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FINANCIAL MARKETS AND SERVICES

SEMESTER - 4

MASTER OF COMMERCE
(Finance and Accounting Specialisation)

BLOCK - 2

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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COURSE INTRODUCTION

This is the second course of M.Com. Programme of fourth semester Finance and Accounts specialisation . This course “Financial Markets and Services” of M. Com. 4th semester has been structured to give the learners a broad idea about the financial markets and services.The course is designed keeping in mind the present changes in the financial system.

The course has 15 units and is divided into two blocks: Block 1 and Block 2.

Block 1 consist of 7 units discussing the basics of Indian financial system, money market, capital market, listing of securities, merchant banking services and trading and settlement system in stock exchange.

Block 2 concentrates on OTCEI, stock market indices, SEBI, new instruments and participants in Indian stock market, derivative market, NBFIs and Microfinance.

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

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

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning and Definition of OTCEI

8.4 New Concepts Introduced by OTCEI

8.5 Need for Starting OTCEI

8.6 Promotion of OTCEI

8.7 Features of OTCEI

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8.9 Advantages of OTCEI

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8.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and structure of OTCEI
- know the need, features and participants of OTCSI
- describe the advantages and disadvantages of OTCEI
- explain the rules for listing procedures, trading and settlement in OTCEI
- state the meaning of foreign exchange
- interpret the trading norms, players and role of NYSE
- state the meaning and composition of NASDAQ
- enumerate composition of foreign exchange markets

8.2 INTRODUCTION

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

8.3 MEANING AND DEFINITION OF OTCEI

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

The over-the-counter exchange of India (OTCEI) is an electronic stock exchange based in India that consists of small and medium sized firms aiming

to gain access to the capital markets like electronic exchanges in the U.S. such as the NASDAQ. There is no central place of exchange, and all trading occurs through electronic networks.

Over-the-counter (OTC) or off-exchange trading is done directly between two parties, without the supervision of an exchange. It is contrasted with exchange trading, which occurs via exchanges. A stock exchange has the benefit of facilitating liquidity, providing transparency, and maintaining the current market price.

The first electronic OTC stock exchange in India was established in 1990 to provide investors and companies with an additional way to trade and issue securities. This was the first exchange in India to introduce market makers, which are firms that hold shares in companies and facilitate the trading of securities by buying and selling from other participants.

Over the Counter Exchange of India (OTCEI) can be defined as a stock exchange without a proper trading floor. All stock exchanges have a specific place for trading their securities through counters. But the OTCEI is connected through a computer network and the transactions are taking place through computer operations. OTCEI is recognized under the Securities Contract (Regulation) Act and so all the stocks listed in this exchange enjoy the same benefits as other listed securities enjoy.

8.4 NEW CONCEPTS INTRODUCED BY OTCEI

OTC Exchange of India was founded in1990 under the Companies Act 1956 and got recognized by the Securities Contracts Regulation Act, 1956 as a stock exchange. It has a pattern along the lines of the NASDAQ market and has introduced several innovations to the Indian capital markets. OTC Exchange of India introduced certain new concepts in the Indian trading system:

- Screen based nationwide trading known as OTCEI Automated Securities Integrated System or OASIS
- Market Making
- Sponsorship of companies
- Trading done in share certificates

- Weekly Settlement Cycle
- Short Selling
- Demat trading through National Securities Depository Limited for convenient paperless trading
- Tie-up with National Securities Clearing Corporation Ltd for Clearing
- Scrip less trading
- Designed trading in debt instruments commonly known as PSU bonds and also in the equity shares of unlisted companies

8.5 NEED FOR STARTING OTCEI

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

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

8.6 PROMOTION OF OTCEI

OTCEI has been incorporated under Section 25 of the Companies Act. As a result of which the word 'Limited' need not be used since it is promoted for a common cause of promoting the interest of small and medium companies. This privilege has been given to the company by the Central Government. This

company was promoted by a group of financial institutions owned by the Government of India, consisting of UTI, ICICI, IDBI, SBI Capital Market, IFCI, LIC, GIC; and Can Bank Financial Services (which is a subsidiary of Canara Bank).

8.7 FEATURES OF OTCEI

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

- **Ring less Trading:** For greater accessibility to the investor, the OTC Exchange has eliminated the trading ring. Trading will take place through a network of computers of OTC dealers located at several places within the same city and even across cities. The exchange allows dealers to quote, query and transact through a central OTC computer using telecommunication links.
- **National Reach:** Unlike other stock exchanges, the OTC Exchange has a nationwide reach. This enables widely dispersed trading across cities, resulting in greater liquidity. Companies thus, have the unique benefit of nationwide listing and trading of their scrips by listing at just one exchange, the OTC exchange.
- **Computerized:** All the activities of the OTC trading process are computerized. This facilitates a more transparent, quick and disciplined market. The trading mechanism brings out these features of the system.
- **Exclusive List of Companies:** The OTC Exchange will not list and trade in companies listed on any other exchange. It will list an entirely new set of companies, sponsored by members of the OTC Exchange.
- **Closeness:** Initially counters were opened at Bombay and were followed by counters at other centers. OTCEI will give public notice as to the availability of counters where trading take place. Facility for trading will be available after the offer at the counters of the sponsor and the additional Market Maker addresses will be given in the new issue application attached to offer for sale document (OSD) and with all the dealers of OTCEI.

- **Authorized Dealers:** All members and dealers are authorized and approved by the OTCEI
- **Liquidity through Market Making:** The sponsor-member requires day quotes (buy and sell) for the 12 months from the date of commencement of trading. Besides compulsory market maker, there are additional market maker and voluntary market maker who give two way quotes for the scrip.
- **Efficient Market Pricing:** Competition among market makers produces efficient pricing. This reduces spreads between buy and sell quotations. It also increases the capacity to absorb larger volumes, to the benefit of investors' .The market makers continually analyze companies and provide information about them to their investors, thus helping investors to make an informed investment decision.
- **Transfer of Securities:** Investors will be required to submit transfer deeds to any of the OTCEI counters for transferring the shares in their names. Shares will be automatically transferred in the name of the investors, if the consolidated holding of the shares does not exceed 0.5% of the issued capital of the company.
- **Investor Registration:** For buying and selling shares on the OTCEI and investor needs "INVESTOTC Card". Application for "INVESTOTC Card" can be made at any of the counters of OTCEI and also at the time of applying for new issues on the OTCEI. The share application form includes the necessary details to be filled in for obtaining INVESTOTC Card.
- **Transparency of Transactions:** At the OTC Exchange, the investor can see the available quotations on the computer screen at the dealer's office before placing the order. The confirmation slip/trading document generated through the computer gives the exact price of the transaction and the brokerage charge. So the investor's interest is totally safeguarded. This system also ensures that transactions are done at the best prevailing quotation in the market.

- **Faster Delivery and Payment:** On the OTC Exchange, the transaction is settled within a period of 7 days. Further, the investor actually gets the delivery of the scrip or the payment for the scrip sold within 7 days.
- **Sponsorship:** The companies that seek listing on the OTC Exchange have to approach one of the members appointed by the OTC for acting as a sponsor to the issue. The sponsor makes thorough appraisal of the project, resulting in investors getting a choice of quality companies. Through the sponsor-ship agreement, the sponsor is committed to making market in that scrip by giving a buy / sell quote for a minimum period of 1 year from the date of listing. Investors are benefited by this as it enhances the liquidity of the scrips listed on the OTC Exchange.
- **Listing of Small and Medium Sized Companies:** In the past, many small and medium sized companies were not able to enter the capital market, due to the listing requirement of the Securities Contract (Regulation) Act, 1956. The Act specified that a minimum issued equity capital of Rs. 3 crores and maximum 25 crores for issuing. The OTC Exchange provides an ideal opportunity to these companies to enter the Capital market. In fact, any company with an issued capital of more than Rs. 30 lakhs and less than Rs. 25 crores can raise finance from the capital market through the OTC Exchange.
- **Bought-Out Deals:** Through the concept of bought-out deals, OTCEI allows companies to place their equity meant to be offered to the public with the sponsor -member at a mutually agreed price. This ensures swifter availability of funds to companies for timely completion of projects and a listed status at a later date.

8.8 CONSTITUENTS OF OTCEI

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

- Companies
- Dealers
- Members

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

There are three types of intermediaries exist in OTCEI:

- Members
- Dealers
- Sponsors

8.9 ADVANTAGES OF OTCEI

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

a) To Companies:

- Provides method of raising funds through capital market instruments which are priced fairly. In OTCEI the company will be able to negotiate the issue price with the sponsors who will market the issue.
- Saves unnecessary issue expenses on raising funds from capital markets. The method of sponsors pricing the scrips with members of OTCEI who will in turn, off – load the scrips to public will obviate the need for a public issue as we know them today. Therefore, almost all associated costs will be eliminated.
- Offer documents of companies seeking listing on OTCEI will not be vetted by SEBI. Such companies shall only file their offer documents with SEBI and SEBI will communicate its comments to the issuer company and lead manager within 21 days.
- Retains greater degree of management stability. The OTC Exchange will list scrips even with 40% of the capital made available for public trading.

- Provides greater accessibility to large pool of captive investor base. This enhances fund raising power substantially. OTC Exchange will create a nationwide network, where investors will be serviced who will form the captive investor base for companies.

b) To Investor:

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

c) To Economy:

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

8.10 LISTING REQUIREMENTS IN OTCEI

The members of the OTCEI will invite companies to list on the exchange for raising capital. There are dealers who perform the dual role of a broker and market maker. A broker acts on behalf of buyer or seller, while a market maker has a responsibility to make available the particular share in the maker for transactions and to maintain reasonable price through supply and demand forces.

For any company to list its shares in OTCEI it requires sponsorship by members of the OTCEI and it must also have two market makers. The OTCEI has also laid down rules regarding listing requirements.

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

8.11 TRADING PROCESS ON OTCEI

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

A listed company may either make a direct sale to the public or offer for sale and bought out offer. In a direct public issue, a sponsor does not have to take any shares. If the sponsor takes up shares he can offer these later to the public and the price can be in accordance with the OTCEI.

If an investor purchases a security at a public offer he is issued a counter receipt which gives information about the investor as well as the company, share price, date of transaction, brokerage and total value of transactions. When an investor wishes to sell the security, he has to produce the counter receipt (CR).

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

- **Initial Allotment**

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

- **Buying in the Secondary Market:**

For the purpose of buying shares listed on the OTCEI. a person has to get himself registered (if he is not already registered). After this, he informs the counter operator about the number of the shares to be purchased. The counter operator displays the rates on the screen. After getting himself satisfied with the rate, the investor hands over the cheque to the operator. On the encashment of the cheque, the CR is handed over to the investor. This procedure normally takes about a week.

- **Selling in the Secondary Market:**

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

OTC has a unique feature of trading compared to other traditional exchanges. That is, certificates of listed securities and initiated debentures are not traded at OTC. The original certificate will be safely with the custodian. But, a counter receipt is generated out at the counter which substitutes the share certificate and is used for all transactions.

In the case of permitted securities, the system is similar to a traditional stock exchange. The difference is that the delivery and payment procedure will be completed within 14 days. Compared to the traditional Exchanges, OTC Exchange network has the following advantages.

- OTCEI has widely dispersed trading mechanism across the country which provides greater liquidity and lesser risk of intermediary charges.
- Greater transparency and accuracy of prices is obtained due to the screen-based scripless trading.
- Since the exact price of the transaction is shown on the computer screen, the investor gets to know the exact price at which s/he is trading.
- Faster settlement and transfer process compared to other exchanges.

In the case of an OTC issue (new issue), the allotment procedure is completed in a month and trading commences after a month of the issue closure, whereas it takes a longer period for the same with respect to other exchanges. Thus, with the superior trading mechanism coupled with information transparency investors are gradually becoming aware of the manifold advantages of the OTCEI.

8.12 MARKET MAKING

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

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

Advantages of market making:

To Companies:

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

To Investors:

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

Types of Market Makers:

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

8.13 NEW YORK STOCK EXCHANGE (NYSE)

The New York Stock Exchange (NYSE) is a stock exchange located in New York City that is the largest equities-based exchange in the world, based on the total market capitalization of its listed securities. Formerly run as a private organization, the NYSE became a public entity in 2005 following the acquisition of electronic trading exchange Archipelago. In 2007 a merger with Euronext, the largest stock exchange in Europe, led to the creation of NYSE Euronext, which was later acquired by Intercontinental Exchange, the current parent of the New York Stock Exchange.

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

a) Features of NYSE

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

b) History of the New York Stock Exchange

The New York Stock Exchange dates back to May 17, 1792. On that day, 24 stockbrokers from New York City signed the Buttonwood Agreement at 68 Wall Street. The New York Stock Exchange kicked off with five securities, which included three government bonds and two bank stocks. NYSE's head start as the major U.S. stock exchange, many of the oldest publicly traded companies are on the exchange. Con Edison is the longest listed NYSE stock, tracing its roots back to 1824 as New York Gas Light Company. Along with American stocks, foreign-based corporations can also list their shares on the NYSE if they adhere to certain Securities and Exchange Commission (SEC)

rules, known as listing standards. The New York Stock Exchange passed the milestone of 1 million shares traded in a day in 1886. In 1987, 500 million shares were trading hands on the NYSE during a normal business day. By 1997, 1 billion shares were traded daily on the NYSE.

c) How the New York Stock Exchange Works

Located on Wall Street in New York City, the NYSE, also known as the 'Big Board' is made up of 21 rooms that are used to facilitate trading. The main building, located at 18 Broad Street, and the one at 11 Wall Street, were both designated historical landmarks in 1978. The NYSE is the world's largest stock exchange by market cap, estimated to be $28.5 trillion as of June 30, 2018. The NYSE relied for many years on floor trading only, using the open outcry system. Many NYSE trades have transitioned to electronic systems, but floor traders are still used to set pricing and deal in high-volume institutional trading. Currently, the NYSE is open for trading Monday through Friday from 9:30 AM to 4:00 PM ET. The stock exchange is closed on all federal holidays. When federal holidays fall on a Saturday, the NYSE is sometimes closed the preceding Friday. When the federal holiday falls on a Sunday, the NYSE may be closed the following Monday.

d) Key Players of the NYSE

- **Specialists:** Specialists are brokers dealing in a particular stock who remain at one location on the trading floor. They help level out the supply and demand of stocks available in the market. According to the U.S. Securities and Exchange Commission, "They do this by stepping in with their own capital to help reduce market volatility when there are not sufficient buyers or sellers." Most specialists are in charge of trading 5-10 stocks. They track their trades and quotation changes in an 'order book.'
- **Floor Traders:** They trade exclusively from their own accounts but can also act on behalf of others and receive commission for their services. Like their name indicates, these are the people seen on the floor of the stock exchange.

8.14 TRADING FLOOR

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

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

Key Features

- Trading floor refers to an area where trading activities in financial instruments, such as equities, fixed income, futures etc., takes place.
- Trading floors sit in the buildings of various exchanges, such as the New York Stock Exchange (NYSE) and the Chicago Board of Trade (CBOT).
- Open outcry was the primary trading method used on trading floors before the rise of electronic trading.

8.15 NYSE TRADING FLOOR

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

In an era where trading floors are becoming a relic of the past, the NYSE announced in 2017 that it would allow all U.S. stocks and exchange–traded

funds to trade on its trading floor, increasing the number of securities that could be traded on the trading floor from roughly 3,500 to about 8,600. This expansion was completed in the first half of 2018.

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

8.16 PLAYERS ON TRADING FLOOR

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

8.17 ROLE OF SPECIALIST

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

Most specialists trade five to 10 stocks at a time on any given trading day. There is usually one specialist per stock who stands ready to step in and

buy or sell as many shares as needed to ensure a fair and orderly market in that security. Each specialist has a particular spot on the floor of the exchange, called a trading post, where the buying and selling of stock occurs. Floor traders, who act on behalf of customers and buy and sell the stock, gather around a specialist's trading post to learn the best bid and ask offers for security or stock. Specialists execute a trade when bid and ask orders match.

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

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

Specialists started on the floor of the New York Stock Exchange in 1872. In 1986, as many as 420 floor brokers sold approximately 250 million shares of stock every trading day. Since the advent of electronic trading, the vast majority of trades occur digitally, as opposed to through specialists on the floor.

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

- **Auctioneer -**Shows best bids and offers, becoming a market maker.
- ***Catalyst*** -Keeps track of the interests of different buyers and sellers and continually updates them.

- ***Agent*** -Places electronically routed orders on behalf of clients. Floor brokers can leave an order with a specialist, freeing themselves up to take on other orders. Specialists then take on the responsibilities of a broker.
- **Principal** -Acts as the major party to a transaction. Since specialists are responsible for keeping the market in equilibrium, they are required to execute all customer orders ahead of their own.

8.18 ROLE OF DEPOSITORIES AND DEPOSITORY PARTICIPANTS (DPS)

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

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

8.19 NASDAQ

It is an American stock exchange behind only the New York stock exchange. It stood for National Association of Securities Dealers Automated Quotations. It was founded on February 4, 1971 and it began trading on February 8, 1971. It is located at Liberty plaza 165 Broadway, New York City, United States.

Features of NASDAQ:

- It was the world first electronic screen based equity securities trading market in the United States.

- It is the second largest exchange in the world by market capitalization of 6831 US$ billion as on 31th January 2015.
- The number of listings as on July, 2015 was 3058.
- Its main index is the NASDAQ Composite.
- The small order execution system (SOES) provides an electronic method for dealers to enter their trades.
- NASDAQ has a pre-market session from 4 AM To 9.30 AM eastern, a normal trading session from 9.30 AM to 4.00 PM and a post market session from 4.00 PM to 8.00 PM.
- Its official website is Nasdaq.com.
- The NASDAQ has had an average annualized growth rate of 9.24 % as of June 2015.
- The status of NASDAQ was changed from stock market to a licensed national securities exchange in 2006.

Requirements for Listing:

- Be registered with the united States Securities and Exchange Commission.(SEC).
- Have at least three market makers
- Meet minimum requirements for assets, capital, public shares and shareholders.

8.20 NASD RULES

The National Association of Securities Dealers (NASD) was a self-regulatory organization of the securities industry and a predecessor of the Financial Industry Regulatory Authority (FINRA). It was responsible for the operation and regulation of the NASDAQ stock market and over-the counter markets. It also administrated exams for investment professionals, such as the Series 7 exam. The NASD was charged with watching over the NASDAQ's market operations.

The NASD was founded in 1939, under provisions of the 1938 Maloney Act amendments to the Securities Exchange Act of 1934. It was also the leading founder of the NASDAQ stock market, which was established in 1971. Operating as an overseer of stock market operations for market activity and

the NASDAQ under the overall supervision of the Securities and Exchange Commission (SEC), the NASD played a leading part in the management of stock trading in the market from 1939 to 2007. In that year, it merged with the regulation, enforcement, and arbitration arm of the New York Stock Exchange to form FINRA.

(a) The following NASD Rules and Interpretative Material there under are specifically applicable to transactions and business activities relating to PORTAL securities:

(i) Rules 0113, 0114, 0115, 2110, 2120, 2230, 2240, 2250, 2260, 2270, 2310, 3370, and 8210;

(ii) The Rule 8100 and Rule 8300 Series; and

(iii) IM-2310-2, IM-2420-1, IM-2440, IM-3310, and IM-3320.

(b) The following NASD rules and Interpretative Material thereunder are specifically applicable to transactions and business activities relating to PORTAL securities, with the exceptions specified below:

(i) Rule 2320, except for paragraph (g), which requires that a member obtain quotations from three dealers to determine the best inter-dealer market for the subject security;

(ii) Rule 2330, except for paragraph (d); and

(iii) Rule 3110.

(c) The following NASD Rules are applicable to members and persons associated with members regardless of whether the member participates in transactions in PORTAL securities:

(i) Rules 0111, 0112, 0120, and 0121.

(ii) Rules 2210, 3020, 3030, 3040, 3050, 3060, 3130, 3140, and 3340.

(d) The following NASD Rules and Interpretative Material thereunder are not applicable to transactions and business activities relating to PORTAL securities:

(i) Rules 1130, 2450, 2520, 2710, 2730, 2740, 2750, 2790, 2810, 2820, 2830, 2860, 3210, and 3360.

8.21 TRADING FIRMS ON NASDAQ

The NASDAQ (**National Association of Securities Dealers Automated Quotations**) is an electronic stock exchange with more than 3,300 company listings. It currently has a greater trading volume than any other U.S. stock exchange, carrying out approximately 1.8 billion trades per day. The NYSE is still considered the biggest exchange because its market capitalisation far exceeds that of the NASDAQ. The NASDAQ trades shares in a variety of companies, but is well known for being a high-tech exchange, trading many new, high growth, and volatile stocks. This is partially due to the fact that the listing fees on the NASDAQ are significantly lower than those for the New York Stock Exchange whose maximum price is only $150,000.

The NASDAQ is a publicly owned company, trading its shares on its own exchange under the ticker symbol NDAQ.

The NASDAQ, as an electronic exchange, has no physical trading floor, but conducts all of its trades through a computer and telecommunications system. The exchange is a dealers' market, meaning brokers buy and sell stocks through a market maker rather than from each other. A market maker deals in a particular stock and holds a certain number of stocks on his own books so that when a broker wants to purchase shares, he can purchase them directly from the market maker.

The NASDAQ is located in New York's Times Square. The building is instantly recognisably by its large outdoor electronic display which provides up to the minute financial information 24 hours a day.

Companies that get listed on the NASDAQ tend generally to be younger, more dynamic and more focused on technology, science, and innovation, rather than businesses in more traditional industries, such as manufacturing or finance, which tend to usually favor the NYSE.

8.22 ELECTRONIC COMMUNICATION NETWORKS (ECNs)

An electronic communication network (ECN) is a computerized system that automatically matches buy and sell orders for securities in the market. It connects major brokerages and individual traders so they can trade directly

between themselves without going through a middleman and make it possible for investors in different geographic locations to quickly and easily trade with each other. The U.S. Securities and Exchange Commission (SEC) requires ECNs to register as broker-dealers.

An ECN makes money by charging a fee for each transaction to meet financial obligations. It attempts to eliminate the third party's role in executing orders entered by an exchange market maker or an over-the-counter market maker and permits such orders to be entirely or partly executed. Orders placed through ECNs are usually limit order.

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

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

Functions Provided by an Electronic Communication Network:

ECNs are computer-based systems that display the best available bid and ask quotes from multiple market participants, and then automatically match and execute orders. They not only facilitate trading on major exchanges during market hours but also are used for after-hours trading and foreign currency trading. ECNs allow for automated trading, passive order matching and speedy execution.

Real World Examples of ECNs:

Some of the different ECNs include Instinet, SelectNet, and NYSE Arca. Instinet was the first ECN, founded in 1969, and is used by small brokerages

and for transactions between institutions. It is widely used by market makers for NASDAQ trades, but individuals and small firms can also use it.

SelectNet is used primarily by market makers, but it does not require immediate order execution and helps investors trade with specific market makers. NYSE Arca grew out of the merger between the New York Stock Exchange (NYSE) and Archipelago, an early ECN from 1996. It facilitates electronic stock trading on major U.S. exchanges such as the NYSE and NASDAQ. In foreign exchange markets, certain Forex brokers are designated as ECN brokers who can facilitate currencies trades across electronic matching networks.

8.23 ORDER ENTRY FIRMS

NASDAQ is a unique market organization that provides a competitive trading environment and efficient, low-cost execution of orders. There are multiple market participants, including order-entry firms, market makers and electronic communications networks (ECNs) that utilize NASDAQ's trading services.

Definition of Order entry firms:

An order-entry firm is a NASDAQ member firm that enters orders for execution and anonymous display.

Order Entry Capabilities:

- Access the inside bid and asks, as well as individual market maker quotes, for each security traded on NASDAQ.
- Enter orders in all NASDAQ automated services.
- View daily statistical and index-related information.
- View share- and dollar-volume leaders, net gainers and losers.

8.24 ORDER EXECUTION ON NASDAQ

Often investors and traders alike do not fully understand what happens when they click the "enter" button on their online trading account. If you think your order is always filled immediately after they click the button in your ac-

count, you are mistaken. You might be surprised at the variety of possible ways in which an order can be filled and the associated time delays. How and where your order is executed can affect the cost of your transaction and the price you pay for the stock.

A common misconception among investors is that an online account connects the investor directly to the securities markets. This is not the case. When an investor places a trade whether online or over the phone, the order goes to a broker. The broker then looks at the size and availability of the order to decide which path is the best way for it to be executed.

A broker can attempt to fill your order in several ways:

- **Order to the Floor.** For stocks trading on exchanges such as the NYSE, the broker can direct your order to the floor of the stock exchange, or a regional exchange. In some instances, regional exchanges will pay a fee for the privilege to execute a broker's order, known as payment for order flow. Because your order is going through human hands, it can take some time for the floor broker to get to your order and fill it.
- **Order to Third Market Maker.** For stocks trading on an exchange like the NYSE, your brokerage can direct your order to what is called a third market maker. A third market maker is likely to receive the order if: i) they entice the broker with an incentive to direct the order to them, or ii) the broker is not a member firm of the exchange in which the order would otherwise be directed.
- **Internalization. Internalization** occurs when the broker decides to fill your order from the inventory of stocks your brokerage firm owns. This can make for quick execution. This type of execution is accompanied by your broker's firm making additional money on the spread.
- **Electronic Communications Network (ECN). ECNs** automatically match buy and sell orders. These systems are used particularly for limit orders because the ECN can match by price very quickly.

- **Order to Market Maker.** For over-the-counter markets such as the NASDAQ, your broker can direct your trade to the market maker in charge of the stock you wish to purchase or sell. This is usually timely, and some brokers make additional money by sending orders to certain market makers (payment for order flow). This means your broker may not always be sending your order to the best possible market maker.

As you can see, your broker has different motives for directing orders to specific places. Obviously, they may be more inclined to internalize an order to profit on the spread or send an order to a regional exchange or willing third market maker and receive payment for order flow. The choice the broker makes can affect your bottom line.



CHECK YOUR PROGRESS

Write the full form of the following:

a) OTCEI

b) OTC

c) CR

d) SCS

e) OASIS

f) PMM

g) AMM

h) NYSE

i) NASDAQ

j) ECNs

k) SEC

l) NDAQ

m) CBOT



8.25 LET US SUM UP

In this unit, we have discuss the following :-

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



8.26 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan

- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- OTCEI Website



8.27 ANSWERS TO CHECK YOUR PROGRESS

a) Over the Counter Exchange of India

b) Over-the-counter

c) Counter Receipt

d) Sale Confirmation Slip

e) Automated Securities Integrated System

f) Principal Market Makers

g) Additional Market Maker

h) New York Stock Exchange

i) National Association of Securities Dealers Automated Quotations

j) Electronic Communications Networks

k) Securities and Exchange Commission

l) National Database of Accredited Qualifications

m) Chicago Board of Trade



8.28 POSSIBLE QUESTIONS

1. Write short notes on the following:

   a) OTCEI

   b) Listing procedures in OTCEI

   c) Market making

   d) Foreign stock exchange

   e) New York Stock Exchange

f) NASDAQ

2. Give the meaning of OTCEI. Enumerate its role in Indian financial system.
3. Discuss about the listing requirements and procedures in OTCEI. Mention the advantages of OTCEI.
4. Write an explanatory note on New York Stock Exchange.

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UNIT 9 : STOCK MARKET INDICES

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Meaning of Stock Market Indices

9.4 Purposes of Calculating Stock Index

9.5 Need for Indices

9.6 Usefulness of Indices

9.7 Consideration in Developing Indices

9.8 Methods for Calculating Stock Market Index

9.9 Stock Indices in India

9.10 Scrip Selection Criteria

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

9.12 Overview of Stock Market Indices in Foreign Countries

9.13 Let Us Sum Up

9.14 Further Reading

9.15 Answers to Check Your Progress

9.16 Possible Questions

9.1 LEARNING OBJECTIVES

After going through this unit you will able to:

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

9.2 INTRODUCTION

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

9.3 MEANING OF STOCK MARKET INDICES

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

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

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

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

Some of the notable indices in India are as follows:

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

9.4 PURPOSES OF CALCULATING STOCK INDEX

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

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

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

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

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

9.5 NEED FOR INDICES

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

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

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

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

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

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

9.6 USEFULNESS OF INDICES

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

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

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

9.7 CONSIDERATION IN DEVELOPING INDICES

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

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

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

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

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

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

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

9.8 METHODS FOR CALCULATING STOCK MARKET INDEX

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

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

   The number of shares outstanding means the total number of shares currently held by all its shareholders, including shares held by institutional investors and restricted shares owned by the company's officers and insiders. S&P 500 index in the USA uses this method.

2. **Free Float Market Capitalisation method:** Free Float is the percentage of shares available in the market for trading. It excludes restricted shares held by the government in the form of strategic investment, shares held by companies' officers and insiders, shares locked under employee stock option plan etc. Companies in the index are provided with the free float factors based on its percentage of shares in free

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

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

9.9 STOCK INDICES IN INDIA

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

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

9.9.1. Broad Market Indices

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

a) *Bombay Stock Exchange (BSE) Indices - SENSEX*

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

How is Sensex calculated?

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

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

b) National Stock Exchange (NSE) Index - NIFTY

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

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

How is Nifty calculated?

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

9.9.2. Sectoral Indices

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

a) Sectoral Indices in NSE are:

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

- **Nifty Financial Services Index:** The Nifty Financial Services Index is designed to reflect the behavior and performance of the Indian financial market which includes banks, financial institutions and housing finance and other financial services companies. The Nifty Finance Index comprises of 15 stocks that are listed on the National Stock Exchange (NSE).
- **Nifty FMCG Index:** FMCGs (Fast Moving Consumer Goods) are those goods and products, which are non-durable, mass consumption products and available off the shelf. The Nifty FMCG Index comprises of maximum of 15 companies who manufacture such products which are listed on the National Stock Exchange (NSE).
- **Nifty IT Index:** Information Technology (IT) industry has played a major role in the Indian economy. In order to have a good benchmark of the Indian IT sector, IISL has developed the Nifty IT sector index. Nifty IT provides investors and market intermediaries with an appropriate benchmark that captures the performance of the IT segment of the market. Companies in this index are those that have more than 50% of their turnover from IT related activities like IT Infrastructure , IT Education and Software Training , Telecommunication Services and Networking Infrastructure, Software Development, Hardware Manufacturer's, Vending, Support and Maintenance.
- **Nifty Media Index:** The Nifty Media Index is designed to reflect the behavior and performance of the Media & Entertainment sector including printing and publishing. The Nifty Media Index comprises of stocks that are listed on the National Stock Exchange (NSE).
- **Nifty Metal Index:** The Nifty Metal Index is designed to reflect the behavior and performance of the Metals sector including mining. The Nifty Metal Index comprises of maximum of 15 stocks that are listed on the National Stock Exchange.
- **Nifty Pharma Index:** Pharmaceuticals sector is one of the key sectors where Indian companies have created a global brand for themselves besides software. Indian companies have taken advantage of the opportunities in the regulated generics market in the western countries and made deep inroads especially in providing low cost equivalents of

expensive drugs. Pharma outsourcing into India and low cost Healthcare services are expected to be the key areas of growth in the near future. In addition, the inherent potential of biotechnology has also attracted many new companies and this is also a key growth area for Indian companies. IISL has developed Nifty Pharma Index to capture the performance of the companies in this sector.

- **Nifty Private Bank Index:** The Nifty Private Bank Index is designed to reflect the performance of the banks from private sector. The Nifty Private Bank Index comprises of 10 stocks that are listed on the National Stock Exchange (NSE).
- **Nifty PSU Bank Index:** The Indian banking system, reaping the benefits of strong credit off take and improved risk management practices. The public sector banks with their existing widespread branch network have been primarily increasing their IT related expenditure. The core profitability of the public sector banks continue to rise on the back of improving operating efficiencies. Consolidation would further improve PSU banks' competitive edge against their private counterparts in servicing customers -both retail and corporate; in the international and domestic markets. Recognizing these changing dynamics of Indian banking industry, IISL has developed Nifty PSU Bank Index to capture the performance of the PSU banks.
- **Nifty Realty Index:** Real estate sector in India is witnessing significant growth. Recent dynamics of the market reflected the opportunity of creating wealth across real estate companies, as proven by recent listings of real estate companies resulting into prominent growth in public funds and private equity. The main growth thrust is coming due to favorable demographics, increasing purchasing power, existence of customer friendly banks & housing finance companies, professionalism in the real estate sector and favourable reforms initiated by the government to attract global investors.

b) Sectoral Indices in NSE are:

- S&P BSE TECK

- S&P BSE Information Technology
- S&P BSE CONSUMER DURABLES
- S&P BSE Fast Moving Consumer Goods
- S&P BSE POWER
- S&P BSE India Infrastructure Index
- S&P BSE OIL & GAS
- S&P BSE AUTO
- S&P BSE PSU
- S&P BSE Healthcare
- S&P BSE CAPITAL GOODS
- S&P BSE BANKEX
- S&P BSE METAL
- S&P BSE REALTY

9.9.3. Thematic Indices

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

Thematic Indices in NSE:

- Nifty Commodities Index
- Nifty CPSE Index
- Nifty Corporate Group Indices
- Nifty Energy Index
- Nifty India Consumption Index
- Nifty Infrastructure Index
- Nifty MNC Index
- Nifty PSE Index
- Nifty Services Sector Index

- Nifty100 Liquid 15 Index
- Nifty Midcap Liquid 15 Index
- Nifty Shariah 25 Index
- Nifty 50 Shariah
- Nifty 500 Shariah Index

Thematic Indices in BSE:

- S&P BSE GREENEX
- S&P BSE CARBONEX

4. Strategy Indices

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

9.10 SCRIP SELECTION CRITERIA

a) SENSEX

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

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

- **Market Capitalization Weightage:** The weightage of each scrips in SENSEX based on three- month average free-float market capitalization should be at least 0.5% of the Index.
- **Industry/Sector Representation:** Scrip selection would generally take into account a balanced representation of the listed companies in the universe of BSE.
- **Track Record:** In the opinion of the Index Committee, the company should have an acceptable track record.

b) NIFTY

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

Other factors:

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

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

A) Company Selection Criteria for Analysis:

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

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

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

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

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

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

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

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

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

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

B) Scoring Mechanism for Group 'A' Companies:

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

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

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

4. Compliance Monitoring (10%)

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

9.12 OVERVIEW OF STOCK MARKET INDICES IN FOREIGN COUNTRIES

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

a) Global Stock Market Indexes

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

Along with the MSCI, some of the most popular global stock market indexes include:

- FTSE All-World Index
- S&P Global 100 Index
- S&P Global 1200 Index
- Dow Jones Global Titans 50

- Russell Global Index

b) Regional Stock Market Indexes

Regional stock market indexes track equities from specific regions around the world. For instance, these indexes may cover Asian, European, or Latin American equities. They help investors and analysts compare the performance of specific countries to a general region to highlight what assets are over and under-performing. The funds tied to these indexes may also be helpful in building exposure to specific regions of the world.

Some of the most popular regional stock market indexes are listed below.

Asia

- S&P Asia 50 Index
- Dow Jones Asian Titan 50 Index
- FTSE ASEAN 40 Index

Europe

- Euro Stoxx 50 Index
- FTSE Euro 100 Index
- S&P Europe 350 Index

Latin America

- S&P Latin America 40 Index

c) National Stock Market Indexes

National stock market indexes provide exposure to individual countries. In some cases, the equities in these indexes will consist entirely of large-cap stocks, similar to the Dow Jones Industrial Average in the United States. In other cases, the equities may be considered small-cap since the country may not have many large companies. This is often the case in emerging market and frontier market economies. Here are some of the top global and national stock market indexes.

China

- SSE Composite Index
- SZSE Component Index
- CSI 300 Index

Japan

- Nikkei 225 Index
- Topic Index
- JPX-Nikkei 400 Index

Germany

- DAX 30 Index
- TecDAX Index
- MDAX Index

United Kingdom

- FTSE 100 Index
- FTSE All-Share Index
- FTSE techMark Index

France

- CAC 40 Index
- CAC Next 20 Index
- CAC Mid 60 Index

India

- Bombay Stock Market Index
- National Stock Exchange of India Index
- MCX Stock Exchange Index

Italy

- FTSE MIB Index

- FTSE Italia Mid Cap Index
- MIBTel Index

Brazil

- Bovespa Stock Index
- IBrX Stock Index
- ITEL Stock Index

Canada

- S&P TSX 60 Index
- S&P TSX Composite Index
- S&P TSX Venture Composite Index

South Korea

- KOSPI Index
- KOSDAQ Index

d) Other Stock Market Indexes

There are many other types of specialized stock market indexes for certain demographics. For example, the S&P Islamic Index and Shariah indexes are geared toward investors adhering to Islamic laws, while other indexes cater towards goals like Environmental-Social-Government (or ESG) investments. Investors may want to consider these types of indexes, which may also provide exposure to global stocks with certain restraints.

Some popular alternative stock market indexes include:

- S&P Global BMI Shariah Index
- Stoxx Global ESG Leaders Index



CHECK YOUR PROGRESS

Write the full form of the following:

a) BSE

b) NSE

c) SENSEX

d) NIFTY

e) KCBT

f) IISL



9.13 LET US SUM UP

In this unit, we have discuss the following :-

- A market index is a hypothetical portfolio of investment holdings which represents a segment of the financial market. A stock market index shows changes taking place in the stock market.
- A stock market index is created by selecting a group of stocks that are representative of the whole market or a specified sector or segment of the market.
- An index is important to measure the performance of investments against a relevant market index. It is used to give information about the price movements of products in the financial, commodities or any other markets.
- Stock market indexes are meant to capture the overall behaviour of equity markets.
- Stock index helps investors understand the health of the stock market enables them to study the market sentiment and makes it easy to compare the performance of an individual stock.

- There are various methods for calculating the stock market index.
- Most of the trading in the Indian stock market takes place on its two stock exchanges, i.e. the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).
- The BSE index is SENSEX, also called the BSE 30. SENSEX stands for Stock Exchange Sensitive Index.
- The NSE index is NIFTY, also called NIFTY 50. Full form of NIFTY is 'National Stock Exchange Fifty'.
- There are three most common types of indexes in world's market; they are 'global' indexes, 'regional' indexes, and 'national' indexes.



9.14 FURTHER READING

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



9.15 ANSWERS TO CHECK YOUR PROGRESS

a) Bombay Stock Exchange

b) National Stock Exchange

c) Stock Exchange Sensitive Index.

d) National Stock Exchange Fifty

e) Kansas City Board of Trade

f) India Index Service and Products



9.16 POSSIBLE QUESTIONS

1. Write short notes on the following:
    a) Stock market index
    b) Bombay Stock Exchange
    c) National Stock Exchange
    d) Stock Exchange Sensitive Index
    e) National Stock Exchange Fifty
    f) Scrip Selection Criteria
2. Give the meaning of stock market index. Enumerate the purposes needs of calculating stock indices.
3. Describe the methods for calculating stock market index.
4. Write a detail note on stock indices in India.
5. What are the main indices used by the national level stock exchanges in India, and what is their significance?

UNIT 10 : SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Meaning of SEBI

10.4 Preamble of SEBI

10.5 Reasons for Establishment of SEBI

10.6 Present Members of the Board

10.7 Constitution of SEBI

10.8 Various Departments of SEBI

10.9 Organisational Structure of SEBI

10.10 Objectives of SEBI

10.11 Role of SEBI

10.12 Role of SEBI in Regulating Insider Trading

10.13 Powers of SEBI

10.14 Functions of SEBI

10.15 Responsibilities of SEBI

10.16 SEBI in India's Capital Market

10.17 SEBI and the Capital Market Reforms in India

10.18 Investor Protection Measures by SEBI

10.19 Let Us Sum Up

10.20 Further Reading

10.21 Answers to Check Your Progress

10.23 Possible Questions

10.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the historical perspective of the securities market reforms in India
- describe the reasons for establishment of SEBI
- interpret the management, organizational structure, objectives, powers and role of SEBI in India
- enumerate the role of SEBI in Indian capital market
- explain the functions of SEBI
- discuss the functions of various departments of SEBI

10.2 INTRODUCTION

The buying and selling of long term securities namely stock, shares, bonds and debentures are held in stock market or securities market. Stock market is the mirror of the economy of any country. Therefore in India, for the orderly development and to regulate the functions of securities market the Securities and Exchange Board of India (SEBI) was set. The main idea of the establishment of SEBI was to keep a check on malpractices and protect the interest of investors. This unit will discuss about the meaning, role, functions and various aspects of SEBI in India.

10.3 MEANING OF SEBI

Securities and Exchange Board of India, popularly known as SEBI is the apex body of Indian Stock Market. It is the regulator, controller and promoter for securities market in India. The Securities and Exchange Board of India was enacted on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992. However, SEBI was first established in the year 1988 as a non-statutory body for regulating the securities market. It became an autonomous body in 1992 and more powers were given through an ordinance. Since then it regulates the market through its independent powers. Its head quarter is in Mumbai.

Establishment of SEBI was one of the greatest reforms that took place in Indian economy. It protects the interest of Investors and regulates the functioning of Indian Financial System. The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as **"...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto".**

10.4 PREAMBLE OF SEBI

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

10.5 REASONS FOR ESTABLISHMENT OF SEBI

During 1980s, there was tremendous growth in the capital market due to increasing participation of public. With the growth in the dealings of stock markets led to lot of malpractices like rigging of prices, unofficial premium on new issues, delay in delivery of shares, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. by the brokers, merchant bankers, companies, investment consultants and others involved in the securities market. Due to these malpractices the customers started losing confidence and faith in the stock exchange. This resulted in many investor grievances. Because of lack of proper penal provision and legislation, the government and the stock exchanges were not able to redress these grievances of the investors. This necessitated a need for a separate regulatory body, and hence Securities and Exchange Board of India was established. Its main objective was to promote orderly and healthy growth of securities and to provide protection to the investors.

10.6 PRESENT MEMBERS OF THE BOARD

At present one chairman and four whole time member constitute the board.

10.7 CONSTITUTION OF SEBI

The SEBI is body of six members comprising the chairman, two members from the official of the ministry of central bank dealing with finance and law, two members who are professionals and have experience or special knowledge relating to securities market, and one member from RBI. All the member except the RBI member are appointed by government who also lays down their terms of office, tenure and conditions of services, and who also removes any member from the office under any circumstances. The central government is empowered to supersede the SEBI in public interest or if, on account of grave emergency and some other circumstances.

The work of SEBI has been organized into five operational department each of which is headed by an executive director who report to Chairman. Besides, there is a legal Department and Investigation Department. The department is further divided into division. The SEBI has regional offices at Calcutta, Chennai and Delhi. It has also formed two non statutory advisory committees namely Primary Market Advisory Committee and Secondary Market Advisory Committee with members from market player, recognized investor association and other eminent person. SEBI has a corporate framework comprising various departments each managed by a department head. There are about 20 departments under SEBI.

The hierarchical structure of SEBI consists of the following members:

- The chairman of SEBI is nominated by the Union Government of India.
- Two officers from the Union Finance Ministry will be a part of this structure.
- One member will be appointed from the Reserve Bank of India.
- Five other members will be nominated by the Union Government of India.

10.8 VARIOUS DEPARTMENTS OF SEBI

- Market Intermediaries Regulation and Supervision Department (MIRSD)
- Market Regulation Department (MRD)
- Commodity Derivatives Market Regulation Department (CDMRD)
- Corporation Finance Department (CFD)
- Investment Management Department (IMD)
- Integrated Surveillance Department (ISD)
- Investigations Department (IVD)
- Enforcement Of Department (EFD)
- Legal Affairs Department (LAD)
- Enquiries and Adjudication Department (EAD)
- Office of Investor Assistance and Education (OIAE)
- General Services Department (GSD)
- Department of Economic and Policy Analysis (DEPA)
- Office of the Chairman (OCH)
- Information Technology Department
- The Regional Offices (RO's)

10.9 ORGANISATIONAL STRUCTURE OF SEBI

i) SEBI a Statutory body

ii) Its activities are divided into five departments. Each department is headed by an executive director.

iii) The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.

iv) SEBI has formed two advisory committees to deal with primary and secondary markets.

These committees consist of market players, investors associations and eminent persons.

The Ministry of Finance of the Government of India has overall administrative control over its functions. On 30th January 1992, it was given a statutory status through an ordinance, which later on was replaced by Act of Parliament known as Securities and Exchange Board of India Act, 1992. SEBI is considered as watchdog of the securities market. The SEBI is managed by its members, which consists of following:

i) The chairman who is nominated by Union Government of India

ii) Two members, i.e., officers from Union Finance Ministry

iii) One member from the Reserve Bank of India

iv) The remaining five members are nominated by Union Government of India out of them at least three shall be whole-time members.

The office of SEBI is situated at Mumbai with its regional offices at Kolkata, Delhi and Chennai.

10.10 OBJECTIVES OF SEBI

As an important entity in the market it works with following objectives:

i) It tries to develop the securities market

ii) Promotes investors interest

iii) Makes rules and regulations for the securities market

Following are the overall objectives of SEBI:

i) *Protection*: To guide, educate, and to protect the rights and interests of the investors

ii) *Competitive and Professional*: To make the intermediaries like merchant bankers, brokers etc. competitive and professional by regulating their activities and developing a code of conduct

iii) *Prevention of Malpractices*: To prevent trading malpractices

iv) *Balancing:* To establish a balance between statutory regulation and self regulation by the securities industry

v) *Orderly Functioning*: To promote orderly functioning of stock exchange and securities industry by regulating them

10.11 ROLE OF SEBI

The SEBI plays an important role to create an environment which facilitates efficient mobilization and allocation of resources through the securities market. This environment consists of rules and regulations, policy framework, practices and infrastructures to meet the needs of three groups which mainly constitute the market i.e. issuers of securities (companies), the investors and the market intermediaries.

(i) To the Issuers: SEBI aims to provide a market place to the issuers where they can confidently look forward to raise the required amount of funds in an easy and efficient manner.

(ii) To the Investors: SEBI aims to protect the right and interest of the investors by providing adequate, accurate and authentic information on a regular basis.

(iii) To the Intermediaries: In order to enable the intermediaries to provide better service to the investors and the issuers, SEBI provides a competitive, professionalised and expanding market to them having adequate and efficient infrastructure.

10.12 ROLE OF SEBI IN REGULATING INSIDER TRADING

Company insiders have information unavailable to the public. These individuals have firsthand knowledge of what the company is doing and better information concerning what the future might hold. If there are likely problems for the company in the future, such as poor earnings, slow growth, or lawsuits, then insiders can sell their stock before these events happen. When this information becomes public, the stock's price should decrease. However, this price decrease occurs after the insider has sold his or her shares, thus avoiding the

loss. In this case the insider beats the market. On the other hand, insiders know when their company has a bright future, high potential earnings, innovative products being developed, etc. When the future looks bright, insiders can buy shares before the public becomes aware of these facts. The price, later, fully increases to represent the positive information. In both cases, insiders use private information to beat the market.

Earlier, the concept of insider trading was limited to the aspect of a company insider tipping of an outsider and the outsider using the tip and trading in the company's shares, this constitutes a breach of fiduciary duty owed by the insider to the company's shareholders; it was called the classical theory of insider trading.

10.13 POWERS OF SEBI

- Power to call periodical returns from recognized stock exchanges
- Power to compel listing of securities by public companies
- Power to levy fees or other charges for carrying out the purposes of regulation
- Power to call information or explanation from recognized stock exchanges or their members
- Power to grant approval to byelaws of recognized stock exchanges
- Power to control and regulate stock exchanges
- Power to direct enquiries and conduct investigations to be made in relation to affairs of stock exchanges or their members
- Power to suspect company's finances, accounts and audit and conducting a check on the same
- Power for levying penalties and adjudication
- Power of central government to issue directions
- Power of central government to supersede the Board
- Power to grant immunity

- Power to exempt from tax on wealth and income or in any other manner as it thinks fit
- Power to make rules and regulations
- Power to lay rules and regulations before Parliament

10.14 FUNCTIONS OF SEBI

The functions of SEBI can be divided into three parts viz:

- Regulatory function,
- Development function, and
- Protective function.

1. Regulatory Functions

Regulatory functions of SEBI are as follows:

*a) Registration of Brokers and Agents***:** SEBI registers brokers, sub-brokers, transfer agents, merchant banks etc.

*b) Notifications of Rules and Regulations***:** It notifies rules and regulations for the smooth functioning of all intermediaries in the securities' market.

*c) Levying of Fees***:** It levies fees, penalties and other charges for contravening its directions and orders.

*d) Regulator of Investment Schemes***:** It registers and regulates collective investment schemes and mutual funds.

*e) Prohibits Unfair Trade Practices***:** SEBI prohibits fraudulent and unfair trade practices.

*f) Inspection and Enquiries***:** It undertakes inspection and conducts enquiries and audit of stock exchange

*g) Performing and Exercising Powers***:** It performs and exercises such powers under Securities Contracts (Regulation) Act 1956, as have been delegated to it by the Government of India.

2. Development Functions

Development functions of SEBI are as under:

*a) Training to Intermediaries***:** It promotes training of intermediaries of the securities.

*b) Promotion of Fair Trade***:** It promotes fair trade practices by making underwriting optional.

c) Research: It publishes information useful to all market participants for conducting research.

3. Protective Functions

Protective Functions of SEBI are as under:

*a) Prevents Insider Trading***:** Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading. It does so by prohibiting insiders such as directors, promoters etc. to make profit through trading of securities using confidential price sensitive information.

b) Prohibits Fraudulent and Unfair Trade Practices: It prohibits fraudulent and unfair trade practices in the security market, such as price rigging and sale or purchase of securities through misleading statements. Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

*c) Promotes Fair Practices***:** It promotes fair practices and code of conduct in the securities market e.g. it looks after the interests of the debenture holders in terms of any mid-term revision of interest rates etc.

*d) Educates Investors***:** It educates the investors through campaigns.

10.15 RESPONSIBILITIES OF SEBI

SEBI basically has only three responsibilities areas which are as follows:

i) For the *issuer* of securities
ii) For the *investors* of securities
iii) For the market *intermediaries*

Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors, to promote the development of, and to regulate the securities market, by such measures as it thinks fit.

- regulating the business in stock exchanges and any other securities markets
- registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner
- registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds
- promoting and regulating self-regulatory organisations
- prohibiting fraudulent and unfair trade practices relating to securities markets
- promoting investors' education and training of intermediaries of securities markets
- prohibiting insider trading in securities
- regulating substantial acquisition of shares and take-over of companies
- calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market
- levying fees or other charges for carrying out the purposes of this Act
- conducting research for the above purposes
- issuing commissions for the examination of witnesses or documents
- the discovery and production of books of account and other documents, at such place and such time as may be specified by the Board
- suspend the trading of any security in a recognized stock exchange

- restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities
- to regulate or prohibit issue of prospectus, offer document or advertisement soliciting money for issue of securities

10.16 SEBI IN INDIA'S CAPITAL MARKET

The Securities and Exchange Board of India, is the national regulatory body for the securities market, set up under the securities and Exchange Board of India Act, 1992, to protect the interest of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith and incidental too. As per the SEBI act, 1992, the power and functions of the Board encompass the regulation of stock exchanges and other securities markets; registration and regulation of the working stock brokers, sub-brokers, bankers to an issue (a public offer of capital), trustees of trust deeds, registrars to an issues, merchant bankers, under writers, portfolio managers, investment advisors and such other intermediaries who may be associated with the stock market in any way; registration and regulations of mutual funds; promotion and regulation of self-regulatory organizations; prohibiting fraudulent and unfair trade practices and insider trading in securities markets; regulating substantial acquisition of shares and takeover of companies; calling for information from, undertaking inspection, conducting inquiries and audits of stock exchanges, intermediaries and self-regulatory organizations of the securities market; performing such functions and exercising such powers as contained in the provisions of the Capital Issues(Control) Act,1947 and the Securities Contracts (Regulation) Act, 1956, levying various fees and other charges, conducting necessary research for above purposes and performing such other functions as may be prescribes from time to time.

SEBI as the watchdog of the industry has an important and crucial role in the market in ensuring that the market participants perform their duties in accordance with the regulatory norms. The stock exchange as a responsible Self Regulatory Organization (SRO) functions to regulate the market and its prices as per the prevalent regulations. SEBI play complimentary roles to en-

hance the investor protection and the overall quality of the market. SEBI from time to time have adopted many rules and regulations for enhancing the Indian capital market. The recent initiatives undertaken are as follows:

i) **Sole Control on Brokers:** Under this rule every brokers and sub brokers have to get registration with SEBI and any stock exchange in India.

ii) **For Underwriters:** For working as an underwriter an asset limit of 20 lakhs has been fixed.

iii) **For Share Prices:** According to this law all Indian companies are free to determine their respective share prices and premiums on the share prices.

iv) **For Mutual Funds:** SEBI's introduction of SEBI (Mutual Funds) Regulation in 1993 is to have direct control on all mutual funds of both public and private sector.

10.17 SEBI AND THE CAPITAL MARKET REFORMS IN INDIA

The following points highlight the top four steps taken by SEBI to strengthen the capital market reforms.

1. **Primary Market Reforms:**

SEBI has introduced various guidelines and regulatory measures to improve conditions of capital issues. As per these measures companies issuing capital in the primary market are now required to disclose and clarify all material facts and specific risk factors, if any, related to their projects along with the basic information related to calculation of premium.

In order to ensure fair and truthful disclosures, SEBI has also introduced code of advertisement for public issues. SEBI has made the underwriting of issue optional so as to reduce the cost of issue. SEBI has also enhanced the minimum application size along with the proportion of each issue allowed for firm allotment to institutions such as mutual funds.

SEBI has again introduced shares and takeovers and also frame conditions under which disclosures and mandatory public offers are to be made to the shareholders.

SEBI has also brought merchant banking statutorily under its regulatory framework. Now the merchant bankers are to be authorised by SEBI and to adopt stipulatory capital adequacy norms and also abide by the code of conduct. Under the present framework, merchant bankers are having greater degree of accountability in the documentation of offer and its issue process.

In order to protect the interest of investors, the “Banker to the Issue” is now brought under the control of SEBI. SEBI has also advised stock exchanges to collect a deposit of one per cent of the issue amount from the companies in order to attain greater care and diligence for timely action related to public issues of capital.

In case of non-compliance of the provisions related to listing agreement, non-despatch of refund orders, share certificates etc. by registered post within the stipulated time frame, the company is going to forfeit such one per cent deposit.

In order to cross check the difference between the promises and performances of the companies, the SEBI has advised stock exchanges to amend the listing agreement and make it obligatory on the part of listed company to furnish annual statement to the SEs showing variations if any, between financial projections, projected utilisation of fund and its actual utilisation.

Setting up of private mutual funds is now being permitted by the Government and a few have been set up. The mutual funds are now permitted to underwrite public issues in order to improve the scope of its investment. SEBI has also relaxed the guidelines for making investment in the money market instruments. Moreover, SEBI has also issued fresh guidelines for making advertisement by mutual funds.

In order to ensure that all disclosures have been clearly made by the company in its offer documents, SEBI checks these documents carefully as a routine job. Various guidelines and regulatory measures of capital issues are incorporated by the SEBI to promote healthy and efficient functioning of the primary market.

Even after the introduction of all these measures, there are many instances of break of issue procedures in collusion with the unscrupulous promoters and corrupt officials of the lead banks and also with the top officials of SEBI as it was found in case of mega-issue of M.S. Shoes East Ltd. in March, 1995.

2. Global Depository Receipts (GDRs):

The Government of India permitted Indian companies to have access in the international capital markets through Euro equity shares since 1992. In the initial period, the Government allowed the utilisation of Euro issue proceeds for approved end uses.

Later on, with the accumulation of foreign exchange reserves with RBI, the issuing companies were allowed to retain the Euro-issue proceeds abroad and repatriate them in times of need.

Till January 1995, Indian Companies have been able to raise US $ 3.6 billion through launching of GDR issues and US $ 1.1 billion through launching of Euro Convertible Bonds (ECBs).

Moreover, the Government of India has also liberalised investment norms for the NRIs sufficiently which has enabled the NRIs and overseas corporate bodies to buy shares and debentures without prior permission from the Reserve Bank of India.

3. Secondary Market Reforms:

SEBI has introduced secondary market reforms and as a part of its reforms, it has started the process of registration of intermediaries like stock brokers and sub-brokers under the provisions of the Securities and Stock Exchange Board Act, 1992.

Here the registration in done on the basis of certain eligibility norms viz., capital adequacy, transparency infrastructure etc. SEBI has also introduced rules so as to make the way for client/broker relationship more transparent and to segregate client and broker accounts.

In order to protect and preserve the integrity of stock markets, the SEBI has introduced certain regulations under the provisions of SEBI Act, which, in turn, would help inspire confidence of the investor in the stock exchanges. Inspite of this, insider trading, rigging of the market and manipulating stock market price quotations are still continuing.

The traditional trading system of Indian SEs has been constantly reviewed by SEBI since 1992. SEBI is instrumental in simplifying procedures, attaining transparency in costs and prices of stocks, speeding up clearing and settlement and transferring shares in the name of buyers. SEBI has prohibited completely the “renewal” of transactions in “B” group securities so as to settle the transactions within 7 days.

SEBI has also issued guidelines for the composition of Governing Body (GB) of stock exchange so as to make it more broad-based. Moreover, SEBI had successfully reconstituted the GBs of stock exchanges in 1994-95.

Government has also permitted the foreign institutional investors (FIIs) like mutual funds, pension funds, investment trusts, asset or portfolio management companies etc. to invest their capital in Indian capital market as and when they are registered with SEBI. Total number of FIIs, registered with SEBI, which was only 10 in January 1993 and 136 in January 1994 has substantially increased to 286 in January 1995.

Besides, the cumulative net investments of FIIs have considerably increased from $ 200 million in January 1993 to $ 3 billion in January 1995, which reflects the growing impact of liberalisation policy of the country.

4. Capital Market Reforms, 1996-97:

An array of capital market reforms were introduced during 1996- 97, encompassing primary and secondary markets, equity and debt, and foreign institutional investment. Primary market reforms aimed at imparting greater flexibility in the issue process and strengthening the criteria for accessing the securities market. Reforms in the secondary market aimed at improving market transparency, integrity and trading infrastructure.

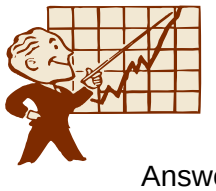
10.18 INVESTOR PROTECTION MEASURES BY SEBI

Investors are the pillar of the financial and securities market. They determine the level of activity in the market. They put the money in funds, stocks, etc. to help grow the market and thus, the economy. It is very important to protect the interest of the investors. Investor protection involves various measures established to protect the interests of investors from malpractices. Securities and Exchange Board of India (SEBI) is responsible for regulations of the Mutual Funds too and safeguard the interests of the investors. Investor protection measures by SEBI are in place to safeguard the investors from the malpractices in shares, the stock market, Mutual Fund, etc. The Role of SEBI in Investor Protection SEBI has given out various methods and measures to ensure the investor protection from time to time. It has published various directives, driven many investor awareness programmes, set up Investor Protection Fund (IPF) to compensate the investors.

Investor protection legislation is implemented under the Section 11(2) of the SEBI Act. The measures are as follows:

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

- Assessment of fees and other charges.



CHECK YOUR PROGRESS

Answer as directed:

a) SEBI was established in _____. (Fill in the gap)

b) A new company which has not completed 12 months' commercial production has to issue shares only _____. (Fill in the gap)

c) Registration of brokers is compulsory. (Write True or False)

d) Investors' protection is the major responsibility of SEBI. (Write True or False)

e) The two national level stock exchanges in India are ..... and ..... of India. (Fill in the gap)

f) SEBI is the ..... for the Securities Market in India. (Fill in the gap)



10.19 LET US SUM UP

In this unit, we have discuss the following :-

- Securities and Exchange Board of India, popularly known as SEBI is the apex body of Indian Stock Market.
- It is the regulator, controller and promoter for securities market in India.
- The Securities and Exchange Board of India was enacted on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.
- The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.
- The Ministry of Finance of the Government of India has overall administrative control over its functions.
- The SEBI is body of six members comprising the chairman, two members from the official of the ministry of central bank dealing with finance and law, two members who are professionals and have experience or special knowledge relating to securities market, and one member from RBI.

- SEBI has a corporate framework comprising various departments each managed by a department head. There are about 20 departments under SEBI.
- The functions of SEBI can be divided into three parts viz: regulatory function, development function, and protective function.



10.20 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- SEBI (Disclosure & Investor Protection) Guidelines 2000
- SEBI (Stock Brokers & Sub Brokers) Regulations 1992
- SEBI (FII) Regulations
- SEBI (Insider Trading) Regulations



10.21 ANSWERS TO CHECK YOUR PROGRESS

(a) April 12, 1992 (b) at par (c) True (d) True (e) Bombay Stock Exchange, National Stock Exchange (f) Regulator



10.22 POSSIBLE QUESTIONS

1. Write short notes on the following:
   b) Organisational structure of SEBI
   c) Book building
   d) Insider trading
   e) Stock invest
2. What is SEBI? What are its objectives? Discuss the role of SEBI in the development of Indian capital market.
3. Discuss about the functions of Securities Exchange Board of India (SEBI). Explain how does SEBI protect the interest of investors?

4. Has SEBI succeeded so far in being the regulator of securities market?
5. Is it necessary for India to have a separate Securities and Exchange Board of India? If yes, elaborate.
6. “Stock trading is a boon as well as bane.” Discuss.
7. What are the differences between Sensex and NIFTY? Analyse the importance of each for Indian capital market.
8. On what basis we take 30 scrips in BSE index for calculating BSE SENSEX?

UNIT 11 : NEW INSTRUMENTS AND PARTICIPANTS IN INDIAN STOCK MARKETS

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Concept of Depository Receipts

11.4 American Depositary Receipts (ADRs)

11.5 Global Depositary Receipt (GDRs)

11.6 Difference between ADR and GDR

11.7 Euro Issues

11.8 Other International Issues (Foreign Euro-Bonds):

11.9 Indian Depository Receipts (IDRs)

11.10 Foreign Institutional Investor (FII)

11.11 Foreign Direct Investment

11.12 Foreign Direct Investment (FDI) in India

11.13 Demutualization

11.14 Let Us Sum Up

11.15 Further Reading

11.16 Answers to Check Your Progress

11.17 Possible Questions

11.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning of depository receipts
- understand the meaning, definition and working of American Depository Receipts (ADRs)
- know the meaning, definition and trading of Global Depository Receipts (GDRs)

- kind the differences between ADRs and GDRs
- describe the meaning, advantages, disadvantages and sources of Euro Issues
- explain the effect of GDRs in Indian capital market
- state the meaning of IDRs and FIIs
- interpret the SEBI guidelines for FIIs
- enumerate meaning and trends of FDIs in India
- state the meaning of Regional Stock Exchange
- know about Demutualisation

11.2 INTRODUCTION

In India, many families save money on a monthly basis from their income mainly to secure their future. Putting ones money in savings account or locker will not help the money to multiply. One can multiply their money by Investing. An individual can invest money in various financial instruments which are available in India. In this unit we will discuss about some capital instruments.

11.3 CONCEPT OF DEPOSITORY RECEIPTS

Many publicly listed companies in India, trades their shares through Bombay Stock Exchange or National Stock Exchange. A lot of companies also want to trade their shares in overseas stock exchange, although the companies need to comply with some policies. In such a situation companies get itself listed through ADR or GDR. For this purpose, the company deposits its shares to the Overseas Depository Bank (ODB) and the bank issues Depository Receipts in exchange for shares. These receipts are then listed on the stock exchange and offered for sale to the foreign investors. Depository Receipts help the Non-Resident Indian's or foreign investors to invest in Indian companies by using their regular equity trading account. Market regulator SEBI sets the ball rolling to give Indian companies increased access to foreign funds

through the American Depository Receipts (ADR) and Global Depository Receipts (GDR) route.

Depository Receipt is a mechanism through which a domestic company can raise finance from the international equity market. In this system, the shares of the company domiciled in one country are held by the depository i.e. Overseas Depository Bank, and issues claim against these shares. Such claims are known as Depository Receipts that are denominated in the convertible currency, mostly US$, but these can also be denominated in Euros. Now, these receipts are listed on the stock exchanges.

11.4 AMERICAN DEPOSITARY RECEIPTS (ADRs)

An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares-or as little as one share-investment in a foreign company's stock. The ADR trades on markets in the U.S. as any stock would trade.

ADRs represent a feasible, liquid way for U.S. investors to purchase stock in companies abroad. Foreign firms also benefit from ADRs, as they make it easier to attract American investors and capital without the hassle and expense of listing themselves on U.S. stock exchanges. The certificates also provide access to foreign listed companies that would not be open to U.S. investment otherwise.

a) Definition of ADR:

American Depository Receipt (ADR) is a negotiable certificate, issued by a US bank, denominated in US$ representing securities of a foreign company trading in the United States stock market. The receipts are a claim against the number of shares underlying. ADR's are offered for sale to American investors. By way of ADR, the US investors can invest in non-US companies. The dividend is paid to the ADR holders, is in US dollars. ADR's are easily transferable, without any stamp duty. The transfer of ADR automatically transfers the number of shares underlying.

b) Working of American Depositary Receipts:

ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution overseas. ADR holders do not have to transact the trade in the foreign currency or worry about exchanging currency on the forex market. These securities clear through U.S. settlement systems. To offer ADRs a U.S. bank will purchase shares on a foreign exchange. The bank will hold the stock as inventory and issue an ADR for domestic trading. ADRs list either on the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or the NASDAQ, but they are also sold over-the-counter (OTC). U.S. banks require that foreign companies provide them with detailed financial information. This requirement makes it easier for American investors to assess a company's financial health.

c) Types of ADRs:

American depositary receipts come in two basic categories:

- A bank issues a sponsored ADR on behalf of the foreign company. The bank and the business enter into a legal arrangement. Usually, the foreign company will pay the costs of issuing an ADR and retaining control over it. While the bank will handle the transactions with investors. Sponsored ADRs are categorized by what degree the foreign company complies with U.S. Securities and Exchange Commission (SEC) regulations and American accounting procedures.
- A bank also issues an unsponsored ADR. However, this certificate has no direct involvement, participation or even permission from the foreign company. Theoretically, there could be several unsponsored ADRs for the same foreign company, issued by different U.S. banks. These different offerings may also offer varying dividends. With sponsored programs, there is only one ADR, issued by the bank working with the foreign company.

One primary difference between the two types of ADRs is where investors can buy them. All except the lowest level of sponsored ADRs register with the SEC and trade on major U.S. stock exchanges. Unsponsored ADRs will trade only over-the-counter. Also, unsponsored ADRs never include voting rights.

ADRs are additionally categorized into three levels, depending on the extent to which the foreign company has accessed the U.S. markets:

- **Level-I**: This is the most basic type of ADR where foreign companies either don't qualify or don't want to have their ADR listed on an exchange. This type of ADR can be used to establish a trading presence but not to raise capital. Level-I ADRs found only on the over-the-counter market has the loosest requirements from the Securities and Exchange Commission (SEC) and they are typically highly speculative. While they are riskier for investors than other types of ADRs, they are an easy and inexpensive way for a foreign company to gauge interest for its securities in the U.S.
- **Level-II:** As with Level-I ADRs, Level-II ADRs can be used to establish a trading presence on a stock exchange, and they can't be used to raise capital. Level-II ADRs have slightly more requirements from the SEC than do Level-I ADRs, but they get higher visibility and trading volume.
- **Level-III:** Level-III ADRs are the most prestigious of the three ADR levels. With these, an issuer floats a public offering of ADRs on a U.S. exchange. They can be used to establish a substantial trading presence in the U.S. financial markets and raise capital for the foreign issuer. They are subject to full reporting with the SEC.

11.5 GLOBAL DEPOSITARY RECEIPT (GDRs)

A Global Depositary Receipt (GDR) is a bank certificate issued in more than one country for shares in a foreign company. A Global Depository Receipt is very similar to an American Depository Receipt (ADR). It is a type of bank certificate that represents shares in a foreign company, such that a foreign branch of an international bank then holds the shares. The shares themselves trade as domestic shares, but, globally, various bank branches offer the shares for sale. Private markets use GDRs to raise capital denominated in either U.S. dollars or Euros. When private markets attempt to obtain Euros instead of U.S. dollars, GDRs are referred to as European Depositary Receipts (EDRs).

Investors trade GDRs in multiple markets, which they generally refer to as capital markets as they are considered to be negotiable certificates. Investors use capital markets to facilitate the trade of long-term debt instruments

and for the purpose of generating capital. GDR transactions in the international market tend to have lower associated costs than some other mechanisms that investors use to trade in foreign securities.

a) Shares per Global Depositary Receipt:

Each GDR represents a particular number of shares in a specific company. A single GDR can represent anywhere from a fraction of a share to multiple shares, depending on its design. In a situation that involves multiple shares, the receipt value shows an amount higher than the price for a single share. Depository banks manage and distribute various GDRs and function in an international context.

b) Definition of GDR:

GDR or Global Depository Receipt is a negotiable instrument used to tap the financial markets of various countries with a single instrument. The receipts are issued by the depository bank, in more than one country representing a fixed number of shares in a foreign company. The holders of GDR can convert them into shares by surrendering the receipts to the bank. Prior approval of Ministry of Finance and FIPB (Foreign Investment Promotion Board) is taken by the company planning for the issue of GDR.

c) Trading of Global Depositary Receipt Shares:

Companies issue GDRs to attract interest by foreign investors. GDRs provide a lower-cost mechanism in which these investors can participate. These shares trade as though they are domestic shares, but investors can purchase the shares in an international marketplace. A custodian bank often takes possession of the shares while the transaction processes, ensuring both parties a level of protection while facilitating participation.

Brokers who represent the buyer manage the purchase and sale of GDRs. Generally, the brokers are from the home country and are sellers within the foreign market. The actual purchase of the assets is multi-staged, involving a broker in the investor's homeland, a broker located within the market associated with the company that has issued the shares, a bank representing the buyer, and the custodian bank.

If an investor desires, brokers can also sell GDRs on their behalf. An investor can sell them as-is on the proper exchanges, or the investor can convert them into regular stock for the company. Additionally, they can be canceled and returned to the issuing company.

d) Effect of GDRs in Indian Capital Market:

Indian capital markets are largely affected by GDRs from its very inception having the following characteristics:

- Transactions from Indian stock market are shifted from domestic to foreign market.
- Since the Indian stock markets depend on the World-wide market, investors are now acquainted with the up to-date economic affairs of the world as well
- Retail investors of India are practically outlined from the investment point of view.

11.6 DIFFERENCE BETWEEN ADR AND GDR

ADR and GDR are commonly used by the Indian companies to raise funds from the foreign capital market. The principal difference between ADR and GDR is in the market; they are issued and in the exchange, they are listed. While ADR is traded on US stock exchanges, GDR is traded on European stock exchanges. ADR and GDR are two depository receipts that are traded in local stock exchange but represent a security issued by a foreign public listed company.

Comparison Chart of ADR and GDR

Basis For Comparison	ADR	GDR
Acronym	American Depository Receipt	Global Depository Receipt
Meaning	ADR is a negotiable instrument issued by a US bank, representing non-US company stock, trading in the US stock exchange.	GDR is a negotiable instrument issued by the international depository bank, representing foreign company's stock trading globally.
Relevance	Foreign companies can trade in US stock market.	Foreign companies can trade in any country's stock market other than the US stock market.
Issued in	United States domestic capital market.	European capital market.
Listed in	American Stock Exchange such as NYSE or NASDAQ	Non-US Stock Exchange such as London Stock Exchange or Luxemberg Stock Exchange.
Negotiation	In America only.	All over the world.
Disclosure Requirement	Onerous	Less onerous
Market	Retail investor market	Institutional market.

11.7 EURO ISSUES

Euro-issues mean the issue which is listed on European Stock Exchange although the subscriptions for the same may come from any corner of the world other than India. Euro issue is a name given to sources of finance or capital available to raise money outside the home country in foreign currency. The most commonly used sources of funds that fall under Euro issues are American Depository Receipts (ADRs), Global Depository Receipts (GDRs), and Foreign Currency Convertible Bonds (FCCB) among others.

- **Global Depository Receipts (GDR):**

Under GDR option, the company is permitted to issue equity shares and companies can keep them in the custody of a domestic custodian. The overseas depository bank, upon instruction from domestic custodian bank,

issues fresh securities in the nature of GDR for the foreign market against shares kept under local custodian bank.

All this happens under strict guidelines permitted by the government of India. In simple words, this essentially is a process of issuing securities in a foreign country by a foreign depository bank which are authorised by the issuing company in the domestic country. These are denominated in foreign currency, usually in U.S. dollars and are listed on exchanges outside the home country.

- **American Depository Receipts (ADRs):**

The ADRs are similar to GDR in all major aspects; however, the differentiating feature is that the ADRs are more likely to be listed and traded on New York Stock Exchange while GDRs are usually listed on exchanges in Europe.

- **Foreign Currency Convertible Bonds (FCCBS):**

FCCBs are very similar to bonds in nature and can be converted into an equity stock by the bond holder at a later date at a pre-agreed price. These, like ADR and GDR, are issued by Indian companies outside the home country in foreign currency. These enjoy higher preference as they are issued as bonds, but at the same time, do not dilute the holding on an immediate basis and can help companies to raise money at a cheaper rate of interest. The FCCBs issued by companies also have to be done within the set of guidelines permitted by the government of India.

a) Advantage of Euro Issues:

Some of the major advantages and limitations of Euro issues to enable the better understanding of the concept and understand why companies find it attractive to raise money through this route are as follows:

- Raising funds by way of euro issue acts as a cheap source of foreign currency funds for the company without exchange risks especially for companies that have foreign currency receivables.
- In a case of funding by way of equity, debt to equity ratios and debt service coverage ratio wouldn't be an issue.

- Euro issues provide a larger market and international access to funds and may lead to easy larger volume funding which may be difficult from domestic sources. It opens up many new opportunities for the companies in new markets.
- Companies gain international exposure and can enhance liquidity for its shares.

B) Disadvantage of Euro Issues:

Despite many advantages of euro issues making it an attractive source of finance for companies; there are few limitations of euro issues which need to be evaluated before choosing the right option. The limitations are given below:

- Though euro issues are usually available at lower costs, companies which do not have adequate receivables may run currency exchange risk and may have to incur hedging costs which may turn out to be higher than the cost saved.
- Not all companies can avail funds via euro issues. The companies have to follow the guidelines issued by Reserve Bank of India and meet the criterions to avail funding through this route.
- Companies may have to undergo stake dilution if raised by way of equity or convertible bonds.

C) Sources of Euro Issues:

- **Foreign Currency Convertible Bonds (FCCB):** Foreign Currency Convertible Bonds (FCCB) is an equity linked foreign currency debt security subscribed by non-residents which can be converted into shares. The Bond has a fixed interest or coupon rate. The interest of the bond may be opted for conversion into equity. The company must have to pay interest in dollars till the conversion takes place. Needless to mention that if the conversion option is not exercised, the redemption of such bonds must be made in dollars.

- **Global Depository Receipts (GDRs)**: Global Depository Receipts (GDR) is a negotiable certificate dominated, in US dollars, issued by

the overseas depository bank outside India against issue of equity shares Each GDR contains one or more shares of the issuing company. These depository receipts may be traded freely either in any international stock exchange or over the counter exchange outside India, or among the restricted groups.

11.8 OTHER INTERNATIONAL ISSUES (FOREIGN EURO-BONDS):

Needless to say that, GDRs is not the single source of investment for receiving foreign currency finance. There is one additional method by which foreign currency finance offered by companies from the International Capital Market the Euro-Bonds. It is interesting to note that domestic capital market of different countries use different names for such bonds issue e.g. Bull Dogs' in U K. Swiss Frances in Switzerland etc. similarly, each domestic market of a country maintains its own rules and regulations. That is why, borrower from one country may borrow in some other country's currency of course according to the rules and regulations prevailed in that country.

The different types of foreign bonds:

- **Euro – Convertible Bonds:** We know that a convertible bond is a debt instrument that provides the holder of the bond an option to convert the bond into equity shares of the company. Normally, at the time of conversion, the price of the equity shares is inclusive of certain premium money although the bonds carry fixed percentage of interest.

- **Euro-Convertible Zero-Bonds**: These bonds also are similar to convertible bonds. Interest is not paid on the bonds. At the same time conversion of bonds is made on marketing at pre-determined price. Normally the period of maturity is taken for 5 years.

- **Euro-Bonds with Equity Warrants**: These bonds contain a coupon rate/prices which has been determined by the market rate/ price. Pure

bonds are transacted at a discount. The investors who prefer to create a fixed income funds may use these bonus for their purposes.

- **General Euro-Bonds**: It has already been explained that bonds are debt instruments. Thus a plain Euro-Bond is also a debt instrument. Investor who wants to invest his investment for the purpose of adding/ increasing his investments do not prefer it.

11.9 INDIAN DEPOSITORY RECEIPTS (IDRs)

An Indian Depository Receipt (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India) against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian Securities Markets. The IDR is a specific Indian version of the similar global depository receipts. A foreign company can access Indian securities market for raising funds through issue of Indian Depository Receipts (IDRs). The foreign company IDRs will deposit shares to an Indian depository. The depository would issue receipts to Indian investors against these shares. The benefit of the underlying shares (like bonus, dividends etc.) would accrue to the depository receipt holders in India. IDR's are based on the original American Depository Receipts that were first introduced in 1927 in the US.

The Ministry of Corporate Affairs of the Government of India, using section 642 read with section 605A had prescribed the Companies (Issue of Indian Depository Receipts) Rules, 2004 (IDR Rules) vide notification number GSR 131(E) dated February 23, 2004. The rules for IDRs were operationalized by the SEBI, the Indian markets regulator in 2006. Operation instructions under the Foreign Exchange Management Act were issued by the Reserve bank of India on July 22, 2009. The SEBI has been notifying amendments to these guidelines from time to time. The Standard Chartered PLC became the first global company to file for an issue of Indian depository receipts in India in 2010.

a) Eligibility to Issue IDRs:

The regulations relating to the issue of IDRs is contained in Securities and Exchange Board of India (Issue of capital and disclosure requirements) Regulations, 2009, as revised from time to time. According to Clause 26 in Chapter III ("Provisions as to public issue"), the following are required of any company intending to make a public issue in India:

- It has net tangible assets of at least Indian Rupee three crore in each of the preceding three full years (of twelve months each), of which not more than fifty per cent are held in monetary assets: Provided that if more than fifty percent of the net tangible assets are held in monetary assets, the issuer has made firm commitments to use such excess monetary assets in its business or project;
- It has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least three out of the immediately preceding five years: Provided that extraordinary items shall not be considered for calculating distributable profits;
- It has a net worth of at least INR one crore in each of the preceding three full years (of twelve months each);
- The aggregate of the proposed issue and all previous issues made in the same financial year in terms of issue size does not exceed five times its pre-issue net worth as per the audited balance sheet of the preceding financial year;
- If it has changed its name within the last one year, at least fifty per cent. of the revenue for the preceding one full year has been earned by it from the activity indicated by the new name.

Further, Clause 97 in Chapter X stipulates additional requirements from a foreign company intending to make an issue of IDRs, an issuing company making an issue of IDR shall also satisfy the following:

- The issuing company is listed in its home country;
- The issuing company is not prohibited to issue securities by any regulatory body;

- The issuing company has track record of compliance with securities market regulations in its home country.

b) Issue Process:

According to SEBI guidelines, IDRs will be issued to Indian residents in the same way as domestic shares are issued. The issuer company will make a public offer in India, and residents can bid in exactly the same format and method as they bid for Indian shares. The issue process is exactly the same: the company will file a draft Red Herring Prospectus (DRHP), which will be examined by SEBI. The general body of investors will get a chance to read and review the DRHP as it is a public document, available on the websites of SEBI and the book running lead managers. After SEBI gives its clearance, the company sets the issue dates and files the document with the Registrar of Companies.

In the next step, after getting the Registrar's registration ticket, the company can go ahead with marketing the issue. The issue will be kept open for a fixed number of days, and investors can submit their application forms at the bidding centers. The investors will bid within the price band and the final price will be decided post the closure of the Issue. The receipts will be allotted to the investors in their demat account as is done for equity shares in any public issue. On 26 October 2010, SEBI notified the framework for rights issue of Indian Depository Receipts (IDRs). Disclosure requirement for IDR rights would more or less be in line with the reduced requirement applicable for domestic rights issue.

11.10 FOREIGN INSTITUTIONAL INVESTOR (FII)

A foreign institutional investor (FII) is an investor or investment fund registered in a country outside of the one in which it is investing. Institutional investors most notably include hedge funds, insurance companies, pension funds, and mutual funds. The term is used most commonly in India and refers to outside companies investing in the financial markets of India.

A foreign institutional investor (FII) is any type of large investor who does business in a country other than the one in which the investment instrument is being purchased. In addition to the types of investors above, others include banks, large corporate buyers or representatives of large institutions. All FIIs take a position in a foreign financial market on behalf of the home country in which they are registered.

a) Definition of Foreign institutional investors:

Foreign institutional investors (FIIs) are those institutional investors which invest in the assets belonging to a different country other than that where these organizations are based. Foreign institutional investors play a very important role in any economy. These are the big companies such as investment banks, mutual funds etc, who invest considerable amount of money in the Indian markets. With the buying of securities by these big players, markets trend to move upward and vice-versa. They exert strong influence on the total inflows coming into the economy.

Market regulator SEBI has over 1450 foreign institutional investors registered with it. The FIIs are considered as both a trigger and a catalyst for the market performance by encouraging investment from all classes of investors which further leads to growth in financial market trends under a self-organized system.

b) Foreign Institutional Investors (FII) in India:

Countries with the highest volume of foreign institutional investments are those that have developing economies. These types of economies provide investors with higher growth potential than in mature economies. This is why these investors are most commonly found in India, all of which must register with the SEBI to participate in the market.

Foreign Portfolio/Institutional Investors (FPI/FII) have been one of the biggest drivers of India's financial markets and have invested around Rs 13.39 trillion (US$ 191.60 billion) in India between FY02-20 (till December 4, 2019). Highly developed primary and secondary markets have attracted FIIs/FPIs to the country. Investments by FIIs/FPIs in India are regulated by the Securities and Ex-

change Board of India (SEBI) while the ceilings on such investments are maintained by the Reserve Bank of India (RBI). Following are the few types of FIIs investing in India:

- Hedge Funds
- Foreign Mutual Funds
- Sovereign Wealth Funds
- Pension Funds
- Trusts
- Asset management Companies
- Endowments, University Funds, etc.

The total market capitalisation (M-cap) of all the companies listed on Bombay Stock Exchange (BSE) rose to a record high level of Rs 151.08 trillion (US$ 2.16 trillion) in 2018-19 and reached Rs 154.12 trillion (US$ 2.20 trillion) in 2019-20.

c) Recent Developments/Investments:

Some of the recent significant FII/FPI developments are as follows:

- In 2018-19, India ranked seventh with a market cap of US$ 2.1 trillion.
- From February to June 2019, FIIs invested a net of US$ 11.4 billion in Indian equities.
- Domestic Institutional Investors (DIIs) and foreign portfolio investors (FPI) together invested Rs 1.43 lakh crore (around US$ 20 billion) in 2019.
- Foreign institutional ownership increased to an eight-quarter high of 20.93 per cent by the end of September for 414 firms in the BSE 500 index.
- In quarter 2 (up to September 2019), FIIs have sold Indian shares worth US$ 3.17 billion.
- Union Bank of Switzerland (UBS) maintained its Nifty target at 9,500 by March 2019.
- Morgan Stanley has set its Sensex target to 40,000 by June 2020.

- Investments by foreign portfolio investors (FPIs) in Indian capital markets have reached net Rs 10,312 crore (US$ 1.48 billion) investments in June 2019. FPIs invested Rs 1,937.54 crore (US$ 277.23 million) into debt segment during August 1-9,2019.
- In September 2018, Embassy Office Parks filed the papers for India's first Real Estate Investment Trusts (REIT). In September 2019, Embassy Office Parks announced plans to expand its portfolio in Hyderabad and Chennai and list nation's second REIT in 2020-21.

d) Government/Regulatory Initiatives:

- In May 2019, SEBI proposed reducing the overall time taken for rights issue from 55-58 days to around 31 days. This will make the application and allotment process more efficient.
- In September 2018, SEBI has reduced the time to list shares on stock exchange after initial public offerings to three days from previous six days.
- A report filed by a panel appointed by the Securities and Exchange Board of India on December 04, 2018 has proposed direct overseas listing of Indian companies and other regulatory changes.
- In September 2018, the Securities and Exchange Board of India relaxed the Know-Your-Client (KYC) requirement for Foreign Portfolio Investors (FPIs).
- In September 2018, SEBI allowed Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) to start commodity derivate segments.
- SEBI has also allowed foreign entities to participate in the commodity derivatives segment of Indian stock exchanges, to help them hedge their exposures. It has also proposed to allow Non Resident Indians (NRIs) to invest through FPI route after meeting specific KYC norms.
- In August 2018, SEBI reduced the timeline for public issue of debt securities from 12 days to six days.
- Foreign Portfolio Investors are also allowed to invest up to 25 per cent in Category III Alternative Investment Funds (AIF) in India. Different types

of funds such as hedge funds, Private Investment in Public Equity (PIPE) funds, etc. are operating in India as Category III AIFs.

- Investments by FPIs have also been allowed in Real Estate Investment Trusts (REITs) and Infrastructure Investment Trust (InvITs).

e) Example of a Foreign Institutional Investor (FII):

If a mutual fund in the United States sees an investment opportunity in an Indian-based company, it can purchase the equity on the Indian public exchange and take a long position in a high-growth stock. This also benefits domestic private investors who may not be able to register with the Securities and Exchange Board of India. Instead, they can invest in the mutual fund and take part in the high growth potential.

f) Regulations for Investing in Indian Companies:

All FIIs are allowed to invest in India's primary and secondary capital markets only through the country's Portfolio Investment Scheme (PIS). This scheme allows FIIs to purchase shares and debentures of Indian companies on the normal public exchanges in India.

However, there are many regulations included in the scheme. There is a ceiling for all FIIs that states the max investment amount can only be 24% of the paid-up capital of the Indian company receiving the investment. The maximum investment can be increased above 24% through board approval and the passing of a special resolution. The ceiling is reduced to 20% of the paid-up capital for investments in public sector banks.

The RBI monitors daily compliance with these ceilings for all foreign institutional investments. It checks compliance by implementing cutoff points 2% below the max investment amounts. This gives it a chance to caution the Indian company receiving the investment before allowing the final 2% to be invested.

11.11 FOREIGN DIRECT INVESTMENT

A Foreign Direct Investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in an-

other country. It is thus distinguished from a foreign portfolio investment by a notion of direct control. In simple words, foreign direct investments are investments made by one company into another located in another country. FDIs are actively utilized in open markets rather than closed markets for investors.

A foreign direct investment is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets, including establishing ownership or controlling interest in a foreign company. However, FDIs are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies.

Foreign direct investments are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies. Foreign direct investment frequently involves more than just a capital investment. It may include provisions of management or technology as well. The key feature of foreign direct investment is that it establishes either effective control of or at least substantial influence over the decision-making of a foreign business. FDIs not only bring money with them but also skills, technology and knowledge.

11.12 FOREIGN DIRECT INVESTMENT (FDI) IN INDIA

Apart from being a critical driver of economic growth, foreign direct investment (FDI) is a major source of non-debt financial resource for the economic development of India. Foreign companies invest in India to take advantage of relatively lower wages, special investment privileges such as tax exemptions, etc. For a country where foreign investments are being made, it also means achieving technical know-how and generating employment.

The Indian government's favourable policy regime and robust business environment have ensured that foreign capital keeps flowing into the country. The government has taken many initiatives in recent years such as relaxing FDI norms across sectors such as defence, PSU oil refineries, telecom, power exchanges, and stock exchanges, among others.

FDI is an important monetary source for India's economic development. Economic liberalisation started in India in the wake of the 1991 crisis and since then, FDI has steadily increased in the country. Today, India is a part of top 100-club on Ease of Doing Business (EoDB) and globally ranks number one in the greenfield FDI ranking.

a) Routes through which India gets FDI:

- **Automatic route:** The non-resident or Indian company does not require prior nod of the RBI or government of India for FDI. Sectors which come under up to 100% Automatic Route' category are:
    - Infrastructure Company in the Securities Market: 49%
    - Insurance: up to 49%
    - Medical Devices: up to 100%
    - Pension: 49%
    - Petroleum Refining (By PSUs): 49%
    - Power Exchanges: 49%
- **Govt. route:** The government's approval is mandatory. The company will have to file an application through Foreign Investment Facilitation Portal, which facilitates single-window clearance. The application is then forwarded to the respective ministry, which will approve/reject the application in consultation with the Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce. DPIIT will issue the Standard Operating Procedure (SOP) for processing of applications under the existing FDI policy. Sectors which come under the 'up to 100% Government Route' category are:
    - Banking & Public sector: 20%
    - Broadcasting Content Services: 49%
    - Core Investment Company: 100%
    - Food Products Retail Trading: 100%
    - Mining & Minerals separations of titanium bearing minerals and ores: 100%
    - Multi-Brand Retail Trading: 51%

- Print Media (publications/ printing of scientific and technical magazines/ specialty journals/ periodicals and facsimile edition of foreign newspapers): 100%
- Print Media (publishing of newspaper, periodicals and Indian editions of foreign magazines dealing with news & current affairs): 26%
- Satellite (Establishment and operations): 100%

b) FDI prohibition:

There are a few industries where FDI is strictly prohibited under any route. These industries are:

- Atomic Energy Generation
- Any Gambling or Betting businesses
- Lotteries (online, private, government, etc)
- Investment in Chit Funds
- Nidhi Company
- Agricultural or Plantation Activities (although there are many exceptions like horticulture, fisheries, tea plantations, Pisciculture, animal husbandry, etc.)
- Housing and Real Estate (except townships, commercial projects, etc)
- Trading in TDR's
- Cigars, Cigarettes, or any related tobacco industry

c) FDI inflow:

During the fiscal ended March 2019, India received the highest-ever FDI inflow of $64.37 billion. The FDI inflows were $45.14 billion during 2014-15 and $55.55 billion in the following year. According to the Department for Promotion of Industry and Internal Trade (DPIIT), FDI equity inflows in India stood at US$ 446.11 billion during March 2000 to September 2019, indicating that government's effort to improve ease of doing business and relaxation in FDI norms is yielding results.

FDI equity inflows in India stood at US$ 26.09 billion during April-September 2019. Data for Q2 2019-20 indicates that the service sector attracted the highest FDI equity inflow of US$ 4.45 billion, followed by telecommunications sector - US$ 4.28 billion, computer software and hardware – US$ 4.02 billion, and trading – US$ 2.14 billion. During Q2 2019-20, India received the maximum FDI equity inflows from Singapore (US$ 8.01 billion), followed by Mauritius (US$ 6.36 billion), Netherlands (US$ 2.32 billion), USA (US$ 2.15 billion), and Japan (US$ 1.78 billion).

d) Investments/ developments:

Some of the recent significant FDI announcements are as follows:

- In January 2020, Amazon India announced investment of US$ 1 billion for digitising small and medium businesses and creating one million jobs by 2025.
- In January 2020, Mastercard announced its plans to invest up to US$ 1 billion in India over next five years to double-up its research and development efforts for the Indian market.
- In October 2019, French oil and gas giant Total S.A. have acquired a 37.4 per cent stake in Adani Gas Ltd for Rs 5,662 crore (US$ 810 million) making it the largest Foreign Direct Investment (FDI) in India's city gas distribution (CGD) sector.
- In August 2019, Reliance Industries (RIL) announced one of India's biggest FDI deals, as Saudi Aramco will buy a 20 per cent stake in Reliance's oil-to-chemicals (OTC) business at an enterprise value of US$ 75 billion.
- In October 2018, VMware, a leading software innovating enterprise of US has announced investment of US$ 2 billion in India between by 2023.
- In August 2018, Bharti Airtel received approval of the Government of India for sale of 20 per cent stake in its DTH arm to an America based private equity firm, Warburg Pincus, for around $350 million.

- In June 2018, Idea's appeal for 100 per cent FDI was approved by Department of Telecommunication (DoT) followed by its Indian merger with Vodafone making Vodafone Idea the largest telecom operator in India
- In May 2018, Walmart acquired a 77 per cent stake in Flipkart for a consideration of US$ 16 billion.
- In February 2018, Ikea announced its plans to invest up to Rs 4,000 crore (US$ 612 million) in the state of Maharashtra to set up multi-format stores and experience centres.

e) Government Initiatives:

In August 2019, government permitted 100 per cent FDI under the automatic route in coal mining for open sale (as well as in developing allied infrastructure like washeries). In Union Budget 2019-20, the government of India proposed opening of FDI in aviation, media (animation, AVGC) and insurance sectors in consultation with all stakeholders. 100 per cent FDI is permitted for insurance intermediaries.

As of February 2019, the Government of India is working on a road map to achieve its goal of US$ 100 billion worth of FDI inflows. In February 2019, the Government of India released the Draft National E-Commerce Policy which encourages FDI in the marketplace model of e-commerce. Further, it states that the FDI policy for e-commerce sector has been developed to ensure a level playing field for all participants.

Government of India is planning to consider 100 per cent FDI in Insurance intermediaries in India to give a boost to the sector and attracting more funds. In December 2018, the Government of India revised FDI rules related to e-commerce. As per the rules 100 per cent FDI is allowed in the marketplace-based model of e-commerce. Also, sales of any vendor through an e-commerce marketplace entity or its group companies have been limited to 25 per cent of the total sales of such vendor. In September 2018, the Government of India released the National Digital Communications Policy, 2018 which envisages increasing FDI inflows in the telecommunications sector to US$ 100 billion by 2022.

In January 2018, Government of India allowed foreign airlines to invest in Air India up to 49 per cent with government approval. The investment cannot exceed 49 per cent directly or indirectly. No government approval will be required for FDI up to an extent of 100 per cent in Real Estate Broking Services. The Government of India is in talks with stakeholders to further ease foreign direct investment (FDI) in defence under the automatic route to 51 per cent from the current 49 per cent, in order to give a boost to the Make in India initiative and to generate employment.

11.13 DEMUTUALIZATION

Demutualization is a process by which a private, member-owned company, such as a co-operative, or a mutual life insurance company, legally changes its structure, in order to become a public-traded company owned by shareholders. The idea is to change the structure of exchanges that were originally formed as trusts. Demutualisation allows such associations to conduct commercial business to make a profit just like a normal. Demutualization is when a company structured as a mutual company transitions to a stockholder corporation. The most commonplace that demutualization happens is among companies in the life insurance sector.

Demutualization refers to the conversion of an existing non-profit organization into a profits-oriented company. In other words, an association that is mutually owned by members converts itself into an organization that is owned by shareholders. The company can take different shapes and forms, that is, it could be either a listed or unlisted company which may be closely held or publicly held. This process involves the segregation of members' right into distinct segments, viz. ownership rights and trading rights. It changes the relationship between members and the stock exchange. Members while retaining their trading rights acquire ownership rights in the stock exchange, which have a market value, and they also acquire the benefits of limited liability.

Demutualization involves the complex process of transitioning a company's financial structure, from a mutual company into a shareholder-driven model. Mutual companies (not to be confused with mutual funds) are entities seeded by private investors who are also customers or members of these

operations. Businesses such as insurance companies, savings and loan associations, banking trusts, and credit unions are commonly structured as mutual companies. Mutual insurance companies typically collect policyholder premiums from their members and spread risk and profits through various mechanisms.

Thus demutualization refers to the transition process of an exchange from a "mutually-owned" association to a company "owned by shareholders". In other words, transforming the legal structure of an exchange from a mutual form to a business corporation form is referred to as demutualization.

Any organization that is a non-profit body (which is not the same as loss-making), and is not distributing its profits to owner-members but retains the same to develop infrastructure of the organization, can demutualise. For instance, Australia's life insurer and funds manager AMP recently demutualised, as did Sun Life Assurance, the Canadian insurance firm. Recently, several stock exchanges like the London Stock Exchange and two US stock exchanges, New York Stock Exchange and Nasdaq, have announced that they will demutualise.

The first exchange to get demutualized was the Stockholm Stock Exchange in 1993. After that many exchanges have demutualized. This includes the major stock exchanges like New York Stock Exchange, Chicago Mercantile Exchange, London Stock Exchange, Australian stock Exchange, Deutsche Börse, Toronto Stock Exchange, Singapore Stock Exchange to name a few.

After demutualization, the ownership, the management and the trading rights at the exchange are segregated from one another. A demutualised exchange is way different from a mutual exchange; the three functions of ownership, management and trading are intervened into a single Group in a mutual exchange. A demutualised exchange has all these three functions clearly segregated.

a) Demutualization of Stock Exchanges in India:

SEBI had formed a Group on Corporatisation and Demutualization of Stock Exchanges under the Chairmanship of Justice M H Kania, former Chief Justice of India, for advising SEBI on corporatization and demutualization of exchanges and to recommend the steps that need to be taken to implement the same. The Group submitted its Report to SEBI on August 28, 2002.

The process of demutualising all the broker-run exchanges in India actually started with the Bombay Stock Exchange which was demutualised in August 2005. In the UK, the London Stock Exchange got demutualised in March 2000. In the case of both these exchanges, the legal process was broadly the same: conversion from a not-for-profit mutual entity, i.e., an association of stock-brokers, into a for-profit public limited company. However, the underlying purpose of demutualisation in India is absolutely different from that in the UK.

In India, demutualisation was mandated by the government as a regulatory measure directed at ending the brokers' control over the exchanges. By contrast, the London SE's demutualisation was entirely its own voluntary decision, aimed at developing its business in the fast changing and globalising world. This step was expected to improve its international competitiveness, provide greater flexibility, facilitate speedier decision-making, and enable it to form international alliances, as and when necessary.

b) Process of Demutualization:

Corporatisation of Stock Exchanges is the process of converting the organizational structure of the stock exchange from a non-corporate structure to a corporate structure. Traditionally, some of the stock exchanges in India were established as "Association of persons", like BSE, ASE and MPSE. Corporatisation of these exchanges is the process of converting them into incorporated Companies.

c) Forces behind the Demutualization:

Demutualization as a concept is neither a very new concept nor very sophisticated. The essence lies with the separation of ownership and management. Thus it is well driven by the good intentions of proper governance, which has taken a new turn after the collapse of many large corporations in the year 2002.

d) Advantages of Demutualization:

The advantages of demutualized stock exchange are as follows.

- Demutualization results in more flexible governance structure fostering decisive action in response to changes in the business environment.
- It leads to greater investor participation in the governance of the exchange.

- It yields an improved platform in response to potential competitors in the form of alternative trading systems.
- Demutualization allows greater flexibility and access to global markets.
- It also facilitates faster and more complete consolidation of stock exchanges to enhance available synergies.
- It ensures increased access to resources for capital investment raised by way of equity offerings or private investment.



CHECK YOUR PROGRESS

Write the full form of the following:

a) ADRs

b) GDRs

c) ODB

d) IDRs

e) FIIs

f) RSEs

g) FDI

h) NRIs

i) FCCB



11.14 LET US SUM UP

In this unit, we have discuss the following :-

- Companies want to trade their shares in overseas stock exchange need to get them listed through ADR or GDR.
- For this purpose, the company deposits its shares to the Overseas Depository Bank (ODB) and the bank issues Depository Receipts in exchange for shares.

- Depository Receipt is a mechanism through which a domestic company can raise finance from the international equity market.
- An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares-or as little as one share-investment in a foreign company's stock.
- A Global Depositary Receipt (GDR) is a bank certificate issued in more than one country for shares in a foreign company.
- Euro-issues mean the issue which is listed on European Stock Exchange although the subscriptions for the same may come from any corner of the world other than India.
- An Indian Depository Receipt (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian securities Markets.
- A foreign institutional investor (FII) is any type of large investor who does business in a country other than the one in which the investment instrument is being purchased.
- A Foreign Direct Investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country.
- FDI is a major source of non-debt financial resource for the economic development of India.
- A regional stock exchange is a stock exchange not located in that country's primary financial centers, and where regional companies are listed.
- Demutualization is a process by which a private, member-owned company, such as a co-operative, or a mutual life insurance company, legally changes its structure, in order to become a public-traded company owned by shareholders.



11.15 FURTHER READINGS

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

- Financial Services – By M. P. Tripathy



11.16 ANSWERS TO CHECK YOUR PROGRESS

a) American Depository Receipts
b) Global Depository Receipts
c) Overseas Depository Bank
d) Indian Depository Receipts
e) Foreign Institutional Investor
f) Regional Stock Exchanges
g) Foreign Direct Investment
h) Non Resident Indians
i) Foreign Currency Convertible Bonds



11.17 POSSIBLE QUESTIONS

1. Write short notes on the following:
   a) American Depository Receipts (ADRs)
   b) Global Depository Receipts (GDRs)
   c) Indian Depository Receipts (IDRs)
   d) Euro Issues
   e) Foreign Institutional Investor (FIIs)
   f) Regional Stock Exchanges (RSEs)
   a) Foreign Direct Investment (FDI)
2. Distinguish between ADRs and GDRs.
3. Give the meaning of ADRs. Write a detail note on types and working procedure of ADRs.
4. What do you mean by GDRs? Describe the effects of GDRs in Indian capital market.
5. What is FDI? Enumerate the need for FDIs in India.

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Unit 12 : DERIVATIVES MARKETS

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Meaning and Definition of Derivatives

12.4 Classifications of Derivatives

12.5 Participants in the Derivatives Market

12.6 Characteristics of Derivatives

12.7 Functions of Derivatives

12.8 Benefits of Derivatives

12.9 Exchange Traded Derivatives

12.10 Development of Exchange-Traded Derivatives

12.11 Exchange Traded Vs. OTC Derivatives Markets

12.12 Global Derivatives Market

12.13 Derivatives Market in India

12.14 Historical Development of Derivative Market in India

12.15 Origin of the Derivatives Market in India

12.16 L. C. Gupta Committee on Derivatives

12.17 Recommendations of Prof. J. R. Varma Committee Report

12.13 Let Us Sum Up

12.14 Further Reading

12.15 Answers to Check Your Progress

12.16 Possible Questions

12.1 LEARNING OBJECTIVES

After reading this unit you will able to:

- know the Meaning of Derivatives
- discusse the Characteristics of Derivatives
- functions of derivatives know the
- users of derivatives know the
- salient Points of derivatives explain

12.2 INTRODUCTION

In the present state of the economy, there is an imperative need for the corporate clients to protect their operating profits by shifting some of the uncountable financial risks to those who are able to bear and manage them. In this context, derivatives occupy an important place as a risk reducing machinery. This unit discusses about the meaning, types, functions and many other aspects of derivatives in Indian context.

12.3 MEANING AND DEFINITION OF DERIVATIVES

A derivative is a financial instrument that derives its value from an underlying asset. The underlying asset can be equity, currency, commodities, or interest rate. Thus, a change in the underlying asset leads to an equivalent change in the derivative. Derivative markets are investment markets where derivative trading takes place. The derivatives market refers to the financial markets for financial instruments such as underlying assets and financial derivatives. Derivatives are contracts which derive their value from the underlying assets. These are widely used to speculate and make money. Some use them as a risk transfer vehicle as well.

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

Derivatives are financial contracts whose value is dependent on an underlying asset or group of assets. The commonly used assets are stocks, bonds, currencies, commodities and market indices. The value of the underlying assets keeps changing according to market conditions. The basic principle behind entering into derivative contracts is to earn profits by speculating

on the value of the underlying asset in future. Imagine that the market price of an equity share may go up or down. You may suffer a loss owing to a fall in the stock value. In this situation, you may enter a derivative contract either to make gains by placing accurate bet. Or simply cushion yourself from the losses in the spot market where the stock is being traded.

According to Securities Contract Regulation Act (SCRA) 1956, derivatives may be defined as:

a) A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security;

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

D.G. Gardener defined the derivatives as "A derivative is a financial product which has been derived from market for another product."

The above definition conveys that the derivatives are financial products. Derivative is derived from another financial instrument/ contract called the underlying. A derivative derives its value from underlying assets.

Accounting standard SFAS133 defines "a derivative instrument is a financial derivative or other contract which will comprise of all three of the following characteristics:

(i) It has one or more underlying asset, and one or more notional amount or payments provisions or both. Those terms determine the amount of the settlement or settlements.

(ii) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors.

(iii) Its terms require or permit net settlement. It can be readily settled net by a means outside the contract or it provides for delivery of an asset that puts the recipients in a position not substantially different from net settlement

12.4 CLASSIFICATIONS OF DERIVATIVES

Derivative contracts can be classified into the following four types:

a) Forward Contract: A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future. In case of a forward contract the price which paid/received by the parties is decided at the time of entering into contract. It is the simplest form of derivative contract mostly entered by individuals in day to day's life. Forward contract is a cash market transaction in which delivery of the instrument is deferred until the contract has been made. Although the delivery is made in the future, the price is determined on the initial trade date. One of the parties to a forward contract assumes a long position (buyer) and agrees to buy the underlying asset at a certain future date for a certain price. The other party to the contract known as seller assumes a short position and agrees to sell the asset on the same date for the same price. The specified price is referred to as the delivery price. The contract terms like delivery price and quantity are mutually agreed upon by the parties to the contract. No margins are generally payable by any of the parties to the other. Forwards contracts are traded over-the-counter and are not dealt with on an exchange unlike futures contract. Lack of liquidity and counter party default risks are the main drawbacks of a forward contract.

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

- These are traded on an organised exchange like IMM, LIFFE, NSE, BSE, CBOT etc.
- These involve standardized contract terms viz. the underlying asset, the time of maturity and the manner of maturity etc.
- These are associated with a clearing house to ensure smooth functioning of the market.

- There are margin requirements and daily settlement to act as further safeguard.
- These provide for supervision and monitoring of contract by a regulatory authority.
- Almost ninety percent future contracts are settled via cash settlement instead of actual delivery of underlying asset.

c) Options Contract: Options are financial derivative contracts that give the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price (referred to as the strike price) during a specific period of time. American options can be exercise at any time before the expiry of its option period. On the other hand, European options can only be exercised on its expiration date.

In case of futures contact, both parties are under obligation to perform their respective obligations out of a contract. But an options contract, as the name suggests, is in some sense, an optional contract. An option is the right, but not the obligation, to buy or sell something at a stated date at a stated price. A 'call option' gives one the right to buy; a 'put option' gives one the right to sell. Options are the standardized financial contract that allows the buyer (holder) of the option, i.e. the right at the cost of option premium, not the obligation, to buy (call options) or sell (put options) a specified asset at a set price on or before a specified date through exchanges.

Options contracts are of two types: call options and put options. Apart from this, options can also be classified as OTC (Over the Counter) options and exchange traded options. In case of exchange traded options contract, contracts are standardized and traded on recognized exchanges, whereas OTC options are customized contracts traded privately between the parties. A call options gives the holder (buyer/one who is long call), the right to buy specified quantity of the underlying asset at the strike price on or before expiration date. The seller (one who is short call) however, has the obligation to sell the underlying asset if the buyer of the call option decides to exercise his option to buy.

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

12.5 PARTICIPANTS IN THE DERIVATIVES MARKET

Derivatives contracts are being bought and sold by a large number of individuals, business organizations, governments and others for a variety of purposes. The participants in the derivatives market can be broadly categorized into the following four groups:

i) Hedgers: Hedging is when a person invests in financial markets to reduce the risk of price volatility in exchange markets, i.e., eliminate the risk of future price movements. Derivatives are the most popular instruments in the sphere of hedging. It is because derivatives are effective hedges in correspondence with their respective underlying assets.

The prime aim of the introduction of futures markets is to allow for companies and individuals to protect themselves against future unfavourable changes in prices (for financial futures in particular changes in interest and exchange rates). As a result the futures market serves as the way of reducing or even eliminating risk. This is achieved through hedging. An example of a case that requires hedging could be when someone is obliged to hold a large inventory of a commodity that cannot be sold until a later date. A futures contract would be used to hedge against any future price fluctuations (fix the price) by having the hedger going short the commodity futures (short hedging). If the price of the asset goes down the investor does not perform well on the sale of the asset, but makes a gain on the short futures position. If the price of the

asset goes up, the investor gains from the sale of the asset, but makes a loss on the futures position. It is quite possible that the prices will fluctuate in such a way that the investor would have been better off if he/she had not undertaken the hedging strategy. However, the purpose of hedging is no other than to reduce the risk being faced or will be faced by making the outcome more certain. It does not necessarily improve the outcome.

ii) Speculators:

Speculation is the most common market activity that participants of a financial market take part in. It is a risky activity that investors engage in. It involves the purchase of any financial instrument or an asset that an investor speculates to become significantly valuable in the future. Speculation is driven by the motive of potentially earning lucrative profits in the future.

The risk reduced by hedging is transferred to the counterparty to the trade, who may be another hedger with opposite requirements or a speculator. Speculators expose themselves to risk by buying or selling in futures market in order to profit from the future price fluctuations (buy an asset when the price is low and sell it when it is high) and thus, provide liquidity to the market. They are classified according to their methods. Speculators seek to trade profitably based on price movements in the next few minutes. (They try to profit by a few ticks per trade on a large number of transactions). Day traders close out their futures positions on the same day that the positions were initiated, so as to avoid large price movements when the market is closed. Position traders, keep a futures position for long periods of time (weeks or even months) so that price moves in a favourable way to their position.

iii) Arbitrageurs:

Arbitrage is a very common profit-making activity in financial markets that comes into effect by taking advantage of or profiting from the price volatility of the market. Arbitrageurs make a profit from the price difference arising in an investment of a financial instrument such as bonds, stocks, derivatives, etc

Arbitrageurs are investors who exploit price discrepancies between markets by entering into transactions in two or more markets. When the op-

portunity emerges, an arbitrageur tries to take advantage of it by buying in one market at a particular ‘price and simultaneously selling in the other market at a higher price. However, these price discrepancies can only be temporary since they can easily be eliminated by the arbitrage process itself. This is done, because the purchase in one market will drive prices up for that market, while the sale in the other will drive prices down. Consequently, arbitrage is very important for keeping futures and underlying spot prices in line.

iv) Margin traders:

In the finance industry, the margin is the collateral deposited by an investor investing in a financial instrument to the counterparty to cover the credit risk associated with the investment. A margin refers to the minimum amount that you need to deposit with the broker to participate in the derivative market. It is used to reflect your losses and gains on a daily basis as per market movements. It enables to get leverage in derivative trades and maintain a large outstanding position.

12.6 CHARACTERISTICS OF DERIVATIVES

- Derivatives have the characteristic of Leverage or Gearing. With a small initial outlay of funds (a small percentage of the entire contract value) one can deal big volumes.
- Pricing and trading in derivatives are complex and a through understanding of the price behaviour and product structure of the underlying is an essential pre-requisite before one can venture into dealing in these products.
- Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.

12.7 FUNCTIONS OF DERIVATIVES

- **Risk management:** The prices of derivatives are related to their underlying assets, as mentioned before. They can thus be used to increase or decrease the risk of owning the asset. For example,

you can reduce your risk by buying a spot item and selling a future contract or call option. This is how it works. If there is a fall in the spot price, the corresponding futures and options contract will also fall. You can repurchase the contract at a lower price, which will result in a gain. This can partially offset the loss on the spot item. The ease of speculation in the derivatives market makes it easier for an investor seeking to protect a position or an anticipated position in the spot market.

- **Price discovery:** Derivative market serves as an important source of information about prices. Prices of derivative instruments such as futures and forwards can be used to determine what the market expects future spot prices to be. In most cases, the information is accurate and reliable. Thus, the futures and forwards markets are especially helpful in price discovery mechanism.
- **Operational advantages:** Derivative markets have greater liquidity than the spot markets. The transactions costs therefore, are lower. This means commissions and other costs for traders are lower in derivatives markets. Further, unlike securities markets that discourage shorting, selling short is much easier in derivatives.

Therefore, by virtue of risk management, short selling, price discovery, and improved liquidity, derivatives make the markets more efficient.

12.8 BENEFITS OF DERIVATIVES

Derivatives provide a range of benefits by enabling the exchange of future risks. Not only can businesses around the world effectively use derivatives to hedge risks by reducing uncertainty about future prices, derivatives also foster investments, since investors can achieve better returns at a lower cost. In this way, derivatives fulfill an important function in the price discovery of assets.

- **Protection against risks**

The most important benefit of derivatives is the ability to manage market risk, i.e. to lower the actual market risk level to the desired one. This task of minimizing or eliminating risk, often called hedging, means that derivatives

can safeguard corporate and financial institutions against unwanted price movements. For example, an airline can today lock in the price for fuel needed at a future point in time using kerosene forward. Even with a minimum upfront investment, derivatives serve to limit the volatility of companies' cash flows. This in turn gives rise to more reliable forecasting, lower capital costs, and higher capital productivity -all of which contribute to economic growth.

- **Possibility of trading on future price expectations**

A second essential function fulfilled by derivatives is price discovery, allowing investors to trade on future price expectations. By trading in derivatives, investors effectively disclose their beliefs on future prices and increase the amount of information available to all market participants. In this way, derivatives enhance valuation and thereby allocation efficiency.

For example, investors can take positions against the market if they expect an asset to drop in value (e.g. a derivatives contract to sell a single stock). Alternatively, they can take the market position (e.g. a futures contract on a commodity) if they perceive an asset to be undervalued and expect its value to rise again in the future. Adopting such strategies is important to reduce the risk of assets being subject to under- or overvaluation and allows a consistent valuation over time.10) Derivatives have further benefits. They can be employed for hedging and investment purposes at very low transaction costs, especially in comparison to investing directly in the underlying.11) In addition, derivatives enable rapid innovation of products that can be easily customized to the needs of any user.

12.9 EXCHANGE TRADED DERIVATIVES

An exchange traded derivative is a financial instrument that trades on a regulated exchange and whose value is based on the value of another asset. Exchange traded derivatives have become increasingly popular because of the advantages they have such as standardization, liquidity, and elimination of default risk. Futures and options are two of the most popular exchange traded derivatives. These derivatives can be used to hedge exposure or speculate on a wide range of financial assets like commodities, equities, currencies, and even interest rates.

One of the defining characteristic of exchange traded derivatives is their mark-to-market feature, wherein gains and losses on every derivative contract are calculated on a daily basis. If the client has incurred losses that have eroded the margin put up, he or she will have to replenish the required capital in a timely manner or risk the derivative position being sold off by the firm.

Exchange traded derivatives are well suited for the retail investor, unlike their over-the-counter cousins. In the OTC market, it is easy to get lost in the complexity of the instrument and the exact nature of what is being traded. In that regard, exchange traded derivatives have two big advantages:

- **Standardization**: The exchange has standardized terms and specifications for each derivative contract, making it easy for the investor to determine how many contracts can be bought or sold. Each individual contract is also of a size that is not daunting for the small investor.
- **Elimination of default risk**: The derivatives exchange itself acts as the counterparty for each transaction involving an exchange traded derivative, effectively becoming the seller for every buyer, and the buyer for every seller. This eliminates the risk that the counterparty to the derivative transaction may default on its obligations.

12.10 DVELOPMENT OF EXCHANGE-TRADED DERIVATIVES

Derivatives have probably been around for as long as people have been trading with one another. Forward contracting dates back at least to the 12th century, and may well have been around before then. Merchants entered into contracts with one another for future delivery of specified amount of commodities at specified price. A primary motivation for pre-arranging a buyer or seller for a stock of commodities in early forward contracts was to lessen the possibility that large swings would inhibit marketing the commodity after a harvest. The following factors have been driving the growth of financial derivatives:

- Increased volatility in asset prices in financial markets,
- Increased integration of national financial markets with the international markets,

- Marked improvement in communication facilities and sharp decline in their costs,
- Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and
- Innovations in the derivatives markets, which optimally combine the risks and returns over a large number of financial assets leading to higher returns, have reduced risk as well as transactions costs as compared to individual financial assets.

12.11 EXCHANGE TRADED VS. OTC DERIVATIVES MARKETS

The OTC derivatives markets have witnessed rather sharp growth over the last few years, which have accompanied the modernization of commercial and investment banking and globalization of financial activities. The recent developments in information technology have contributed to a great extent to these developments.

Exchange refers to the formally established stock exchange wherein securities are traded and they have a defined set of rules for the participants. When the trading is performed through the exchange, it is under the supervision of the exchange and so it ensures that all the rules and regulations are duly complied with. Whereas, Over the Counter (OTC) is a dealer oriented market of securities, which is a decentralized and unorganized market where trading happens by way of phone, emails, etc.

While both exchange-traded and OTC derivative contracts offer many benefits, the former have rigid structures compared to the latter. The highly leveraged institutions and their OTC derivative positions were the main cause of turbulence in financial markets in 1998. The OTC derivatives markets have the following features compared to exchange traded derivatives:

- The management of counter-party (credit) risk is decentralized and located within individual institutions.
- There are no formal centralized limits on individual positions, leverage, or margining.
- There are no formal rules for risk and burden-sharing.

- There are no formal rules or mechanisms for ensuring market stability and integrity, and for Safeguarding the collective interests of market participants, and
- The OTC contracts are generally not regulated by a regulatory authority and the exchange's self regulatory organization, although they are affected indirectly by national legal systems, banking supervision and market surveillance.

Comparison Chart

Basis for Comparison	**OTC (Over The Counter)**	**Exchange**
Meaning	Over the Counter or OTC is a decentralized dealer market wherein brokers and dealers transact directly via computer networks and phone.	Exchange is an organized and regulated market, wherein trading of stocks takes place between buyers and sellers in a safe, transparent and systematic manner.
Market maker	Dealer	Exchange itself
Used by	Small companies	Well established companies
Physical Location	No	Yes
Trading hours	24×7	Exchange hours
Stocks	Unlisted Stocks	Listed Stocks
Transparency	Low	Comparatively high
Contracts	Customized	Standardized

12.12 GLOBAL DERIVATIVES MARKET

Over the past 25 years, the financial market has seen strong growth and innovation, and derivatives have contributed substantially to this impressive development. Today, the global derivatives market is a main pillar of the international financial system and the economy as a whole. Businesses around the world today use derivatives to effectively hedge risks and reduce uncertainty about future prices. Derivatives contribute to economic growth and increase the efficiency of markets by improving price discovery for assets.

Derivatives are financial instruments that are traded among market participants over the counter (OTC) or via regulated markets (on-exchange), whereby the former comprises the majority of the market. Derivatives are used

to protect against and manage risks, offering their users various benefits compared to other financial instruments. Considering the key role played by the global derivatives market in the global economy, it is not at all surprising that the market has seen such strong growth over the past decades.

Derivatives are an important class of financial instruments that are central to today's financial and trade markets. They offer various types of risk protection and allow innovative investment strategies. Around 25 years ago, the derivatives market was small and domestic. Since then it has grown impressively. No other class of financial instruments has experienced as much innovation. Product and technology innovation together with competition have fuelled the impressive growth that has created many new jobs both at exchanges and intermediaries as well as at related service providers. As global leaders driving the market's development, European derivatives players today account for more than 20 percent of the European wholesale financial services sector's revenues and contribute 0.4 percent to total European GDP.

Given the derivatives market's global nature, users can trade around the clock and make use of derivatives that offer exposure to almost any 'underlying' across all markets and asset classes. The derivatives market is predominantly a professional wholesale market with banks, investment firms, insurance companies and corporate as its main participants.

The global derivatives market is a main pillar of the international financial system and economy. As an indispensible tool for risk management and investment purposes, derivatives are used by more than 94 percent of the world's largest companies. Benefits of derivatives that make them indispensable to the global financial system and the economy are:

- Provide risk protection with a minimum upfront investment and capital consumption.
- Allow investors to trade on future price expectations thus improving efficiency of price discovery.
- Have very low overall transaction costs compared with investing directly in the underlying asset.
- Allow fast product innovation because new contracts can be introduced rapidly.

- Can be customized to the specific needs of any user.

12.13 DERIVATIVES MARKET IN INDIA

At present the Indian stock markets are not having any risk hedged instruments that would allow the investors to manage and minimize the risk. In industrialized countries apart from money market and capital market securities, a variety of other securities known as 'derivatives' have now become available for investment and trading. The derivatives originate in mathematics and refer to a variable which has been derived from another variable. A derivative is a financial product which has been derived from another financial product or commodity. The derivatives do not have independent existence without underlying product and market. Derivatives are contracts which are written between two parties for easily marketable assets. Derivatives are also known as deferred delivery or deferred payment instruments.

In India, the emergence and growth of derivatives market is relatively a recent phenomenon. Since its inception in June 2000, derivatives market has exhibited exponential growth both in terms of volume and number of contract traded. The market turnover has grown from Rs.2365 Cr. in 2000-2001 to Rs. 26444804.86 Cr. in 2013-14. Within a short span of time, derivatives trading in India has surpassed cash segment in terms of turnover and number of traded contracts.

12.14 HISTORICAL DEVELOPMENT OF DERIVATIVE MARKET IN INDIA

The origin of derivatives can be traced back to the need of farmers to protect themselves against fluctuations in the price of their crop. From the time it was sown to the time it was ready for harvest, farmers would face price uncertainty. Through the use of simple derivative products, it was possible for the farmer to partially or fully transfer price risks by locking-in asset prices. These were simple contracts developed to meet the needs of farmers and were basically a means of reducing risk.

Derivative markets in India have been in existence in one form or the other for a long time. In the area of commodities, the Bombay Cotton Trade

Association started future trading way back in 1875. This was the first organized futures market. Then Bombay Cotton Exchange Ltd. in 1893, Gujarat Vyapari Mandall in 1900, Calcutta Hesstan Exchange Ltd. in 1919 had started future market. After the country attained independence, derivative market came through a full circle from prohibition of all sorts of derivative trades to their recent reintroduction.

In 1952, the government of India banned cash settlement and options trading, derivatives trading shifted to informal forwards markets. In recent years government policy has shifted in favour of an increased role at market based pricing and less suspicious derivatives trading. The first step towards introduction of financial derivatives trading in India was the promulgation at the securities laws (Amendment) ordinance 1995. It provided for withdrawal at prohibition on options in securities.

In the Indian derivatives market, we deal with derivative securities. Here derivatives market, trade takes place with the help of derivative securities. Such derivative securities or instruments are forward, futures options and swaps. Participants in derivatives securities not only trade in these simple derivative securities but also trade hybrid derivative instrument.

12.15 ORIGIN OF THE DERIVATIVES MARKET IN INDIA

Derivatives market in India has a history dating back in 1875. The Bombay Cotton Trading Association started future trading in this year. History suggests that by 1900 India became one of the world's largest futures trading industry. However after independence, in 1952, the government of India officially put a ban on cash settlement and options trading. This ban on commodities future trading was uplift in the year 2000. The creation of National Electronics Commodity Exchange made it possible.

In 1993, the National stocks Exchange, an electronics based trading exchange came into existence. The Bombay stock exchange was already fully functional for over 100 years then. Over the BSE, forward trading was there in the form of Badla trading, but formally derivatives trading kicked started in its present form after 2001 only. The NSE started trading in CNX Nifty index fu-

tures on June 12, 2000, based on CNX Nifty 50 index. The main instruments for derivatives trading in India are future contracts, options contracts, swaps and etc. These instruments are originally meant for hedging purpose. However, their use for speculation can't be ruled out.

12.16 L. C. GUPTA COMMITTEE ON DERIVATIVES

SEBI appointed the L. C. Gupta Committee on 18th November 1996 to develop appropriate regulatory framework for derivatives trading and to recommend suggestive bye-laws for Regulation and Control of Trading and Settlement of Derivatives Contracts. The Committee was also to focus on financial derivatives and in particular, equity derivatives. The Committee submitted its report in March 1998.

The Board of SEBI in its meeting held on May 11, 1998 accepted the recommendations of the Dr. L.C. Gupta Committee and approved the phased introduction of derivatives trading in India beginning with Stock Index Futures. The Board also approved the 'Suggestive Bye-laws' recommended by the committee for Regulation and Control of Trading and Settlement of Derivatives Contracts. SEBI circulated the contents of the Report in June 98.

The LC Gupta Committee had conducted a wide market survey contacting several entities relevant to derivatives trading like brokers, mutual funds, banks/FIs, FIIs and merchant banks. The Committee observed that there was a widespread recognition of the need for derivatives products including Equity, Interest Rate and Currency derivatives products. However Stock Index Futures was the most preferred product followed by stock index options. Options on individual stocks were the third in the order of preference. The participants interviewed mostly stated that their objective in derivative trading would be hedging. But there were also a few, interested in derivatives dealing for speculation/dealing.

The important recommendations of L. C. Gupta Committee are:

1. Need for coordinated development

The Committee feels that the attempt should be to develop an integrated market structure. SEBI-RBI coordination mechanism as all the three

types of financial derivatives are set to emerge in India in the near future, it is desirable that such development be coordinated. The Committee recommends that a formal mechanism be established for such coordination between SEBI and RBI in respect of all financial derivatives markets. This will help to avoid the problem of overlapping jurisdictions.

2. Cash and Futures Market Relationship

The Committee felt that the operations of the cash market, on which the derivatives market will be based, needed improvement in many respects. It therefore suggested improvements to the Cash Market.

3. Derivatives Exchanges

The Committee strongly favoured the introduction of financial derivatives to facilitate hedging in a most cost-efficient way against market risk. There is a need for equity derivatives, interest rate derivatives and currency derivatives. There should be phased introduction of derivatives produces. To start with, index futures to be introduced, which should be followed by options on index and later options on stocks. The derivative trading should take place on a separate segment of the existing stock exchanges with an independent governing council where the number of trading members should be limited to 40 percent of the total number. Common Governing Council and Governing Board members are not allowed. The Chairman of the governing council should not be permitted to trade (broking/dealing business) on any of the stock exchanges during his term. Trading is to be based on on-line screen trading with disaster recovery site. Per half hour capacity should be 4-5 times the anticipated peak load. Percentage of broker-members in the council is to be prescribed by SEBI. Other recommendations of the Committee about the structure of Derivative Exchanges are as under:

- The settlement of derivatives to be through an independent clearing corporation/clearing house, which should become counter party for all trades or alternatively guarantee the settlement of all trades.
- The clearing corporation to have adequate risk containment measures and to collect margins through EFT.
- The derivative exchange to have both on-line trading and surveillance systems.

- It should disseminate trade and price information on real time basis through two information vending net works.
- It should inspect 100 percent of members every year.
- The segment can start with a minimum of 50 members.
- The Committee recommended separate membership for derivatives segment.
- Members of equity segment cannot automatically become members of derivative segment.
- Provision for arbitration and investor grievances cells to be set up in four regions.
- Provision of adequate inspection capability and all members to be inspected.

4. Regulatory framework

Regulatory control should envisage modern systems for fool-proof and fail-proof regulation. Regulatory framework for derivatives trading envisaged two-level regulation i.e. exchange-level and SEBI-level, with considerable emphasis on self-regulatory competence of derivative exchanges under the overall supervision and guidance of SEBI. There will be complete segregation of client money at the level of trading /clearing member and even at the level of clearing corporation.

5. Regulatory Role of SEBI

SEBI will approve rules, bye-laws and regulations. New derivative contracts to be approved by SEBI. Derivative exchanges to provide full details of proposed contract, like - economic purposes of the contract; likely contribution to the market's development; safeguards incorporated for investor protection and fair trading.

6. Specifications Regarding Trading

Stock Exchanges are to stipulate in advance trading days and hours. Each contract is to have pre-determined expiration date and time. Contract expiration period may not exceed 12 months. The last trading day of the trading cycle is to be stipulated in advance.

7. Membership Eligibility Criteria

The trading and clearing member will have stringent eligibility conditions. The Committee recommended for separate clearing and non-clearing members. There should be separate registration with SEBI in addition to registration with the stock exchange. At least two persons should have passed the certification program approved by SEBI. A higher capital adequacy for Derivatives segment recommended than prescribed for cash market. The clearing members should deposit minimum Rs. 50 lakh with the clearing corporation and should have a net worth of Rs. 3 crore. A higher deposit proposed for Option writers.

8. Clearing Corporation (CC)

The Clearing System to be totally restructured. There should be no trading interests on board of the CC. The maximum exposure limit to be liked the deposit limit. To make the clearing system effective the Committee stressed stipulation of Initial and mark-to-market margins. Extent of Margin prescribed to co-relate to the level of volatility of particular Scrips traded. The Committee therefore recommended margins based on value at risk - 99% confidence (The initial margins should be large enough to cover the one day loss that can be encountered on the position on 99% of the days. The concept is identified as “Worst Scenario Loss”). It did not favour the system of Cross-margining (This is a method of calculating margin after taking into account combined positions in futures, options, cash market etc. Hence, the total margin requirement reduces due to cross-hedges). Since margins to be adjusted frequently based on market volatility margin payments to be remitted through EFT (Electronic Funds Transfer). To prevent brokers who fail/default to provide/restore adequate margin from trading further the stock exchange must have the power/facility to disable the defaulting member from further trading. Brokers/sub-brokers is also to collect margin collection from clients. Exposure limits to be on gross basis. Own/clients margin to be segregated. No set off permitted. Trading to be clearly indicated as own/clients and opening/closing out. In case of default, only own margin can be set off against members’ dues and the CC should promptly transfer client’s margin in separate account. CC to close out

all open positions at its option. CC can also ask members to close out excess positions or it may itself close out such positions. CC may however permit special margins on members. It can withhold margin or demand additional margin. CC may prescribe maximum long/short positions by members or exposure limit in quantity / value / % of base capital.

9. Mark to Market and Settlement:

There should the system of daily settlement of futures contracts. Similarly the closing price of futures is to be settled on daily basis. The final settlement price is to be as per the closing price of underlying security.

10. Sales Practices:

- Risk disclosure document with each client mandatory
- Sales personnel to pass certification exam
- Specific authorisation from client's board of directors/trustees

11. Trading Parameters

- Each order - buy/sell and open/close
- Unique order identification number
- Regular market lot size, tick size
- Gross exposure limits to be specified
- Price bands for each derivative contract
- Maximum permissible open position
- Off line order entry permitted

12. Brokerage

- Prices on the system shall be exclusive of brokerage
- Maximum brokerage rates shall be prescribed by the exchange
- Brokerage to be separately indicated in the contract note

13. Margins From Clients

- Margins to be collected from all clients/trading members
- Daily margins to be further collected
- Right of clearing member to close out positions of clients/TMs not paying daily margins
- Losses if any to be charged to clients/TMs and adjusted against margins

14. Other Recommendations

- Removal of the regulatory prohibition on the use of derivatives by mutual funds while making the trustees responsible to restrict the use of derivatives by mutual funds only to hedging and portfolio balancing and not for speculation.
- Creation of derivatives Cell, a derivatives Advisory Committee, and Economic Research Wing by SEBI.
- Declaration of derivatives as securities under section 2(h)(iia) of the SCRA and suitable amendment in the notification issued by the Central Government in June 1969 under section 16 of the SCRA.

12.17 RECOMMENDATIONS OF PROF. J. R. VARMA COMMITTEE REPORT

SEBI, while accepting the recommendations of Dr L C Gupta Committee, appointed a Committee under Prof. J R Varma to recommend measures for risk containment for derivatives market in India. This Committee focused on ways of making operational the broad recommendations of the Dr. L.C. Gupta Committee to maintain the initial margin to cover 99% Value at Risk (VaR). The report provides the methodology for determining initial margin to be charged on Index Futures contracts, prescribes liquid net-worth, exposure limits for clearing members, transparency and disclosure norms for the Clearing Corporation and position limits etc.

The Committee enumerated the risk containment issues that assume importance in the Indian context such as Estimation of volatility, Calendar spreads, Trader Net-Worth, Margin Collection and Enforcement, Clearing Corporation, Position Limits, Legal Issues etc. The report, submitted in October 1998, provided the methodology for determining initial margin to be charged on Index Futures contracts, prescribes liquid net-worth, exposure limits for clearing members, transparency and disclosure norms for the clearing corporation and position limits etc. The risk containment measures for other derivatives contracts were subsequently prescribed by SEBI from time to time.

With regard to margining system, Prof. J R Varma Committee report suggested that SEBI should authorise the use of a particular VaR estimation methodology but should not mandate a specific minimum margin level.

The Committee also recommended that the volatility estimated at the end of the day's trading should be used in calculating margin calls at the end of the same day. Further, the volatility estimation and margin fixation methodology was also required to be clearly made known to all market participants so that they can compute what the margin would be for any given closing level of the index. The trading software for this purpose should itself provide this information on a real time basis on the trading workstation screen.

The Committee took note of the international practice of levying very low margins on calendar spreads. A calendar spread is a position at one maturity which is hedged by an offsetting position at a different maturity. Even though Committee observed that the cost of carry is not an efficient money market rate, in order to ensure that the margining system operates smoothly when a calendar spread is turned into a naked short or long position on the index either by the expiry of one of the legs or by the closing out of the position in one of the legs the margin on calendar spreads was decided should be far higher than international practice. Thus the Committee suggested that:

- The margin on calendar spreads should be levied at a flat rate of 0.5% per month of spread on the far month contract of the spread subject to a minimum margin of 1% and a maximum margin of 3% on the far side of the spread for spreads with legs upto 1 year apart. A spread with the two legs three months apart would thus attract a margin of 1.5% on the far month contract.
- The margining of calendar spreads should be reviewed at the end of six months of index futures trading.
- A calendar spread should be treated as a naked position in the far month contract as the near month contract approaches expiry. This change should be affected in gradual steps over the last few days of trading of the near month contract. Specifically, during the last five days of trading of the near month contract, the following percentages of a calendar spread shall be treated as a naked position in the far month contract: 100% on day of expiry, 80% one day before expiry, 60% two days before expiry, 40% three days before expiry, 20% four days before expiry. The balance of the spread shall continue to be treated as a spread.

This phasing in will apply both to margining and to the computation of exposure limits.

- If the closing out of one leg of a calendar spread causes the members liquid net worth to fall below the minimum levels specified by Exchanges/ SEBI, his terminal shall be disabled and the clearing corporation shall take steps to liquidate sufficient positions to restore the members liquid net worth to the levels mandated.
- The derivatives exchange should explore the possibility that the trading system could incorporate the ability to place a single order to buy or sell spreads without placing two separate orders for the two legs.
- For the purposes of the exposure limit, a calendar spread shall be regarded as an open position of one third of the mark to market value of the far month contract.

The Committee also recommended laying down of operational guidelines by clearing corporation on collection of margin and standard guidelines for back office accounting at the clearing member and trading member level to facilitate the detection of non-compliance at each level. The Committee felt the need to have another level of defence in the form of the broker's net worth to avoid any crisis from time to time.



CHECK YOUR PROGRESS

Write the full form of the following:

i) SCRA

ii) SEBI

iii) OTC

iv) NSE

v) BSE

vi) EFT

vii) CC



12.18 LET US SUM UP

In this unit, we have discuss the following :-

- The derivatives market refers to the financial markets for financial instruments such as underlying assets and financial derivatives.
- The term derivatives refer to a broad class of financial instruments which mainly include options and futures.
- A forward contract is an agreement between two parties to buy or sell an asset at a specified point of time in the future.
- Futures contracts are traded on exchanges that work as a buyer or seller for the counterparty.
- Options are financial derivative contracts that give the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price during a specific period of time.
- Swap is an agreement between two or more parties to exchange stream of cash flows over a period of time in the future.
- An exchange traded derivative is a financial instrument that trades on a regulated exchange and whose value is based on the value of another asset.
- Today, the global derivatives market is a main pillar of the international financial system and the economy as a whole. Businesses around the world today use derivatives to effectively hedge risks and reduce uncertainty about future prices.



12.19 FURTHER READING

- Financial Markets and Services –By E. Gordon & Dr. K Natarajan
- Indian Financial System –By Gobinda Deka
- Financial Services – By M. P. Tripathy
- Financial Derivatives in India – By Jagadish R. Raiyani

12.20 ANSWERS TO CHECK YOUR PROGRESS

i) Securities Contract Regulation Act

ii) Securities and Exchange Board of India

iii) Over the Counter

iv) National Stock Exchange

v) Bombay Stock Exchange

vi) Electronic Funds Transfer

vii) Clearing Corporation

12.21 POSSIBLE QUESTIONS

1. Define derivatives.
2. Distinguish between forward and futures markets.
3. List any four points related to regulation of derivatives in India.
4. What are credit derivative instruments?
5. Differentiate Badla from a Forward trade.
6. Distinguish between swap and option.
7. Explain the various functions of derivatives market and types of players.
8. Explain the measures specified by SEBI to enhance protection of rights of investors in derivatives market.
9. Give any the recommendations of L. C. Gupta Committee.
10. Mention any the recommendations of J. R. Varma Committee.
11. “Trading in derivatives encouraged investors to speculate”. Comment.

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UNIT 13 : NON-BANKING FINANCIAL INSTITUTIONS

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Meaning and Concept of Non-Banking Financial Institutions

13.4 Definition of Non-Banking Financial Company

13.5 Difference between NBFIs and Banks

13.6 Registration of NBFIs/NBFCs

13.7 Supervisory Framework for NBFIs/NBFCs

13.8 Role of NBFIs/NBFCs

13.9 Evolution of Non-Banking Financial Companies

13.10 Different Types of NBFIs/NBFCs in India

13.11 Functions/ Services Provided by NBFCs/NBFIs

13.12 Sources of Funds of NBFIS

13.13 Investment Strategies of NBFIs

13.14 Let Us Sum Up

13.15 Further Reading

13.16 Answers to Chek Your Progress

13.17 Possible Questions

13.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and role of non-banking financial institutions
- differentiate between banking and non-banking financial companies
- interpret the guidelines for regulating non-banking financial companies
- identify the types of non-banking financial companies
- explain the various types of services provided by non-banking financial companies
- discuss the evolution of non-banking financial companies in India

13.2 INTRODUCTION

There are so many financial institutions exist in the financial system, that provide banking like services. But they are not actual banks. These institutions are specialized in some particular sectors or groups. These institutions are not allowed to take deposits from the public. This unit discusses about the role of such non-banking financial institutions in the financial system of the country.

13.3 MEANING AND CONCEPT OF NON-BANKING FINANCIAL INSTITUTIONS

The term non-bank financial institutions (NBFIs) refer to companies that offer financial services, but do not hold banking licenses and cannot accept deposits. Insurance companies, brokerage firms, and companies offering microloans are examples of non-bank financial institutions.

Non-bank financial intermediaries play an important role in promoting savings in the country. Savers need stores of value to hold their savings in. These institutions provide a wide range of financial assets as store of value and make available expert financial services to the savers.

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license and cannot accept deposits from the public. However, NBFIs do facilitate alternative financial services, such as investment (both collective and individual), risk pooling, financial consulting, brokering, money transmission, and check cashing. NBFIs are a source of consumer credit (along with licensed banks). Examples of nonbank financial institutions include insurance firms, venture capitalists, currency exchanges, some microloan organizations, and pawn shops. These non-banking financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups.

Non-Bank Financial Institutions (NBFIs) or Non-Bank Financial Intermediaries (NBFIs) also termed as Non-Bank Financial Companies (NBFCs), supplement banks by providing the infrastructure to allocate surplus resources to individuals and companies with deficits. Additionally, NBFIs also introduces

competition in the provision of financial services. While banks may offer a set of financial services as a packaged deal, NBFIs unbundle and tailor this service to meet the needs of specific clients. Additionally, individual NBFIs may specialize in one particular sector and develop an informational advantage. Through the process of unbundling, targeting, and specializing, NBFIs enhances competition within the financial services industry.

13.4 DEFINITION OF NON-BANKING FINANCIAL COMPANY

Reserve Bank of India defines NBFC as 'A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme of arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).'

According to the Reserve Bank of India Amendment Act, 1997 the Non Banking Finance Company was defined as under:

- A financial institution which is a company,
- A non banking institution which is a company and whose principal business is to receiving of deposits under any scheme/arrangement/in any other manner or lending in any manner and
- Other non banking institutions/class of institutions as the RBI may specify

This definition excludes financial institutions besides institutions which carry on agricultural operations as their principal business. Non-banking finance companies consist mainly of finance companies which carry on hire

purchase finance, housing finance, investment, loan, equipment leasing or mutual benefit financial companies but do not include insurance companies or stock exchanges or stock-broking companies.

13.5 DIFFERENCE BETWEEN NBFIs AND BANKS

The difference between banks and NBFIs is mainly in the nature of the liabilities of the two and, to some extent, in the structure of their assets. While the liabilities of commercial banks usually consist of demand and time deposits, those of NBFIs do not ordinarily include demand deposits, the mutual benefit financial companies, commonly known as Nidhis, being notable exceptions. From the point of view of assets held, it may be said that commercial banks hold a wide variety ranging from short-term and medium-term to long term credits and they also use various credit instruments like overdrafts, cash credits, bills, etc. On the other hand, the assets of NBFCs are more specialized. For instance, hire purchase finance companies confine their operations mainly to the financing of transport operations and consumer credit while housing finance companies make loans for housing purpose.

Many activities and functions of NBFI's are similar to those of banks. The distinction between them has become considerably indistinct. It is true that NBFIs, unlike banks, are still not a part of payments mechanism. They cannot create money but in many other respects, they are substitution and complementary with banks.

NBFIs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:

- NBFI cannot accept demand deposits;
- NBFIs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;
- Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFIs, unlike in case of banks.

Difference between Banks and NBFCs in table form

Features/Indicators	Banks	NBFCs
Regulated By	RBI-Banking Act	Companies Act and the direction of RBI
The process of Loan sanction	Moderately Stringent	Easier and faster
Product Offering	all types of loans	Majorly property loans
Interest Rate Benchmark	Base rate + Margin	Retail Prime Lending Rate(RPLR)-Spread
Overdraft Facility	Available	Not Available
Passing interest rate benefit to existing borrowers	No much room more existing borrowers	High chance for existing and new borrowers to get benefited from discounts and offers
Pre-payment convenience through NEFT	Available at banks for all customers	Usually prefers cheque payments to process Electronic Clearing Service(ECS)
Interest Rates	Rate of interest will be comparatively lower	Depends on the property and applicant and most of the times will be higher than banks

13.6 REGISTRATION OF NBFIs/NBFCs

In terms of Section 45-IA of the RBI Act, 1934, no Non-banking Financial Company can commence or carry on business of a non-banking financial institution without a) obtaining a certificate of registration from the bank and without having a Net Owned Funds of ₹ 25 lakhs (Two crore since April 1999). However, in terms of the powers given to the Bank, to prevent dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982, Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit Company.

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should comply with the following:

- It should be a company registered under Section 3 of the companies Act, 1956.

- It should have a minimum net owned fund of ₹ 200 lakh. (The minimum net owned fund (NOF) required for specialized NBFCs like NBFC-MFIs, NBFC-Factors, CICs is indicated separately in the FAQs on specialized NBFCs).

13.7 SUPERVISORY FRAMEWORK FOR NBFIs/NBFCs

The Supervisory framework for NBFCs is based on three aspects—(a) the size of NBFC, (b) type of activity (c) the acceptance or otherwise of public deposits. Towards this end, a four-pronged supervisory strategy comprising

(a) On-site inspection based on CAMELS (Capital, Assets, Management, Earnings, Liquidity, Systems and Procedures) methodology.

(b) Computerized off-site surveillance through periodic control returns,

(c) An effective market intelligence network, and

(d) A system of submission of exception reports by auditors of NBFCs

Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-broking/sub-broking, Venture Capital Fund Companies, Nidhi Companies, Insurance companies and Chit Fund Companies are NBFCs but they have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

Housing Finance Companies are regulated by National Housing Bank, Merchant Banker/Venture Capital Fund Company/stock-exchanges/stock brokers/sub-brokers are regulated by Securities and Exchange Board of India, and Insurance companies are regulated by Insurance Regulatory and Development Authority. Similarly, Chit Fund Companies are regulated by the respective State Governments and Nidhi Companies are regulated by Ministry of Corporate Affairs, Government of India. Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation.

It may also be mentioned that Mortgage Guarantee Companies have been notified as Non-Banking Financial Companies under Section 45 I (f) (iii) of the RBI Act, 1934. Core Investment Companies with asset size of less than 100 crore, and those with asset size of 100 crore and above but not accessing public funds are exempted from registration with the RBI.

13.8 ROLE OF NBFIs/NBFCs

Non-Banking Financial Companies play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. There are different types of institutions involved in financial services in India. These include commercial banks, financial institutions and non-banking finance companies. Due to the financial sector reforms, NBFCs have been emerged as an integral part of the Indian financial system. Non-banking finance companies frequently act as suppliers of loans & credit facilities and accept deposits, operating mutual funds and similar other functions. They are competitive and complimentary to banks and financial institutions.

13.9 EVOLUTION OF NON-BANKING FINANCIAL COMPANIES

India soon after independence launched on a programme of rapid industrialization which needed long term investment in capital assets. Industries which were essential and required huge investments were setup by the Government of India in the public sector. The government also extended guarantees whenever loan was obtained by the public sector industries from the foreign agencies. Public financial institutions were established for instance, the Industrial Development Bank of India and the statutory Finance Corporations. The development banks have been providing large and medium industrial concerns direct finance assistance and small and medium industrial concerns through the State Financial Institutions. These corporations issue bonds and debentures and also accept deposits from the public. But the private sector had to rely mostly on the commercial banks which were also not grown to such a scale as to provide corporate funds required by the promoters. Tradi-

tionally banks have been financing manufacturing activity by providing working capital. With the shortage of financial resources against expanding activities the companies were mostly depending on credit deals. Capital goods such as machinery, equipment etc., were imported on deferred payment terms.

With the inadequacy of the financial institutions and the services provided by them companies were set up in the private sector under the Companies Act whose main business was to do non-banking financial business. To set up a non-banking financial company is a very attractive proposition. There is no gestation period. The capital investment in equity is also not huge as in the case of manufacturing companies. In most of the companies the equity was built up on long term by successful operation. The advantages of securing additional assets through non-banking financial companies came to be realised in the seventies. Acquisition of equipment and capital assets through leasing was favoured to overcome the disabilities arising out of the MRTP Act which prescribed asset qualification for declaration of an undertaking as a giant. The MRTP Act declared any undertaking having 100 crore assets as disclosed in the balance sheet as an MRTP company. As assets secured on lease are owned by the lessor company and not by the lessee and are not also in theory transferable to the lessee the leased equipment or assets did not form the constituent of gross block of the borrowing manufacturing company. Many industrial groups or manufacturing companies set up non banking financial companies as associate finance companies. There are no special advantages derived under the MRTP Act now as the concept of MRTP company has lost its significance when the pre-entry sanctions under that Act were removed.

The non banking financial sector in India has recorded marked growth in the recent years, in terms of the number of Non-banking financial companies (NBFCs), their deposits and so on. Keeping in view the growing importance of NBFCs, the banking laws (miscellaneous provisions) act, 1963 was introduced to regulate them. To enable the regulatory authorities to frame suitable policy measures, several committees have been appointed from time to time to conduct an in depth study of these institutions and make suitable recommendations for their healthy growth, within the given regulatory frame work. The suggestions/recommendations made, by them in the context of the con-

temporary financial scenario, formed the basis of the formulation of policy measures by the regulatory authorities/Reserve Bank of India (RBI). The committees that deserve specific mention in this regard are the: Bhabatosh Datta study group (1971), James Raj study Group (1975), Chakravarthy Committee (1985), Vaghul committee (1987), Narasimham Committee on Financial systems (1991) and Shah committee (1992). The Shah committee, as a follow-up to the Narasimham committee, was the first to suggest a comprehensive regulatory framework for NBFCs. While, in principle, endorsing the Shah Committee's frame work of regulations for NBFCs, the RBI had implemented a number of its recommendations and incorporated them in the RBI Directions that regulate and supervise the working and operations of such companies. The Khanna Group, 1996, had suggested a supervisory framework for NBFCs. In pursuance of its recommendations, the RBI Act was amended in January, 1997. As a further follow-up, the RBI Acceptance of public deposits directions, the RBI NBFCs Prudential norms directions and the RBI NBFCs auditor's report directions were modified/issued in January, 1998. The RBI acceptance of public deposits directions were modified in December, 1998, as recommended by the Vasudev Task Force Group.

13.10 DIFFERENT TYPES OF NBFIs/NBFCs IN INDIA

RBI has identified as many as 12 categories of NBFCs. Five of them are regulated by the RBI, Chit funds jointly by the RBI and the Registrar of Chits and two (mutual benefit funds including Nidhis and micro finance companies) by the Department of Company Affairs, Government of India. The National Housing Bank (NHB) regulates housing finance companies. Stock Broking and Merchant Banking Companies are regulated by the Securities and Exchange Board of India and insurance companies come under the Insurance Regulatory and Development Authority. The different categories of NBFCs operating in India under the supervisory control of RBI are:

- Residuary Non-banking Finance Companies (RNBCs)
- Miscellaneous Non-Banking Finance Companies (MNBCs)

1. **Residuary Non-Banking Company:** Residuary Non-Banking Company is a class of NBFC, which is a company and has as its principal business

the receiving of deposits, under any scheme of arrangement or in any other manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

2. **Miscellaneous Non-Banking Financial Companies**: Miscellaneous Non-Banking Financial Companies are another type of NBFCs and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above.

Further, NBFCs are categorized in terms of a) type of liabilities into Deposit and Non-Deposit accepting NBFCs, b) non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND), and c) by the kind of activity they conduct. Within this broad categorization the different types of NBFCs are as follows:

i) **Asset Finance Company (AFC) :** An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

ii) **Investment Company (IC)**: IC means any company which is a financial institution carrying on as its principal business the acquisition of securities,

iii) **Loan Company (LC):** LC means any company which is a financial institution carrying on as its principal business the providing of finance

whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

iv) **Infrastructure Finance Company (IFC):** IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.

v) **Systemically Important Core Investment Company (CIC-ND-SI):** CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:-

- it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
- it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to and investments in debt issuances of group companies or guarantees issued on behalf of group companies.
- Its asset size is 100 crore or above
- It accepts public funds

vi) **Infrastructure Debt Fund Non- Banking Financial Company (IDF-NBFC):** IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

vii) **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI):** NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

- loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding 1,00,000 or urban and semi-urban household income not exceeding 1,60,000;
- loan amount does not exceed 50,000 in the first cycle and 1,00,000 in subsequent cycles;
- total indebtedness of the borrower does not exceed 1,00,000;
- tenure of the loan not to be less than 24 months for loan amount in excess of 15,000 with prepayment without penalty;
- loan to be extended without collateral;
- aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;
- loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

viii) **Non-Banking Financial Company-Factors (NBFC-Factors):** NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

ix) **Mortgage Guarantee Companies (MGC)**: MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is 100 crore.

x) **Non-Operative Financial Holding Company (NOFHC)**: NOFHC is financial institution through which promoter / promoter groups will be permitted to set up a new bank. It's a wholly-owned Non-Operative Financial Holding Company which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators to the extent permissible under the applicable regulatory prescriptions.

13.11 FUNCTIONS/ SERVICES PROVIDED BY NBFCs/NBFIs

NBFCs provide range of financial services to their clients. Types of services under non-banking finance services include the following:

- Hire Purchase Services
- Leasing Services
- Housing Finance Services
- Asset Management Services
- Venture Capital Services
- Mutual Benefit Finance Services (Nidhi)

Now we take a look at each type of service that an NBFI could undertake.

1. Hire Purchase Services

Hire purchase is the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the installments, the owner can repossess the goods. Hire purchase is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor Finance Co., Bajaj Auto Finance Company is some of the hire purchase financing companies.

2. Leasing Services

A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFI may obtain license to commence leasing services subject to, they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. is some of the Leasing companies in India.

3. Housing Finance Services

Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may

undertake the services /activities such as Providing long term finance for the purpose of constructing, purchasing or renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing Finance Co. Ltd., HDFC is some of the housing finance companies in our country.

4. Asset Management Services

Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.

5. Venture Capital Services

Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise to venture projects. In India, venture capital concentrates on seed capital finance for high technology and for research & development. ICICI ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, IDBI and others also promoting venture capital finance activities.

6. Mutual Benefit Finance Services (Nidhis)

A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification.

There are two main types of such funds, open-ended fund and close-ended mutual funds. In case of open-ended fund, the fund manager continuously allows investors to join or leave the fund. The fund is set up as a trust, with an independent trustee, who keeps custody over the assets of the trust. Each share of the trust is called a Unit and the fund itself is called a Mutual Fund. The portfolio of investments of the Mutual Fund is normally evaluated daily by the fund manager on the basis of prevailing market prices of the securities in the portfolio and this will be divided by the number of units issued to determine the Net Asset Value (NAV) per unit. An investor can join or leave the fund on the basis of the NAV per unit.

13.12 SOURCES OF FUNDS OF NBFIS

A Non-Banking Financial Company (NBFC) is a company which carries on the business of loans and advances, acquisition of shares, bonds, stock, insurance business or hire-purchase, but does not include any institution whose principal business objective is agriculture or agriculture allied activity, purchase or sale of any goods (other than securities) ordinary business activity or providing any services and sale/purchase/construction of immovable property. As these financial institutions lack the ability to raise money supply at a low rate like banks, they end up raising funds at a higher interest rate, thereby causing the hurdle rate on their funds to increase proportionately in order to maintain Net Interest Margins between 1-3%. This causes NBFCs to seek alternative strategies for deployment of funds in order to generate a higher return (thereby taking on a higher risk pattern). Funding source of NBFCs comprises debentures, borrowings from banks and FIs, public deposits, commercial papers, and inter-corporate loans.

1. Sources of Funds

There are three primary sources of funds looking to raise money without deposits:

a) Long Term: These are through term loans obtained from banks in a single quantum, after deciding on the amount of funds to be deployed in the normal course of operations of the NBFC. The advantage of doing so is that banks can usually lend at much lower rates owing to the nature of the CASA

deposits, which favours the business model of NBFCs that have a more aggressive risk-return profile. These kind of loans can be unsecured or secured through Government Securities (which again is monitored by the Treasury Department), and repayment can be done in bullet or a structured schedule. This repayment should ideally be mirrored with the repayment schedules of the assets on the balance-sheet. A good credit rating is mandatory for raising large sums at a competitive interest rate.

b) Medium Term: Bonds are used as a common route to reduce the interest rate on the sources of funds. The coupon rate on the bond is selected in order to reflect the rating profile of the NBFC as well as a return better than the Government Securities. In some cases, tax-free bonds are also issued for priority sectors such as infrastructure and roads. The maturity profile of these bonds coincides with the repayment/interest schedules of the investments made by the NBFCs (and displayed as assets on the balance sheet). Bonds can be issued to retail investors as well, which is a primary advantage for NBFCs during bond placement.

c) Short Term: Short term loans offered by an NBFC can be issued by raising funds through Commercial Paper (CPs). CP is short term unsecured promissory notes issued by companies, with tenure of 3 months to 12 months.

2. RBI Regulations for funding in NBFC

NBFCs (Non-Banking Financial Companies) as the name suggests, are not banking companies. They do not rely on CASA (Current Account Savings Account) deposits for raising funds. As CASA deposits are only meant for banks, wherein the banks are provided with licenses by the RBI in order to accept monies from the public. NBFCs do not have those luxuries, it means, the NBFCs needs to look for alternate sources of the money supply, which are higher than the deposits taken by banks, where the interest rate offered is between 4-6 percent.

The financial institutions capable of raising money supply at a low rate like banks and end up raising funds at a higher interest rate. This causes NBFCs to seek for alternative strategies for raising funds in order to generate a higher return. The Key Points to keep in mind while raising funds in NBFC are:

- Evaluating the mismatch between assets & liabilities; and
- Minimizing the mismatch in assets and Liabilities.

NBFCs can raise funds from various sources. One of the best options to raise fund is from foreign investment. After the liberalization of the Indian economy in 1991, there have been witnessed a significant interest of foreign investors in the Indian NBFC sectors.

Foreign investment in NBFC sector is permitted under the automatic route as per the FDI policy.

- The automatic route is one where no approval from Foreign Investment Promotion Board (FIPB) or RBI approval is needed before making the proposed investment. Up to 100%, foreign investment is permitted without the approval of FIPB under the automatic.
- All foreign transactions are required to rout only through entities licensed by the RBI as per the regulations framed under FEMA.
- A Foreign investment which is allowed under automatic route only in the non-banking financial service activities are as follows:
    - Merchant Banking, Underwriting, Portfolio Management Services, Stock Broking, Asset Management, Venture Capital, Custodian Services, Factoring
    - Leasing & Finance, Housing Finance, Credit Card Business, Micro Credit, Rural Credit, Non-fund based activities, Investment Advisory Services, Financial Consultancy, Forex Broking, Credit Rating Agencies, Money Changing Business, etc.
- FDI in such NBFC's is allowed without any minimum capitalization norms after 2016.

13.13 INVESTMENT STRATEGIES OF NBFIs

Debt Strategy: The fixed income portfolio will be invested in debt securities maturing in line with the maturity of scheme. The fixed income strategy would to buy and hold. The debt portfolio is largely run as an accrual income product and will be passively managed. The Fixed income portion is intended to be invested across sectors and in AA and AAA & Equivalent rated debt securities. The investment philosophy for fixed income investments fol-

lows from the objective to deliver optimal risk-adjusted returns across the products.

A combination of top, down and bottom up approaches are used to construct portfolios. Global and local macro-economic variables such as growth indicators, inflation outlook, currency changes, liquidity, etc. are analyzed to determine the long-term and short-term trends. Short-term, cyclical economic considerations are used to fine-tune the duration of the portfolios.

The investment universe includes government securities, corporate bonds, mortgages backed securities, and asset backed securities and money market instruments. They make asset allocation changes within this universe depending upon changes in relative valuations / spreads and the forward outlook for them. They maintain high credit quality portfolios across the board. Normally, portfolios have more than 85% in AA or higher rated assets. Credit risks are assumed after internal due diligence. The investment strategy of individual funds follows from the investment philosophy enunciated above and is fine tuned to suit the respective investment objectives of the funds.

Equity Strategy: The equity exposure would be in equity & equity-related instruments, primarily through long call options on Nifty, with expiry near to the maturity of the scheme. The equity derivative strategy would endeavor to provide exposure to equities by buying call options. The participation rate would depend on the prevailing prices of the option contract. The total Equity exposure of the fund will be in the range of 5%-20%. The Fund intends to buy call options with December 2014 expiry, and may invest some portion into large cap stocks for the remaining tenor of the fund.

Investment Philosophy: The overall investment philosophy stems from our objective of delivering superior risk adjusted returns to investors over an extended time frame. The investment philosophy is rooted in a set of well established but flexible principles that relies extensively on fundamental research. It is driven by the belief that over time stock prices reflect a business' underlying intrinsic values and its long-term prospects. As a result, the research process aims to arrive at a comprehensive understanding of a company's business including the nature of its interactions with customers, suppliers, com-

petitors and regulators. The idea is to identify superior businesses with growing and predictable cash flows run by competent management. When valuing businesses, they take the perspective of a co-owner of the business and thus lean heavily on the concept of cash flows and economic earning power. In addition, they rely on various earnings multiples besides analyzing private market value and appropriate regional and global comparisons.

The basic principles that serve as the foundation for the above investment approach are:

Managing risk: Their aim is to purchase stocks at a price that represents a material discount to their long-term intrinsic value or at a price that is attractive from a relative value standpoint. Doing so explicitly recognizes the importance of capital preservation and provides a supportable underlying value that provides some insulation if actual outcomes are milder than initially forecast. This is consistent with a long-term, business-like approach to investing and allows for the challenges that companies will possibly face in a competitive and fast-changing market. Besides looking at risk of an individual investment decision, we also thoroughly analyze and aim to manage overall portfolio risk.

Maintain a balanced outlook on the market: Downside risks to financial stability persist. In a number of markets, including several emerging markets, asset valuations could come under pressure if interest rates rose more than expected and adversely affected investor sentiment. They do not believe in taking a call on the near term direction of the market indices. They avoid market timing and as a result, except for extenuating circumstances, our funds do not make substantial cash allocations. The same market mechanism that creates the opportunity for successful long-term returns also presents volatility and accompanying anxieties in the short term. As long-term investors, they feel it is appropriate to maintain the patience and discipline that is demanded at such times and to the extent possible take advantage of such uncertainty. Through the active management process, they aim to achieve higher risk-adjusted returns over time across all their products.

Focus on the long term: There is substantive empirical evidence to suggest that equities as an asset class have provided superior risk adjusted returns over the long term. However, over short periods of time equity returns can be quite volatile influenced by fluctuating investor emotions and temporary fads. Additionally, different investment styles, sectors and approaches come in and out of favor distorting short-term performance. Longer-term returns are driven by economic fundamentals. As a result prices and fundamentals do decouple over shorter periods but tend to converge over time.



CHECK YOUR PROGRESS

Answer as directed:

a) Non- banking financial institutions (NBFIs) are registered under _____. (Fill in the blanks)

b) A Non - Banking Financial Institution cannot accept demand deposit and cannot issue cheques. (Write True or False)

c) UTI, LIC etc, are examples of NBFIs. (Write True or False)



13.14 LET US SUM UP

In this unit, we have discuss the following :-

- A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license and cannot accept deposits from the public.
- Insurance companies, brokerage firms, and companies offering microloans are examples of non-bank financial institutions.
- Non-Bank Financial Institutions (NBFIs) or Non-Bank Financial Intermediaries (NBFIs) are also termed as Non-Bank Financial Companies (NBFCs).
- Non-Banking Financial Company (NBFC) is registered under the Companies Act, 1956.
- Many activities and functions of NBFI's are similar to those of banks.

- Non-Banking Financial Companies play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector.
- RBI has identified as many as 12 categories of NBFCs.
- NBFCs provide range of financial services to their clients.
- Funding source of NBFCs comprises debentures, borrowings from banks and FIs, public deposits, commercial papers, and inter-corporate loans.



13.15 FURTHER READING

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



13.16 ANSWERS TO CHECK YOUR PROGRESS

(a) Companies Act (b) True (c) False



13.17 POSSIBLE QUESTIONS

1. Write short notes on the following:
   a) Residuary Non-banking Companies (RNBCs)
   b) Miscellaneous Non-banking Companies (MNBCs)
   c) Asset Finance Company (AFC)
2. Define Non-Banking Financial Companies. Discuss various services provided by NBFCs.
3. Analyse the structure and growth of NBFCs in India.
4. Enumerate the features of the RBI Regulations governing NBFCs.

5. Briefly discuss the features of Prudential Norms for NBFCs.
6. What are the features of regulations for Accepting Public Deposits by NBFCs?
7. What are the recent trend and changes in NBFCs?
8. What are the problems faced by the NBFCs today? What are the suggestions you can make to the government for promotion of NBFC sector?

UNIT-14 : INSURANCE SECTOR IN INDIA

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Meaning and Nature of Secondary Market

14.3 Meaning of Insurance

14.4 Need for Insurance

14.5 Objectives of Insurance

14.6 Role of Insurance

14.7 Characteristics of Insurance

14.8 Principles of Insurance

14.9 Types of Insurance

14.10 Life Insurance

14.11 General Insurance

14.12 Crop Insurance

14.13 Micro Insurance

14.14 Entry of Private Players in Insurance Sector in India

14.15 The Present Scenario of Insurance Sector in India

14.16 The Future of Insurance Sector in India

1.17 Insurance Regulatory and Development Authority (IRDA)

14.18 Duties, Powers and Functions of IRDA

14.19 Let Us Sum Up

14.20 Further Reading

14.21 Answers to Check Your Progress

14.22 Possible Questions

14.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and need of insurance
- understand the need for insurance
- explain the objectives of insurance

- differentiate between general insurance and life insurance
- understand the meaning of crop insurance and micro insurance
- study the role and functions of IRDA
- interpret the guidelines for regulating insurance sector by IRDA
- identify the types life various insurance policies in India

14.2 INTRODUCTION

All of us wish to achieve financial freedom at some point in our life, and when it comes to doing that, we tend to believe that savings are enough to be financially stable. But, if we look at life from a practical perspective, we would understand that savings alone are not enough to achieve financial freedom; protection from any unforeseen losses and contingencies by insuring our assets is equally important. This unit will discuss about the need and importance of various insurance.

14.3 MEANING OF INSURANCE

Insurance is a means of protection from any unforeseen losses and contingencies. It is a risk-management technique used for hedging against various uncertain losses. Insurance is a contractual agreement between two parties in which one party promise to protect another party from uncertainties and losses. The first party is insurance company or insurer who agrees to protect and compensate the other party for losses suffered by it. Another party is insured or insurance policy holder who gets protection under insurance policy in return for premium which he is required to pay regularly to insurer.

In simple terms, insurance is just the protection against the losses. By taking insurance policy, different insurance policy holders pool their interest together. Loss suffered by any of the insured property or life is paid out of premium amount paid by these policy holders to insurance company. Insurance is an effective tool to avoid losses by transferring or sharing it with other individual. It boosts confidence level of peoples and acts as supporting pillar by compensating them at time of emergencies.

Insurance helps in economic development of country by mobilising people's saving by attracting them for investment in insurance policies. Insurance companies reinvest the collected amount in different investment avenues for earning profit. There are generally three steps in insurance process: Firstly, select the insurance policy as per your needs, then you need to pay the premium amount regularly and at last claim your insured amount with the help of supporting documents in case if any unfortunate event occurs.

14.4 NEED FOR INSURANCE

1. Financially Security

No matter how much you are earning or how much you have saved; your financial position can be dented by an unexpected event in a moment. So, the best way to become financially secure is to cover yourself, your family, and your assets with insurance. You can buy or renew insurance online and receive a payout for financial support, in case there happens to be an unforeseen event.

2. Transfer of Risk

The contract of insurance works on the 'principle of transfer of financial risk from the insured to the insurer'. As an insured, you pay premiums to receive compensation from the insurer, in case of occurrence of an unforeseen event. So, having insurance reduces the financial burden on your shoulders.

3. Complete Protection for You and Your Family

Family is the most important asset that you have and your family also depends on you for financial support. This is why it is important to make sure that you and your family are completely secure to face any emergency.

4. No More Stress or Tension During Difficult Times

None of us can see the future or predetermine the future events. Any unforeseen tragedy can leave you physically, mentally, and financially strained. So, if you have insurance to take care of the outcomes of such tragedies such as illness, injury or permanent disability, even death- you save yourself and your family from tension and stress. With insurance in place, any financial stress will be taken care of, and you can focus on your recovery.

5. Some Types of Insurances are Compulsory

Insurance is necessary because sometimes it is mandatory as per the law. An example of this is motor insurance. As per the Motor Vehicle Act of 1988, it is compulsory to have at least a third-party motor insurance for every motor vehicle plying on road in India.

6. Peace of Mind

Having insurance offers you financial security and also peace of mind. No amount of money can replace your peace of mind. So, when you have insurance you know that you are secured against any unforeseen events in life, and this gives you complete peace of mind.

14.5 OBJECTIVES OF INSURANCE

Though the primary objective of insurance is to financially guard against unpredictable life occurrences there are also some other important objectives. The overall objectives of insurance are as follows:

1. Granting Security to People

Insurance primarily serves the purpose of granting security against losses and damages to people. It is an agreement enters into by two parties in which one promises to protect other from losses in return for premium paid by other party. One party is insurance company and other one is insured. Insurance companies guarantee the insured of compensation in case of any unfavourable contingencies. Insured need to pay premium to insurance companies in return for guarantee of compensation.

2. Minimisation of Losses

Insurance aims at minimisation of losses arising from future risks and uncertainties. It adds certainty of payments to people for happening of uncertain events. Insurance assures the individuals for compensation of losses. It minimises the risk through proper planning and administration. Insurance companies suggest people for taking safety measures like installation of fire detection devices, alarm and cameras system etc. They also join hands with various organisations like fire brigade, health and various organisations which work for reducing losses and damages. This way, insurance works toward minimising the happening of various losses.

3. Diversifying the Risk

Insurance works towards diversifying the risk among large number of people. It aims at reducing the adverse effects of any future contingency by spreading the overall risk associated with it. It is medium through which people share their risk with others. Insurance companies compensate the insured for losses out of premium they charged from their different policy holders. The loss incurred by single individual is diversified among large peoples by insurance companies by utilising the collected premium amount for paying compensations.

4. Reduces the Anxiety and Fear

Insurance policies relieve the individuals of any tension and fear regarding the future risks and uncertainties. It guarantees them of compensation in occurrence of any unfavourable contingencies. Assurance of compensation is the most relieving factor for tensed and worried people. They are certain of payment on occurrence of various uncertain events. It makes them confident and they focus on their activities with full attention.

5. Mobilises the Saving

Mobilisation of savings is another important objective of insurance. It attracts people for investments by presenting them with numerous insurance policies guarantying of compensation for losses. Large number of people takes this insurance policy in order to insure them against losses and damages. Insurance companies are able to generate large amount of funds in the form of premium that they charged from their policy holders regularly. These funds are then invested by these companies into securities and stock in market and earn incomes. Ideal lying resources with public are employed by insurance companies towards income generating sources.

6. Generation of Capital

Insurance companies leads to capital generation by collecting large amount of funds from public. They regularly charges premium from their large customers for providing them protection against losses. These funds are invested for industrial development by subscribing to shares of companies. Companies are able to get their required capital through insurance industry as this

invests in companies for earning dividends and other incomes. This boosts the industry performance and economic growth of country. Also, bigger investments lead to creation of various employment opportunities.

7. Tax Relief to the Insure

Another important objective of insurance is to provide tax benefit to the insured in life insurance and some health related insurances. Under Section 80C and 10D of the Income Tax Act, there are provisions of getting income tax benefits on life insurance. Under section 80C, premiums that you pay towards a life insurance policy qualify for a deduction up to 1.5 lakh, while Section 10(10D) makes income on maturity tax-free if the premium is not more than 10% of the sum assured or the sum assured is at least 10 times the premium. But if the sum assured is less than 10 times the premium, for instance you pay Rs.1 lakh as premium for a sum assured of Rs.5 lakh, you will get a deduction on the premium up to 10% of the sum assured. In the example, your deduction will be Rs.50,000 and not Rs.1 lakh.

14.6 ROLE OF INSURANCE

1. Provides Protection

The primary function of insurance is to provide protection to insured in case of any uncertain event. Insurance guarantees the person to protect him from sufferings in case of damages and losses. Future risks and uncertainties cannot be controlled or reduce through insurance but it can only compensate for the losses caused by these uncertain events. Insurance policies help a person to recover back to its original position after incurring losses by compensating them.

2. Sharing of Risk

Sharing of risk is an important function played by insurance. It is a means of pooling risk of one person among a large number of persons. Compensation for losses suffered by one individual is paid out of premium paid by different policyholders. Risk is diversified and shared among different persons. It reduces the adverse effect of uncertain events on only one person by sharing of risk.

3. Provides Certainty

Insurance provides reliability and certainty of payments to business. Happening of unexpected events is uncertain and cannot be determined. The uncertainties of these events can be minimized through proper planning and administration. Insurance helps in adding certainty to these uncertain events. It assures businessmen of certain payments on happening of unexpected events. It relieves them from large damages and losses.

4. Improves the Efficiency

Insurance has an effective role in improving the efficiency of the business. By providing the guarantee for compensation in case of any mishaps, it relieves the businessmen of worries and tension of risk. It boosts their confidence level and they work with full attention towards their roles. Insurance reduces the miseries and concern for losses or damages. This leads to better productivity of the organisation thereby increasing the overall efficiency.

5. Prevention of losses

It acts as a cover against the losses. Insurance guides business in taking appropriate corrective measures for reducing damages and losses. It suggests them for observing safety measures like installation of automatic fire detective devices, alarm systems etc. Insurance company's joins hand with institutions which help in avoiding losses like fire brigade, health organisations and other intuitions. It will help in reducing losses which will ensure lower payment of compensation to insured. This will also enable the insurer in reducing the amount of premium and will motivate more savings.

6. Helps in Earning Foreign Exchange

Insurance is an important means of earning foreign exchange. Several companies operate internationally with many branches in different countries. They need to take insurance policy as per the legal requirements of the country. Several countries earn foreign exchange by issue of insurance policies like marine insurance and many other different policies.

7. Promotes Economic Development

Insurance promotes the economic development of the country. It leads to generation of large amount of funds by insurance companies through the premium collected by them from insured. It utilises the ideal lying money with

people by attracting them for investment in various investment policies. All collected money by insurance companies is invested in shares of various companies and other investment avenues for earning profit. This leads to industrial development in the country thereby accelerating the rate of economic growth.

14.7 CHARACTERISTICS OF INSURANCE

1. Personal Contract

Insurance contracts are generally personal in nature. It is an agreement between the insurance company and insured and such agreement is bound by certain obligations. Both the party is required to fulfill their obligation to keep the contract legal. Insurance contract cannot be transferred to any other person without the consent of insurance policy holder. Insured is required to pay premium to insurer regularly as his part of obligation. Whereas insurer need to compensate insured in case of any losses as his part of obligation.

2. Pooling of Risk

Insurance are meant for pooling the risk of various policy holders. It helps in the reducing the adverse effect of heavy losses on single individual on occurrence of any contingency. Insurer compensates the insured for the losses incurred by him out of premium paid by different policy holders. Premium paid by different policy holders is used for recovering the losses incurred by insured individuals. This way risk of single individual is pooled among different individuals and its effect is minimized

3. Unilateral

Insurance contracts are unilateral. This means that both the parties (insurer and insured) who enter into insurance contracts are equally bound to perform their respective obligations. Insured need to pay the decided policy premium without any default. Policy premium is the cost for protection against losses provided by insurer. Insured is required not to pay any cost other than policy premium. Similarly, insurer has the right to compensate the insured for losses and damages arising out of contingency. It is their legal duty in exchange for the premium they are charging.

4. Cost of Risk

The cost of risk in insurance contract is the value of insurance object. Insurance companies before entering into contract properly evaluate the value of subject matter of insurance contract. Proper knowledge of insurance object enables the insurer in calculation of right premium amount to be paid by insured. Higher the risk associated with insurance object, higher will be premium charged. On the other hand, lower risk invited low premium by insurer from insured.

5. Assures of Compensation

Insurance policies assure the policy holder of compensation in occurrence of losses and damages. These policies are taken by insured to seek protection from future risks and uncertainties. Insurance companies guarantee the people for compensating them for losses. They assure to bring them back in their original position in which they were before occurrence of such losses. Assurance for compensation by insurer motivates people for investment in insurance policies.

6. Executor

Insurance contacts are executory which means compensation is paid only on occurrence of the contingency. It is included in agreement done that insured is liable to claim for compensation from insurer only if he incurs losses. Insured cannot profit from the insurance policies and can be compensated for losses only. If any contingency do not occur then insurer is not liable to pay any compensation.

7. No misrepresentation or concealment

Insurance contract is assumed to be free from any misrepresentation and concealment of information. Any misrepresentation or concealment of facts from both insurer and insured side will make the insurance contract void. Insured is required to disclose full information regarding insurance object fairly to insurer. Similarly, insurance companies are required to explain clearly the terms and conditions of insurance contract to insured.

14.8 PRINCIPLES OF INSURANCE

1. Principle of Utmost Good Faith

It states that both the parties to contract must enter into a contract in good faith. They both should reveal all material information and facts regarding contract to each other accurately and honestly. Insured should tell the insurer all details truly so that insurance companies are able to calculate the right premium amount. Also, the insurer should provide all information regarding insurance contract with fairness to insured. Any misrepresentation of facts and figures will make insurance policy legally revoked or cancelled.

2. Principle of Indemnity

Principle of indemnity means insurance contracts are done to provide protection and compensate against uncertain losses, damages or injuries. Indemnity simply means protection, security and compensation for damages or losses. Insured cannot enter into an insurance contract for earning profit but it is meant for recovery of losses only. Insurance are meant to bring back the insured into the original position in which he was before happening of uncertainties. Principle of indemnity does not apply to the life insurance contract.

3. Principle of Insurable Interest

This principle states that insurance policy holder must have insurable interest in the subject matter of insurance. He must have some vested interest in it and must be affected by existence and non-existence of object of insurance. It is not necessarily required by insured to be the owner of insurance object. Existence of an object should provide him some benefits and gains. Any damage to an insurance object should adversely affect the insured and provides him heavy losses.

4. Principle of Subrogation

Principle of subrogation states that after paying compensation, the ownership right of property will transfer from insured to insurer. This principle gives insurer right to recover amount from third party who is responsible for happening of uncertainties and losses to insurer. Principle of subrogation allows insurer to pursue legal methods against that third party to recover the amount of losses. However, insurer can claim amount only to the extent of amount paid by him to insured as compensation.

5. Principle of Loss Minimization

This principle states that insured should always take all necessary steps to avoid losses and damages to insured property. It is his obligation to mini-

mize the losses to insured property in case of any uncertainties like blast or fire outbreak. Insured should not be negligible or act irresponsible towards the property only because it is insured for losses. Therefore, insured should try to protect insured property and avoid any losses.

6. Principle of Contribution

Principle of contribution states that insured cannot make profit by insuring the property with more than one insurance company. The insured in case of any uncertainties can claim only the actual amount of loss. Insurance companies will compensate to insured on basis on 'principle of contribution'. All Insurance companies will share the losses to extent of sum insured with them. In case if only one insurance company pays the full amount of loss it can demand contribution from other insurance companies.

7. Principle of Causa Proxima

Causa proxima means the 'direct cause' or 'nearest cause'. The principles of Causa proxima are applicable when there are series of causes for losses or damages to insured property. According to this, the most nearest and dominant cause for losses and damages is considered for calculating the liability of insurer.

14.9 TYPES OF INSURANCE

The Indian Insurance Sector is basically divided into two categories - Life Insurance and Non-life Insurance. The Non-life Insurance sector is also termed as General Insurance. Both the Life Insurance and the Non-life Insurance is governed by the Insurance Regulatory and Development Authority of India (IRDAI).

There are two broad types of insurance:

1. Life Insurance, and
2. General Insurance

The Insurance sector in India consists of total 57 insurance companies. Out of which 24 companies are the life insurance providers and the remaining 33 are non-life insurers. Out which there are seven public sector companies. Life insurance companies offer coverage to the life of the individuals,

whereas the non-life insurance companies offer coverage with our day-to-day living like travel, health, our car and bikes, and home insurance. Not only this, but the non-life insurance companies provide coverage for our industrial equipment's as well. Crop insurance for our farmers, gadget insurance for mobiles, pet insurance etc. are some more insurance products being made available by the general insurance companies in India.

The life insurance companies have gained an investment prospectus in the recent times with an idea of providing insurance along with a growth of your savings. But, the general insurance companies remain reluctant to offer pure risk cover to the individuals.

14.10 LIFE INSURANCE

Life insurance is a contract between an individual and an insurance company, in which the insurance company provides financial security in return for regular payments of premiums to the insurance company. In case of the policyholder's death or if the policy matures, the insurance company shall pay a prescribed amount to the individual after a period of time or to their family, on basis of the contract.

Types of Life Insurance

Broadly, there are five basic types of life insurance plans:

1. **Term insurance**

Term plans are the most basic form of life insurance. They provide life cover with no savings / profits component. They are the most affordable form of life insurance as premiums are cheaper compared to other life insurance plans.

2. **Endowment plans**

Endowment plans differ from term plans in one important aspect i.e. maturity benefit. Unlike term plans which pay out the sum assured, along with profits, only in case of an eventuality over the policy term, endowment plans pay out the sum assured under both scenarios- death and survival.

3. Unit linked insurance plans (ULIPs)

Unit linked insurance plans (ULIPs) are a variant of the traditional endowment plan. They pay out the sum assured (or the investment portfolio if it's higher) on death/maturity. Since ULIPs invest in stock markets they are well-suited for individuals with appetite for risk.

4. Whole life policy

A whole life insurance policy covers a policyholder over his life. The main feature of a whole life policy is that the validity of the policy is not defined so the individual enjoys the life cover throughout his life.

5. Money back policy

This is a variant of the endowment plan. A money back policy gives periodic payments over the policy term. To that end, a portion of the sum assured is paid out at regular intervals. If the policy holder survives the term, he gets the balance sum assured.

14.11 GENERAL INSURANCE

General insurance covers non-life assets such as your home, vehicle, health, damage property from floods, fire, thefts, accidents and man-made disasters etc.

Types of general insurance

1. Health insurance:

Health Insurance is an essential risk mitigating tool. Health insurance prevents out-of-pocket expenses while dealing with a medical emergency. A general health insurance plan is an indemnity plan that pays for hospitalisation expenses up to the sum insured. While you can avail a standalone health policy, family floater plans provide coverage to all the members of your family. On the other hand, critical illness plans are fixed-benefit plans which provide a lump sum upon diagnosis of a critical ailment, taking care of pre and post-hospitalisation costs. These plans help take care of astronomical costs associated with the treatment of critical ailments.

2. Marine insurance:

Marine insurance was the earliest well-developed kind of insurance, with origins in the Greek and Roman marine loan. It was the oldest risk hedging instruments to mitigate risk in medieval times. Marine insurance covers the loss or damage of ships, cargo, terminals, and any transport by which the property is transferred, acquired, or held between the points of origin and the final destination. Cargo insurance is the sub-branch of marine insurance, though Marine insurance also includes Onshore and Offshore exposed property, (container terminals, ports, oil platforms, pipelines), Hull, Marine Casualty, and Marine Liability.

3. Fire Insurance:

Fire insurance is property insurance that provides coverage for loss or damage to a structure damaged or destroyed in a fire. Fire insurance is an agreement between two parties, i.e., insurer and insured, whereby insurer undertakes to indemnify the loss suffered by the insured in consideration for his (insured) paying of certain sum called 'Premium'. Fire insurance policies provide payment for the loss of use of the property as a result of a fire, or for additional living expenses that were necessitated by uninhabitable conditions as well as damage to personal property and nearby structures. A fire insurance policy includes additional coverage against smoke or water damage due to a fire and is usually effective for one year. Fire insurance policies that are about to expire are usually renewable by the homeowner, under the same terms as the original policy.

Fire insurance was started after marine insurance. Marine insurance was useful only to persons engaged in some kind of trade. The fire havoc can be experienced by persons of all walks of life. The Great Fire of London in 1956 destroyed 13,000 houses in four days. This 'Great Fire' gave birth to Fire Insurance. Fire insurance is a contract to indemnify the loss suffered by the insured. This contract does not help in controlling or preventing fire but it is a promise to compensate the loss.

A fire insurance contact may be defined as 'an agreement' whereby one party in return for a consideration undertakes to indemnify the other party

against financial loss which the latter may sustain by reason of certain subject-matter being damaged or destroyed by fire or other defined perils up to an agreed amount.

The term 'fire' must satisfy two conditions:

(a) There must be actual fire or ignition;

(b) The fire should be accidental.

The property must be damaged or burnt by fire. If the property is damaged by heat or smoke without ignition it will not be covered under the word 'fire'.

4. Motor vehicle insurance:

Motor insurance covers your vehicles against accidents, damage, theft, vandalism, and so on. This form of insurance comes in two forms - comprehensive and third-party. A comprehensive motor insurance policy provides a 360-degree cushion to your vehicle against damages caused due to flood, fire, riot, etc. Along with this, it also offers you the rider, personal accident coverage along with third-party liability. On the other hand, a third-party motor insurance takes care of the damages suffered by a third-party in case of an accident caused by your vehicle. It won't cover any damages to your vehicle. As per the Motor Vehicles Act, 1988, it's mandatory for every vehicle running on the road to have a third-party insurance.

5. Home insurance:

As the name suggests, a home insurance policy protects your home and its belongings from the damages suffered due to man-made or natural disasters. Some home insurance policies also provide coverage for temporary living expenses in case you are living on rent, due to your home undergoing renovation.

6. Travel insurance:

In case you are travelling abroad, a travel insurance policy protects you against losses suffered due to loss of baggage, delays in flight and trip

cancellation. In some cases, if you are hospitalised while travelling, travel insurance may also offer cashless hospitalisation.

Difference between life and general insurance

1. **Meaning and Coverage:** Life insurance covers your life and also has provisions to provide a savings and investment avenue. Savings here mean the benefit on maturity. For example, if the policyholder outlives the policy period, he or she can get back the premium paid over the years. General insurance is a contract of indemnity covering non-life assets. It is a promise to make good on your losses, but with no savings or investment avenue i.e. if the claim is not made, no part of the premium can be got back.
2. **Purpose:** Life insurance gives a payout in case the policyholder dies, whereas in case of a general insurance, payouts is made in the event of an unexpected loss such as an accident or a theft or a sudden liability.
3. **Term of contract and payment:** Life insurance is a long-term contract and requires you to pay the premiums in monthly installments. General insurance meanwhile is a short-term contract, to be renewed every year, and requires you to pay the entire premium on renewal.
4. **Insurable interest:** With life insurance, the policyholder must be present during the issuing of a life insurance policy. With general insurance however, the policyholder must be present during the time of contract and at the time of loss.
5. **Payment of claim:** In case of life insurance, the insurable amount is paid on the occurrence of the event or on maturity of the policy. For general insurance, losses are reimbursed when the uncertain event occurs.
6. **Policy value:** Life insurance can be done for any value based on the premium the policy holder willing to pay. In case of general insurance, the amount payable is restricted to the liability incurred or actual loss suffered, irrespective of the policy amount.

The table below summarises the major differences between life and general insurance:

Parameters	Life insurance	General insurance
Meaning	Covers life	Covers non-life assets
Contract term	Long-contract that requires paying premiums for several years	Generally, annual contracts which need to be renewed every year
Payment of claim	Is payable in case of the death of the policyholder during the policy term or on policy maturity	Reimbursed during an eventuality
Savings component	Present	Absent

Both life and general insurance are needed to comprehensively cover all aspects of your life. Life insurance and general insurance are two different forms of insurances. General insurance covers any other risk except for life-risk of the person injured. Life Insurance covers only the life-risk of the person insured. In the table below, all the key points between Life Insurance and general Insurance have covered:

Key Points	Life Insurance	General Insurance
Meaning	It is an insurance contract, which covers the life-risk of the person insured	It is an insurance that is not covered under Life insurance
Form	It is a form of investment	It is a contract of indemnity
Term of Contract	It's a long term contract	It's a short term contract
Premium	Premium has to be paid over the year	Premium has to be paid lump sum
Insurance claim	Insurable amount is paid either on the occurrence of the event, or on maturity	Loss is reimbursed, or liability will be repaid on the occurrence of uncertain event
Insurable Interest	Must be present at the time of contract	Must be present, at the time of contract and loss both
Policy Value	It can be done for any value based on the premium policy	The amount payable under life insurance is confined to the actual loss suffered

14.12 CROP INSURANCE

Crop insurance is purchased by agricultural producers to protect against loss of their crops caused by natural disasters, such as hail, drought, floods, storms and other natural calamities, or the loss of revenue due to declines in the prices of agricultural commodities. A farmer or grower may desire to grow a crop associated with a particular defined attribute that potentially qualifies for a premium over similar commodity crops, agricultural products, or derivatives thereof.

Crop insurance is a vital component of agriculture, especially in a country like India, where the majority of farmers are small and marginal with low savings that reduces their ability to weather agricultural risks and fluctuations. Programmes extending insurance cover for crops in India have long been in operation, but have not been able to include the majority of the agricultural sector within their ambit.

In India a multiperil crop insurance called National Agriculture Insurance Scheme (NAIS) was implemented by Agriculture Insurance Company o India, an Indian government owned company. The scheme is compulsory for all farmers who take agricultural loans from any financial institution. It is voluntary for all other farmers. The premium is subsidized for farmers who own less than two hectares of land. This insurance follows the area approach. This means that instead of individual farmers, a specific area is insured. The area may vary from gram panchayat or block or district from crop to crop or state to state. The claim is calculated on the basis of crop cutting experiments carried out by agricultural departments of respective states. Any shortfall in yield compared to past 5 years average yield is compensated.

Agriculture in India is highly susceptible to risks like droughts and floods. It is necessary to protect the farmers from natural calamities and ensure their credit eligibility for the next season. For this purpose, the Government of India introduced many agricultural schemes throughout the country. The recent scheme was Pradhan Mantri Fasal Bima Yojana (PMFBY). The PMFBY was launched in 2016 and replaces all the prevailing yield insurance schemes in India. The scheme has extended coverage under localized risks, post-harvest

losses etc. and aims at adoption of technology for the purpose of yield estimation. Through increased farmer awareness and low farmer premium rates the scheme aims at increasing the crop insurance penetration in India.

14.13 MICRO INSURANCE

Insurance Regulatory and Development Authority of India (IRDAI) has created a special category of insurance policies called micro-insurance policies to promote insurance coverage among economically vulnerable sections of society. The IRDA Micro-insurance Regulations, 2005 defines micro-insurance as 'a general or life insurance policy with a sum assured of Rs. 50,000 or less'.

The micro-insurance portfolio has made steady progress. More life insurers have commenced their micro-insurance operations and many new products are being introduced every year. The distribution infrastructure has also been considerably strengthened and the new business has shown a decent growth, though the volumes are still small. Life Insurance Corporation of India (LIC) contributed the most both in terms of policies sold and number of micro-insurance agents.

With the notification of the IRDA (Micro-insurance) Regulations 2005, by the Authority, there has been a steady growth in the design of products catering to the needs of the poor. The flexibilities provided in the Regulations allow the insurers to offer composite covers or package products. Insurance companies are now offering already approved general insurance products as micro-insurance products with the approval of the Authority, if the sum assured for the product is within the range prescribed for micro-insurance.

A general micro-insurance product is any:

- Health insurance contract
- Any contract covering belongings such as
- Hut
- Livestock
- Tools or instruments or
- Any personal accident contract
- They can be on an individual or group basis

A life micro-insurance product is:

- A term insurance contract with or without return of premium
- Any endowment insurance contract or
- A health insurance contract
- They can be with or without an accident benefit rider and
- Either on an individual or group basis

There is flexibility in the regulations for insurers to offer composite covers or package products that include life and general insurance covers together.

Intermediaries:

Micro- insurance business is done through the following intermediaries:

- Non-Government Organisations
- Self-Help Groups
- Micro-Finance Institutions

14.14 ENTRY OF PRIVATE PLAYERS IN INSURANCE SECTOR IN INDIA

Insurance was the only sector which had been fully nationalized and change in it was started only when the country completed its first decade of economic reform. The Indian insurance industry was revolved around two public sector players, viz., Life Insurance Corporation (LIC) of India and General Insurance Corporation (GIC) of India. LIC has been operated in the life segment lodge in the people brain by providing wide range of services, building an extensive network of branches and offering employment to a large number of agents. The non-life insurance sector was overwhelmingly dominated by GIC. The Malhotra Committee observed that both life and non life insurance sector is facing some serious problem due to mismanagement and poor structure. Therefore, committee proposed restructuring of LIC and GIC. Privatization of India's insurance did not happen in the form of disinvestment rather as a policy decision to keep the public sector insurance companies intact and allow private companies to conduct insurance business. India initiated the process of Insurance Sector Reform as part of macro economic reform with the Committee on Reforms in the Insurance Sector constituted in April, 1993.

Until 1999, there were no private insurance companies in India. The government then introduced the Insurance Regulatory and Development Authority Act in 1999, thereby de-regulating the insurance sector and allowing private companies. Furthermore, foreign investment was also allowed and capped at 26% holding in the Indian insurance companies. The entry of private companies was allowed in both life and non-life sector. The sector was opened in August 2000 for registration of the companies. However, a single company cannot transact business in both sectors.

India allowed private companies in insurance sector in 2000, setting a limit on FDI to 26%, which was increased to 49% in 2014. Insurance Laws (Amendment) Act, 2015 provides for enhancement of the foreign investment cap in an Indian insurance company from 26% to an explicitly composite limit of 49% with the safeguard of Indian ownership and control. The collaboration with the foreign markets has made the Insurance Sector in India grow tremendously with a high current market share. Private insurers like HDFC, ICICI and SBI have been some tough competitors for providing life as well as non-life products to the insurance sector in India.

14.15 THE PRESENT SCENARIO OF INSURANCE SECTOR IN INDIA

In the history of the Indian insurance sector LIC was the only life insurance provider. Other four public sector companies namely the National Insurance, United India Insurance, Oriental Insurance and New India Assurance provided non-life insurance or say general insurance in India. However, with the introduction of new private sector companies, the insurance sector in India gained a momentum in the year 2000. But, there are yet many more insurers who are awaiting for IRDAI approvals to start both life insurance and non-life insurance sectors in India.

So far as the industry goes, LIC, New India, National Insurance, United insurance and Oriental are the only government ruled entity that stands high both in the market share as well as their contribution to the Insurance sector in India. There are also some two specialized insurers – Agriculture Insurance

Company Ltd catering to Crop Insurance, Export Credit Guarantee of India catering to Credit Insurance and Deposit Insurance Corporation of India catering to deposit insurance. Whereas, others are the private insurers (both life and general), who have done a joint venture with foreign insurance companies to start their insurance businesses in India.

Life Insurance Companies in India:

- Aegon Life Insurance Co. Ltd.
- Aviva Life Insurance Co. India Ltd.
- Bajaj Allianz Life Insurance Co. Ltd.
- Bharti AXA Life Insurance Co. Ltd.
- Birla Sun Life Insurance Co. Ltd.
- Canara HSBC Oriental Bank of Commerce Life Insurance Co. Ltd.
- DHFL Pramerica Life Insurance Co. Ltd.
- Edelweiss Tokio Life Insurance Co. Ltd
- Exide Life Insurance Co. Ltd.
- Future Generali India Life Insurance Co. Ltd.
- HDFC Standard Life Insurance Co. Ltd.
- ICICI Prudential Life Insurance Co. Ltd.
- IDBI Federal Life Insurance Co. Ltd.
- IndiaFirst Life Insurance Co. Ltd
- Kotak Mahindra Old Mutual Life Insurance Ltd.
- Max Life Insurance Co. Ltd.
- PNB MetLife India Insurance Co. Ltd.
- Reliance Life Insurance Co. Ltd.
- Sahara India Life Insurance Co. Ltd.
- SBI Life Insurance Co. Ltd.
- Shriram Life Insurance Co. Ltd.
- Star Union Dai-Ichi Life Insurance Co. Ltd.
- Tata AIA Life Insurance Co. Ltd.

General Insurance Companies:

- Aditya Birla Health Insurance Co. Ltd.

- Bajaj Allianz General Insurance Co. Ltd.
- Bharti AXA General Insurance Co.Ltd.
- Cholamandalam General Insurance Co. Ltd.
- Future Generali India Insurance Co.Ltd.
- HDFC ERGO General Insurance Co. Ltd.
- ICICI Lombard General Insurance Co. Ltd.
- IFFCO-Tokio General Insurance Co. Ltd.
- Kotak General Insurance Co. Ltd.
- L&T General Insurance Co. Ltd.
- Liberty Videocon General Insurance Co. Ltd.
- Magma HDI General Insurance Co. Ltd.
- Raheja QBE General Insurance Co. Ltd.
- Reliance General Insurance Co. Ltd.
- Royal Sundaram Alliance Insurance Co. Ltd
- SBI General Insurance Co. Ltd.
- Shriram General Insurance Co. Ltd.
- TATA AIG General Insurance Co. Ltd.
- Universal Sompo General Insurance Co.Ltd.
- Apollo Munich Health Insurance Co.Ltd.
- Star Health Allied Insurance Co. Ltd.
- Max Bupa Health Insurance Co. Ltd.
- Religare Health Insurance Co. Ltd.
- Cigna TTK Health Insurance Co. Ltd.

14.16 THE FUTURE OF INSURANCE SECTOR IN INDIA

Though LIC continues to dominate the Insurance sector in India, the introduction of the new private insurers will see a vibrant expansion and growth of both life and non-life sectors in 2017. The demands for new insurance policies with pocket-friendly premiums are sky high. Since the domestic economy cannot grow drastically, the insurance sector in India is controlled for a strong growth.

With the increase in income and exponential growth of purchasing power as well as household savings, the insurance sector in India would introduce

emerging trends like product innovation, multi-distribution, better claims management and regulatory trends in the Indian market.

The government also strives hard to provide insurance to individuals in a below poverty line by introducing schemes like the:

- Pradhan Mantri Suraksha Bima Yojana (PMSBY),
- Rashtriya Swasthya Bima Yojana (RSBY) and
- Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY).

Introduction of these schemes would help the lower and lower-middle income categories to utilize the new policies with lower premiums in India.

With several regulatory changes in the insurance sector in India, the future looks pretty awesome and promising for the life insurance industry. This would further lead to a change in the way insurers take care of the business and engage proactively with its genuine buyers. Some demographic factors like the growing insurance awareness of the insurance, retirement planning, growing middle class and young insurable crowd will substantially increase the growth of the Insurance sector in India.

1.17 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

Based on the recommendation of Malhotra committee regarding establishment of a strong, effective and independent regulatory body to protect interest of policyholders and development of insurance industry, the Government of India had established interim regulatory authority in January 1996 through an exclusive order. Later on, this Interim Regulatory Authority becomes Insurance Regulatory and Development Authority of India (IRDAI).

The constitution of IRDA is a landmark in landscape of financial sector. The Insurance Regulatory and Development Authority of India Act, 1999 provides for composition, tenure of office chairperson and other members, removal from office, salary and allowances of chairperson and members, duties, power and function of IRDA. Insurance Regulatory and Development Authority of India Act made several amendments to the Insurance Act 1938, LIC

Act 1956 and GIC Act 1972 which revoked the monopoly conferred to the Life Insurance Corporation of India and General Insurance Corporation of India.

As per the provisions of IRDA Act, 1999, Insurance Regulatory and Development Authority (IRDA) was established on 19th April 1999 as an autonomous body to protect the interests of holder of insurance policy and to regulate, promote and ensure orderly growth of the insurance industry in India. IRDA started its functioning on April 19, 2000 headed by N. Rangachary as its first Chairperson with 4 full-time directors, 2 part-time directors and 25-members in Insurance Advisory Council. The members of the council represent various industries and professions.

IRDA as a regulatory authority has heavy responsibilities and difficult roles to play. On the one side, it has to protect against malpractices and secure fair treatment to policyholders. On the other side, it has to impose restrictions in such a manner that growth of insurance industry is not hampered. IRDA regulations cover minimum requirements for best practices in the area of licensing, prudential regulations and requirements, supervisory powers, managing asset qualities and enhancing corporate governance.

Objectives of IRDA

- To protect the interest of policyholders of insurance policies;
- To bring about speedy and orderly growth of the insurance industry and to provide long term funds for accelerating growth of the economy;
- To set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence of those it regulates;
- To ensure speedy settlement of genuine claims, to prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery;
- To promote fairness, transparency and orderly conduct in financial markets dealing with insurance and build a reliable management information system to enforce high standards of financial soundness amongst market players;
- To take action where such standards are inadequate or ineffectively enforced;

- To bring about optimum amount of self-regulation in day-to-day working of the industry consistent with the requirements of prudential regulation.

14.18 DUTIES, POWERS AND FUNCTIONS OF IRDA

Section 14 of IRDA Act, 1999 lays down the duties, powers and functions of IRDA. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business. Without prejudice to the generality of the provisions contained in sub-section (1), the powers and functions of the Authority shall include:

i) Issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;

ii) Protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

iii) Specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents

iv) Specifying the code of conduct for surveyors and loss assessors;

v) Promoting efficiency in the conduct of insurance business;

vi) Promoting and regulating professional organisations connected with the insurance and re-insurance business;

vii) Levying fees and other charges for carrying out the purposes of this Act;

viii) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;

ix) Control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938);

x) Specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

xi) Regulating investment of funds by insurance companies;

xii) Regulating maintenance of margin of solvency;

xiii) Adjudication of disputes between insurers and intermediaries or insurance intermediaries;

xiv) Supervising the functioning of the Tariff Advisory Committee;

xv) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);

xvi) Specifying the percentage of life insurance business



CHECK YOUR PROGRESS

Fill in the blanks:

a) _____ is the regulator of insurance sector in India?

b) A fixed amount of money collect by insurance companies from their clients is called _____.

c) IRDA Act was passed in _____.

d) The Insurance that provides protection against loss by fire is called _____ Insurance.

e) Mediclaim is an example of _____ insurance.



14.19 LET US SUM UP

In this unit, we have discuss the following :-

- Insurance is a contractual agreement between two parties in which one party promise to protect another party from uncertainties and

losses. The first party is insurance company or insurer who agrees to protect and compensate the other party for losses suffered by it.

- Insurance helps in economic development of country by mobilising people's saving by attracting them for investment in insurance policies.
- The Indian Insurance Sector is basically divided into two categories - Life Insurance and Non-life Insurance. The Non-life Insurance sector is also termed as General Insurance.
- Both the Life Insurance and the Non-life Insurance is governed by the Insurance Regulatory and Development Authority of India (IRDAI).
- Life insurance is a contract between an individual and an insurance company, in which the insurance company provides financial security in return for regular payments of premiums to the insurance company.
- General insurance covers non-life assets such as your home, vehicle, health, damage property from floods, fire, thefts, accidents and man-made disasters etc.
- Crop insurance is the insurance of agricultural producers against loss of crops caused by natural disasters, such as hail, drought, floods, storms and other natural calamities.
- Micro-insurance is a general or life insurance policy with a sum assured of Rs. 50,000 or less.
- Insurance Regulatory and Development Authority (IRDA) protects the interests of holder of insurance policy and to regulate, promote and ensure orderly growth of the insurance industry in India.



14.20 FURTHER READING

- Principles & Practice of Insurance -By M Motihar
- Insurance: Principles and Practice -By M.N. Mishra & S B Mishra



14.21 ANSWERS TO CHECK YOUR PROGRESS

a) IRDA b) premium c) 1999 d) fire e) general



14.22 POSSIBLE QUESTIONS

1. Write short notes on the following:
   a) Life insurance
   b) General insurance
   c) Crop insurance
   d) Micro insurance
   e) Entry of private sectors in insurance in India
2. What are the different types of Insurance Coverage?
3. What do you mean by term ‘Insurer’ and ‘Insured’?
4. What is General Insurance policy? What does it cover?
5. What is life insurance? What are the different types of Life Insurance?
6. Distinguish between General Insurance from life insurance.
7. Mention the powers and duties of IRDA.

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UNIT 15 : MICRO FINANCE

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

15.3 Meaning and Origin of Micro Finance

15.4 Definition of Micro Finance

15.5 Need for Micro Finance

15.6 Role of Micro Finance

15.7 Micro Finance in India

15.8 Micro Finance Institutions (MFIS)

15.9 Model of Micro Finance

15.10 Role of Micro Finance in Economic Development

15.11 Role of NABARD in Promoting Micro Finance

15.12 Problems of Micro Finance

15.13 Let Us Sum Up

15.14 Further Reading

15.15 Answers to Check Your Progress

15.16 Possible Questions

15.1 LEARNING OBJECTIVES

After going through this unit you will able to:

- state the meaning and definition of micro finance
- describe needs of micro finance
- interpret the functions of micro finance
- discuss about micro finance in India
- enumerate the role of micro finance in Indian economy
- explain the role of NABARD in the field of micro finance
- discuss various models of micro finance
- identify the problems of micro finance

15.2 INTRODUCTION

The money lenders, who used to provide small amount of loans to the poor and needy people of India and around the world, are the oldest informal and unorganized form of microcredit. The interest rate charged by them is so high that the poor people. Gradually, this type of credit attained the shape of microcredit and was further supplemented by many credit associations, co-operatives and banks. Here the concept of micro finance arises. This unit discusses about the various aspects of micro finance especially in India.

15.3 MEANING AND ORIGIN OF MICRO FINANCE

Micro finance is the provision of financial services like savings, micro credit, micro insurance and funds transfer. Micro Finance refers to the provision of affordable financial services such as small loans, small savings, micro insurance and funds transfer facilities extended to socially and economically poor and disadvantaged segments of the society to enable them to increase their income levels and improve standard of living. The main aim of micro finance is to provide small loans to poor people particularly living below poverty line, who are not able to raise loan for productive purposes from other sources and to improve their standard of living by increasing their earning and saving covering associated risks.

The poor people need minimum financial services. They need to open saving bank account in the bank to keep and multiply their small savings by carrying out productive activities and getting small loans from banks to purchase the assets and increase the level of their activities. In order to cover the life and activities risks, they require micro insurance facilities. They also require funds deposit and transfer facilities at their nearby places. The provision of these minimum financial services is covered in microfinance.

The concept of microfinance initiated as an introduction of Muhammad Yunus (2006) in the form of Grameen Bank in Bangladesh. Mr. Mohammad Yunus and Grameen Bank Bangladesh were given Noble Prize in the year 2006 for their efforts to create economic and social development through microfinance.

15.4 DEFINITION OF MICRO FINANCE

Micro-finance refers to small savings, credit and insurance services extended to socially and economically disadvantaged segments of society. In the Indian context terms like 'small and marginal farmers', 'rural artisans' and 'economically weaker sections' have been used to broadly define micro-finance customers.

Microfinance refers to the movement in the entire world where in low income households have some access to the basic affordable financial services from banks or financial institutions to finance their productive economic activities, create assets, generate income after meeting expenses to save some net surplus and also to protect their life and activities against various hazards and risks.

The recent Task Force on Micro Finance has defined micro finance as "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas, for enabling them to raise their income levels and improve living standards".

According to International Labour Organization, "Microfinance is an economic development approach that involves providing financial services through institutions to low income clients"

Microfinance has been defined by the National Microfinance Taskforce, 1999 in India as "Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban and urban areas for enabling them to raise their income levels and improve living standards."

15.5 NEED FOR MICRO FINANCE

The banks have been more or less hesitant in providing small finance to the poor people with little or no cash income. The poor people have no or few assets to offer as collateral security for the loans to the banks. Thus bank fear having little recourse against the defaulting borrowers. The majority of the poor people does not have saving bank account in the bank and bank need proper identity and address proof before providing microcredit to them. The lack of knowledge, initiatives and collateral securities are the hindrances in

getting the credit from banks. The people need microfinance to carry out their economic activities in commercial manner. The needs of microfinance are as follows:

- For the economic growth and transformation of the nation
- To eradicate poverty and record development of the nation
- To meet the life cycle needs, emergency needs and investment needs of the people
- For economic and social upliftment of the people
- For women empowerment through development

15.6 ROLE OF MICROFINANCE

- Microfinance provides finance to the poor people for carrying out their economic activities and helps them to meet the basic needs of life.
- Microfinance helps the poor people to increase their income, savings and standard of living.
- Microfinance provides employment to the poor people by providing self employment opportunities in various sectors and activities.
- Microfinance protects the poor people against the risks by providing life insurance and assets insurance.
- Microfinance helps in alleviating poverty by providing affordable financial services.
- Microfinance helps in increasing economic growth and development in the country.
- Microfinance promotes gender equity by supporting women empowerment and their economic participation and hence improving well being of the poor households.
- Microfinance provides improvements in household economic welfare and enterprise stability and growth.
- Micro finance helps in increasing savings, investments and developments.
- Micro finance provides employment opportunities to unemployed people and full employment to the under employed people

15.7 MICRO FINANCE IN INDIA

In India, NABARD initiated the concept of microfinance as per this idea and established link between Self Help Group (SHGs), Non Government Organizations (NGOs) and Banks. The SHGs are formed and nurtured by NGOs. On attaining maturity the SHGs get credit from banks and extend to members. By 2006 in India more than 22 lakh SHGs were financed by Commercial Banks, RRBs and Cooperative Banks. The microfinance movement has multiplied and large number of SHGs, NGOs, Microfinance Institutions (MFIs), and Non Banking Financial Companies (NBFCs) has emerged to provide microfinance to the poor and needy rural people. Thus the microfinance has emerged as a movement and established an industry.

The microfinance industry is growing fast in India. The recent studies show that the top sixty microfinance institutions in India have nearly ten million customers who have been provided small loans under microfinance. The microfinance aims at removal of poverty, empowering poor, mostly women to start their own economic activities, earn money and achieve financial independence. The recent studies also show that the recovery in microfinance is as high as 97% which facilitates cycling of banks funds for the productive purposes.

Indian microfinance continues to grow rapidly towards extending outreach to a growing share of poor households, which are yet to be reached directly by the banks. The Self Help Groups Bank linkage (SHGBLP) programme which started simply as a bank outreach programme, has through the passage of time slowly metamorphosed into a holistic programme for financial, economic, social and of late, technological capital building in rural areas. Thus the SHG-Bank Linkage Programme has expanded at a fast pace in India to evolve into the largest microfinance programme in the world, and undoubtedly, it is the main microfinance programme in India.

This success saga of the SHGBLP is made possible by the untiring efforts and the zeal of hundreds of channel partners, NGOs, Government, bank branches and above all millions of SHG women who reposed their trust in this initiative for ushering change in their own lives. As on 31st March 2018, there

are 8.7 million SHGs out of which 5.02 million SHGs have outstanding bank loans of Rs. 75598 Cr to the Banks. The total deposits of SHGs with banks was to the tune of Rs. 19592 crore. There are more than 100 Scheduled Banks, 300 DCCBs, 27 State Rural livelihood Missions and over 5000 NGOs engaged in the Self Help Group Bank Linkage Programme.

The important milestones in the journey so far of the SHG Bank Linkage movement spearheaded by NABARD with the support of Reserve Bank of India and the G.O.I. are as follows:

- 1987: NABARD takes the lead in partnering with NGOs, particularly MYRADA, to pilot the SHG Bank linkage model due to poor performance of formal institutions in providing finance to the rural areas, informal sector and the "unbankable" poor.
- 1991: RBI advised all scheduled Banks about NABARD's proposed pilot and sought active participation from the Banks.
- 1992: NABARD launches the SHG Bank Linkage Programme initially to cover 500 SHGs which was an innovation for harnessing the flexibility of the Informal system with the strength and affordability of the formal system.
- 1996: Financing to SHGs was mainstreamed into the normal operations of the banks by the Reserve Bank of India in April 1996.
- 1998: In the Union Budget of 1998-99, Government announced that NABARD would endeavor to ensure credit linkage of 2 lakh SHGs in a period of 5 years.
- 1999: Swarna Gram Swarojgar Yojana (SGSY), an amalgamation of government programmes like Integrated Rural Development Program (IRDP) etc. was launched as a holistic programme to eradicate poverty by using the vehicle of SHGs for purveying microcredit for all rural poor especially the BPL families.
- 2000: A dedicated Fund viz. Micro Finance Development Fund was created in NABARD with a sizeable corpus of Rs. 100 Crore for various initiatives and interventions for the ascent of SHGBLP movement
- 2006: RBI issues guidelines for Branchless banking initiative in the rural areas through use of Business Correspondents and Business Facilitators.

- 2008: NABARD establishes NABFINS, a subsidiary of NABARD to provide financial services in two broad areas of Agriculture and Microfinance. Based on the recommendations of the "Committee on Financial Inclusion" two Funds, namely the "Financial Inclusion Fund (FIF)" and the "Financial Inclusion Technology Fund (FITF)", were set up at NABARD with an overall corpus of Rs. 500 crore each.
- 2011: NRLM, a flagship poverty alleviation programme, was launched by the Ministry of Rural Development, Govt. of India.
- 2012: The SHG-Bank Linkage Programme was given a renewed thrust with the launch of SHG-2.
- 2012: Women SHG programme (WSHG) for intensifying SHGs in the 150 Left Wing Extremism affected and backward districts of India implemented by NABARD in association with the Department of Financial Services, Ministry of Finance, G.O.I.
- 2015: Based on the impact evaluation studies on MEDPs, Livelihood and Enterprise Development Programme (LEDP) for creating sustainable livelihoods amongst SHG members was introduced on pilot basis in select states.
- 2015: The SHG BLP Strategic Advisory Board was constituted in NABARD with various stakeholders as well as representatives of DFS, NRLM, RBI, Bankers and Domain Experts to focus on strategic action plan on SHG BLP, digitization, livelihood promotion and a proper eco system to facilitate greater credit flow to the SHGs.
- 2015: Eshakti Pilot Project initiated by NABARD for digitisation of SHG records to bring transparency and accuracy in SHG's transactions in Ramgarh and Dhule districts of Jharkhand and Maharashtra respectively.
- 2016: EShakti pilot project extended to additional 23 districts in India.
- 2017: EShakti pilot project extended to 75 more districts thus covering 100 districts.

15.8 MICROFINANCE INSTITUTIONS (MFIS)

The important channel for growth of microfinance in India is through Microfinance Institutions (MFIs) lending through individual and group approach. They emerged in India in the late 1980s in response to the gap in availability of banking service for the un-served and under-served rural population. These institutions operating in the country follow a variety of credit methodologies. The work of MFIs commenced around the same time when the SHG-Bank Linkage Programme was evolving. Many of them were inspired by the Grameen Bank in Bangladesh and the innovations taking place in Latin America. Voluntary agencies and Non-Governmental Organisations (NGOs) undertook financial intermediation as a part of larger social good. Majority of these NGOs were registered as a Trust or a Society. The Micro Units Development & Refinance Agency Ltd (MUDRA), NBFC set up by the Government of India (GoI) in 2015 with its total focus on microenterprise, has to hand-hold and facilitate the development process of smaller MFIs and not for profit MFIs as they are the ones who operate in remote locations and with the underserved populations. As per MFIN, as on 31 March 2018 the microfinance industry has a total loan portfolio of Rs. 136633 crore.

15.9 MODEL OF MICRO FINANCE

The various models currently being used by microfinance institutions throughout the world are: Associations, Bank Guarantees, Community Banking, Cooperatives, Credit Unions, Grameen, Group, Individual, Intermediaries, NGOs, Peer Pressure, ROSCAs, Small Business, and Village Banking models. A total of 14 models are existing in India. Different institutions in formal and informal sector have successfully tried out these models. Though these models have their own specific strengths and weaknesses, they have demonstrated to provide financial services to the unorganized sector with effective outreach. There is also a range of other methodologies that MFIs follow. Some MFIs start with one methodology and later on move or diversify to another methodology so that they do not exclude certain socio-economic categories of clients. So it becomes important to have a basic understanding of methodologies and activity of Credit Lending Models.

A. Association or Group Model

An association is formed by the poor in the target community to offer microfinance services (micro savings, microcredit, micro-insurance, etc.) to themselves. Associations or groups can be composed of youth, or women; they can form around political/religious/cultural issues; can create support structures for microenterprises and other work-based issues. It gathers capital and intermediates between banks, MFIs and its members. Example: Self Help Groups. In some countries, an 'association' can be a legal body that has certain advantages such as collection of fees, insurance, tax breaks and other protective measures.

Group method primarily involves a group of individuals, which becomes the basic unit of operation for the MFIs. As MFIs have to provide collateral free loans, group methodologies help in creating social collateral (peer pressure) that can effectively substitute physical collateral. Group becomes a basic unit with which MFIs deal. The group approach delegates the entire financial process to the group rather than to the financial institutions. All financial activities like savings, getting loans, repayment of loans and record keeping are managed at the group level.

In this method, 10-20 members are organized to form a group. These group members make regular savings of fixed amount in a common fund. The amount and frequency of savings is mutually decided by the group members. After the successful working of such a group for some months the group is linked to a financial institution for getting credit. The financial institutions issue loan in the name of group and whole group is considered responsible for repayment. The amount of loan depends upon the total accumulated amount of saving of the group. The group itself selects its members before acquiring a loan. Loans are granted to selected member(s) of the group first and then to the rest of the members. Most MFIs require a percentage of the loan that is supposed to be saved in advance, which points out the ability to make regular payments and serve as collateral. Group members themselves decide about the criteria of dividing the loan among the group members. With this loan the whole group may jointly start a micro-enterprise or the members may start

their individual businesses. An individual may also use his loan for consumptive purpose or meeting other priority needs.

Group members are jointly accountable for the repayment of each other's loans and usually meet weekly to collect repayments. To ensure repayment, peer pressure and joint liability works very well. The entire group will be disqualified and will not be eligible for further loans, even if one member of the group becomes a defaulter. The creditworthiness of the borrower is therefore determined by the members rather than by the MFI. These type of group based credit delivery methods help to empower the group members because they remain involved in various group activities. They visit the bank, market and hold group meetings which help them to increase self-confidence.

B. Community Banking Model

Community Banking Model essentially treats the whole community as one unit, and establishes semi-formal or formal institutions through which microfinance is dispensed. Such institutions are usually formed by extensive help from NGOs and other organizations, who also train the community members in various financial activities of the community bank, closely related to the village banking model. These institutions may have savings components and other income-generating projects included in their structure. In many cases, community banks are also part of larger community development programmes which use finance as an inducement for action. Village banks are community-based credit and savings associations. They typically consist of 25 to 50 low-income individuals who are seeking to improve their lives through self-employment activities.

Community-based organizations (CBO) differ from solidarity group in that they assume eventual graduation of their borrowers from the lending institutions. Therefore, the primary function of CBOs is to develop internal financial management capacity of the group in order to create a mini-bank, independent of the lending institution, owned and managed entirely by the poor. The subcategories of the CBOs are community managed loan funds (CMLF) and village savings and loan associations (VSLA). The former is more widely known as a village banking model and it was developed by John Hatch of FINCA.

The Reasons Why Community Banking Makes Sense of Popularity

- It is “micro” enterprise with “macro” impact. One out of five people struggle to live on less than Rs.50 a day. But a loan of Rs. 5,000 can make the difference between abject poverty and survival. Creating a successful small business generates on-going income for food and shelter for the family and funds for children to attend school.
- It helps people help themselves. Loans to start or expand small businesses help the poor raise their standard of living under their own management and initiative.
- Community banks borrow a lump sum during fixed cycles and distribute smaller increments to each bank member. The guarantee on the loan is the high degree of peer pressure among members to assure that all pay back on time. In the case that one member defaults, the others members must cover the deficit to ensure access to another loan cycle.
- Small loans are direct deposits against hunger. When mothers earn, whole family gets benefits. This increased capacity to buy more food improves the family’s diet, making them less vulnerable to disease and death.
- It breaks the cycle of poverty. In developing countries more than half of the population survives by working in small-scale businesses or microenterprises. Access to credit enables the poor to transform their own communities. And because the model is replicable and the money is recycled, community banks can cost-effectively reach far greater numbers of people than traditional aid programs.
- It doesn’t create dependency. Bank members don’t need to receive loans for a lifetime. Many “graduate” after a few years with healthy businesses that rely on their own profits for continued growth.
- Members learn while they earn. Bank members learn skills that improve their businesses and personal lives. They elect officers, keep records, budget their incomes and savings, and share marketing strategies. Some groups add health education to their weekly meetings.

- It provides a safe way to save. Commercial banks require such high minimum deposits that the very poor are locked out. When banked collectively, precious savings are protected from theft, exploitation and natural disasters. Savings plans in community banks often give people the opportunity to save for the first time in their lives.
- It builds more than small businesses. By providing mutual support and encouraging individual empowerment, community banks build stronger families and strengthen civil society. Members often use their new skills to build up community organizations and their churches.
- It pays for itself. Community bank programs have the potential and goal of becoming self-sustaining. The interest charged on loans helps finance program operations and provides continued capital to make loans available to new communities.

C. Co-Operative Model

Cooperatives are very much like 'associations and Community Banks' except that their ownership structure does not include the poor. A co-operative is an autonomous association of persons belonging to the same local or professional community united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise. Some cooperatives include member-financing and savings activities in their mandate. Members participate in all the major decisions and democratically elect officers from among themselves to monitor the administration of the co-operative. Creditworthiness and loan security are a function of cooperative membership within which member savings and peer pressure are assumed to be a key factor. Though the magnitude and timing of savings and loans are largely unrelated, a special effort is made to mobilize savings from members.

The leading organization that has been successful in using the co-operative form in rural micro finance in India has been the Cooperative Development Forum (CDF), Hyderabad, which has relied upon a 'credit union' involving the saving first strategy. It has built up a network of Women Thrift Groups (WTGs) and Men Thrift Groups (MTGs). They are registered under Mutually

Aided Cooperated Society Act (MACs) and mobilize savings resources from the members and access outside/supplementary resources from the individual system. The WTG or MTG are divided into small groups (10 to 15 members) to facilitate better monitoring of thrift and repayment of loans. CDF encouraged members to identify more strongly with their WTG/MTG rather than with the groups, as WTG/MTG are the primary legal entities and viable units of operation.

Advantages of the Model

- Most of the WTG/MTGs decided to register themselves under the New Generation Cooperative Act, which allows for greater flexibility and autonomy in operations. A set of geographically continuous cooperatives forms an association of WTG/MTG.
- The Associations provides training, management of the loan insurance fund and inter-lending. It also plays a support role by helping the member cooperative in handling accounting, auditing and other administrative matters.
- Cooperatives can access various types of savings from its members besides providing credit like other MFOs. It can also easily get its stakeholders in the governance structure by the use of democratic processes.
- Cooperatives can grow organically by setting up federations as and when they have a need to wield clout and negotiate on matters of policy.

Contribution of Cooperative Models for Economic Development

Cooperatives reach significantly more individuals and families in the microfinance sector than other financial institutions. They have helped to improve access to finance for all. Financial cooperatives contribute to social development and improved living conditions in communities. They constantly innovate. They can fully assume their role in redefining the global financial sector if their importance and specific nature is recognized. They contribute to socio-economic development by:

- Creating sustainable local prosperity;
- Making it possible for all individuals to become self-sufficient;
- Helping to safeguard against excesses, risks and overly aggressive practices;

- Making members more resilient to external shocks;
- Participating in the creation of quality jobs;
- Being major drivers of economic growth;
- Encouraging innovation and sustainable development.
- Potential to scale-up their coverage of poor.
- Bringing good dividends in terms of increased lending and assured recovery.

Drawback of the Model

- The macro level studies indicate that the cooperatives at large have not been able to fully tap the potential of SBLP for reviving their business position. The general skewed spread of SBLP has also affected the linkage by cooperatives.
- Lack of appreciation of the potential involved under SBLP and inadequate professional and other abilities to pursue a programme of SBLP type are some of the constraints faced by the cooperatives.
- Cooperatives also experience problems in accessing mainstream finance, because of their poor image. No single cooperative has reached up to the level of activity to become eligible to be incorporated in the formal system of microfinance.
- Again, the greatest challenge on the governance front is the fact that so many cooperatives are not part of an organized network, but function as standalone organizations. Their area of operations is demarcated; this weakens their capacity for good governance.

D. The Grameen Model

Grameen model is based on the concept of joint liability. It is the brainchild of Prof Muhammad Yunus, founder of Grameen Bank in Bangladesh. Grameen model is the most accepted and prevalent micro-finance delivery model in the world today. Many MFIs have accepted the model as it has high focus on standardization and discipline. It has been highly successful in its banking service to the poor as well as in its poverty alleviation programmes. The most significant aspect of the Grameen Bank Model has been its high loan recovery rate (98%and above).

Grameen model is being followed by India by Association for Sarva Seva Farms (ASSEFA), Activities for Social Alternatives (ASA), SHARE Microfinance. Lt CASHPOR Financial and Technical Services Ltd have adopted this methodology with little variations.

The Objectives of the Grameen Bank Model:

- To extend banking facilities to poor men and women
- Eliminate the exploitation of the poor by moneylenders
- Create opportunities for self-employment for the vast multitude of unemployed in rural area
- Bring the disadvantaged, mostly women from the poorest households, within the fold of an organizational format which they could understand and manage by themselves
- Reverse the age-old vicious circle of 'low income, low saving and low investment' into a virtuous circle of 'low income, injection of credit, investment, more income, more savings, more investment, more income'.

Features of Grameen Model:

'Grameen credit' according to Muhammad Yunus, is based on the premise that the poor have skills which remain unutilised or under-utilised. 'Grameen credit' promotes credit as a human right and is targeted at the poor, particularly poor women. The most distinctive feature is that it is not based on any collateral, or legally enforceable contracts, but on trust. It provides service at the doorstep of the poor based on the principle that the bank should go to the people.

Another unique feature of 'Grameen credit' is that it gives high priority to building social capital through the formation of groups and centers, develops leadership qualities and undertakes a process of discussion among borrowers. It lays special emphasis on protection of the environment and children's education, and provides scholarships and student loans for higher education. For the formation of human capital it attempts to increase people's access to technology, like mobile phones and solar power.

Working of Grameen Model:

- Operating Unit: A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The man-

ager and workers start by visiting villages to familiarise themselves with the local milieu in which they will be operating and identify prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local population. Grameen model, as mentioned, is a joint liability group model.

- **Eligibility for Loan:** In the first stage, out of Group of five prospective borrowers; only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks, other members of the group become eligible themselves for a loan.
- **Group Meetings:** Meetings also take place only at the Central level and individual groups do not meet. Group meetings take place only in front of the Field staff of the MFI. The model suggests weekly meeting for frequent interaction with the clients to reduce credit risk. These groups of five meet together weekly, with seven other groups, so that bank staff meets with forty clients at a time. The meetings are conducted for carrying out the financial transactions only. The meetings are conducted systematically in a short-time and other social issues are not discussed.
- **Terms and Conditions of Loan:** Flat interest is charged again for making the system standardized. In flat rate system installment size of repayment remains small for all weeks and hence is convenient and easier to explain. Also, it is easy to break the loan installment into the principal and interest component. The group leader collects the loan repayments and savings prior to the meeting and hands it over to the Centre leader who gives it to the field worker during the meeting. This collected amount is deposited in the branch on the same day.
- **Joint Liability:** The Group and Center are Joint liability Groups, which means that all members are jointly responsible ('liable') for the repayment. MFI recovers full money from Center, if any member has defaulted; the group members have to pool in money to repay to the MFI. If Group members are unable to do it, Center as whole has to contribute and share the responsibility. According to the rules, if one member

ever defaults, all in the group are denied subsequent loans. Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense, collective responsibility of Group/Peer pressure replaces the collateral.

E. Intermediary Model

Access to microfinance has improved lives up to some extent, the estimated impact appear to be quite small and heterogeneous. This is because of the restrictions mandated by microfinance institutions. A better model of microfinance should be designed that will be more flexible system of microfinance that targets smallholder agriculture, without requiring collateral and without endangering financial sustainability. Ideally it should allow individual liability loans, drop savings requirements, have less rigid repayment schedules (so that recipients can invest in high return projects with longer gestation period like agriculture) and reduce/eliminate costly meetings with MFI officials. Designing such a model that functions is not easy because crucial issues like borrower selection and repayment incentives have to be addressed.

Intermediary model of credit lending position is a 'go-between' organization between the lenders and borrowers. The intermediary plays a critical role of generating credit awareness and education among the borrowers (including, in some cases, starting savings programmes. These activities are geared towards raising the 'credit worthiness' of the borrowers to a level sufficient enough to make them attractive to the lenders. The links developed by the intermediaries could cover funding, programme links, training and education, and research. Such activities can take place at various levels from international and national to regional, local and individual level.

Intermediaries could be individual lenders, NGOs, microenterprise/ microcredit programmes, and commercial banks (for government financed programmes). Lenders could be government agencies, commercial banks, international donors, etc.

From a policy perspective this approach resembles the recent policy recommendation by the Reserve Bank of India to set up a network of banking correspondents (BCs) and banking facilitators (BFs) in order to expand finan-

cial services to rural areas, remote locations and uncovered households. The agents in our framework could be viewed as BFs.

Advantages of the Model:

- The loans involve several dynamic features to encourage borrower repayment incentives: future eligibility for loans is linked to repayment of current loans, and loan sizes grow progressively with successful repayment. Safe borrowers would make a positive contribution to social surplus.
- The loans are designed to finance cultivation and marketing of agriculture produce. Borrowers can repay in the form of producer's cold store receipts at harvest time, so they do not have to sell the crop at that time in order to repay the loans.
- An insurance aspect is included in the loan: repayment obligations are reduced following adverse village level covariate shocks to crop yields or revenues (which are verified by post-harvest surveys).
- Intermediated loans experience higher take up (controlling for landholding) as these clients do not have to bear the burden of making up for the repayment burdens of their group members if the latter default. Nor do they have to incur the costs of attending group meetings, achieving savings targets, or all the problems of free-riding and social tensions.
- Some additional features reduce transactions costs for borrowers: loans are made directly by the MFI, with MFI officials visiting each borrower in their homes. Borrowers do not have to open bank accounts, with all transactions taking place at their door-step. There are no savings requirements or mandated meetings with agents or MFI officials.
- The administrative costs of lenders are substantially lower owing to the elimination of these requirements, since MFIs do not have to hire officials who conduct weekly meetings and collect savings deposits from borrowers.

Drawbacks of the Model:

- The success of this program will crucially depend on the agent recommending good clients. So the obvious question is: what are the agent's incentives to recommend good clients. Therefore handsome share of commission has to be given to agents.

- With the higher provision of incentives for intermediaries, cost of borrower will rise, which will further deteriorate the situation.
- Agents can refer clients, pursue the client's proposal and facilitate the MFIs to carry out its transactions; however the final decision on whether to actually provide the loan to the recommended household rests with the actual lender.
- Finally agents might be politically motivated and might view this as an extension of the government anti-poverty programs and use this to increase the political dominance of the party in power within the village.

F. Individual Banking Model

In the past decade, many MFIs have begun to recognize that the traditional group based lending (GBL) model is too restrictive and not universally applicable. As a result, many institutions have started to shift towards various alternative models including group based loans with individual liabilities where repayment is still weekly during a group meeting, or by simply shifting to a model that extends an individual liability loan. The shift towards individual loans has been remarkable over the past few years. As Dean Karlan and Jonathan Zinman said "recent estimates suggest that about one-half of microfinance institutions are individual liability lenders." Therefore, it is not accurate to denote that microfinance is solely based on a group lending methodology. The individual model is, in many cases, a part of a larger 'credit plus' programme, where other socio-economic services such as skill development, education, and other outreach services are provided. This is a straight forward credit lending model where micro loans are given directly to the borrower. It does not include the formation of groups, or generating peer pressures to ensure repayment.

Advantages of the Model:

There are many reasons why individual loans are better in some instances than group loans.

- Specifically, these loans may attract new clients who did not participate previously in microfinance programs because the group atmosphere did not suit their needs. In turn, this allows an MFI to increase its reach.

- Individual loans also permit MFIs to tailor the loan specifically for its clients' needs. This is especially attractive for agricultural financing, which needs more flexibility in its repayment cycles.
- Individual loans also give a client more privacy. By taking away the group atmosphere, individuals do not have to disclose their financials to anyone other than the MFI.
- Finally, individual loans give MFI an opportunity to monitor the uses of the loan more closely to ensure that it is going to the assumed purpose. This means that MFOs must become more actively engaged with individual clients, which could potentially increase the costs of servicing these loans.

Drawbacks of the Model:

Individual lending also comes with some reservations.

- Few MFIs provide individual loans to low-income people because poorer clients are considered higher risk clients due to their lack of collateral, plus the labor intensive nature of the credits and hence the lack of profitability of small-credits.
- Group peer pressure is absent and therefore programme management, client appraisal poses specific challenges. Here clients have to be monitored and deeper field research is necessary in order to choose the right clientele, especially because these people have no tangible collateral or credit history and in most cases are illiterate.
- With this model, the loan is given directly to the borrower and it is his/her sole duty to pay back the full amount plus interest rates without financial support from a group in case he/she defaults.
- Technical assistance as well as payment schedules and business management training is generally provided by the MFI for recovery of loans. More monitoring might lead to increased costs of servicing a loan, as mentioned previously. Screening potential clients might end up being costly as well.

15.10 ROLE OF MICROFINANCE IN ECONOMIC DEVELOPMENT

Microfinance play an important role in beginning and expanding the small business by offering small loans to lower income groups which generate income and employment to local communities. Microfinance has been treated as an important tool for economic development. Microfinance plays vital role in economic development through following ways:

- **Poverty Alleviation:** According to World Bank report 1.4 billion population in developing countries is living on less than 1.25 US dollar a day. That's why to alleviate poverty by the year 2015 is one of the major millennium development goal announced by UNO in 2008. To eradicate poverty most of the nations including India have been pursuing various policies and programmes.
- **Women Empowerment:** Microfinance is an important tool not only reducing poverty but also empowering women as normally more than 50% SHGs are formed by women. SHGs has proved to be strategic tool for organizing women in groups and promoting their saving habits to gain greater access to financial and economical resources. Poor women use small loans to start a long chain of economic activity and raise their socio-economic status in the society.
- **Financial Inclusion:** Microfinance has been recognized as an important tool in connectivity the unbanked population to mainstream institutional banking services. It has contributed to reduce their dependency on informal money lenders and non-institutional sources.
- **Mobilization of Savings:** Microfinance develops the saving habits among the people. Now poor people with meager income also save money and are bankable. The financial resources generated through saving of group members and micro credits obtained from banks are utilized to provide loans to its members.
- **Financial Stability:** Microfinance has also played a greatest in providing financial stability to people which contributed to local economies in substantial extent. Small loans have offered opportunities to earn extra income, so that people can pay for their extreme necessities.

- **Global Poverty:** Financial stability to poor and low income families through small loans may break the poverty cycle for future generation. As many of these communities started growing, the local economies are started flourishing. The gross domestic product of the country started increasing and gap between the poorer and wealthiest people has also decreased.
- **Development of Skills:** Microfinance has helped in identifying the potential rural entrepreneurs. SHGs encourage its members to set up their businesses jointly or individually. They receive training from their supporting institutions and learn leadership qualities. Thus, microfinance helps indirectly in the Development of Skills.

15.11 ROLE OF NABARD IN PROMOTING MICROFINANCE

- **The SHG-Bank Linkage Program:** NABARD conceptualised and launched Self-Help-Group-Bank Linkage Program (SBLP) in 1992, which attempts to link the rural poor in large numbers to the formal banking sector in a sustainable and cost effective manner. This has emerged as the predominant micro finance model in the country and is now a proven method of financial inclusion, providing unbanked rural clientele access to formal financial services from the existing banking system.
- **Supporting Grant to Agencies:** NABARD continued to extend grant support to NGOs, RRBs, DCCBs, Farmer Clubs (FCs) and Individual Rural Volunteers (IRVs) for promoting and nurturing quality SHGs. Efforts continued towards roping in new Self-Help Promoting Institutions (SHPIs) and supporting the existing ones.
- **Capacity Building:** Capacity building of stakeholders is crucial for up-scaling the SHG movement and maintaining the quality & sustainability of SHGs. NABARD supports capacity building programs for SHG members, officers of commercial banks, cooperative banks, RRBs, PRIs, and Government departments including IAS officers.

- **Micro-enterprise Promotion:** NABARD launched in 2008-09 a scheme for supporting small-scale activity based groups [ABGs] under which NABARD provides support for capacity building, production and investment credit and market related aspects. NABARD support is in the form of grant for group formation, training, extension services, and market linkage.
- **Micro-Enterprise Development Program:** NABARD in 2005-06 had launched a pilot program 'Micro-Enterprise Development Program' (MEDP) to motivate and assist members of matured SHGs to take up income generating activities on a sustainable basis. MEDP is being implemented in nine districts in nine States, involving 14 NGOs, which act as 'Micro-Enterprise Promotion Agency' (MEPA).
- **Support to SHG-Federations:** NABARD, recognizing the emerging role of the SHG Federations and their value addition to functioning of SHGs, enhancing the bargaining powers of group members and livelihood promotion, introduced in 2008-09, a flexible scheme to support SHG-Federations, on a model neutral basis.
- **Support to Joint Liability Groups (JIG):** NABARD had launched pilot project on financing Joint Liability Groups (JLGs) through select RRBs and PCARDB, which proved success.
- **Support to MFIs:** Recognizing the role of MFIs in supplementing the efforts of the formal banking network in providing credit support to unreached clients for inclusive growth, NABARD supports them through grant and loan-based assistance from the Micro-Finance Development and Equity Fund (MFDEF).
- **Revolving Fund Assistance:** NABARD has been selectively supporting MFIs by providing revolving financial assistance (RFA) for on lending to the unreached poor as also experimenting with various MF models to innovate alternative, sustainable and replicable credit delivery systems.
- **Support for Rating of MFIs:** NABARD provides financial assistance to commercial banks and RRBs to avail the services of credit rating agencies (such as CRISIL, M-CRIL, ICRA, CARE and Planet Finance)

for the purpose of rating of MFIs and empowering them to intermediate between the lending banks and the clients.

- **Capital/Equity Support:** NABARD, under its Capital/Equity Support scheme, provides financial assistance to MFIs to leverage capital/equity for accessing funds from banks, providing financial services at an affordable cost to the poor, and achieve sustainability in credit operations over 3 to 5 years.
- **Rajiv Gandhi Mahila Vikas Pariyojana:** NABARD in collaboration with the Rajiv Gandhi Cheritable Trust (RGCT) has designed the Rajiv Gandhi Mahila Vikas Pariyojana to promote, credit link and form SHG Federations in selected districts of Uttar Pradesh.
- **SHG-Post Office Program:** The project aimed at utilizing the vast network of Post Offices in rural areas in disbursement of credit to rural poor, on an agency basis.
- **Financial Assistance for Developing Software:** NABARD had sanctioned Rs.10.29 lakh to MYRADA for developing software for NGOs to help them understand the functioning and performance of SHGs.
- **NABARD-KfW program:** The NABARD-KfW program being implemented in Gujarat aims at improving access of poor women to micro-credit on a sustainable basis, both in rural and urban areas.
- **NABARD-GTZ Rural Finance Program:** Under the 'NABARD-GTZ Rural Finance Program' training modules were developed to sensitize bank branch managers and SHG members for minimizing risks in lending through early warning system and provided to training institutes involved in MF.

15.12 PROBLEMS OF MICRO FINANCE

- **Financial illiteracy:** One the major problems in India towards the growth of the microfinance sector is illiteracy of the people. This makes it difficult in creating awareness of microfinance and even more difficult to serve them as microfinance clients.
- **Lack of information:** There are various sources of credit information in India, but none of these focuses on small, rural borrowers. Credit

information on such borrowers is difficult to obtain because the majority of the rural poor rely on money lenders and other informal lenders, and it is not in the interest of such lenders to pass on a borrower's good credit repayment record to other providers of finance.

- Inability to generate funds: MFIs have inability to raise sufficient fund in the microfinance sector which is again an important concerning challenge. Through NBFCs are able to raise funds through private equity investment because of the for profit motive, such MFIs are restricted from taking public deposits.
- Heavy dependence on banks & FIS: MIF's are dependent on borrowing from banks & FIS. For most of the MFI's funding sources are restricted to private banks & apex MFI's.
- Weak governance: Many MFI's are not willing to convert to a corporate structure; hence they trend to remain closed to transparency and improved governance, thus unable to attract capital. MFI's also facing a challenge to strike a balance between social and business goals.
- High Interest Rate: MFIs are charging very high interest rates, which the poor find difficult to pay. MFIs are private institutions and therefore require being economically sustainable. They do not get any subsidized credit for their lending activities and that is why they need to recover their operational costs from borrowers
- Regional Imbalances: There is unequal geographical growth of Microfinance institutions and SHGs in India. About 60% of the total SHG credit linkages in the country are concentrated in the Southern States. However, in States which have a larger share of the poor, the coverage is comparatively low.



CHECK YOUR PROGRESS

Write the full form of the following:

1) SHGs _____

2) NGOs _____

3) MFIs _____

4) MUDRA Bank _____

5) NABARD _____

6) RRBs _____

7) SBLP _____



15.13 LET US SUM UP

In this unit, we have discuss the following :-

- Micro Finance refers to the provision of affordable financial services extended to socially and economically poor and disadvantaged segments of the society.
- The main aim of micro finance is to provide small loans to poor people particularly living below poverty line.
- The concept of microfinance initiated as an introduction of Muhammad Yunus (2006) in the form of Grameen Bank in Bangladesh.
- In India, NABARD initiated the concept of microfinance.
- Microfinance aims at removal of poverty, empowering poor, mostly women.
- The important channel for growth of microfinance in India is through Microfinance Institutions (MFIs).
- The various models currently being used by microfinance institutions throughout the world are: Associations, Bank Guarantees, Community Banking, Cooperatives, Credit Unions, Grameen, Group, Individual, Intermediaries, NGOs, Peer Pressure, ROSCAs, Small Business, and Village Banking models.
- Microfinance has been treated as an important tool for economic development.



15.14 FURTHER READING

- Microfinance in India: Approaches, Outcomes, Challenges –By by Tara S Nair (Editor)
- Indian Microfinance: The Challenges of Rapid Growth -By Prabhu Ghate
- Microfinance in India: A Performance Evaluation –By Anil Kumar Chauhan and S. M. Feroze
- Website of NABARD & RBI



15.15 ANSWERS TO CHECK YOUR PROGRESS

1) Self-Help Groups
2) Non-government Organizations
3) Microfinance Institutions
4) Micro Units Development Refinance Agency Bank
5) National Bank for Agriculture and Development
6) Regional Rural Banks
7) Self-Help-Group-Bank Linkage Program



15.16 POSSIBLE QUESTIONS

1. Write short notes on:
    - Micro Insurance
    - Micro Credit
    - MUDRA Bank
2. Define and explain Microcredit?
3. Define and explain Microfinance?
4. Why Microfinance is needed?
5. What is the role of Microfinance?

6. What are the general characteristics of Microfinance clients?
7. What is meant by Microfinance? Differentiate between Microcredit and Microfinance?
8. Explain the role of Microfinance? What are the benefits of Microfinance?
9. Define and explain Microfinance? How the Microcredit emerged and turned into Microfinance?
10. How Microfinance provides economic and social upliftment of the poor people who are in the grip of vicious cycle of poverty?

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