance accelerates the economic growth of the country:**To develop the economic growth of the country, insurance provides strong hand and mind, with protection against loss of property and capital to produce more wealth. It provides protection against different kinds of loss caused by risk. It accumulates the capital from the insured and utilizes for the development of country. Thus, the insurance meets all the requirements for the economic growth of a country.
- **Insurance provides credit facilities:** The insured person can get loan by pledging insurance policy and the interest will not exceed the cash value of policy charged by insurer. In case of death of insured person, the policy can be utilized for setting of the loan with interest. Business person can take loan on the basis of insurance documents from the bank also.
- **Insurance helps to reduce inflation:** Inflation created from over supply of money and on less production entities. Insurance can help to reduce the inflationary pressure in two ways. Firstly, it collects money as an amount of premium which controls over supply of money and secondly, it provides sufficient funds for increase production entities. Thus, it reduces the impact of inflation.
- **Insurance makes security and welfare of employees:** The security and welfare of employees is the responsibility of employer. These security and welfare can easily be met by life insurance, accident and sickness benefit and pension which are generally covered by group insurance. The premium for group insurance is normally bear by the employer. Insurance is the simple method for employer to fulfill their responsibility. Due to these benefits, employees will devote their maximum capacities to complete their job.

- **Other Importance of Insurance:**
  - Insurance helps to promote foreign trade providing protection again trade risk.
  - Insurance increases business efficiency eliminating the loss of damage, destruction, or disappearance of property of goods.
  - Insurance protects the social wealth providing protection against social evil.
  - Development of insurance business helps to solve the evil of unemployment, generating employment opportunity in the country.
  - The insured gets tax benefit in life insurance.



CHECK YOUR PROGRESS

Q 1: Which sector regulates Insurance and reinsurance in India?

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Q 2: Write a short note on Indian insurance sector. (Within 50 words)

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Q. 3: When was life insurance sector was nationalised in India?

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Q. 4: State whether the following statement are True (T) or False (F)

(a) A coverage that protects businesses engaged in electronic commerce from losses caused by hackers is termed as Hacker Insurance.

(b) Insurance is a policy regulated under laws and therefore the amount of insurance can neither be paid as gambling nor as charity.

11.6 TYPES AND METHODS OF INSURANCE

11.6.1 Types of Insurance

Basically, there are two broad types of insurance – Life Insurance and General Insurance.

- **Life Insurance:** Life Insurance is a financial cover for a contingency linked with human life, such as death, disability, accident, retirement etc. Human life is subject to risks of death and disability due to natural and accidental causes. When human life is lost or a person is disabled permanently or temporarily, there is loss of income to the household. Although human life cannot be valued, a monetary sum could be determined based on the loss of income in future years. Hence, in life insurance, the Sum Assured (the amount guaranteed to be paid in the event of a loss) is by way of a 'benefit'. Life Insurance products provide a definite amount of money in case the life insured dies during the term of the policy or becomes disabled on account of an accident.

Types of Life Insurance Policies:

- **Term Insurance:** One can choose to have protection for a set period of time with Term Insurance. In case of death or total and permanent disability, if the benefit is offered, the dependants of the insured will be paid a benefit. However, in Term Insurance, no benefit is normally payable if the life assured survives the term.
- **Whole Life Insurance**: With whole life insurance, the insured is guaranteed lifelong protection. Whole life insurance pays out a death benefit so the insured can be assured that his/her family is protected against financial loss that can happen after the insured's death.
- **Endowment Policy**: An Endowment Policy is a savings linked insurance policy with a specific maturity date. If an unfortunate event by way of death or disability occurs to

the insured during the period, the Sum Assured will be paid to his/her beneficiaries.

- **Money back plans or cash back plans**: Under this plan, certain percent of the sum assured is returned to the insured person periodically as survival benefit and after the expiry of the term, the balance amount is paid as maturity value. The life risk may be covered for the full sum assured during the term of the policy irrespective of the survival benefits paid.
- **Children Policies:** These types of policies are taken on the life of the parent/children for the benefit of the child. By such policy the parent can plan to get funds when the child attains various stages in life. Some insurers offer waiver of premiums in case of unfortunate death of the parent/ proposer during the term of the policy.
- **Annuity (Pension) Plans:** When an employee retires he/ she no longer gets his salary while his/her need for a regular income continues. Retirement benefits like Provident Fund and Gratuity are paid in lump sum which are often spent too quickly or not invested prudently with the result that the employee finds himself/herself without regular income in his/her post - retirement days. Pension is therefore an ideal method of retirement provision because the benefit is in the form of regular income. It is wise to provide for old age, when we have regular income during our earning period to take care of rainy days. Financial independence during old age is a must for everybody.

- **General Insurance:** General Insurance is the insurance of assets, financial assets etc. If there is an economic loss by a contingency and if it is covered under a policy, the loss is compensated by general insurance policies. Types of general insurance are as follows:

- **Health Insurance:** It covers the medical expenses of the insured if the insured fall ill or injured and need medical assistance.
- **Motor Insurance:** This is the plan for vehicles. These plans are mandatory as per law and have to be bought for every vehicle.
- **Travel Insurance:** These plans are to cover financial emergencies that the insured person may face during his travelling.
- **Home Insurance:** These plans cover the financial losses that one may suffer in case of his home and its contents are damaged.
- **Fire Insurance:** These policies cover the damages caused by fire and other related hazards.

Some other types of general insurance are:

- **Marine Insurance:** It is a contract by which insurer engage to assure the owner of a ship, cargo or freight against losses from certain perils or sea risks to which their ship or cargo may be exposed.
- **Credit Insurance:** Credit insurance means insuring the payment of commercial debts against the risk of non-payment by the borrower because of his insolvency or for some other reason.
- **Group Insurance:** Group Insurance is insurance or life insurance obtained by a person as a member of a group, such as a professional organization, rather than as an individual, because in this way better terms can often be obtained. This is because there is an administrative saving for the company, and sometimes also because a particular group has a better life expectancy than people in general.
- Cyber risk insurance
- Commercial General Liability insurance
- Professional Indemnity insurance etc.

11.6.2: Methods of Insurance

- Co-insurance – risks shared between insurers
- Dual insurance – having two or more policies with overlapping coverage of a risk (both the individual policies would not pay separately – under a concept named contribution, they would contribute together to make up the policyholder's losses. However, in case of contingency insurances such as life insurance, dual payment is allowed)
- Self-insurance – situations where risk is not transferred to insurance companies and solely retained by the entities or individuals themselves
- Reinsurance – situations when the insurer passes some part of or all risks to another insurer, called the reinsurer.

11.7 NEED OF INSURANCE

Life of everyone is full uncertainties. Nobody knows what is going to happen in next moment. This element of uncertainty always pursues around the mind of a person and keeps him worried to think as to what will happen in future in case of any mishappening. This worry is to think about the future of the person and his family. Among a number of worries the main and very important is economic uncertainty of himself or his family. There remain many fields to worry about. Every field need some security cover and to ensure such security cover one is not able to catch the future unfortunate happenings. It therefore becomes prudential to get insured for visual or un-visual events one is able to foresee. There are various reasons behind insurance which are discussed below:

- **Nobody knows what is going to happen:** This is the main reason for having insurance. If one is covered and someone breaks in to his/her home and steals something one get it replaced. This is how insurance should work.
- **Nobody can trust nature:** In 2010, a cloud burst in Himachal Pradesh took life of hundreds of people and thousands of persons

were left as homeless people. In a situation of terrorist's regime any one is exposed to the risk of life and business. Similarly, storms, hurricanes, tornadoes, earthquakes, tsunamis, floods etc. into the mix and it becomes very clear that insurance is still very necessary.

- **Nobody can trust other people:** Accidents happen to everyone, but there are people who cause accidents through negligence, a drunk driver, as for example.
- **For peace of mind:** Knowing that one (and his/her family) are covered by an insurance policy if something unfortunate does happen can help put one's mind at ease.

11.8 FUNCTIONS OF INSURANCE

When we talk about functions of insurance one thing comes to our mind that after purchasing an insurance policy we need not to worry about our future, which is a wrong concept. Every insurance policy is subject to the terms and conditions contained in the insurance agreement and therefore any insurance serves a limited purpose as agreed to between two parties the Insurer and the Insured. One cannot expect more than what one has insured him. It is pertinent to note that the functions of any insurance remained confined to the terms and conditions of different type of insurance policies. The basic functions of an insurance company are discussed below:

Primary Functions

- **Protection:** Primary function of Insurance is to provide protection against future risks, accidents and uncertainty. No insurance can arrest the risk from taking place; no insurance can prevent future miss happenings, but can certainly provide some cover for the losses of risk. Insurance is a protective cover against economic loss by sharing the risk with others, (the pooling members).
- **Collective Risk:** The Insurance policies whether life insurance or general insurance are purchased by many people. However, all of them are not subjected to losses every year. It is only a few who become victim of some misshappenings. It is clear

that insurance is a method by means of which a few losses are shared by a large number of people. All the people insured contribute by paying annual premium towards a fund out of which the persons exposed to risks are paid as per the terms and conditions of the insurance policy purchased by them.

- **Assessment of Risk:** The volume of risk is determined by the Insurance companies by assessing various factors that give rise to risk. The rate of premium is also decided on the basis of risk involved.
- **Certainty:** Unless we are insured we remain uncertain about our capability to meet the future risks. But once we are insured it converts our uncertainty into certainty of bearing future risks.

Secondary Functions

- **Prevention of losses:** We know that precautions are better than the treatment. It is better instead of seeking the help of insurance if one adopts such measure which prevents the losses. Every Insurance prescribes to take preventive measures against losses. As for example, installation of safety devices like automatic sparkler or alarm system, CCTV system etc. If such preventive measures exist, there shall be lower rate of premium for getting insurance cover against risks. Prevention of losses is to adopt preventive measures against unexpected losses.
- **Covering Larger Risks with small capital:** Every businessman is always worried about the security of his business. After making large investments in the business it is natural to take care of the business investments. There are two alternatives- a) the concerned businessman should invest out of his own pocket to create a proper security and to get his business activities insured. In such a case the insurance relives a businessman from security investments by paying small amount in the shape of premium against larger risks and uncertainties. This assures the businessman from security

investments for a small amount of premium against larger losses.

- **Helps in development of larger Industries:** Larger Industries are prone to more risks in their setting up. The large industries have diversified fields of functioning where one field sometimes has no relation with the other field of the same industry. The activities of large industries are diversified that it goes above any planning to cover every type of risk. It is only the insurance that comes not only to help these large industries against possible risk but also help them to grow. It becomes possible only because insurance provides an opportunity to develop to those larger industries which have more risks in their setting ups.

Other Functions

- **Insurance is a tool used for saving and investments:** By purchasing any Insurance Policy it becomes completion by the purchaser to make payment of the insurance policy. This completion is blessing in disguise. Most of the policy buyers particularly individuals do not know the purpose of payment of premium. They know only one thing that paying premium is compulsory for them. Such savings help growth in national economy.
- **It is one of sources to earn Foreign Exchange:** It being an international business, any country is free to earn foreign exchange as much as per the policies of insurance devised in a way to attract more and more foreign business. It is a good source of earning foreign exchange for any country.
- **Risk Free Trade:** Insurance promotes export as insurance, makes the foreign trade risk free with the help of different types of polices under marine insurance cover.
- **Subrogation:** In its most common usage it refers to circumstances in which an insurance company tries to recoup expenses for a claim it paid out when another party should have

been responsible for paying at least a portion of that claim. However there are certain functions which apply to every kind of insurance including life insurance as well as general insurance that includes every type of insurance such as home, automobile, jewellery, property and other valuable assets.

11.9 SHORTCOMINGS OF INSURANCE

Insurance is just a risk transfer mechanism wherein the financial burden which may arise due to some accidental event is transferred to a bigger entity called Insurance Company by way of paying premiums. This only reduces the financial burden and not the actual chances of happening of an event. Insurance is a risk for both the insurance company and the insured. The insurance company understands the risk involved and will perform a risk assessment when writing the policy. As a result, the premiums may go up if they determine that the policyholder will file a claim. The shortcomings are:

- **Moral hazard:** An insurance company may inadvertently find that its insured may not be as risk-averse as they might otherwise be a concept known as moral hazard. This 'insulates' many from the true costs of living with risk, negating measures that can mitigate or adapt to risk and leading some to describe insurance schemes as potentially maladaptive.
- **Complexity of insurance policy contracts:** Insurance policies can be complex and some policyholders may not understand all the fees and coverage included in a policy. As a result, people may buy policies on unfavourable terms. In response to these issues, many countries have enacted detailed statutory and regulatory regimes governing every aspect of the insurance business, including minimum standards for policies and the ways in which they may be advertised and sold.
- **Limited consumer benefits:** Consumers are in most cases advised to select high deductibles and to not insure losses which would not cause a disruption in their life. However, consumers have

shown a tendency to prefer low deductibles and to prefer to insure relatively high-probability, small losses over low-probability, perhaps due to not understanding or ignoring the low-probability risk. This is associated with reduced purchasing of insurance against low-probability losses, and may result in increased inefficiencies from moral hazard.

- **Redlining:** Redlining is the practice of denying insurance coverage in specific geographic areas, supposedly because of a high likelihood of loss, while the assumed motivation is unlawful discrimination. Racial profiling or redlining has a long history in the property insurance industry in the United States.

Inspite of all these shortcomings, in the present day affairs insurance means financial protection against losses arising out of happenings of an uncertain event. In order to protect against such losses one has to bear some financial burden also. This can be ensured by paying certain amount, depending on the risk covered and the amount of expected loss in the form of paying premium to any of the insurance companies. So in simple words the meaning of insurance is to keep a person fearless and unworried about the future happenings which always remain uncertain. It absolves the risk of uncertainty and provides a piece of mind because the insurance facilitates reimbursement during crises situations and compensate for any potential future losses.



CHECK YOUR PROGRESS

Q.5: State the primary functions of insurance. (Answer in about 20 words)

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Q.6: Discuss various roles of Insurance. (Answer in about 60 words)

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Q.7: How moral Hazard problem arises in Insurance market?
(Answer in about 60 words)

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11.10 LET US SUM UP

- Insurance is a means of protection from financial loss. It is a form of risk management, primarily used to evade against the risk of a contingent or uncertain loss. An entity which provides insurance is known as an insurer, insurance company, insurance carrier or underwriter. A person or entity who buys insurance is known as an insured or as a policyholder.
- The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insurer will compensate the insured. The amount of money charged by the insurer to the policyholder for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster.
- Its basic roles are to provide safety and security to human life, generates financial resources by collecting premium which later on encourages saving, improves investment channel by enabling systematic savings due to payment of regular premium and thus insurance plays a crucial role in sustainable growth of an economy.
- India's economy has been in a boom for the last two decades. There has been increased manufacturing and financial activities. This, in turn, has triggered a rapid growth in the insurance sector as well. In the year 2000, the authorities allowed private companies to be a part of the insurance business. Today there are 13 companies in life insurance and 13 in general insurance. The most prominent one is of course LIC. And then there are other major players like New India, Tata AIG, Bajaj Allianz, ICICI Lombard etc.

- The shortcomings of insurance are- problems of moral hazards, complexity in understanding various insurance schemes, denying insurance coverage and limited consumer benefits. Even though in the present day context, insurance means financial protection against losses arising out of happenings of an uncertain event.



11.11 FURTHER READING

- Howard, C. K., Mark, V. and Pauly, S. McMorrow. (2013). *Insurance and Behavioral Economics*. Cambridge University Press.
- Mishra, K.C. and Bakshi, M. (2009). *Insurance Business Environment & Insurance Company Operations*. Cengage Learning.



11.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Insurance Regulatory and Development Authority of India (IRDA) is an autonomous and the statutory body tasked with regulating and promoting insurance and reinsurance in the country. IRDA was constituted by the Insurance Regulatory and Development Authority Act - IRDA Act, 1999 and has its headquarters in Hyderabad, Telangana..

Ans to Q No 2: India's economy has been in a boom for the last two decades. There has been increased manufacturing and financial activities. This, in turn, has triggered a rapid growth in the insurance sector as well. In the year 2000, the authorities allowed private companies to be a part of the insurance business. Today there are 13 companies in life insurance and 13 in general insurance. The most prominent one is of course LIC. And then there are other major players like New India, Tata AIG, Bajaj Allianz, ICICI Lombard etc.

Ans to Q No.3: Life insurance in India was completely nationalised on 19th January 1956, through the Life Insurance Corporation Act.

Ans to Q No.4: (a) True (b) True

Ans to Q No.5: The primary functions of insurance are- protection, collective risks, assessment of risk and certainty.

Ans to Q No 6. The insurance industries develop financial institutions and reduce uncertainties by improving financial resources. Its basic roles are-

- Provide safety and security: Insurance provide financial support and reduce uncertainties in business and human life.
- Generates financial resources: Insurance generates funds by collecting premium. These funds are invested in government securities and stock.
- Life insurance encourages savings: Insurance provides an investment channel too. Life insurance enables systematic savings due to payment of regular premium. Thus life insurance encourages savings.
- Promotes economic growth: Insurance generates significant impact on the economy by mobilizing domestic savings.
- Medical support: A medical insurance considered essential in managing risk in health. The insured gets a medical support in case of medical insurance policy.

Ans to Q No.7: "Moral hazard" refers to the additional health care that is purchased when persons become insured. When people become insured, insurance pays for their care. For example, life insurance companies may require higher premiums or deny coverage altogether to people who work in hazardous occupations or engage in dangerous sports. Liability insurance providers do not provide coverage for liability arising from intentional misconduct committed by or at the direction of the insured. Even if a provider desired to provide such coverage, it is against the public policy of most countries to allow such insurance to exist, and thus it is usually illegal.



11.13 MODEL QUESTIONS

Short questions (Answer each question in about 150 words)

Q 1: Define the term 'Insurance'. Discuss the various types and methods of Insurance.

Q 2: What is meant by the terms a) Group insurance b) Marine Insurance c) Health insurance.

Q 3: Mention the different methods of insurance.

Q 4: Write a short note on-

a) Redlining

b) Moral hazard

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

Q 1: Discuss the various needs for taking Insurance.

Q 2: Explain the primary and secondary functions performed by insurance?

Q 3: Critically discuss the various shortcomings of insurance? Inspite of these limitations do you think that it plays an important role in development of the economy? Justify your answer.

Q 4: Discuss briefly the nature of Insurance.

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UNIT 12: THE BANKING SECTOR

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 History of Banking in India

12.4 Meaning and Definition of Bank

12.5 Classification of Banking Industry in India

12.6 Structure of Banking systems

12.7 Role of Banking Institutions

12.8 Banking Sector Reforms

12.9 Let Us Sum Up

12.10 Further Reading

12.11 Answers to Check Your Progress

12.12 Model Questions

12.1 LEARNING OBJECTIVES

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

- know the concept and evolution of banking system in India
- explain the various types of banks operating in India
- understand the structure of banking system in India
- discuss the role of banking institutions
- explain the important banking sector reforms for developing banking in India.

12.2 INTRODUCTION

A good financial system not only helps in boosting up the economic development of a country but also helps in overall growth of a country. Banking system acts as an important pillar in the financial system of a country. A bank is a financial institution which deals in accepting deposits and advancing loans to its customers. A banking system is also referred as a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolio.

The Indian banking has come a long way from being sleepy business institution to a highly proactive and dynamic entity. This transformation has been largely brought about by the large dose of liberalization and economic reforms that allowed banks to explore new business opportunities rather than generating revenues from conventional system. Over the past three decades, India's banking system has several outstanding achievements to its credit. In this unit, we shall discuss about the history of banking system in India, types of banks, banking structure in India and the reasons behind the banking sector reforms and its various recommendations suggested by Narasimham committee.

12.3 HISTORY OF BANKING IN INDIA

The origin of modern banking in India can be traced back to the English Agency Houses in Kolkata and Mumbai which used to serve as bankers to the East India Company. The General Bank of India, which was established in 1786, was the first banking institution in India. The East India Company established The Bank of Bengal (1809), the Bank of Bombay (1840), Bank of Madras (1843). These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks.

During the last part of the 19th century and the early phase of 20th century, the Swadeshi Movement induced the establishment of a number of banks with Indian Management. For example, Punjab National Bank Ltd in 1895, The Bank of India Ltd in 1906, The Canara Bank Ltd in 1906, The Indian Bank Ltd in 1907, The Bank of Baroda Ltd in 1908, The Central Bank of India Ltd in 1911 and many other banks were established on the same line. But most of the weak banks went bankrupt due to wrong policy decisions taken by the management and also severe banking crisis occurred during the period of World War I. However, the stronger and well managed banks like those mentioned above survived the crisis.

In the year 1920, the "Imperial Bank of India Act" was passed for amalgamating the three Presidency Banks. As such, the 'Imperial Bank of India' was established in 1921. It was given power to hold the Government

funds and manage the Public debt. However, it was not authorized to issue currency.

Between the years 1913 to 1948, there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949. During 18th century, the need to have Cetral Bank was felt but it could be materialized only in the 20th century. On the basis of the recommendations of the Banking Enquiry Committee, the Reserve Bank of India Act was passed in the year 1934. Accordingly, on April 1935 the Reserve Bank of India was constituted.

After independence, the Government has taken some important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. In 1959, the 'State Bank of India' (Subsidiary Banks) Act was passed by which the public sector banking was further extended. The following are the subsidiary of State Bank of India:

- The State Bank of Bikaner
- The State Bank of Jaipur
- The State Bank of Indore
- The State Bank of Mysore
- The State Bank of Patiyala
- The State Bank of Hyderabad
- The State Bank of Saurashtra
- The State Bank of Travancore

In the year 1963, the first two subsidiary bank of SBI were amalgamated under the name of "The State Bank of Bikaner and Jaipur."

In the year 1969, the process of nationalization was carried out and in this process, 14 major commercial banks were nationalized. These banks are Allahabad Bank, Bank of Baroda, Bank of India, Canara Bank, Central Bank of India, Dena Bank, Indian Bank, Indian Overseas Bank, Punjab National Bank, Syndicate Bank, Union Bank of India, United Bank of India,

United Commercial Bank and Vijaya Bank. Again, in the year 1980, six other banks were also nationalized and accordingly the total number of nationalized banks rose up to 20. The six banks are Andhra Bank, New Bank of India, Oriental Bank, Corporation Bank, Punjab & Sindh Bank and Vijaya Bank. But in the year 1993, New Bank of India and Punjab & Sindh Bank merged with the Punjab National Bank.

12.4 MEANING AND DEFINITION OF BANK

Etymologically, the word "bank" is derived from the Greek word 'banque' or the Italian word ' banco', both the word has a common meaning i.e. a bench at which money lenders and money changers used to display their coins and transact business in the market place.

A bank or banker or banking business is one which is engaged in trading in money, depositing & lending and serving the society at large in achieving its goal of economic progress and social wellbeing. The **Webster's Dictionary** defines bank as "an institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another".

Some of the definitions of banks given by different authors are as follows:

According to **Horace White,** "Bank is manufacturer of credit and machine for facilitating exchange"

According to **Crowther,** "Bank is the one that collects money from those who have it to spare or who are saving it out of their income and lends the money so collected to those who require it"

According to **Dr. L. Hart,** "The banker is the one who in the ordinary course of business honors cheques drawn upon him by persons from and for whom he receives money on current accounts."

According to **Sir Kinley,** "A bank is an establishment which makes to individuals such advances of move as may be required and to which individuals entrust money when not required by them for use."



CHECK YOUR PROGRESS

Q 1: Which three banks together constitute the presidency bank? (Answer in about 30 words)

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Q 2: When State Bank of India was nationalized? How many subsidiaries do the State bank of India have?
(Answer in 40 words)

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Q 3: Define the term bank? (Answer in about 50 words)

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12.5 CLASSIFICATION OF BANKING INDUSTRY IN INDIA

Today is the age of specialization and we can find specialization in all fields including banks. Banks have specialization in finance. Now-a-days, various types of banks operate in our country to meet the financial requirements of the customer. Banking industry in India are classified on the basis of its functions, ownership, domicile etc.. These are explained below:

- **Classification on the basis of function**
  - Central bank
  - Commercial bank
  - Industrial bank
  - Agricultural bank
  - Exchange bank
  - Saving bank

- **Classification on the basis of ownership**
  - Public sector bank
  - Private sector bank
  - Co-operative bank
- **Classification on the basis of domicile**
  - Domestic bank
  - Foreign bank
- **Scheduled bank and Non-Scheduled bank**

The above mentioned classifications are explained below:

- **Classification on the basis of functions**
  - **Central bank**: Central bank is considered as the bank of the nation. In India, Reserve Bank of India (RBI) is the central bank, which was established in 1935. The main functions of the Central Bank are to issue currency notes, guide and regulate the banking system in India. The head office of RBI is located at Mumbai. The Central Bank acts as the leader of the banking system and money market of the country by regulating money and credit. RBI is the banker to the government, it is the bankers' banks and the ultimate custodian of a nations foreign exchange reserves. The aim of the Central Bank is not to earn profit, but to maintain price stability and to strive for economic development along with all round growth of the country.
  - **Commercial banks:** A commercial bank is a financial institution whose main business is to accept deposits from the public and to give loans to those who require it. The major role played by commercial banks are – mobilizing savings, promotion of investment, facilitate commerce and trade, development of agriculture and priority sector in the economy, creation of credit, clearing of cheques. It is to be worth mentioning that, large part of the deposits in commercial banks is demand deposits which can be withdrawn and transferred by cheques.
  - **Industrial banks:** An Industrial Bank is one which specialises by providing loans and fixed capital to industrial concerns by

subscribing to share and debenture issued by public companies. They play an important role in the establishment and growth of industries. They provide long-term loans and credits for periods varying between 5 and 15 years for industries to acquire fixed assets. They serve as catalytic agents in mobilisation of capital in other forms of assistance such as, underwriting, guarantee etc. These banks are now a days grouped as 'Development Financial Institutions'. Both, Development Financial Institutions and Commercial banks, finance infrastructural development activities which include construction of transport facilities, building of power-supply stations etc.

- **Agricultural banks:** The main business of agricultural banks is to provide funds to farmers. The agricultural bank worked on the co-operative principle. This fund generally are of two types such as short term fund to buy seeds, fertilizers and other inputs and long term fund to purchase land, to make permanent improvements on land, to purchase agricultural machinery and equipment etc. National Bank for Agriculture and Rural Development (NABARD) is the apex development bank in India entrusted with matters concerning policy, planning and operations in the field of agriculture.
- **Exchange banks:** Exchange banks mainly deal with foreign exchange and foreign exchange transaction. They deal in foreign bills of exchange, import and export of bullion and otherwise participate in the financing of foreign trade. They do a number of incidental services such as opening of letters of credit, issue of foreign currency, drafts and travelers' cheques and supply of information about foreign customers. They provide credit and loans in foreign currency and also accept deposits in Foreign Currency. Nowadays, many banks in India deal in foreign exchange with special authorization from Reserve Bank of India and are known as Authorized Dealers in Foreign Exchange. As per Foreign Exchange Regulation Act, banks dealing in Foreign

Exchange related activities require the permission of Reserve Bank of India. This is applicable to both Indian and Foreign Banks.

- **Savings banks:** The saving banks are the institutions that help in building up the habit of savings among the general public and mobilize their small savings. The main objective of this bank is to promote thrift and saving habits among the middle and lower income sections of the society. The first savings bank was started in Hamburg in 1765. In India, postal savings bank is the example of saving bank. Besides this, all commercial banks have saving accounts. The minimum balance which is required to be kept in the accounts differs from bank to bank. The rate of interest payable on the accounts by banks is determined by RBI. Co-operative banks are normally allowed to pay an additional 0.5 percent interest per annum. Interest rate on savings account with post offices is determined by Government of India.

- **Classification on the basis of ownership**
  - **Public sector banks:** Public sector banks are those banks which managed by the Government of India. Major stake of these banks are held by government. The shares of these banks are listed on stock exchanges. At present, there are 12 public sector banks operating in India.
  - **Private sector banks:** Private sector banks are those banks which are controlled by the private individuals i.e. majority of the stakes of private sector banks are controlled by private individuals. The concept of private sector banking is not a new one, it was practiced since the beginning of banking system in India. Indusland bank was the first private sector bank in India. At present, there are 22 private sector banks operating in India.
  - **Co-operative banks:** Co-operative banks are those banks which are operated on the principle of mutual help and assistance. A co-operative society has to obtain licenses from

Reserve Bank of India before starting banking business and has to follow the guidelines issued by the Reserve Bank of India. Co-operative banks grant short-term loans to the agriculturists for purchase of seeds, harvesting and for other cultivation expenses. They also accept money on deposit form and make loans for their members at a low rate of interest.

- **Classification on the basis of domicile**
  - **Domestic banks:** Any bank having their registered head office in India and operate their business within the same country is called domestic bank. The example of domestic bank in India is the State Bank of India whose head office and branches are situated in India.
  - **Foreign banks:** The banking institution whose head quarter is situated in one country and operates its banking business in another country is called foreign bank. For example, CITY bank which has its head quarter in USA and have their branch in India as well.
- **Scheduled Bank and Non- Scheduled Bank**
  - **Scheduled banks:** Scheduled banks are those bank which have been included in the second schedule of Reserve Bank of India Act 1934. RBI in turn includes only those bank in this schedule which satisfy the criteria laid down vide Section 42(6)(a) of the Act. They are-
    - ⦸ It must have a paid up capital and reserves for an aggregate value of at least Rs.5,00,000.
    - ⦸ It must satisfy RBI that its affair is not conducted in a manner detrimental to the interest of its depositors.
    - ⦸ It must be a corporation and not a partnership or a single owner firm.
  - **Non- scheduled banks:** Non-scheduled banks in India means a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act 1949.



CHECK YOUR PROGRESS

Q 4: What is meant by Commercial bank?
(Answer in about 50 words)

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Q 5: State the difference between Public and Private sector bank?
(Answer in about 50 words)

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12.6 STRUCTURE OF BANKING SYSTEMS

The structure of banking is also termed as organization of banking. The structure of banking differs from country to country depending upon their economic conditions, political structure and financial system. Different country adopts different types of banking system. The commonly identified systems are as follows:

- **Unit banking:** Unit banking refers to a single bank which renders services and operates without any branches anywhere. This type of bank was originated and developed in USA. This type of bank has their own board of directors and stockholders. Unit banking is also termed as "Localised Banking". According to **Solomon and Whilt,** a unit bank is, "a corporation that operates one office and is not related to other banks through either ownership or control". The main reason for the development of unit banking in America is said to be the fear of monopoly in banking.
- **Branch banking:** Branch banking refers to a single bank which operates through network of branches spread all over the country. Branch banking system originated in England. In India most of the

bank operates their business under branch banking system. These branch banks operate under their head offices which is generally situated in big cities. Branch banking is also known as "de-localised banking". In India, the State Bank of India has emerged as one of the biggest banks with large number of branches all over the country.

- **Correspondent banking:** Correspondent banks are those banks which connects two or more banks under unit banking system. Correspondent banking system is developed to remove the difficulties in unit banking system. Correspondent banks are intermediaries through which all unit banks are linked with bigger banks in financial centers. Through correspondent banking, a bank can carry out business transactions in another place where it does not have a branch. This system is very common in international banking transactions.
- **Group banking**: This banking system refers to the system of banking in which two or more banks are directly controlled by a holding company. The holding company may or may not be a banking company. Under group banking, the individual banks may be unit banks, or banks operating branches or a combination of the two. Participating banks retain their own Boards of Directors which are responsible to the supervising and regulatory authority and depositors for the proper operation of the bank. This type of banking system was developed in USA in the year 1900.
- **Chain banking:** It is another form of group banking. It refers to the system in which two or more banks are brought under the common control by a device other than holding company. This may be:
  - Through some group of persons owning and controlling a number of independent banks.
  - Each bank retains its separate identity.
  - Each one carries out its operations without the intervention of any central organization.

- **Pure banking:** Under Pure Banking, the commercial banks give only short term loans to industry, trade and commerce. They specialize in short term finance only. This type of banking is popular in U.K.
- **Mixed banking:** Mixed banking is that system of banking under which the commercial banks perform the dual function of commercial banking and investment banking i.e., it combines deposit and lending activity with investment banking. Commercial banks usually offer both short-term as well as medium term loans. The German banking system is the best example of mixed banking.
- **Universal banking:** Universal banking is the combination of commercial bank, investment banking, development banking, insurance and many other financial activities. It is a place where all financial products are available under one roof. They deal with individual customers as well as big corporate customers. The universal banks expands their lines of business activity by combining the functions of commercial banking and the functions of merchant banking, mutual funds, factoring, credit cards, retail loans, insurance etc. Examples of universal bankers are Citi group (i.e. Citi bank), Hongkong and Shanghai Banking Corporation (HSBC). In Europe universal banks are known as "Bancassurance".
- **Retail banking:** Retail banking is a banking system which executes transactions directly with customers rather than corporations or other banks. Under retail banking system, banks approach to the customers for sale of their products. The products offered by the bank under retail banking system are consumer-oriented like offering a car loan, home loan facility, financial assistance or purchase of consumer durables etc. Therefore, retail banking has large customer-base and hence, large number of transactions with small values. The major players of retail banking in India are ICICI bank, State Bank of India, Punjab National Bank, Bank of India, HDFC and Canara Bank.
- **Wholesale banking:** Wholesale or corporate banking refers to the banking system which deals with limited large-sized customers such

as government agencies, pension funds, and other institutional customers and corporations with strong balance sheets and sound income statement. Instead of maintaining thousands of small accounts and incurring huge transaction costs, under wholesale banking, the banks deal with large customers and keep only large accounts. Services of wholesale bank include cash management, large-sum loans, loan participation, merchant banking, and trust services. This results into few transactions with large amounts thus resulting into cost reduction and higher fees. Foreign banks in India are mostly concentrating in wholesale banking which is aided by fully computerized banking operations. In India, largest players of wholesale banking are SBI, ICICI, IDBI bank, Canara Bank, Bank of India, Punjab National Bank and Central bank of India.

- **Regional rural banking:** Commercial banks generally provide loans to the large borrowers who are engaged in commercial or business activities. Due to these, small traders, village artisans, agricultural laborers etc. in rural and semi-urban areas do not get adequate credit facilities from Commercial banks. In order to solve this issue and provide adequate and timely credits to small borrowers in rural and semi-urban areas, the Central Government set up Regional Rural Banks in 1975 in all over India jointly with State Governments and some Commercial Banks. The Regional Rural Banks was mooted for the development of banking in rural areas and for rural people.



CHECK YOUR PROGRESS

Q 6: What is meant by unit banking?

(Answer in about 30 words)

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Q 7: Write any two advantages of mixed banking?

(Answer in about 30 words)

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Q 8: Write any three difference between unit banking and branch banking? (Answer in about 60 words)

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12.7 ROLE OF BANKING INSTITUTIONS

Role of Banking Institutions

Banks have always played an important role in the economic development of the country. In this modern time money is regarded as essential aspect of our everyday life. A developed financial system of the country ensures to attain development. A modern bank provides valuable services to a country. To attain development there should be a good developed financial system to support not only the economy but also the society. So, a modern bank plays a vital role in the socio-economic matters of the country. Some of the important roles of banks in the development of a country are discussed below.

1. **Promote savings habit among people:** Banks help to promote saving habits among the depositors by introducing different attractive saving schemes. Banks also provide rewards or return on savings in the form of interest. This enables the banking habit or saving habit among the people in the country.
2. **Promotion of investment**: Banks provide various loans and advance facility for the purpose of investment in plant and machinery which in turn helps to promote economic development of the country and also helps to increase production of goods and services.
3. **Capital formation and promote industry**: Capital is one of the most important part of any business or industry. It is the life blood of business. Banks increases its capital formation by collecting deposits from depositors and convert these deposits into loans advances to promote industries.

4. **Facilitate commerce and trade**: In this modern era, trade and commerce plays important role between any countries. For smooth functioning of commerce and trade, the money transactions of a country should be user friendly. A modern bank helps its customers to send and receive funds around the world. A well developed banking system provides various attractive services like mobile banking, internet banking, debit cards, credit cards etc. These kinds of services provides fast and smooth transactions. So, banks help to develop trade and commerce.
5. **Generate employment opportunity**: As banks promote industry and investment these automatically generate employment opportunity. Therefore, banks assists an economy in terms of employment opportunity.
6. **Applying monetary policy**: A good monetary policy helps to stabilize the financial system of the country from inflation, deflection, crisis etc. A well developed banking system is necessary for effective monetary policy of the country.
7. **Balanced regional development:** In tune with the policy of the government to have more balanced development of the economy, the banks do promote lending and investment in those regions and parts of the country which are less developed and thus banks promote social objectives.
8. **Development of agricultural and other priority sectors in the economy:** Agricultural and priority sector are the integral part of any economy. The banks give special treatment in their lending operations to these sectors, such as agriculture, small scale industry (SSI),retail trade, small borrowers, self- employed persons etc. so as to facilitate their growth and provide productive employment in the economy. Exports are also a priority sector which banks helps in various ways.

12.8 BANKING SECTOR REFORMS

In 1969, due to nationalization of bank, the banking sector has been dominated by the public sector banks. Financial repression, limited role of

technology, no risk management etc., are the factors resulting in low rate of profitability and poor assets quality in banks. This resulted in deep economic crisis within the country. In order to overcome this constraints and making the banking environment flexible, the Government then decided to introduce comprehensive economic reforms. Banking sector reforms were part of this economic reform.

Banking Sector Reforms 1991

Banking sector reforms was introduced to bring a transformation change in the structure, efficiency and stability of the banking system in India. Banking sector in India were facing numerous problems till 1991. The problems were:

- Highly regulated by RBI
- Low productivity and efficiency of public sector banks
- Continuous loss borne by public sector bank
- Increasing Non Performing Assets (NPA)
- Poor customer service
- Obsolete work technology
- Unable to meet competitive environment.

In order to counter these problems, a proper and constructive reform was needed. Keeping this in view, the Government of India appointed a High-Level Committee under the Chairmanship of M. Narasimham. The name of the committee was “The Committee on Financial System” (CFS).This committee was also known as “Narasimham Committee”. The objectives of this committee were to rebuild the financial health of commercial banks and to make their functioning efficient and profitable. The said committee submitted their report within three months on November 1991. Major recommendations made by Narasimham Committee on banking sector were as follows:

- **Merger**: On the basis of structure of the banking sector in India, the committee recommended that banks can be restructured by creating 3 to 4 large banks (including SBI), which would become international in character and 8 to 10 national banks with network of branches throughout the country engaged in universal banking. Local

bank operations will be confined to only specific region and rural banks operation would be prominently engaged in financing agricultural and allied activities.

- **Phasing out direct credit:** The committee had recommended to redefine priority sector and also fixed the target of this redefined sector at 10% of the aggregate credit, subject to review after three years. The Government decided not to reduce the priority sector lending from 40%, although the priority sector definition has been redefined.
- **Transparency**: The committee has recommended that the balance sheets of banks and financial institutions should be transparent and full disclosure should be made in balance sheets as recommended by International Accounting Standard Committee. Accordingly, RBI has modified their balance sheet format w.e.f March 1992 and all banks are preparing balance sheets as per modified format.
- **Customer service:** On the recommendation of the committee, Banking Ombudsman Scheme which was introduced in 1995 was revised by RBI and came into force in January 2006. The extent and scope of new scheme is wider than earlier scheme. As per new scheme, customers are allowed to submit online complaint. Again, as per new scheme, banks are advised to frame their KYC policies, keeping in view four elements, such as Customer Acceptance Policy, Customer Identification Procedure, Monitoring of Transactions and Risk Management as required by Prevention of money Laundering Act.
- **Deregulation of interest rates:** The committee recommended that the Interest rates, both on the deposits and advances should be determined on the basis of market forces.
- **New private banks:** The committee recommended that the private sector banks are allowed to operate their businesses. The private sector banks are allowed to raise capital contribution from FIIs up to 20% and from NRIs up to 40%. This has led to increase competition.



FIIs: Foreign Institutional Investors (**FIIs**) are such kind of institutional investors who invest in the assets belonging to a different country other than that where these organizations are based.

- **Phased reduction of SLR and CRR:** The high rate of Statutory Liquidity Ratio(SLR) and Cash Reserve Ratio (CRR) reduced the profits of the banks. Therefore, the committee has recommended to reduce the SLR and CRR in a phased manner.
- **Prudential norms:** As per the recommendation RBI have started prudential norms in order to impart professionalism in commercial banks. Prudential norms include proper disclosure of income, classification of assets and provisions for bad debts so that the books of accounts of commercial banks can depict the accurate picture of financial information.
- **Recovery of debts:** As per recommendation, the Government of India passed the "Recovery of debts due to Banks and Financial Institution Act 1993" in order to facilitate and seep up the recovery of debts due to banks and financial institutions.
- **Local Area Banks (LAB):** As per the recommendation, RBI has issued guidelines for setting up of Local Area Banks (LABs) in 1996. LABs will help in mobilizing rural savings and helps in channelizing them into investment in local areas.



CHECK YOUR PROGRESS

Q 9: State reasons for which reforms in banking sector was needed? (Answer in about 60 words)

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Q 10: State two recommendations suggested by M. Narasimham on banking sector? (Answer in about 40 words)

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12.9 LET US SUM UP

- The first banking institution in India was "The General Bank of India". It was established in the year 1786.
- The combination of three banks namely Bank of Calcutta, Bank of Bombay, and Bank of Madras were called as Presidency Banks. But in 1920 when "Imperial Bank of India Act" was passed, these three banks were amalgamated and renamed as Imperial Bank of India. In the year 1955 Imperia Bank was nationalized and again renamed as State Bank of India.
- The process of nationalization of banking sector started in 1969 with nationalization of 14 banks in India. Again, in 1980 6 new banks were nationalized.
- Central bank in a country is considered as bankers' bank. In India Reserve bank of India is the central bank, which monitors the whole banking system in India.
- Since 1991, banking sector in India was facing numerous problems such as low productivity, continuous loss, increasing NPA, poor customer services, obsolete work technology etc. In order to solve these issues and making banking sector stronger, the Government of India introduced banking sector reforms.
- In 1991, the Government has appointed a committee under the chairmanship of M. Narasimham in order to rebuild the financial health of the banking sector. This committee was well known as "The committee on financial system" or Narasimham committee. The said committee submitted their reports on banking sector reforms on 1991.



12.10 FURTHER READING

- Srivastava, P.K.(2016). *Banking Theory and Practice*. Mumbai: Himalaya publishing House

- Nayak, Niranjan. (2012). Emerging *Scenario of Indian Banking sector*. New Delhi: Neha publishers and distributors.



12.11 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q No 1: The combination of Bank of Calcutta, Bank of Bombay and Bank of Madras were called as Presidency Banks.

Ans. to Q No 2: In the year 1955 Imperial Bank was nationalized and named as State bank of India. After nationalization there were 8 subsidiaries of SBI.

Ans. to Q No 3: An institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another. **Horace White** defines bank as a manufacturer of credit and machine for facilitating exchange.

Ans. to Q No 4: A commercial bank is a financial institution whose main business is to accept deposits from the public and to give loans to those who require it. The major role played by commercial banks are – mobilizing savings, promotion of investment, facilitate commerce and trade, development of agriculture and priority sector in the economy, creation of credit, clearing of cheques.

Ans. to Q No 5: The major difference between public and private sector bank is that control and administration of public sector bank is in the hands of Government of India i.e. majority of the shares of public sector bank are in the hands of government. On the other hand, the control and administration of private sector bank is in the hands of private individuals i.e majority of the shares of public sector bank are in the hands of individuals.

Ans. to Q No 6: Unit banking refers to a single bank which renders services and operates without any branches anywhere. This type of bank was common in USA.

Ans. to Q No 7: Advantages of mixed baking are:

- Provides investment guidance to general public
- Promote rapid industrial development through investment banking.

Ans. to Q No 8: The difference between unit banking and branch banking are:

- **Location:** Unit banking operates in a single branch. On the other hand, branch banking operates through multiple offices i.e. branches.
- **Rate of interest:** The rate of interest in unit banking system is not uniform whereas rate of interest of branch banking is uniform as specified by RBI.
- **Competition:** In unit banking competition is less as compared to branch banking.

Ans. to Q No 9: Reasons for banking sector reforms were:

- Low productivity and efficiency of public sector banks
- Continuous loss borne by public sector bank
- Increasing Non Performing Assets (NPA)
- Poor customer service
- Unable to meet competitive environment

Ans. to Q No 10: Recommendations of banking sector reforms are:

- Establishment of four tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at top and at bottom rural banks engaged in agricultural activities.
- Phased reduction in CRR and SLR.



12.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: What is meant by exchange bank?

Q 2: State the difference between domestic bank and foreign bank.

Q 3: Mention two advantages and two disadvantages of branch banking.

Q 4: What is meant by retail banking?

Q 5: Mention the need for banking sector reforms.

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

Q 1: Discuss the history of development of banking system in India.

Q 2: Write a note on various structure of banking system in India.

Q 3: Discuss the recommendations of banking sector reforms chaired by M. Narasimham.

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UNIT 13: NON-BANKING FINANCIAL COMPANIES

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Call Money Market

13.4 Call and Notice Money

13.5 Types/Categories of Non-Banking Financial Companies

13.6 Size of Non-Banking Financial Companies

13.7 Role of Non Banking Financial Companies

13.8 Let Us Sum Up

13.9 Further Reading

13.10 Answer to Check Your Progress

13.11 Model Questions

13.1 LEARNING OBJECTIVES

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

- know the various nature of Non Banking Financial Companies (NBFCs)
- acquire knowledge on different categories of NBFCs
- explain size and growth of NBFCs in recent time
- understand various roles of NBFCs in the economy.

13.2 INTRODUCTION

In the previous chapter we have learnt about various types of banking institutions and their role in the economy, along with the reforms introduced in banking institutions in recent years. This unit accounts for various aspects associated with Non Banking Financial companies (NBFCs). NBFCs is now come an important segment of financial intermediaries in Indian financial system. The first section of the unit describes the nature of NBFCs, followed by different types of NBFCs in the next section. The third section describes the size and growth of NBFCs and the last section describes the role of NBFCs in Indian economy.

13.3 CALL MONEY MARKET

Non-Banking Financial Company (NBFC) is a company or financial institution registered under the Companies Act 2013 (previously Companies Act,1956). Its principal business is to provide financial services of accepting deposits (except demand deposit) and to issue loans and advances under any scheme. Moreover it acquires bonds, shares or debentures which are issued by the Government or any local bodies in different times. NBFCs are also involved in the business of micro finance, leasing, chit business, hire purchase finance, and insurance. Agricultural activity, industrial activity, purchase or sale of any goods (other than securities) and services and purchase, sale or construction of immovable property does not come under the purview of NBFCs.

According to the Reserve Bank of India (Amendment Act) 1997, A Non-Banking Finance Company means: (i) A Financial Institution which is a company; (ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner; (iii) Such other non-banking institution or class of such institutions as the bank may with the previous approval of the Central Government specify.

Non-banking financial companies are different from banks from the following grounds:

Firstly, NBFCs ,unlike banks, neither accept demand deposits which are repayable on demand nor it issues cheques.

Secondly, Deposit Insurance facility of Deposit Insurance and Credit Guarantee Corporation(DICGC) is not available for NBFCs unlike banks.

13.4 NATURE OF NON-BANKING FINANCIAL COMPANIES

- The NBFCs can take public deposits for a period of 1 to maximum 5 years.
- Payment and settlement systems do not come under the purview of NBFCs.

- NBFCs provide various other services like creating and mobilising credit to meet working capital needs of micro, small and medium scale industries and enterprises. It deals with underwriting of shares and advice on mergers and acquisitions. NBFCs do play a critical role in the development of sectors like transport, employment generation, wealth creation, bank credit in rural segments and to support financially weaker sections of the society. NBFCs also encourage investment in income generating projects.
- NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time
- RBI has not given the guarantee of repayment of deposit by NBFCs.
- Only the companies registered under Companies Act,2013 or under Companies Act, 1956 are incorporated as NBFCs.
- A Non-Banking Financial Institution must possess a Net Owned Funds of Rs 2 crores since April 1999.
- As per the last audited balance sheet NBFCs whose asset size is of Rs 500 crores or more are considered as systemically important NBFCs.
- Though all Non Banking financial companies are registered under Companies Act,2013 or 1956, all are not regulated by RBI. Some are regulated by National Housing Bank (Housing finance companies like Aditya Birla Housing Finance Ltd). All the Merchant Banker/ Venture Capital Fund Company/stock-exchanges/stock brokers/ sub-brokers are regulated by Securities and Exchange Board of India(SEBI). Insurance Regulatory and Development Authority (IRDA) regulates all the general and life insurance companies. Similarly, Chit Fund Companies are regulated by the respective State Governments and the Ministry of Corporate Affairs. Government of India regulates all the Nidhi companies. All these companies do not require to registrar under Section 45-IA of the RBI Act, 1934

13.5 TYPES/CATEGORIES OF NON-BANKING FINANCIAL COMPANIES

Non Banking Financial Companies are categorized on the basis of deposits it receives and the type of credit it offers. The types of NBFCs are-

- **Asset Finance Company (AFC)**: AFCs are engaged in the principal business of providing financial assistance to purchase physical assets such as machinery, heavy industrial equipment, large power generator sets etc.which are used for productive or economic activities.
- **Investment Company(IC):** Acquisition of money from the public and investment of this money in various securities and financial products is the principal business of these companies. Bajaj Allianz General Insurance Company, SBI Mutual Fund are some of the examples of investment company
- **Loan company(LC):** Loan company is a financial institution whose principal business is to provide loans and advances
- **Infrastructure Finance Company (IFC):** It is a non-banking finance company which issues at least 75% of its total assets as infrastructural loan. Moreover it should have a minimum net owned fund of Rs 300 crores. . For example- India Infrastructure Finance Company Limited (IIFCL)
- **Systemically Important core investment Company.(CIC-ND-SI):** It is a NBFC which carries its principal business in acquisition of shares and securities. RBI recognises a company as CIC-ND-SI if at least 90% of its total assets are in the form of investment in shares, debentures or in securities.
- **Infrastructure Debt Fund**: It provides long term debt into infrastructure projects.
- **NBFC Micro Finance Institution (NBFC-MFI):** It is a non deposit taking NBFC which has more than 85% of its assets in the nature of qualifying assets (i.e., borrowers have to satisfy some criteria to qualify for its assets.)

- **NBFC-Factors:** It is a NBFC which is engaged in the principal business of factoring . Factoring is a financial transaction where a company sells its invoices or bills receivables to a third party at a discount rate called as factor. 50% of NBFC-Factor financial assets are distributed to finance factoring businesses.
- **Mortgage Guarantee Company (MGC)**: MGCs transacts in the business of providing mortgage guarantee. If a borrower becomes defaulter of his loan payment Mortgage Guarantee Company provides the guarantee. For example-India Mortgage Guarantee Corporation Pvt Ltd.

In terms of liability structures, NBFCs are subdivided into-

- **Deposit-taking NBFCs (NBFCs-D) -** Which accept and hold public deposits.
- **Non-deposit taking NBFCs (NBFCs-ND) -** Which rely on markets and banks to raise money.



CHECK YOUR PROGRESS

Q 1: State whether the following statements are true (T) or false (F)

a) Acquisition of money from the public and investment of this money in various securities and financial products is the principal business of Investment companies.

b) The NBFCs can take public deposits for a maximum period of 4 years.

Q 2: Write a short note on NBFCs (Answer in about 60 words)

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13.6 SIZE OF NON-BANKING FINANCIAL COMPANIES

In the year 1960, the business of NBFCs started in India as an alternative source of financial need for the investors in the mainstream

banking system. Muthoot finance limited was established as the first NBFC. Afterwards, the size of NBFCs had increased gradually. In the year 1964, RBI formed an expert committee chaired by Dr A.C Shah to regulate, evaluate and supervise the increased structures of NBFCs. The size of the NBFCs had increased tremendously from 7000 in 1981 to around 30,000 in 1992. The guidelines made under the RBI Act, 1934 as amended in 1997 ensured smooth functioning and protection of NBFCs. Afterwards the NBFCs grew significantly in terms of its diversified operations, technological advancements, market products etc. Between 2009 to 2019, the Compounded Annual Growth Rate (CAGR) of total assets of NBFCs were at 18.6%. NBFCs performed better in 2015 in terms of expansion of loan and balance sheet size, decline of gross NPAs, enhancement of capital adequacy level and providing working capital loans for corporate entities.

The asset size of NBFC sector (including HFCs), as on March 31, 2020 is Rs.51.47 lakh crore . As at end-March 2020, NBFCs have been the largest net borrowers of funds from the financial system of which more than half of the funds were from SCBs, followed by Asset Management Companies-Mutual Funds (AMC-MFs) and Insurance Companies.

Though the combined effect of economic slowdown and COVID-19 pandemic has resulted in decline in the non-bank credit growth in the fiscal year 2020 which was started in the second half of 2019, however, Industry, retail loans and service remained the largest recipient of credit extended by NBFCs. Sanction of retail loan increased in 2019-20 as the share prices of all other sectors had fallen. Overall there was a sharp reduction in credit growth in all sectors. 85.7% of the total assets of the sector is dominated by NBFCs-ND-SI Few large government-owned NBFCs, mainly the infrastructure space, comprise 43.3% of the total assets of NBFCs-ND-SI.

Among NBFCs-ND, those with an asset size of ¹ 500 crore or more are classified as non-deposit taking systemically important NBFCs (NBFCs-ND-SI). At the end of 31st January, 2021 there were 58 NBFCs-D and 292 NB. Moreover Microfinance Company and Non deposit taking Non-Systemically Important Companies registered with RBI as on 31st

January,2021 are 94 and 9123 respectively. **(https://rbi.org.in/Scripts/BS_NBFCList.aspx)**

On the basis of **activities** NBFCs undertake, till February 21, 2019, NBFCs were divided into 12 categories. Thereafter, these categories were harmonised in order to provide NBFCs with greater operational flexibility. As a result, Asset Finance Companies (AFCs), Loan Companies (LCs) and Investment Companies (ICs) were merged into a new category called Investment and Credit Company (NBFC-ICC). At present, there are 11 categories of NBFCs in the activity- based classification.

The prime dominant of the NBFC sector is NBFCs- ND-SI, which constitute 86.3 per cent of the total asset size of the sector. Within this segment, government owned NBFCs particularly the two largest NBFCs i.e Power Finance Corporation Limited and Rural Electrification Corporation (REC) Limited hold around two-fifth of the total assets of NBFCs.

Although the NBFC sector grew in size from 26.2 lakh crore in 2017-18 to 51.47 lakh crore in March, 2020 the balance sheet expanded at a very slower rate due to the default on the part of Infrastructure Leasing & Financial Services(IL&FS) and rating downgrade of a few companies. RBI has cancelled the registration of 5,322 NBFCs as recorded on 31st January, 2021. This slowdown was witnessed mainly in the NBFCs- ND-SI category, whereas NBFCs-D broadly maintained their pace of growth. However, in 2019-20 (up to September) growth in balance-sheet size of NBFCs-ND-SI as well as NBFCs-D moderated due to a sharp deceleration in credit growth. Credit expansion was primarily made to the industrial sector and retail loan and service sector. However as per the data released by Finance Industry Development Council (FIDC) at the end of March,2020, the amount of loan sanctioned by NBFCs amounted to Rs 2,56,330.05 cr.

13.7 ROLE OF NON BANKING FINANCIAL COMPANIES

Non banking financial companies contribute to economic development in different ways. It mobilizes resources in the economy by converting the public savings into investments. By increasing the capital

stock in the economy it helps in capital formation. NBFCs provide long term and specialised credit thereby developing the financial market. Moreover it aids in employment generation. The role played by NBFCs in an economy can be studied under the following heads:

- **Role of NBFCs in financial inclusion:** Financial inclusion basically means linking ,awaring and empowering every family in the country to the financial system. As per Rangarajan Committee Report Financial Inclusion is the process of ensuring access to appropriate financial products and services by vulnerable groups such as weaker, unattended and low income groups at an affordable cost in a fair and transparent manner by NBFCs apart from the other formal agencies of financial system such as bank, Micro Finance Institutions (MFI) (most companies are included under NBFCs) etc. These financial services include payments and remittance facilities, savings, loan and insurance services. Micro finance has been looked upon as an important means of financial inclusion in India. Microfinance is not just provision of micro credit but also other services in small quantities to the poor i.e. providing essential financial services to the poor in an affordable way. Financial Inclusion provides the poor with not only deposit accounts or credit but also insurance and remittance facilities. As suggested by the Mor Committee report, in terms of Financial Inclusion, the overall situation remains very insignificant and, on a regional and sectoral basis, very uneven. Previously only the commercial banks were permitted by the Reserve Bank of India for financial inclusion. Later on non-banking financial companies began to take part along with the banks in the financial inclusion initiatives. Since September 2010, several non-bank entities for e.g. NBFC-MFIs that form the significant part of the MFI sector have deeper reach in the rural areas. NBFC-MFIs provide the necessary assistance to the poor borrowers to gain access to various essential financial services. The newly established commercial banks,regional Rural Banks(RRB) and NBFCs would surely give stimulus to the country's financial inclusion initiatives.

- **Role of NBFC in capital market:** Investment activity of NBFCs in the capital market comprises around 16% of their total assets. Some specialized NBFCs are basically engaged in trading of securities in the capital market. These NBFCs therefore help to provide liquidity in the capital market. Further, NBFCs also lend to investors for investing in the capital market.
- **Role of NBFCs in factoring:** Factoring as defined in Factoring Regulation Act,2011 is a financial service under which the factor (assumed to be the third party who does not directly involved in the particular business)renders various services which includes:
  - Discounting bills and collection of clients debts. Under this, the receivables of account of sale of goods or services are sold to the factor at a certain discount rate.
  - The factor becomes responsible for all credit control and debt collection from the buyer and provides protection against any bad debts losses to the firm.

Following the notification of the Factoring Regulation Act by the Government, the Reserve Bank formed a new category of NBFCs called NBFC-Factors and issued directions to them. NBFC-Factors are almost exclusively engaged in providing factoring services. Factoring service which is considered as complementary to bank finance is expected to enable the availability of much needed working capital finance for the small and medium scale industries(MSIs) especially those that have good quality receivables but may not be in a position to obtain enough bank finance due to lack of collateral. By having a continuous business relationship with the Factor in place, small traders, industries and exporters get the advantage of improving the cash flow and liquidity of their business as it also avail some supportive services like sales ledger accounting, collection of receivables, credit protection etc. Factoring helps them to free their resources and have a one stop arrangement for various business needs enabling smooth running of their business.

- **Role of NBFCs in infrastructure financing:** NBFCs have been playing a significant role in the widespread development of the

country's infrastructure. By offering long-term and specialized credit these institutions are enabling the funding and growth of large infrastructure projects across the country**.** Infrastructure Finance Companies (IFCs) and Infrastructure Debt Funds are the specialized NBFCs exclusively engaged in financing the infrastructure sector. Some of these companies have crores of asset size and are experts in financing long term projects. Recognising their importance, the Reserve Bank of India has given special provisions in the form of enhanced bank credit, higher exposure norm ceiling (Banks has to fix ceiling limits on their exposure to specific industry or sector or to a single or group of borrowers with the aim of better risk management and avoidance of credit risk) and provision of External Commercial Borrowing (ECB) i.e., these are the loans in India made by non-resident lenders in foreign currency to Indian borrowers like various Indian corporations and PSUs under automatic route for on-lending to the infrastructure sector. The asset liability pattern however, is a matter of concern in the case of IFCs as these are lending for a longer period of time against comparatively short term liabilities.



CHECK YOUR PROGRESS

Q 3: State whether the following statements are true (T) or false (F).

a) NBFCs creates liquidity in the capital market.

b) NBFCs-D accept and hold public deposits.

Q 4: Explain the role of NBFCs in infrastructure financing. (Answer in about 60 words)

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13.8 LET US SUM UP

- Non-banking financial company means only the non-banking institution which is an investment and credit company or a mutual benefit financial company or a factor registered with the Bank.
- NBFCs are not allowed to accept demand deposits and hence can not issue cheques.
- It provides various services like issuing repeated,specialized and larger loans, delivering credit to a wide variety of niche segments, ranging from infrastructure to consumer durables.
- It mobilises and provides financial and technical assistance and training to micro enterprises.
- The NBFCs should have a minimum investment grade credit rating for its survival.
- To be recognized as NBFC it should be registered under company's Act ,1956 and should have a NOF of Rs. 5 crores.
- NBFCs whose asset size is of Rs 500 crores or more are considered as systemically important NBFCs.
- Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/ sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are all NBFCs but these companies are not regulated by RBI but by some respective authorities.
- There are various types of NBFC which provides financial assistance and loans for several purposes . Out of which some are asset finance company or loan company or investment company or others.
- Non Banking Financial Institution (NBFIs) consist of a group of financial institutions. These are All India Financial Institution(AIFIs), NBFCs, Primary dealers(PD) and Housing Finance Companies (HFCs).

- NBFCs can be classified on the basis of their asset/liability structures, their systemic importance,the activities they undertake.
- The prime dominant of the NBFC sector is NBFCs- ND-SI, which constitute 86.3 per cent of the total asset size of the sector.
- The credit facility has been expanded to various sectors.
- NBFCs play a significant role basically in financial inclusion, investment activity in the capital market,factoring and infrastructure financing.



13.9 FURTHER READING

- Bharati V Pathak.T*he Indian Financial System- Markets,Institutions and Services.* Pearson Education, South Asia.
- www.m.rbi.org.in



13.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) True b) False

Ans to Q No 2: Non-Banking Financial Company (NBFC) is a company or financial institution registered under the Companies Act 2013 (previously Companies Act,1956). Its principal business is to provide financial services of accepting deposits (except demand deposit) and to issue loans and advances under any scheme. Moreover it acquires bonds, shares or debentures which are issued by the Government or any local bodies in different times. NBFCs are also involved in the business of micro finance, leasing, chit business, hire purchase finance and insurance. Agricultural activity, industrial activity, purchase or sale of any goods (other than securities) and services and purchase, sale or construction of immovable property does not come under the purview of NBFCs. Non-banking financial companies are different from banks from the following grounds:

Firstly, NBFCs ,unlike banks, neither accept demand deposits which are repayable on demand nor it issues cheques.

Secondly, Deposit Insurance facility of Deposit Insurance and Credit Guarantee Corporation(DICGC) is not available for NBFCs unlike banks.

Ans to Q No 3: a) True b) True

Ans to Q No 4 : NBFCs have been playing a significant role in the widespread development of the country's infrastructure. By offering long-term and specialized credit these institutions are enabling the funding and growth of large infrastructure projects across the country**.** Infrastructure Finance Companies (IFCs) and Infrastructure Debt Funds are the specialized NBFCs exclusively engaged in financing the infrastructure sector. Some of these companies have crores of asset size and are experts in financing long term projects. Recognising their importance, the Reserve Bank of India has given special provisions in the form of enhanced bank credit, higher exposure norm ceiling (banks has to fix ceiling limits on their exposure to specific industry or sector or to a single or group of borrowers with the aim of better risk management and avoidance of credit risk) and provision of External Commercial Borrowing (ECB) i.e., these are the loans in India made by non-resident lenders in foreign currency to Indian borrowers like various Indian corporations and PSUs under automatic route for on-lending to the infrastructure sector. The asset liability pattern however, is a matter of concern in the case of IFCs as these are lending for a longer period of time against comparatively short term liabilities.



3.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words):

Q 1: What are the different types of NBFCs?

Q 2: How NBFCs are classified in terms of their asset-liability structure?

Q 3: What is meant by factoring ? How NBFCs play a role in factoring?

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

Q 1: Explain the nature of Non Banking Financial Companies(NBFCs)

Q 2: Explain the size and growth of NBFCs in recent period.

Q 3: Explain the role of NBFCs in financial inclusion.

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UNIT 14: THE DERIVATIVE MARKET

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Overview of Derivatives

14.4 Features of the Derivative Market

14.5 Functions of the Derivative Market

14.6 Participants in a Derivative Market and Their Role

14.7 Types of Financial Derivatives

14.8 Let Us Sum Up

14.9 Further Reading

14.10 Answers to Check Your Progress

14.11 Model Questions

14.1 LEARNING OBJECTIVES

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

- know about the derivative market and its participants
- explain the various functions of the derivative market
- learn about the various participants in a derivative market and the role played by them.

14.2 INTRODUCTION

Risk is a characteristic feature of all commodity and capital markets. Prices of all commodities both agricultural and non-agricultural commodities are subject to fluctuations overtime keeping with the prevailing supply and demand conditions. Similarly, the price of shares, debentures, and bonds and other securities are also subject to continuous change. Therefore, the sellers and buyers are constantly and continuously exposed to the risk of losses on account of fluctuations in the prices of such assets. Thus, derivatives came into being primarily to deal with and also to eliminate such price risks prevalent in commodity and security market.

The objective of any investment decision is to get a return with minimum risk. To achieve this objective, various instruments, practices and strategies have been devised and developed in the recent past. With the opening of boundaries for international trade and business, the world trade gained momentum. In the last decade, the world has entered into a new phase of global integration and liberalization. The integration of capital markets world-wide has given rise to increased financial risk with the frequent changes in the interest rates, currency exchange rates and stock prices. To overcome the risk arising out of these fluctuating variables and increased dependence of capital markets of one set of countries to the other and risk management practices have also been reshaped by inventing such instruments as can mitigate the risk element. These new popular instruments are known as financial derivatives which not only reduce financial risk but also open new opportunities for high risk takers. As Derivative is a financial instrument of risk management, these generally do not influence the fluctuation in the underlying asset prices. However, by locking-in asset prices, derivative products minimize the impact of fluctuation in asset prices on the profitability and cash flow situation of risk-averse investors. Derivatives are used by different investors with different purposes to hedge the risk arising from the investments made on the underlying asset to speculate on the underlying asset and gain from price fluctuations, for arbitrage, or to create synthetic products. These are also used to make investment strategies for safe and risk –free investment.

14.3 OVERVIEW OF DERIVATIVES

In the Indian context the **Securities Contracts (Regulation) Act, 1956 SC(R) A**, defines “derivative” as — “A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security”.

John C. Hull has defined a derivative as - “A derivative is a financial instrument whose value depends on (or derives from) the values of other, more basic underlying variables”.

According to Robert L. Mc Donald, “A financial instrument “which has a value determined by the price of something else. This “something else” can be almost anything: it can be assets or commodities”.

Thus a derivative is a financial instrument whose value depends on underlying assets. The underlying assets could be prices of traded securities of gold, copper, aluminium and may even cover prices of fruits and flowers. In practice, it is a contract between two parties that specifies conditions especially dates, resulting values of the underlying variables, and notional amounts under which payments are to be made between the parties. Derivatives have become important in India since 1995, with the amendment of the Securities Contract Regulation Act of 1956.

Derivatives are broadly categorized by the relationship between the underlying asset and the derivative, the type of underlying asset, the market in which they trade, and their pay-off profile. The most common types of derivatives are forwards, futures, options and swaps (We will study about forwards, futures, options and swaps in details in the section of Types of Financial Derivatives of this unit). The most common underlying assets include commodities, stocks, bonds, interest rates, and currencies. Derivatives such as options and futures are traded actively on many exchanges. Forward contracts, swaps and different types of options are regularly traded outside exchanges by financial institutions, banks and corporate clients in over-the-counter markets. There is no single market place or an organized exchange. Organized exchanges began trading in options in 1973, whereas exchange traded debt options started trading in 1982. On the other hand, fixed income futures began trading in 1975, but equity related futures started trading in 1982. The reasons for debt options being stronger than futures are that stock exchanges tend to introduce those instruments that they think will be successful in trading.

Derivatives are used by investors for the following:

- To provide leverage, such that a small movement in the underlying value can cause a large difference in the value of the derivative.
- To speculate and make a profit if the value of the underlying asset moves the way they expect.

- To hedge or mitigate risk in the underlying, by entering into a derivative contract whose value moves in the opposite direction to the underlying position and cancels part or all of it out.
- To obtain exposure to the underlying where it is not possible to trade in the underlying .
- To create option ability where the value of the derivative is linked to a specific condition or event (e.g. the underlying reaching a specific price level).

There are two groups of derivative contracts, which are distinguished by the way they are traded in the market and they are -

***Over-the-counter (OTC)* derivatives**: These are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Products such as swaps, forward rate agreements, exotic options – and other exotic derivatives – are almost always traded in this way. The OTC derivative market is the largest market for derivatives, and is mostly unregulated with respect to disclosure of information between the parties.

Exchange-traded derivative contracts (ETD): These are standardized derivative contracts such as futures and options contracts that are transacted on an organised futures exchange. Exchange traded derivatives have become increasingly popular because of the advantages they have over 'over-the-counter'(OTC) derivatives, such as standardization, liquidity and elimination of default risk. Futures and options are two of the most popular exchange traded derivatives. It acts as an intermediary to all related transactions, and takes initial margin from both sides of the trade to act as a guarantee.

ADVANTAGES OF DERIVATIVES

Derivatives exert a significant impact on modern finance because they provide numerous advantages to the financial markets:

- **Hedging risk exposure -** Since the value of the derivatives is linked to the value of the underlying asset, the contracts are primarily used for hedging risks. For example, an investor may purchase a derivative contract whose value moves in the opposite direction to the value

of an asset the investor owns. In this way, profits in the derivative contract may offset losses in the underlying asset.

- **Underlying asset price determination** - Derivates are frequently used to determine the price of the underlying asset. For example, the spot prices of the futures can serve as an approximation of a commodity price.
- **Market efficiency** - It is considered that derivatives increase the efficiency of financial markets. By using derivative contracts, one can replicate the payoff of the assets. Therefore, the prices of the underlying asset and the associated derivative tend to be in equilibrium to avoid arbitrage opportunities.
- **Access to unavailable assets or markets** - Derivatives can help organizations get access to otherwise unavailable assets or markets. By employing interest rate swaps, a company may obtain a more favourable interest rate relative to interest rates available from direct borrowing.

DISADVANTAGES OF DERIVATIVES

Despite the benefits that derivatives bring to the financial markets, the financial instruments come with some significant drawbacks. They are

- **High risk** - The high volatility of derivatives exposes them to potentially huge losses. The sophisticated design of the contracts makes the valuation extremely complicated or even impossible. Thus, they bear a high inherent risk.
- **Speculative features -** Derivatives are widely regarded as a tool of speculation. Due to the extremely risky nature of derivatives and their unpredictable behaviour, unreasonable speculation may lead to huge losses.
- **Counter-party risk -** Although derivatives traded on the exchanges generally go through a thorough due diligence process, some of the contracts traded over-the-counter do not include a benchmark for due diligence. Thus, there is a possibility of counter-party default.

14.4 FEATURES OF THE DERIVATIVES MARKET

The features of the derivatives market are as follows –

- Derivatives have a maturity or expiry date post on which they terminate automatically.
- Derivatives have the characteristic of leverage or gearing. The value of derivative can move exponentially in comparison to the value of its underlying.
- Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.
- All the transactions in the derivatives takes place in a future specified date.
- There are no specified limits on the number of units that can be transacted in the derivative market as there are no physical assets for transactions.
- The derivatives market is liquid and thus the transaction be easily effected.

14.5 FUNCTIONS OF THE DERIVATIVE MARKET

- **Risk Management:** The prices of derivatives are related to their underlying assets, as mentioned before. They can thus be used to increase or decrease the risk of owning the asset. For example, you can reduce your risk by buying a spot item and selling futures contract or call option. This is how it works. If there is a fall in the spot price, the corresponding futures and options contract will also fall. One can repurchase the contract at a lower price, which will result in a gain. This can partially offset the loss on the spot item. The ease of speculation in the derivatives market makes it easier for an investor seeking to protect a position or an anticipated position in the spot market.
- **Price Discovery:** Derivative market serves as an important source of information about prices. Prices of derivative instruments such as futures and forwards can be used to determine what the market

expects future spot prices to be. In most cases, the information is accurate and reliable. Thus, the futures and forwards markets are especially helpful in price discovery mechanism.

- **Operational Advantages:** Derivative markets have greater liquidity than the spot markets. The transactions costs therefore, are lower. This means commissions and other costs for traders are lower in derivatives markets. Further, unlike securities markets that discourage shorting, selling short is much easier in derivatives. Therefore, by virtue of risk management, short selling, price discovery, and improved liquidity, derivatives make the markets more efficient.



CHECK YOUR PROGRESS

Q 1: What do you understand by the term derivatives? (Answer in about 20 words)

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Q 2: Explain in brief about *over-the-counter (OTC)* derivatives contracts. (Answer in about 20 words)

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Q3: Mention two advantages of derivatives.

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14.6 PARTICIPANTS IN A DERIVATIVE MARKET AND THEIR ROLE

The participants in the derivatives market can be broadly categorized into the following groups:

- **Hedgers -** Hedging is an act, whereby an investor seeks to protect a position or anticipated position in the spot market. It is done by using an opposite position in derivatives. This means that if you have a buy position, you have to create a sell position and vice-

versa. The parties who perform hedging are known as hedgers. In the process of hedging, parties such as individuals or companies owning or planning to own a cash commodity like corn, pepper, wheat, treasury, bonds, notes or bills, etc. are concerned that the cost of the commodity may change before either buying it in the cash market. They want to reduce or limit the impact of such movements, which, if not covered, would incur a loss. In such a situation, the hedger achieves protection against changing prices by purchasing or selling futures contracts of the same type and quantity. One can achieve such similar objectives by exercising options. In a situation when the prices of any underlying stock are intended to fall one can buy put options. Similarly, in situations with price rise, a call option is preferred.

- **Speculators -** Speculators are basically traders. They enter the futures and options contract, with a view to making the profit from the subsequent price movements. They do not have any risk to hedge. In fact, they operate at a high level of risk in anticipation of profits. Speculation provides liquidity in the market. The speculators also perform a valuable economic function of feeding information. These pieces of information are not readily available elsewhere. They also help others in analyzing the derivatives markets.
- **Arbitragers -** Some traders participate in the market for obtaining risk-free profits. They do so by simultaneously buying and selling financial instruments like stocks futures in different markets. This process is known as ‘arbitrage’. Thus, ‘arbitrageurs’ are the person who does such kind of trading. For example, one can always sell a stock on the National Stock Exchange exchange and buy simultaneously back on the Bombay Stock Exchange platform. The arbitrageurs continuously monitor various markets. And wherever there is a chance of arbitraging, they buy from one market and sell in the other market. In this way, they make a riskless profit. They

keep the prices of derivatives and current underlying assets closely consistent and perform a valuable economic function.

Arbitragers and speculators perform almost a similar function. Since they both do not possess any risk to hedge for. They help in identifying inefficiencies that exist among the markets. It is also a fact that arbitragers help in price discovery of stocks. Further, this leads to market efficiency. On the other hand, speculators help in enhancing liquidity in the market.

- **Margin Traders** - A margin refers to the minimum amount that one need to deposit with the broker to participate in the derivative market. It is used to reflect some one's losses and gains on a daily basis as per market movements. It enables to get a leverage in derivative trades and maintain a large outstanding position. Imagine that with a sum of Rs. 2 lakhs you buy 200 shares of ABC Ltd. of Rs 1000 each in the stock market. However, in the derivative market you can own a three times bigger position i.e. Rs 6 lakhs with the same amount. A slight price change will lead to bigger gains/losses in the derivative market as compared to stock market.

14.7 TYPES OF FINANCIAL DERIVATIVES

The four major types of derivative contracts are options, forwards, futures and swaps.

- **Options** - Options refer to a right but not an obligation of the buyer of the option to either buy or sell an underlying at a future date at a pre-determined price. It is, however, an obligation of the seller. The buyer pays a premium to the seller to buy the right. Options can be OTC or exchange traded. The option to buy is call option and the option to sell is a put option. Thus, options are of two types –calls and puts. While "calls" give the buyer the right, but not the obligation, to buy a given quality of the underlying asset at a given price on or before a given future date, "puts" give the seller the right, but not the obligation, to sell a given quantity of the underlying asset at a given price on or before a given date.

- **Futures** - Futures are standardised contracts which allow the holder to buy/sell the asset at an agreed price at the specified date. The parties to the future contract are under an obligation to perform the contract. These contracts are traded on the stock exchange. The values of future contracts are marked-to-market everyday. It means that the contract value is adjusted according to market movements till the expiration date.
- **Forwards** - Forwards are like futures contracts wherein the holder is under an obligation to perform the contract. But forwards are unstandardised and not traded on stock exchanges. These are available over-the-counter and are not marked-to-market. These can be customised to suit the requirements of the parties to the contract.
- **Swaps** - Swaps are derivative contracts wherein two parties exchange their financial obligations. The cash flows are based on a notional principal amount agreed between both the parties without exchange of principal. The amount of cash flows is based on a rate of interest. One cash flow is generally fixed and the other changes on the basis of a benchmark interest rate. Interest rate swaps are the most commonly used category. Swaps are not traded on stock exchanges and are over-the-counter contracts between businesses or financial institutions.



CHECK YOUR PROGRESS

Q 4: Who are the participants in the derivatives market? (Answer in about 50 words)

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Q 5: What is meant by Swaps Derivatives Contract? (Answer in about 30 words).

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14.8 LET US SUM UP

- Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.
- Derivatives have a maturity or expiry date post which they terminate automatically.
- Derivatives have become important in India since 1995, with the amendment of the Securities Contract Regulation Act of 1956.
- *Over-the-counter (OTC)* derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary whereas *Exchange-traded derivative contracts (ETD)* are those derivatives instruments that are traded via specialized derivatives exchanges or other exchanges.
- The participants in the derivatives market can be broadly categorized into hedgers, speculators, arbitragers and margin traders.
- Forwards are over the counter trades and are customized whereas futures are exchange traded and are standardized.
- In futures, the performance of the contract is done only at the future specified date, but in the case of options, the performance of the contract can be done at any time before the expiry of the agreed date. Futures are riskier than the options.



14.9 FURTHER READING

- Pathak, B. V. (2012). *The Indian Financial Sysytem*. Singapore: Pearson
- Gupta, S. B. (2004). *Monetary Economics.* New Delhi: S. Chand & Company Ltd.
- https://shodhganga.inflibnet.ac.in/bitstream/10603/130666/9/09_chapter1.pdfhttp://www.yourarticlelibrary.com/investment-management/derivatives-characteristics-functions-and-uses/89431

- https://indianmoney.com/articles/derivatives-market
- https://cleartax.in/s/financial-derivatives
- https://rmoneyindia.com/research-blog-beginners/participants-derivatives-market/



14.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A derivative is a financial instrument whose value depends on underlying assets. The underlying assets could be prices of traded securities of gold, copper, aluminium and may even cover prices of fruits and flowers.

Ans to Q No 2: *Over-the-counter (OTC)* derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary.

Ans to Q No 3: Two advantages of derivatives are hedging risk exposure and underlying asset price determination.

Ans to Q No 4: The participants in the derivatives market can be broadly categorized into the following groups and they are hedgers, speculators, arbitragers and margin traders**.**

Ans to Q No 5: Swaps are derivative contracts wherein two parties exchange their financial obligations. The cash flows are based on a notional principal amount agreed between both the parties without exchange of principal. The amount of cash flows is based on a rate of interest. One cash flow is generally fixed and the other changes on the basis of a benchmark interest rate.



14.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q1: Write a short note on derivatives as a financial instrument.

Q2: State the features of the derivatives market.

Q3: What are the various functions of the derivatives market?

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

Q1: Discuss briefly about the various participants in the derivatives market?

Q2: Briefly discuss about the advantages and disadvantages of the derivatives market.

Q3: Write a note about the types of derivative contracts.

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UNIT 15: FINANCIAL ASSET VALUATION

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Financial Asset Valuation

15.3.1 Financial Asset Valuation- Determining Present Value

15.3.2 Financial Asset Valuation- Determining Future Value

15.4 Valuation of Debt Instruments

15.5 Valuing Income and Growth Stocks

15.6 Let Us Sum Up

15.7 Further Reading

15.8 Answers to Check Your Progress

15.9 Model Questions

15.1 LEARNING OBJECTIVES

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

- understand the concept of financial asset valuation
- know the methods of determining present value and future value of financial assets
- discuss the valuation of Debt Instruments
- describe valuing income and growth stocks.

15.2 INTRODUCTION

There are two ways in which the firm may raise funds from investors. The firm can raise money by issue of shares (own funds) or by issue of debt instruments like debentures (borrowed funds).

A company sells shares to raise capital. Shareholders (or stockholders) are regarded as the legal owners of the company. There are two types of shareholders i.e. ordinary (also known as equity shareholders) and preference shareholders. The preference shareholders have two preferences over equity shareholders. One at the time of payment of dividend, and second at the time of repayment of capital during winding up of the company.

The payment of dividend to shareholders is neither a legal obligation nor the rate of dividend is fixed. The dividend rate varies from year to year depending on distributable profits of the company and decision of the Board of Directors. Stockholders invest their money in anticipation of return on their invested funds. Their return comprises of capital appreciation of their invested funds and the returns in the form of dividend. Shareholders make capital gains (or losses) by disposing of their shares.

Another important source of finance in companies for raising capital is lenders or creditors. The company may borrow funds from various sources such as banks, financial institutions, public, or by issuing bonds and debentures. Lenders are not the owners and they provide loan or debt capital to the company. They make available the funds by retaining the title to the funds lent. The debts are provided for a fixed period and at a fixed rate of interest. Payment of interest is a legal obligation for the company. Unlike dividend, interest must be serviced even when the company earns low or no profits. The amount of interest which a company pays for servicing its debt in a particular year is a deductible expense for calculating corporate income tax liability for the company. This interest tax shield is valuable to the company as it leads to saving in taxes. A debenture or a bond is an acknowledgement of debt. It certifies the amount of money the company has borrowed, the rate of interest and the maturity period.

Financial assets, also known as securities, are financial instruments or papers like shares, debentures and bonds. The companies raise funds by issuing these securities in primary capital market. These securities are traded by investors in the secondary capital market also called as stock exchanges. Financial asset also indicates lease obligations and borrowings from financial institutions including banks and others. Both the types of financial assets i.e. stocks and debt instruments are traded in secondary market. In this unit, we will learn the different aspects of asset valuation.

15.3 FINANCIAL ASSET VALUATION

Valuation is a method that explains the relationship between risk and return to indicate the worth of an asset. The process of valuation can

be applied to anticipate benefits from real/ physical and financial assets. It helps in estimating their worth at a given point of time. One of the most crucial principle in all types of financial valuation is 'value of a rupee today and value of rupee in future'. As financial asset is represented by a sequence of future cash flows, valuation of a financial asset pertains to estimating the present value of future cash inflows that the financial asset is expected to generate over its life. To attract investors and to maximise shareholders value a firm must take the best possible investment, financing, and dividends decisions. These decisions have significant bearing on the firm's value.

Time value of money indicates that value of a unit of money differs in different time periods

Any rationale investor attaches more value to a specific amount of money today compared to same amount of money receivable at some future date. In other words, the present value of a rupee received at some future date will be less than a rupee received today. This phenomenon is known as **time preference for money** or **time value of money**.



Time value of money indicates that value of a unit of money differs in different time periods.

Now the question is why a rupee today is more valuable than a rupee at some future date? Individuals time preference for money can be attributed to following reasons:

- Alternative investment opportunities
- To cover inflation
- Preference for present consumption
- Risk of uncertainty

- **Alternative investment/ reinvestment opportunities:** The simplest answer is that one could have invested the same rupee somewhere else i.e. alternative investment/ reinvestment opportunities are present in the market and could have earned a return, in the form of interest, dividend, or price appreciation. Thus, if one could earn 4% interest in savings deposit in a bank account, the rupee would be worth Rs. 1.04 after a year.
- **To cover inflation:** One may again ask a question why we need to earn an interest rate to save? The answer is to cover inflationary

effects. As due to inflation the purchasing power of money decreases with passage of time, hence an interest rate is required to compensate for the decline in the purchasing power of the money. The rupee today will fetch more in terms of real goods compared to the same rupee a year later. Hence, an interest rate is required to make good the loss in purchasing power due to inflation.

- **Preference for present consumption:** As money is the means of acquiring goods and services, one needs to be compensated for postponing their present consumption to future. An individual would attach more value to present consumption compared to future consumption. Even if there is no inflationary pressure and a rupee today or after a year will fetch the same quantity of goods, one would prefer to consume the goods today. If one must postpone the consumption, the individual needs to be compensated in the form of an interest rate/ return on the savings. This interest rate is also known as real interest rate. Stronger is the preference for current consumption, higher is the real interest rates.
- **Risk of uncertainty:** So far, we have assumed guaranteed return on savings in future. However, the world lives under the risk of uncertainty. As individuals are exposed to the risk of uncertainty about future returns, they might prefer to enjoy the money now. Hence, they need to be compensated for bearing the risk of uncertainty. Thus, a premium in the form of 'returns' is desired by the investors for bearing the risk of uncertainty.



CHECK YOUR PROGRESS

Q 1: What are two ways in which the firm may raise funds from investors? (Answer in about 40 words)

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Q 2: What are the two preferences the preference shareholders have? (Answer in about 30 words)

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Q 3: Write the meaning of a debenture or bond? (Answer in about 30 words)

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Q 4: What is meant by valuation of a financial asset? (Answer in about 25 words)

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15.3.1 Financial Asset Valuation- Determining Present Value

For investors who want to save now and buy later, the concept of present value is of utmost importance. The practice of estimating the present value of future cash flows is very common. It is the process of estimating the present values of a series of future cash flows. In simple words, it is the current value of a future amount.

A cash flow is either a cash that we expect to receive (cash inflow) or a cash that we expect to pay (cash outflow). Horne and Dhamija define present value as 'a future amount discounted to the present by some required rate'. Thus, present value of future cash inflows and outflows is the current cash equivalents.

To determine the present value of future cash flows the technique of discounting is applied. The rate used for discounting the future cash flows is known as discounting rate. Discounting enables us to convert future cash flows into cash flows today, so that we can compare different alternatives with respect to our investment decisions and decide the best course of action. This concept is central to the notion of financial asset valuation and is applied to determine the present value of a future amount. It is

pertinent to note that present value decreases for a given discount rate as the period increases.

We would discuss the technique of calculating the present values in the following two circumstances:

- Present value of a single cash flow
- Present value of an annuity
- **Present value of a single cash flow:**

Present values can be calculated for any combination of number of years and interest rate. Present value of a single cash flow (Lump Sum) to be received after some future period can be calculated with the help of following formulae:

$PV = F_n \text{ X } PVF_{n,i}$

Where,

'PV' is the present value;

'F_n' is the future value to be received after a period 'n' for which the applicable discounting rate is indicated by 'i'.

Thus, $PVF_{n,i}$ is the **present value factor** for n periods at i rate of interest.

PVF can be computed by using a scientific calculation in a scientific calculator or by using the precalculated 'Present value factor table for a lump sum'.

For calculating the present value of a future amount, one needs to simply find out the present value factor (PVF) for given n and i from the present value factor table and multiply the same by the given future value.

When the cash flows are discounted annually-i.e. interest payments are calculated at the end of the year, based on the balance at the beginning of the year, it is known as 'discrete discounting'.

However, if the interest is calculated more frequently such as half yearly or monthly, it is known as continuous discounting.

The following examples will make it clear –

Ex. 1: What will be the present value of Rs. 1,00,000 payable after 15 years at the interest rate of 12%.



Present / Compound value factor tables for 'a lump sum' and 'an annuity' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These present value factor tables for lump sum gives the pre-computed present values of Rs. 1 after n number of years at i interest rates.

$PV = F_n \text{ X } PVF_{n,i}$

In case of *discrete discounting*:

The present value factor (PVF) for 15 years at 12 percent interest rate is 0.183.

Hence, the PV= Rs.1,00,000 X 0.183 = Rs. 18,300

Ex. 2: What will be the present value of Rs. 1,00,000 payable after 15 years at the interest rate of 12% under continuous discounting?

'Continuous discounting table' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These Continuous discounting table' gives the continuous discounted values (e^{-x}) where '-X' is calculated by multiplying 'n' number of years with 'I' interest rates.



'Continuous discounting table' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These Continuous discounting table' gives the continuous discounted values (e^{-x}) where '- X' is calculated by multiplying 'n' number of years with 'I' interest rates.

In case of continuous discounting:

PV is calculated with the help of the following formulae:

$PV = F_n \text{ X } e^{-x} = F_n \text{ X } e^{-i \text{ X } n.} = \text{Rs. } 1,00,000 \text{ X } 0.16530 = \text{Rs. } 16,530$

For calculating the present value of a future amount under continuous discounting, one needs to simply find out the value of e^{-x} from the table of Continuous discounting and multiply the same by the given future value.

- **Present value of an annuity:**

  An annuity is a stream of constant periodic amount that occur at regular intervals for a specific period. The present value of annuity refers to the present value of sum of all cash inflows of the annuity. This can be explained with the help of the following example.

  Ex. 3: Suppose you want to buy a machine for your enterprise. You have two options- First, you might buy it for cash by paying Rs. 11,000 now; or Second option is you may procure the same on instalment basis by paying Rs. 3,000 a year plus interest @ 12% for next five years. Which option would you prefer?

  In the first option, the outflow of a lumpsum of Rs. 11,000 will be there. However, in the second option outflow of Rs. 3,000 plus interest @ 15% will be there for next five years.

Hence, you must calculate the present value of the annuity i.e. Rs. 3,000.

It can be calculated as follows:

Present Value = Annuity X Present Value Factor of an Annuity of Rs. 1.

PV = A x $PVFA_{n,i}$ = Rs. 3,000 X 3.605 = Rs. 10, 815

Thus, in this case second option seems to be more profitable as the present value of the future cash flows is less than the current price of the machine.



CHECK YOUR PROGRESS

Q 5: What is meant by cash flow? (Answer in about 20 words)

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Q 6: What is discounting rate? (Answer in about 30 words)

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Q 7: Write the meaning of present value? (Answer in about 30 words)

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Q 8: What will be the present value of Rs. 50,000 payable after 10 years at the interest rate of 12% if interest is payable half yearly under continuous discounting?

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Q 9: Suppose a person receives an annuity of Rs. 10,000 for four years. If the rate of interest is 10%, What is the present value of Rs. 10,000 anuity?

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15.3.2 Financial Asset Valuation- Determing Future Value

Compounding technique is applied to find out the future values of present cash flows. In determining the future values, the process of compounding of interest is done. Compound interest is the interest earned on the original (principal) amount as well as interest earned on interest of the earlier periods which is not withdrawn. Determining future value of present cash flows enables the investor to take best investment decision. The alternative which gives highest future value keeping the other things constant is chosen by the investor. The future value of a financial asset will increase with the time and increase as the compounding rate increases.

We would discuss the technique of calculating the future values in the following two circumstances:

- Future value of a single cash flow
- Future value of an annuity
- **Future value of a single cash flow:**

Future value of a single cash flow (Lump Sum) can be calculated with the help of following formulae:

$FV = P \times CVF_{n,i}$

Where 'FV' is the future or compound value to be received after a period 'n' for which the applicable compounding rate is indicated by 'i'.

Thus, $CVF_{n,i}$ is the compound value factor for n periods at i rate of interest.

CVF can be computed by using a scientific calculation in a scientific calculator or by using the precalculated 'Compound value factor table for a lump sum'.

For calculating the future value of a present amount, one needs to simply find out the compound value factor (CVF) for given n and i from the compound value factor table and multiply the same by the given present value. The following example will make it clear.



'Compound value factor table for 'a lump sum' and 'an annuity' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These compound value factor tables for lump sum gives the precomputed future values of Rs. 1 after n number of years at i interest rates.

Ex. 4: Suppose an investor deposits Rs. 20,000 in the savings account of a bank at 8% for 5 years. How much shall it grow at the end of five years?

In case of *discrete discounting*:

The compound value factor (CVF) for 5 years at 8 percent interest rate is 1.469.

Hence, FV = P X $CVF_{n, i.}$ = Rs. 20,000 X 1.469 = Rs. 29,380

Ex. 2: What will be the future value of Rs. 75,000 receivable after 12 years at the interest rate of 10% under continuous compounding?

In case of continuous compounding:

FV is calculated with the help of the following formulae:

FV = PV X e^x = PV X $e^{i X n.}$ = Rs. 75,000 X 3.3201 = Rs. 2,49,007.5

For calculating the future value of a present cash flow under continuous compounding, one needs to simply find out the value of e^x from the table of Continuous compounding and multiply the same by the given present value.



When the cash flows are compounded annually- i.e. interest incomes are calculated at the end of the year, based on the balance at the beginning of the year, it is known as 'discrete compounding'. However, if the interest is calculated more frequently such as half yearly or monthly, it is known as continuous compounding.



'Continuous compounding table' is available in the appendices/ annexure of any finance book or it can be easily downloaded from search engines like 'Google'. These Continuous compounding table' gives the continuous compounded values (e^x) where 'X' is calculated by multiplying 'n' number of years with 'I' interest rates.

- **Future value of an annuity:** The future value of annuity refers to the sum of all cash outflows each year for a specified number of years. This can be explained with the help of the following example.

  Ex. 5: Suppose Rs. 50,000 is deposited at the end of each of the next five years. What would be its future value if the rate of interest is 9%?

  It can be calculated as follows:

  Future Value = Annuity X Compound Value Factor of an Annuity of Rs. 1.

  FV = A x $CVFA_{n, i}$ = Rs. 50,000 X 5.985 = Rs. 2,99,250



CHECK YOUR PROGRESS

Q 10: What is compounding rate? (Answer in about 30 words)

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Q 11: What will be the future value of Rs. 50,000 receivable after 10 years at the interest rate of 6% if interest is compounded continuously?

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Q 12: Suppose a firm deposits Rs. 20,000 for six years. If the rate of interest is 8%, how much would this annuity accumulate at the end of sixth year?

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15.4 VALUATION OF DEBT INSTRUMENTS

As the nature of debt instrument is significantly different from equity instrument, hence their process of valuation also differs. In case of debt instruments, the future cash flows are known in advance and the life of the instrument is usually defined. These financial assets are risk - free and the interest rate earned on them are risk free rates. The value of these assets is the present value of the cash flows, discounted at these risk-free rates.

These debt instruments are commonly known as bond. The bonds issued by governments are usually riskless as the governments have power to print currency to meet its obligations which they otherwise fail to cover. Bonds issued by public sector undertakings are also relatively secure but not free from risk of default. The bonds issued by private sector companies are known as debentures in India. These debentures can be secured as well as unsecured. The rate of interest on these long-term debt instruments are usually fixed. Redeemable bond is repayable after its maturity period. The bond or debenture is generally issued at par value or face value and

fixed interest is payable on par value. The fixed interest rates which are payable on these debt instruments are also known as coupon rate. The value at which the debt instrument is redeemed at the time of maturity is known as redemption value. Redemption value may be higher than the par value (redemption at premium) or equal to par value or it may be less than par value (redemption at discount). Further, the value at which these instruments are traded in market is known as market value which may be different from par value or redemption value.

The basic bonds valuation is explained below:

Ex. 6: Suppose a firm has issued a 10 percent coupon interest rate, 10-year bond with a Rs. 1000 par value that pays interest annually. Compute the value of the bond.

Here,

Bond Value (B_O) = Present Value of Annual Interest (I) + Present Value of Maturity Value (M)

It can be calculated with the help of the following formulae:

$B_O = I \times PVFA_{n,i} + M \times PVF_{n,I}$ = Rs. 100 X 6.145 + Rs. 1000 X 0.386 = Rs. 1,000.

Ex. 7: In the example 6, what would be the value of the bond if the required rate of return is 12 percent.

$B_O = I \times PVFA_{n,i} + M \times PVF_{n,I}$ = Rs. 100 X 5.650 + Rs. 1000 X 0.322 = Rs. 887



CHECK YOUR PROGRESS

Q 13: What is meant by a 'bond'? (Answer in about 40 words)

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Q 14: What is a 'debenture'? (Answer in about 30 words)

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Q 15: Write the meaning of 'coupon rate' with reference to debenture or bond? (Answer in about 30 words)

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Q 16: What is meant by 'redemption value'? (Answer in about 50 words)

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15.5 VALUING INCOME AND GROWTH STOCKS

Investors buy stocks either for dividends or capital gain. Investors who desire to earn higher return via capital gains prefer growth stocks whereas investors who prefer regular income would like to buy income stocks. The stocks which offer higher possibilities of capital gain (due to increase in the market price) are known as Growth stocks. These companies follow low dividend pay-out policy and retain major portion of dividend to achieve a high growth rate. Whereas, the shares on which dividend yield (i.e. dividend per share as a percentage of the market price of the share) is generally high are called Income stocks. Because of high dividend pay-out the prospects of capital gains are lower. The process of valuing income and growth stocks is explained in brief below:

Ex. 8 A company estimates its earnings per share (EPS) at Rs. 6.67, it follows a 100 percent pay-out policy for dividend distribution (i.e. its retention ratio 'b' is zero). In this case its dividend per share (DIV) will be equal to its EPS. Its earnings and dividends would not grow as it does not reinvest any earnings and 'g' would be equal to zero. What would be the price of the shares of the company if the opportunity cost of capital 'K_e' were 15 percent.

The Price of the share 'P_o' can be calculated with the help of the following formulae:

$$Po = \frac{DIV}{Ke - g} = \frac{EPS\,(1-b)}{Ke - rb} = \frac{6.67(1-0)}{0.15 - 0} = Rs.44.47$$

'r' indicates rate of return

Suppose the company decides to pay dividend of Rs. 3 per share and retain and reinvest the balance earnings at a rate of return of 25 percent. What is the company's pay out ratio, retention ratio and growth rate?

$$\text{Payout ratio} = \frac{DIV}{EPS} = \frac{3}{6.67} = 44.98 \text{ or approx } 45 \text{ percent}$$

Retention ratio (b) = 1- pay out=1- 0.45 = 55 percent

Growth rate (g) = Retention ratio X r = b X r = 0.55 X 0.25 = 13.75 percent

If further we assume that the company will follow a constant policy of retaining 55 percent earnings at 25 percent rate of return, then its earnings and dividends will grow continually at 13.75 percent. What would be the effect of this change on the price of the shares?

$$Po = \frac{DIV}{Ke - g} = \frac{EPS\,(1-b)}{Ke - rb} = \frac{6.67(1-0.55)}{0.15 - 0.25 \text{ x } 0.55} = Rs.240.12$$

It is evident that without retention of earnings, the growth is zero and the price of its share is Rs. 44.47. However, when the growth rate becomes 13.75 percent due to retention of earnings, the share price rises to Rs. 240.12. Thus, the difference (Rs. 240.12 - Rs. 44.47) of Rs. 195.65 the value of growth opportunities. The retained and reinvested earnings create additional value since it generates cash flows.



15.6 LET US SUM UP

- There are two ways in which the firm may raise funds from investors. The firm can raise money by issue of shares (own funds) or by issue of debt instruments like debentures (borrowed funds).

- Valuation is a method that explains the relationship between risk and return to indicate the worth of an asset.
- Individuals time preference for money can be attributed to reasons like availability of alternative investment opportunities, to cover inflation, individual's preference for present consumption and risk of uncertainty
- Present value of future cash inflows and outflows is the current cash equivalents. To determine the present value of future cash flows the technique of discounting is applied. The rate used for discounting the future cash flows is known as discounting rate.
- Compounding technique is applied to find out the future values of present cash flows. Compound interest is the interest earned on the original (principal) amount as well as interest earned on interest of the earlier periods which is not withdrawn.
- In case of debt instruments, the future cash flows are known in advance and the life of the instrument is usually defined. These financial assets are risk - free and the interest rate earned on them are risk free rates. The value of these assets is the present value of the cash flows, discounted at these risk-free rates.
- The stocks which offer higher possibilities of capital gain are known as Growth stocks. These companies follow low dividend pay-out policy and retain major portion of dividend to achieve a high growth rate. Whereas, the shares on which dividend yield is generally high are called Income stocks.



15.7 FURTHER READING

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15.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: There are two ways in which the firm may raise funds from investors. The firm can raise money by issue of shares (own funds) or by issue of debt instruments like debentures (borrowed funds).

Ans to Q No 2: The preference shareholders have a preference over equity shareholders at the time of payment of dividend. They also have a preference at the time of repayment of capital at the time of winding up of the company.

Ans to Q No 3: A debenture or a bond is an acknowledgement of debt. It certifies the amount of money the company has borrowed, the rate of interest and the maturity period.

Ans to Q No 4: Valuation of a financial asset pertains to estimating the present value of future cash inflows that the financial asset is expected to generate over its life.

Ans to Q No 5: A cash flow is either a cash that we expect to receive (cash inflow) of cash that we expect to pay (cash outflow).

Ans to Q No 6: To determine the present value of future cash flows the technique of discounting is applied and the rate used to for discounting the future cash flows is known as discounting rate.

Ans to Q No 7: It is the process of estimating the present values of a series of future cash flows. Present value of future cash inflows and outflows is the current cash equivalents.

Ans to Q No 8: In this case, the interest rates 'i' every six months will be 6% (12%/2) and discounting periods 'n' will be 20 six months compounding periods in 10 years.

Hence, PV = PV = F_n X e^{-x} = F_n X $e^{-i X n.}$ = Rs. 50,000 X 0.30119 = Rs. 15,059.5

Ans to Q No 9: PV = A x $PVFA_{n,I}$ = Rs. 10,000 X 3.170 = Rs. 31,700

Ans to Q No 10: Compound interest is the interest earned on the original (principal) amount as well as interest earned on interest of the earlier periods which is not withdrawn.

Ans to Q No 11: FV = PV X e^{x} = PV X $e^{i X n.}$ = Rs. 50,000 X 1.8221 = Rs. 91,105

Ans to Q No 12: FV = A x $CVFA_{n,I}$ = Rs. 20,000 X 7.336 = Rs. 1,46,720

Ans to Q No 13: A 'bond' is a long - term debt instrument repayable after a specified period. The bond or debenture is generally issued at par value or face value and fixed interest is payable on par value.

Ans to Q No 14: The bonds issued by private sector companies are known as debentures in India. These debentures can be secured as well as unsecured. The rate of interest is usually fixed.

Ans to Q No 15: The fixed interest rates which are payable on bonds or debentures are also known as coupon rate.

Ans to Q No 16: The value at which the debt instrument is redeemed at the time of maturity is known as redemption value. Redemption value may be higher than the par value (redemption at premium) or equal to par value or it may be less than par value (redemption at discount).



15.9 MODEL QUESTIONS

Short Questions (Answer each question in about 200 words)

Q 1: Explain the concept of financial asset valuation.

Q 2: Explain the concept of present value.

Q 3: Explain the process of calculating the present value of an annuity with the help of suitable example.

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

Q 1: "A rupee today is more valuable than a rupee at some future date". In the light of this statement discuss the reasons why individuals have time preference for money.

Q 2: Explain the process of calculating the present value of a single cash flow with the help of suitable examples.

Q 3: Explain the process of calculating the future values of 'a single cash flow' and of 'an annuity' with the help of suitable examples.

Q 4: Describe the process of bond valuation with suitable example.

Q 5: Discuss the process of valuing income and growth stocks with example.

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1. Approximately how many hours did you spend for studying the units in the course? | | | |
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

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VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
VII.	Quality of content is engaging, relevant, and up-to-date					
VIII.	The self check questions are very helpful					
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot					

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1. Which aspects of the SLM, according to you, worked well?

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Thank you for taking the time to complete this form.

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