PGBA (S4) 02-1

Management of Financial Services

SEMESTER - IV

BUSINESS ADMINISTRATION

BLOCK - 1

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

Subject Experts

Prof. Nripendra Narayan Sarma, Maniram Dewan School of Management, KKHSOU.
Prof. U. R Dhar, Retd. Professor, Dept of Business Administration, GU.
Prof. Mukulesh Baruah,Director, Assam Institute of Management.

Course Co-ordinator :	Dr. Smritishikha Choudhury, Asst. Prof., KKHSOU
SLM Preparation Team	Dr. Chayanika Senapati, Asst. Prof., KKHSOU

UNITS	**CONTRIBUTORS**
1-7	Ms. Karabi Goswami, AIM

Editorial Team

Content :

1-7	Dr. Devajit Goswami,KKHSOU
Structure, Format & Graphics:	Dr. Smritishikha Choudhury,KKHSOU Dr. Chayanika Senapati, KKHSOU

January, 2019

ISBN :

This Self Learning Material (SLM) of the Krishna Kanta Handiqui State Open University is made available under a Creative Commons Attribution-Non Commercial-Share Alike 4.0 License (international): http://creativecommons.org/licenses/by-nc-sa/4.0/

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

Headquarters: Patgaon, Rani Gate, Guwahati-781017
City Office: Housefed Complex, Dispur, Guwahati-781006; Web: www.kkhsou.in

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

MASTER IN BUSINESS ADMINISTRATION

Management of Financial Services

Block 1

DETAILED SYLLABUS

Unit 1: Introduction to Financial Services:

Concept of Financial Services, Types of Financial Services, Features of Financial Services, Importance of Financial Services, Scope of Financial Services;Service providers in Financial Services sector, Commercial Banks, Non Banking Financial Companies(NBFC), Development Financial Institutions (DFI), Mutual funds, Insurance Companies; New financial products and services, Future of Financial Services in India

Unit 2: Indian Financial System:

Financial System, Significance of the Financial System; Components of the Indian Financial System, Financial Institutions, Financial Markets, Financial Instruments; Functions of the Financial System, Role of the Financial System in Economic Development.

Unit 3: Money Market Instruments:

Concept of Money Market,Characteristics of the Money market; Role and Importance of the Money Market; Money Market Instruments,Call and Short notice money, Commercial Paper, Treasury Bills, Certificate of Deposits (CD), Repurchase Agreements (REPO), Money Market Mutual Funds (MMMF); Recent developments in the Indian Money market, Deficiencies and problems in the Indian Money market

Unit 4: Capital Market:

Concept of Capital Market, Characteristics of Capital Market, Distinction between Money Market and Capital Market; Importance of Capital Market;Components of

Capital Market; Primary Market/New Issue Market, Functions of Primary Market/ New Issue market, Issue Mechanism of an Initial Public Offer (IPO), Intermediaries and their Role in the New Issue Market; Shares, Difference between Shares and Stock, Types of Shares; Debentures/Bonds, Difference between Shares and Debentures, Types of Debentures/ Bonds

Unit 5: Securities Trading, Stock exchanges & SEBI:

Securities Trading, Scrip-Based Traditional Trading/ Physical Trading, Scripless or Paperless Trading/ Dematerialization (Demat); Depository System, Activities of the Depository, Constituents in a Depository System, Role of Depositories in Dematerialization, Role of Depository Participants and Process of Dematerialization; Stock Exchanges, Major Stock Exchange of India, Functionaries of Stock Exchanges; Securities & Exchange Board of India (SEBI), Objectives of SEBI, Functions of SEBI, Organization of SEBI, Powers of SEBI

Unit 6: Indian Banking System and RBI:

Bank Its Meaning, Different kinds of Bank; Banking Structure in India, Types of Scheduled Commercial Banks; Commercial Banks and its Principles, Services provided by Commercial Banks; Reserve Bank of India and its Functions, Traditional Functions, Promotional Functions; Credit Control Measures of RBI, Quantitative Measures, Qualitatative Measures

Unit 7: Management of Risk:

Risk in Financial Services, Causes of Risks; Types of Risks in Financial Services; Difference Between Systematic and Unsystematic Risks; Risk Management by Financial Institutions, Typical Causes of Financial Crisis in Banks;Role of Technology in Risk Management.

COURSE INTRODUCTION

This is the second course of MBA fourth semester Finance specialisation Programme. This course "Management of Financial Services" of MBA 4th semester will focus on the different aspects of management accounting. In this course we have briefly discussed about Financial Services, Financial Services in India, Securities trading, stock exchanges & SEBI etc.

This course consists of fourteen units. This course starts with the unit discussing the concept of the introduction to Financial services.

The course has 14 units and is divided into two blocks: Block 1 and Block 2.

Block 1 deals with the introductory concepts of Financial services, Indian Financial system, money market instrument, Capital Market, Securities trading, stock exchanges & SEBI , Indian Banking System and RBI, Management of Risk.

Block 2 concentrates on Merchant Banking Services, Mutual Funds, Insurance Services and IRDA, Leasing and Hire Purchase, Corporate Restructuring, Securitization, Factoring and Forfaiting and credit rating services

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.

BLOCK INTRODUCTION:

This is the first block of the course “Management of Financial Services”. The Block is divided into7 units and is primarily a learner oriented Self learning material, as it satisfies the requirements of the learners in the filed of Accounting.

This block comprises of the following seven units:

The first unit introduces us to Meaning and Concept of Financial Services

The second unit gives us a broad idea of Indian Financial System.

The third unit gives us an idea on the Money market instruments.

The fourth unit will help us in understanding Capital market.

The fifth unit gives us a broad idea of Securities trading, stock exchanges & SEBI .

The sixth unit will help us in understanding the concept of Indian Banking System and RBI.

The seventh and the last unit of this block explains about Management of Risk.

The Block is devided into seven units:

Unit 1: Introduction to Financial Services

Unit 2: Indian Financial System

Unit 3: Money Market Instruments

Unit 4: Capital Market

Unit 5: Securities Trading, Stock exchanges & SEBI

Unit 6: Indian Banking System and RBI

Unit 7: Management of Risk

UNIT- 1: INTRODUCTION TO FINANCIAL SERVICES

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Concept of Financial Services

- 1.3.1 Types of Financial Services
- 1.3.2 Features of Financial Services

1.4 Importance of Financial Services

1.5 Scope of Financial Services

1.6 Service providers in Financial Services sector

- 1.6.1 Commercial Banks
- 1.6.2 Non Banking Financial Companies(NBFC)
- 1.6.3 Development Financial Institutions (DFI)
- 1.6.4 Mutual funds
- 1.6.5 Insurance Companies

1.7 New financial products and services

1.8 Future of Financial Services in India

1.9 Let us sum up

1.10 Further Reading

1.11 Answers to Check your progress

1.12 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- conceptualize the meaning of financial services, its features and types.
- identify the importance and scope of financial services in an economy.
- explain the role of various service providers operating in the financial services sector.

- know about the growth and future of financial services in India.

1.2 INTRODUCTION

This is the first unit of the course "Management of Financial Services". Before we proceed to the Financial Services, we have to accustom ourselves with the functions of the financial systems. Financial services are a component of overall financial system of an economy. Financial system is significant for capital formation. The capital formation is indispensable for the growth of the economy. The process of capital formation comprises three inter related activities, which are

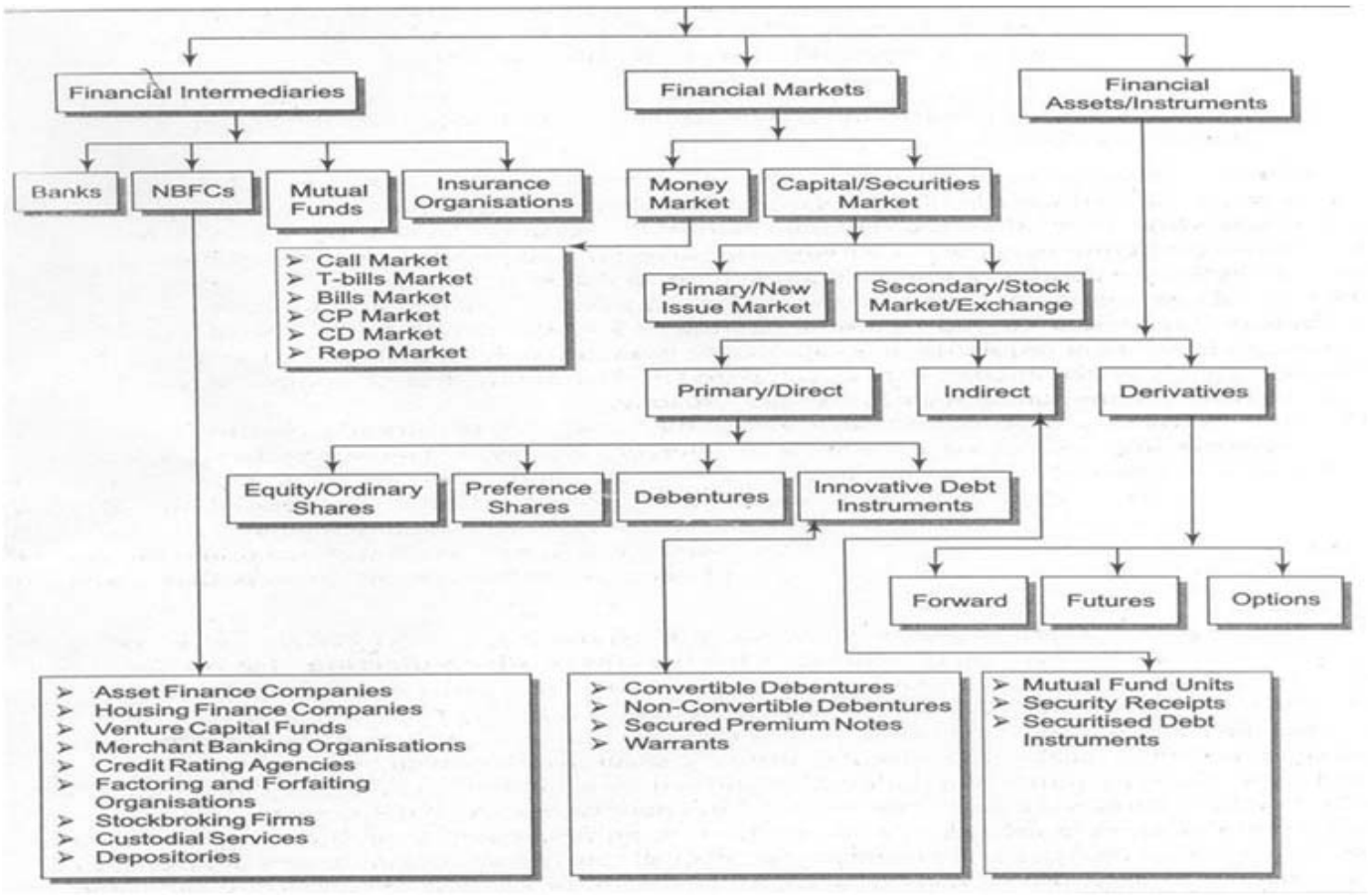
- Savings: Setting aside of resources for specific purposes
- Finance: Assembling of resources from various sources such as domestic savings, funds from abroad, bank deposits etc.
- Investments: The process by which resources are actually committed to production.

The volume of capital formation depends upon the intensity and efficiency with which the above three activities are carried on. The financial system acts as a link between the savers and the investors facilitating smooth flow of savings to industrial investment. The organization structure of financial system consist of three parts, they are

1. Financial Intermediaries
    - Banks
    - Non Banking Financial Company (NBFC)
    - Mutual Funds
    - Insurance Companies
    - Development banks and All India finance institutions etc.
2. Financial Market
    - Capital Market
    - Money Market
3. Financial Instruments.
    - Shares
    - Bonds and Debentures
    - Derivatives etc.

To add, financial services are basically services provided by the financial intermediaries. The organization and components of the financial system has been discussed in greater detail in UNIT 2.

The following chart portrays the organization of the financial system

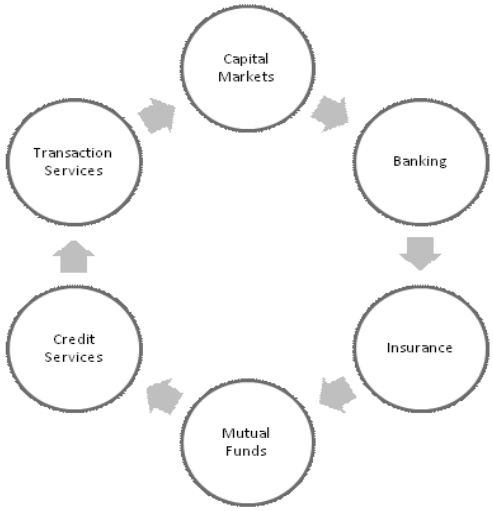


Source: Indian Financial System, M Y Khan, McGraw Hill Education

1.3 CONCEPT OF FINANCIAL SERVICES

Financial Services may simply be defined as services offered by different financial intermediaries such as Banks, Financial Institutions, Insurance Companies, Brokerage Firms, Consumer Finance companies etc. In simple words, Financial Services is basically the services provided by the financial market to the individuals and organizations. It is concerned with the design and delivery of services and financial products to individuals

and businesses within the areas of banking and related financial institutions, financial planning, investments, real assets, insurance and so on.



1.3.1 Types of Financial Services

The financial services can broadly be categorized in four types as described below:

1. **Capital Market services**: It is the segment of financial market where long term funds (one year and above) are issued and traded. The main instruments used in the capital markets are shares, debentures, bonds etc.
2. **Money Market services**: Unlike capital market, money market is the segment in which financial instruments with maturities of less than one year are. Some of the money market instruments are Treasury bills, commercial paper, trade bills, certificate of deposits etc.
3. **Retail Services**: The financial services which is provided to individual customers by various financial intermediaries are termed as Retail services.
4. **Wholesale Services**: The services provided to the corporate institutions which may be directly or indirectly converted in to retail services.

1.3.2 Features of Financial Services

The following are the features of financial services:

1. **Customer centric:** Financial services are mainly customer focused. The company providing these services needs to study the requirement of the customer in terms of liquidity, safety, risk appetite, duration of the product. Innovativeness within the regulatory framework is the key to success for the service providers.
2. **Intangibility:** Financial services are intangible in nature. Hence, the brand and image of the institution providing the service is very important to restore the confidence of the customers.
3. **Perishable in nature:** Financial services do tend to perish if they cannot be offered as per the requirement of the client. Hence the organization needs to ensure proper synchronization of demand and supply.
4. **Dynamic in nature**: Financial services vary with the changing requirements of the customers and the socio-economic environment such as disposable income, standard of living etc.

1.4 IMPORTANCE OF FINANCIAL SERVICES

For any economy, the success of its financial system depends upon the financial services offered by its financial services organization. The importance of good financial services can better be understood by studying the following points.

1. **Economic Growth**: The economic growth of any country depends upon the proper channelization of it savings and investments. The role of financial services industry is to ensure proper mobilization of savings of the people in to productive investments by providing various services to retail as well corporate clients.
2. **Promotion of savings**: One of the prime importance of financial services is to promote savings among people. The financial services organizations continuously innovate products to promote savings among the general public.

3. **Capital formation**: Financial service industry facilitates capital formation by providing different types of capital market intermediary services.
4. **Creation of employment**: The Financial services sector employs millions of people across the globe.
5. **Provision of liquidity**: The financial service industry promotes liquidity in the financial system. It facilitates easy conversion of financial assets into liquid cash.

1.5 SCOPE OF FINANCIAL SERVICES

Financial services cover a wide range of activities, which can be broadly categorized into two groups. They are:

I. Traditional activities:

It includes those activities which financial intermediaries are performing since their inceptions. These activities can further be categorized into :

a. Fund based activities ; and
b. Non Fund based activities

a. Fund based activities: Traditional financial services which includes fund based activities are :

- Underwriting of shares, bonds, debentures in Primary market
- Investments in existing shares, bonds, debentures in Secondary market.
- Participating in money market instruments which include commercial papers, Certificate of deposits, discounting of treasury and commercial bills etc.
- Dealing in foreign exchange
- Engaging in equipment leasing, hire purchase, venture capital etc.

b. Non- Fund based activities: Non- fund based activities are also known as fee based services. As the name suggest, these are the services which financial intermediaries provide in exchange for a commission, fee or charge. The following are the main non fund based activities which the organization offers to their clients.

- Managing pre issue and post issue of Initial Public Offer as per the guidelines of the Regulatory body.
- Arranging placement of capital and debt instruments of the client with prospective institutional investors.
- Arranging funds on behalf of the client from banks and Financial Institutions to meet their project costs or working capital requirements.
- Assisting clients in getting necessary Govt. permissions and clearances.
- Portfolio management for corporate clients, High Net worth Individuals and retail customers.
- Arranging mergers and acquisitions for their clients

II. Modern Activities:

In addition to the above services, the financial intermediaries are rendering innumerable other services in the recent period within the regulatory framework. Most of such services are in the nature of non-fund based activity. Following are some of the modern services introduced in recent past.

- Rendering project advisory services right from the preparation of the project report to raising of funds and obtaining government approval etc.
- Guiding corporate clients in their capital restructuring.
- Acting as trustees to the debenture holders.
- Suggesting suitable changes in the management structure for their corporate clients
- Developing appropriate measures to revive sick units
- Hedging of risks by using swaps and other derivative products.
- Managing the portfolio of large public sector undertakings.
- Advising clients in selecting the best source(s) of funds to suit their requirements
- Minimizing cost of debt and determining optimum debt-equity ratio for their clients.

- Undertaking services relating to capital markets, which mainly includes
  - Clearing services
  - Registration and transfers
  - Collection of income on securities
  - Safe custody of securities

CHECK YOUR PROGRESS

Q1. What are the three main constituents of the financial system?

_____

_____

Q2. What is meant by the term “financial services”?

_____

_____

1.6 SERVICE PROVIDERS IN THE FINANCIAL SERVICES SECTOR

The Financial intermediaries are the service providers in financial services. They are the link between the savers and the investors. The following are the service providers and their role in the overall financial system:

1.6.1 Commercial Banks:

Commercial banks primarily collect savings in the form of deposits from public and lend mainly short term loans to industries and firms. These banks mainly are of two categories:

- Nationalized or Public Sector Banks &
- Private sector banks (they can further be categorized into)
  i. Indian Banks
  ii. Foreign Banks

In addition to the commercial banks there are cooperative bank also. All banks are basically depository institutions. They are financial institutions for both money market and capital markets.

1.6.2 Non Banking Financial Companies (NBFC)

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956. They provide certain types of banking services but they do not hold a bank license. They compete closely with commercial banks in attracting public deposits and allocating those fund to corporate. The difference between commercial banks and NBFCs are :

- NBFCs cannot accept Demand Deposits.
- They are not a part of the payment and settlement system and they can't issue cheques on themselves.
- Deposit Insurance Facility is not available through NBFCs.

1.6.3 Development Financial Institutions (DFI)

In India Development Financial Institutions are developed by Government of India and State Governments to provide financial assistance to specific categories of industries. The financial assistance from DFI's are mostly medium to long term in nature although some of them have recently started supplying short term/ working capital finance to corporates. DFIs are important financial institutions in the capital markets of Indian economy. Few of the DFIs of India are Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), National Small Industries Corporation (NSIC), Small Industrial Bank of India (SIDBI), Northeast Development Financial Institution (NEDFi) and so on.

1.6.4 Mutual Funds

Mutual funds are the financial intermediaries who pool the small savings from public and invest them in a mix of stocks and bonds of corporate and government securities. The mutual fund companies actively manage the portfolio of the investors and earn income

through dividend, interest or capital gains. Mutual funds enable small investors to enjoy the benefits of investment in large companies shares & bonds. Presently Mutual funds play an important role in the Indian capital market.

1.6.5 Insurance Companies

Insurance companies have become key players in the capital market of India. Life Insurance Corporation of India (LICI) & General Insurance Corporation of India (GICI) are two most important public sector institutions in India. With the privatization of insurance sector in India in 2000, many private sector companies have entered the Indian market. As a result insurance sector grew rapidly in the last 15 years and they have deployed enormous financial resources in the Indian financial system.

1.7 NEW FINANCIAL PRODUCTS AND SERVICES

The intense competition in the financial services sector has forced the financial intermediaries to devise new products to meet the demand of its customers. Many new financial products and services have emerged in the capital market. Some of the products and services are given below:

1. **Merchant Banking:**Merchant banking is primarily focused on providing service to business undertakings on various financial matters. It is mainly concerned with providing non-fund based services with respect to arranging funds rather than providing them. They act as an intermediary between those who owns capital and those who need it. Merchant banking involves providing wide range of activities such as marketing of corporate and other securities, corporate advisory services, syndication of credit, underwriting new issues, corporate mergers and so on.
2. **Housing Finance Companies:**Housing finance simply refers to providing finance for house building. In India, National Housing Bank (NHB), a fully owned subsidiary of

Reserve Bank of India was set up in 1988. NHB is the apex institution in the housing finance segment. Some of the key players in the housing finance segments are Housing Development Finance Corporation (HDFC), Housing and Urban Development Corporation (HUDCO), LIC Housing Finance Limited (LIC HFL), Dewan Housing Finance Corporation (DHFL) etc.

3. **Hire Purchase and Consumer Credit Companies:** These types of companies provide finance to business firms to purchase of machinery and equipment. They also providefinance to households to purchase consumer goods on hire purchase basis. Hire purchase is a transaction where goods are purchased by consumer on the condition that the payment will be made in installments. The buyer gets only the possession of the goods but the ownership is transferred only after the payment of the last installment. If the buyer fail to pay the installments, the seller can repossess the goods. Each installment carries an amount of interest.
4. **Venture Capital Funds:** Venture capital funds are investment funds that manage the money of the investors who would like to take equity stakes in start up businesses or Small & Medium Enterprises with strong growth potential. The main objectives of the investors are to earn higher rate of return on their investments, hence venture capital is high risk investment vehicle.
5. **Lease Financing:** A lease is an agreement where a firm acquires a capital asset such as plant & machinery on payment of an agreed fee called lease rentals. The party who acquires the right to use the asset is known as the lessee and the party who gives the right is known as lessor. The ownership remains with the lessor.
6. **Credit Rating Agencies:** Credit rating agencies are responsible for assessing the creditworthiness of a

company. In other words, it rates the issuer of debt instrument on its ability and willingness to repay both interest and principal over the period of the rated instrument. Generally higher rating indicates more safety of the instrument. The rating indicates the judgment about an organisation's financial and business prospects.

7. **Factoring Services:** It is an arrangement under which the NBFC (factor) purchases the account receivables (arising out of credit sale) and make immediate cash payment to the customer (supplier/creditor). Thus the factor provides finance to the client in respect of account receivables. The factor or the institution undertakes the responsibility of collecting the receivables. Hence the risk is borne by the factor for which it charges fees from the client. The fee or the charge is called factorage.
8. **Forfaiting:** Forfaiting is related to international trade, where the forfaitor (financing agency) discounts an export bill and pay immediate cash to the exporter. It is a technique which helps the exporter to sell his goods on credit to the importer and receives cash before the due date against the bill from the financial institution.
9. **Custodial Services:** Custodial service is a fee based service provided by various financial intermediaries. Custodial services include keeping shares and bonds of the clients, collection of dividends & interest on behalf of the client, updating client about the corporate developments etc.
10. **Loan syndication:** Some of the projects needs huge amount of funding, hence it is not possible for one bank or financial institution to cater to such amount of loan. In such cases number of banks or FIs join together and form a syndicate to provide the loan. This act of providing large sum of money by forming a syndicate or consortium is called loan syndication. The risk and the interest on the loan is also shared among the syndicate members.

11. **Securitisation:**Securitisation is a financial innovation. Loans given by a financial agency is an asset in the books of the organization who is giving the loan. These loans are illiquid in nature and are not tradable or transferable. Securitisation is a process of transforming the loans into marketable securities. It is the conversion of existing or future cash flows into marketable securities that can be sold to investors.Some of the assets that can be securitized are loans like car loans, housing loans etc. and future cash flows like ticket sales, credit card payments, car rentals or any other form of future receivables.

12. **Bill Discounting:** Another popular form of financial product is bill discounting. In business most of the bills raised are time bill which is payable after a certain period of time. But businessman or the trader needs immediate cash for its working capital requirement, in such a situation the holder of the bill discount it with the banker/ financial agency to meet its liquidity. The organizations which discount the bill deduct a certain percentage from the bill as their fee and credit the remaining funds to the holder. On the due date of the bill, the drawee makes the payment to the bank/ financial agency. In case he fails to make the payment on the due date, the banker will recover the amount from the customer who has discounted the bill. So in a nutshell, bill discounting is basicallygiving loans on the basis of the security of a bill of exchange.

13. **Corporate Advisory services:** Certain financial intermediaries offer advisory services in the field of Euro Loans, GDR (Global Depository Receipts), ADR (American Depository Receipts) etc to their corporate clients. Such services are gaining popularity among corporate in recent times. This service is also referred to as corporate counseling.



CHECK YOUR PROGRESS:

Q.3 Fill in the blanks:

a) …….finance simply refers to providing finance forhouse building.

b) Northeast Development Financial Institution (NEDFi)is a……..

c) The fee or the charge for Factoring services is called ……..

d) This act of providing large sum of money by forming a syndicate or consortium is called……..

e) ……services is also referred to as corporate counseling.

1.8 FUTURE OF FINANCIAL SERVICES IN INDIA

The Indian financial services sector accounts for 6% of the nation's GDP (Gross Domestic Product) and is growing at a rapid pace. Indian financial services werecontrolled mainly by the Government till 1990's. In the year 1991 financial sector reform were initiated with a view to accelerate economic growth. Till then nationalized banks were the main service provider in this segment. Various reforms have been introduced in the Indian financial sector post 1990's, of which few of the prominent reforms are:

- Deregulation of lending rates
- Opening of the capital market to foreign Institutional Investors (FII)
- Free pricing of equity shares
- Licensing of new private sector banks and relaxation in new branch licensing.
- Opening up of insurance sector to private players
- Allowing Indian companies to raise capital abroad by issue of equity in the form of GDR (Global Depository Receipts)

All these have made the Indian financial services sector highly competitive. To stay ahead of the competition, the financial intermediaries

have introduced several new products and instruments in banking, insurance and capital market space.

This has resulted in the increase of the number of regulatory bodies in India. Apart from RBI, other new regulatory institutions have been established to regulate, supervise and develop the different financial markets and institutions. The following are the new regulatory institutions

- SEBI (Securities and Exchange Board of India): To regulate Indian stock market and mutual funds.
- IRDA (Insurance Regulatory and Development Authority): To regulate & develop Indian insurance industry.
- PFRDA (Pension Fund Regulatory and Development Authority): To regulate and develop pension fund industry.

These financial sector regulators have ensured that new regulation and guidelines are in tandem with the global norms. These developments have given a robust boost to the progress and modernization of the financial services sector in India.

- **Banking Sector:** As per the "India in Business" a website of the Government of India, Indian banking sector were worth $ 1.8 trillion in the financial year 2014-15. According to a report by KMPG-CII, India's banking sector will become fifth largest in the world by 2020.
- **Insurance Sector:** India's life insurance sector is biggest in the world and its market size is expected to touch about $ 400 billion by 2020. The size of the life insurance market during FY 2014-15 was $ 52 billion.

  Similarly the non-life insurance sector has grown significantly from $ 2.6 billion in 2002 to $ 14 billion in 2015.
- **Mutual Fund:** Mutual fund industries assets under management (AUM) recorded a compounded annual growth rate (CAGR) of 12.8% over Financial Year 2007 to 2016 to reach $215.4 billion as on 30th September, 2015. India is considered one of the preferred investment destinations globally.

- **Capital Markets:** The number of listed companies on National Stock Exchange (NSE) & Bombay Stock Exchange (BSE) has increased from 6445 companies in FY 2010 to 8634 companies in Jan 2015. This has resulted in to rapid expansion of the brokerage segment.
- **Non Banking Finance Companies (NBFC):** NBFC space has also grown substantially in past few years. NBFCs are the dominant player in retail finance space; more than 80% of equipment leasing and hire purchase are catered by NBFCs. As of 31st March 2015, there were 11842 NBFCs registered with RBI. Source: www.ibef.org

All the above points clearly indicate a bright future of financial services in India. Around 46% of the household savings in India are invested in bank deposits and 54% in other financial assets. With the introduction of innovative & customized products by various financial intermediaries, the shift is happening from simple bank deposits to other classes of financial assets.



1.9 LET US SUM UP

The following aspects have been discussed in this unit:

- The capital formation is indispensable for the growth of the economy. The process of capital formation comprises three inter related activities, which are Savings ,Finance and Investments.
- The organization structure of financial system consist of three parts, they are Financial Intermediaries, Financial Markets and Financial Instruments.
- Financial Services is concerned with the design and delivery of services and financial products to individuals and businesses within the areas of banking and related financial institutions, financial planning, investments, real assets, insurance and so on.
- The financial services can broadly be categorized in four types. Capital market services, Money market services, Retail services and Wholesale services.

- Customer centricity, Intangibility, perishability and dynamism are some characteristic features of the financial markets.
- The scope of traditional financial service may be categorized broadly as fund based and non fund based activities.
- Commercial banks, NBFC's, DFI's , Mutual funds , Insurance companies are financial intermediaries who act as service providers in the financial system.
- The financial sector regulators like SEBI, IRDA and PFRDA have ensured that new regulation and guidelines are in tandem with the global norms. These developments have given a robust boost to the progress and modernization of the financial services sector in India.



1.10 FURTHER READING



- Financial Services (2011) by Thummuluri Siddaiah; Pearson Education
- Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
- Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
- Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education

1.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: The organization structure of financial system consist of three parts, they are – Financial Intermediaries, Financial Markets and Financial instruments.

Ans to Q No.2: Financial Services is basically the services provided by the financial market to the individuals and organizations. It is

concerned with the design and delivery of services and financial products to individuals and businesses within the areas of banking and related financial institutions, financial planning, investments, real assets, insurance and so on.

Ans to Q No.3: a. Housing b. Development Financial Institution(DFI) c. factorage d. Loan syndication e. Corporate advisory



1.12 MODEL QUESTIONS

(1) Briefly explain the process of capital formation in an economy. Show the organization of the Indian financial system, diagrammatically.

(2) Explain the features of Financial services and its importance for any economy.

(3) What are fund and non fund based financial services? Explain.

(4) What are financial intermediaries and discuss their respective role in the financial system?

(5) Discuss the activities and role of few new financial products and services that have emerged in the capital market.

(6) Discuss the future of financial services in India.

(7) Write short notes on:

a. Bill Discounting.

b. Loan Syndication

c. Securitisation

d. Factoring Services

e. Merchant banking

*** ***** ***

UNIT- 2: INDIAN FINANCIAL SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Financial System

2.4 Significance of the Financial System

2.5 Components of the Indian Financial System

- 2.5.1 Financial Institutions
- 2.5.2 Financial Markets
- 2.5.3 Financial Instruments

2.6 Functions of the Financial System

2.7 Role of the Financial System in Economic Development

2.8 Let Us Sum Up

2.9 Further Reading

2.10 Answers to Check your progress

2.11 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- state the meaning of a financial system.
- know the components of the Indian Financial system.
- explain the difference between Money Market and Capital Market.
- know the functions of the financial system.
- state the role of the financial system in economic development.

2.2 INTRODUCTION

This is the second unit of the course “Management of Financial Services”. The financial system of an economy deals with the financial transactions and the exchange of money among savers, investors, lenders and borrowers. In this unit, we are going to discuss the meaning of a financial system and the components of the Indian Financial system.

We will get an idea on the difference between Money Market and Capital Market. We will also discuss the functions of the financial system and the role of the financial system in economic development.

2.3 CONCEPT OF FINANCIAL SYSTEM

Mr. L.M. Bhole & Mr. Jitendra Mahakud, has defined financial system in their book *'Financial Markets and Institutions'* as*" Financial system means a set of complex and interlinked institutions, agents, practices, markets, transactions, claims and liabilities dealing in money, credit and finance of an economy".* Hence the financial system of an economy mainly deals with four factors namely

- Money: It is the current medium of exchange or means of payment.
- Credit: It is the finance made available by lender to the borrower.
- Debt: It is the obligation of the borrower to make future payments to the lender.
- Finance: It is the monetary resources comprising of debt and ownership of funds of the state, company or individual

These terms are closely related and are often used synonymously. Hence, "financial system" is a set of institutional arrangement that interlink three main elements, namely, financial assets, financial market and financial institutions dealing in transfer of funds from the fund surplus units to fund deficit units.

2.4 SIGNIFICANCE OF THE FINANCIAL SYSTEM

The development of any country's economy largely depends upon the efficiency of its financial system. It helps in production, capital accumulation and economic growth of a country in the following ways:

I. **By encouraging savings**: An efficient financial system provides a wide range of financial products to lure customers to save and invest. The various financial intermediaries constantly innovate and customize their products to suit the need of the investors. They pool the funds from the people who have surplus money and invest

it accordingly. Savings are done by households as well as business firms. Savings by households are done to meet known as well as unknown future needs such as post retirement expense, education and marriage of the children, desire to own physical assets, accidents, sickness etc. Businesses also need savings to park their excess funds or to meet any future emergency expenses.

II. **By mobilising savings**:The Savings done by individuals and business firms needs to be collected and made available to the units who need funds for expansion and growth. The financial system is a highly efficient mechanism for mobilizing savings. Mobilisation of savings takes place when savers hold financial assets in the form of currency, bank deposits, post office savings deposits, insurance policies, mutual funds, bills, stocks and debenture and so on. Financial assets can be classified in to two categories: primary securities and secondary securities. Primary securities are issued by the organizations, firms or Government who borrows the money. The investor who subscribed the issue directly puts the money in to the deficit spending unit. On the other hand, the secondary securities are the securities issued by financial intermediaries such as banks, insurance companies and so on. When individuals buys secondary securities,they hand over their saving to the financial intermediaries. These institutions further allocate the funds among borrowers. However every time the savings does not go through the financial system, when the savers decide to put his savings in to tangible assets like house, precious metals, business etc. the money flows directly without entering the financial system.

III. **By channelizing the savings:** The financial system of a country ensures smooth, efficient and socially equitable distribution of credit. The old system of credit used by money lenders and indigenous bankers had many flaws. They do not have any credit allocation plan for the economy as a whole. But the modern financial system with new financial intermediaries, assets and market plays an

important role in the provision of credit. The financial intermediaries act between the ultimate lender and the ultimate borrower. They mobilize savings of the lenders by selling their products such as deposits, insurance, mutual funds etc. and they allocate these funds to deficit spenders at their own risks.

2.5 COMPONENTS OF THE INDIAN FINANCIAL SYSTEM

The Indian financial system consists of mainly three elements. They are a) Financial Institutions b) Financial Market and c) Financial Instruments. These three components of financial system provide the way to collect money from the people who have it and distribute it to those who can use it best. We shall briefly describe these three components of Indian financial system one by one:

2.5.1 Financial Institutions

Financial institutions or financial intermediaries includes all kinds of organizations which facilitates and intermediate financial transactions of both individuals and corporate. They act as a bridge between the borrowers and lenders in the financial markets. Financial Institutions in India can broadly be classified into three categories, they are a) Regulatory Financial Institutions b) Intermediary Financial Institutions and c) Non- intermediary Financial Institutions

a. ***Regulatory Financial Institutions***: These are the institutions which regulates functions and activities of other financial intermediaries. In India, Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) Insurance regulatory and Development Authority (IRDA) are examples of regulatory financial institutions. RBI as the central bank of India regulates all the activities of the commercial banks, cooperative banks, other banks and non-bank finance institutions. SEBI acts as the regulator of capital markets and mutual funds including venture capital and Foreign

Institutional Investors. IRDA regulates all the public sector and private sector life and non-life insurance companies.

b. ***Intermediary Financial Institutions:*** These are the institutions which intermediate between savers and investors. In other words, Intermediary Financial Institutions mobilize savings from the market and lend in the form of loans to the individuals and corporate. All banks are part of Intermediary Financial Institutions. Many Non- Banking Financial Institutions (NBFI) also acts as an Intermediary Financial Institutions who lend money as well as mobilize savings. UTI, LICI, GIC are some of the NBFIs in India.

c. ***Non- intermediary Financial Institutions:*** These are the institutions which get funds from the Government and lend them to target borrowers for special purposes. They do not mobilize funds from the savers. In India, examples of Non-intermediary Financial Institutions are Industrial Finance and Corporation of India (IFCI), National bank for Agriculture and Rural Development (NABARD), State Industrial Development Corporation (SIDC), State Financial Corporation's (SFCs) and so on.

2.5.2 Financial Markets

The financial market in India is consisting of two major segments a) Money Market and b) Capital Market. Let us understand both these markets in detail.

Money Market: It is the market for short- term funds. Money market deals with those financial assets whose period of maturity is up to one year. Money market deals in credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills etc. These instruments are close substitutes of money. The money market helps the corporate, other organizations and Government to meet their short term fund requirement. The main players of the Indian money market are Commercial Banks, Cooperative Banks

and few other specialized financial institutions like LIC, GIC, UTI etc. The RBI is the apex body of the money market in India.

Capital Market: Unlike Money market, Capital Market deals with medium and long term funds. It comprise of all long term borrowings from banks and financial institutions, borrowings from foreign markets and raising of capital via issuing of shares, bonds, debentures etc.

The markets where securities are traded are called Securities Market. It consists of two different segments namely primary market and secondary market.

I. ***Primary Market***: Primary market is also known as new issue market where it deals with new or fresh issue of shares and debentures. Corporates raise fund from the market through issue of shares and debentures at their formative stage or subsequently for their expansion of business. They raise funds either through initial public offer or through private placement of securities. Hence, primary market introduces financial assets for the first time in the market.

II. ***Secondary Market***: When the market deals in existing or old financial assets, it is known as the secondary market. Stock exchange plays a vital role in the secondary market. Secondary market is an organized market where shares and debentures are traded regularly with high degree of security and transparency. Unlike the primary market where the major players are banks, financial institutions, insurance companies, mutual fund houses etc. the main players in the secondary market are the stock brokers/ broking houses who facilitates buying and selling of securities.

2.5.3 Financial Instruments

Financial instruments are the financial assets. Mr. L.M. Bhole & Mr. Jitendra Mahakud,states that "*Financial assets represent claims for the payment of a sum of money sometime in the future (repayment*

of principal) and/or a periodic payment in the form of interest or dividend". Certain financial instruments like Bank deposits, bonds, debentures, the holder of the instrument receives both the regular and periodic payment in the form of interest and repayment of principal at a fix date. Whereas with regard to ordinary shares, the holder may or may not receive periodic payment in the form of dividend.

Financial instruments can further be classified as tradable/ transferable instruments and non-tradable/ non- transferable instruments. Financial assets such as Bank deposits, corporate deposits, post office savings, insurance policies, National Savings Certificate (NSC), provident funds, pension funds etc. are non-tradable/ non- transferable instruments. Whereas instruments such as equity shares, debentures, government bonds etc. are tradable/ transferable instruments.

The financial instruments are traded both in the capital market as well in the money market. The capital market instruments are mainly equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity of more than a year. On the other hand, money market instruments includes treasury bills, commercial paper, certificate of deposits, bills of exchange etc. Their maturities are less than one year.

Apart from the above the mature financial system has few of the hybrid instruments which has the feature of both equity and debentures. Convertible debentures, warrants are examples of hybrid financial instruments.

As already discussed earlier, financial services are the products and services offered by financial intermediaries and market for the facilitation of various financial transactions and other related activities. The financial services provided by the Indian financial system includes banking, merchant banking, housing finance, lease financing, credit rating, hire purchasing, factoring, custodial services, loan syndication, bill discounting and so on.



CHECK YOUR PROGRESS

Q1. Name the two main segments of the Indian Financial System.

.....

.....

Q2. Define financial assets.

.....

.....

Q3. Name the following:

a. Two regulatory financial institutions: _____

b. Two intermediary financial institutions:_____

c. Two non-intermediary financial institutions:_____

2.6 FUNCTIONS OF THE FINANCIAL SYSTEM

The financial system of a country performs certain valuable functions for the economic development of that country. The Indian financial system performs the following functions for the growth and development of the economy.

1. **Mobilizing savings:** Mobilization of savings is one of the prime functions of any financial system of a country and India is no different. The Indian financial systems through its various financial intermediaries mobilize savings from the general public and institutions across the country.
2. **Channelizing the savings:** The efficiency of the financial system of any country depends upon how efficiently they channelize the savings into productive activities. The financial intermediaries need to deploy the funds in productive ways so that all round development of the economy takes place. The financial intermediaries have the necessary skills, information, expertise and infrastructure to decide and determine the right investment options.
3. **Supply of liquidity:**In financial term liquidity refers to money and monetary assets. The financial system needs to ensure that there is sufficient liquidity in the system to maintain the production of goods and

services. Whenever there is any urgency for money by individual, corporate or government, the financial system should be strong enough to meet such demands. Hence the financial system perform an important function of providing liquidity in to the system.

4. **Payment function:** A developed financial system demands that the financial transactions happen both safely as well as swiftly. Hence, it is necessary that all the payment instruments such as cheques, cards (debit and credit cards) etc. are accepted and honored by all parties across the length and breadth of the country. Otherwise transaction of goods and services will be hampered.
5. **Transformation function:** Apart from the above mentioned functions, the financial system performs various types of transformation services. These transformation functions are briefly discussed below:
   a. **Asset- Liability Transformation function:** As we are aware that various financial intermediaries accepts deposits from the public, government or organizations and channelize these funds to those who need them as loans. In this process, the deposits which the financial intermediaries accept become liabilities in their books of accounts, because these are the funds which they need to return to the depositors on demand or after certain period of time. Similarly the money which the financial intermediaries lend in the form of loan to their clients becomes asset in their books of accounts. This process is known as the asset- liability transformation function of financial institutions.
   b. **Size Transformation function:** Financial Intermediaries generally pool funds from small savers/ depositors and lend big amounts to large corporate houses. These institutions can acquire better information and thus can reduce transaction costs. They can achieve economies of scales in lending and borrowing. This process is known as size transformation function.
   c. **Risk Transformation function:** A sound financial system require wide range of financial assets. A financial institution can minimize the risk by keeping different types of financial assets in its portfolio.

A portfolio is a particular combination of different types of financial assets. Holding variety of financial assets is known as diversification. More the diversification of financial assets less is the risk of default. Financial intermediaries thus help savers to reduce risk by offering wide range of financial assets.

d. **Maturity Transformation function:** Different customers (both borrower and lender) have different maturity requirements. Some may prefer to save for long- term while some may prefer to borrow for a small period of time. Hence, the liquidity preference varies from customer to customer. An advance financial system provides products with different maturities so that it suits the needs of both borrower as well as the savers. This function is known as maturity transformation function.

2.7 ROLE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

The financial system of a country plays an important role in the economic development of that country. The more organized and developed the financial system, the higher will be the rate of growth of that country. The financial system plays the following role in the development of the country.

a. **Generating savings**: Any country needs capital to expand its economy; lack of capital creates a vicious circle of poverty in the economy. The financial system needs to ensure that the creation of capital continues to fuel the economic growth. Therefore, the financial system needs to induce people to save more and for these they need to introduce variety of financial instruments to cater the needs of the public. Hence the financial intermediaries need to encourage savings by ensuring security of funds of the general public, by providing reasonable returns on their investments, by expanding the network of branches to the remote areas of the country and so on.

b. **Mobilizing savings**: India is a vast country, there are numerous small savers scattered all over the country. The financial intermediaries including commercial banks needs to strengthen their network across

the length and breadth of the country to mobilize savings. Presently government is pushing the banks and financial institutions to expand their branch networkin rural areas to mobilize savings from all sectors of the economy.

c. **Allocation of fund**: Generation and mobilization of funds is not enough for the development, the funds needs to be properly allocated to ensure overall development of the economy. The government and the regulatory bodies adopts certain control devise to ensure that the funds are flowing in to the desired sectors of the economy.

d. **Financing industry**: For industrial growth in an economy, supply of short- term, medium-term and long-term finance is essential. The financial intermediaries provide such type of finance to the industries. Short-term fund is needed to meet industries working capital requirement. Medium term fund is required to purchase tools and equipment. Long term finance is required for acquiring land and buildings, plant and machinery etc. The financial system helps firms in raising funds for meeting its requirements for various kinds of capital.

e. **Financing trade**: The financial intermediaries help in financing both internal and external trade of an economy. They provide many important services like providing loans to the retailers and wholesalers, discounting bills of exchange, providing overdraft facilities, offer foreign exchange to exporters and importers etc. All these facilities ensure smooth functioning of both internal and external trade of an economy. In India Export and Import Bank (EXIM) was set up exclusively to facilitate export and import of the country.

f. **Agriculture Financing**: India is an agricultural economy; more than 70% of the population in India is depend upon agriculture. Hence focus on agriculture should be the prime importance of Indian financial system. In this regard government has set upmany exclusive financial institutions to provide finance for agricultural marketing, for land development, for irrigation facilities etc. National Bank for Agriculture and Rural Development (NABARD) is one of the premier financial institutions in this regard.

g. Financing Small Scale Industries: Unemployment becomes a serious issue in many economies across the globe. One of the role of financial system is to generate employment in rural sector. In India many financial institutions such as State Industrial Development Corporation (SIDC), Small Industrial Development Bank of India (SIDBI), State Financial Corporation and so on has been established financial assistance to the small scale industries across the country. Growth of small scale industries leads to employment generation in specifically in rural areas. Thus financial institutions help in expansion of small and cottage industries in the country.

h. Developing Capital Market and Money Market: The development of the economy of a country requires efficient financial system. The stronger the financial system, the more developed the capital and money market. Developed capital and money market increase the velocity of circulation of money, increase the mobility and availability of funds, ensure more rational and proper allocation of resources, ensure healthy competition and so on. All these help in economic development of a country.



CHECK YOUR PROGRESS

Q4. Fill up the blanks:

a. Financial Intermediaries generally pool funds from small savers/ depositors and lend big amounts to large corporate houses. This process is known as _____transformation process.

b. _____ is one of the premier financial institutions with regard to agricultural financing.

c. The stronger the financial system, the more developed the_____ and _____market.

d. In India _____ was set up exclusively to facilitate export and import of the country.



2.8 LET US SUM UP

We have discussed the following aspects in this unit:

- The financial system of an economy mainly deals with four factors namely Money, Credit , Debt and Finance.
- The development of the financial system of an economy is significant as it promotes the growth of an economy by encouraging, mobilizing and channelizing savings.
- The Indian financial system consists of mainly three elements. They are a) Financial Institutions b) Financial Market and c) Financial Instruments.
- Financial Institutions in India can broadly be classified into three categories, they are a) Regulatory Financial Institutions b) Intermediary Financial Institutions and c) Non- intermediary Financial Institutions
- The financial market in India is consisting of two major segments a) Money Market and b) Capital Market.
- The capital market instruments are mainly equity shares, preference shares, warrants, debentures and bonds. These securities have a maturity of more than a year. On the other hand, money market instruments includes treasury bills, commercial paper, certificate of deposits, bills of exchange etc. Their maturities are less than one year.
- The financial system of a country plays an important role in the economic development of that country. The more organized and developed the financial system, the higher will be the rate of growth of that country.



2.9 FURTHER READING

i. Financial Services (2011) by Thummuluri Siddaiah; Pearson Education

ii. Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.

iii. Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.

iv. Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.

v. Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education

vi. The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House

2.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: The financial market in India is consisting of two major segments a) Money Market & b) Capital Market.

Ans to Q2: "*Financial assets represent claims for the payment of a sum of money sometime in the future (repayment of principal) and/or a periodic payment in the form of interest or dividend".*Certain financial instruments like Bank deposits, bonds, debentures, the holder of the instrument receives both the regular and periodic payment in the form of interest and repayment of principal at a fix date.

Ans to Q3:

a. RBI; SEBI
b. LIC; SBI
c. NABARD; SIDC

Ans to Q4:

a. Size
b. National Bank for Agriculture and Rural Development (NABARD)
c. Capital; Money
d. Export & Import Bank (EXIM)



2.11 MODEL QUESTIONS

(1) What is a financial system? Explain its significance in the development of an economy.

(2) Write a note on the components of the Indian Financial system.

(3) Explain the functions of the Financial system.

(4) Illustrate and explain the Asset Liabilty transformation function and Size transformation function of the financial system.

(5) Illustrate and explain the Risk transformation function and Maturity transformation function of the financial system.

(6) Write Short notes on:

a. Money and Capital markets

b. Financial Intermediaries

c. Primary and Secondary markets

*** ***** ***

UNIT- 3: MONEY MARKET INSTRUMENTS

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Concept of Money Market

- 3.3.1 Characteristics of Money market

3.4 Role and Importance of Money Market in Economic Development

3.5 Money Market Instruments

- 3.5.1 Call and Short notice money
- 3.5.2 Commercial Paper
- 3.5.3 Treasury Bills
- 3.5.4 Certificate of Deposits (CD)
- 3.5.5 Repurchase Agreements (REPO)
- 3.5.6 Money Market Mutual Funds (MMMF)

3.6 Recent Developments in the Indian Money Market

3.7 Deficiencies and Problems in the Indian Money Market

3.8 Let Us Sum Up

3.9 Further Reading

3.10 Answers to Check your progress

3.11 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- state the concept and characteristics of Money market.
- know the role and importance of Money market.
- list and define the various Money market instruments.
- know the recent developments in the Indian Money market.
- explain the deficiencies and problems in the Indian Money market.

3.2 INTRODUCTION

In this unit we are going to discuss the concept of money market.

The financial market of an economy consists of money market and capital market. Money market is the market for short financial assets having a maturity of less than one year. On the other hand capital market is the market for long- term fund requirements. In this unit we shall discuss about role and importance of the money market. We shall discuss the different money market instruments. At the end of this unit, we will discuss the recent developments as well as the deficiencies and problems in the Indian Money market.

3.3 CONCEPT OF MONEY MARKET

Money market facilitates borrowers for short -term funds and also gives opportunities to lenders to park their surplus funds for short duration. Money market transactions between borrowers and lenders mostly take place through telephone, mails and agents. No personal contacts or presence of the both parties is essential for negotiations in money market. Money market instruments provided high degree of liquidity which can be converted in to cash.

3.3.1 Characteristics of Money Market

The following are the main characteristics of a money market.

- It is a wholesale market for short- term debt instruments.
- The maturity of money market instruments are less than one year.
- It deals with those financial assets which are liquid in nature.
- Generally money market transactions are done over phone or emails and subsequently relevant documents are exchanged.
- Unlike capital market transactions which takes place through stock exchanges, there is no formal place for money market transactions.
- The players in the money market are mostly RBI, commercial banks, cooperative banks, financial institutions and corporate.
- No brokers are involved in money market transactions.

- Money market consists of several sub-markets like call money market, treasury bill market, commercial bill market, commercial paper market etc.

3.4 ROLE OF MONEY MARKET IN ECONOMIC DEVELOPMENT

The money market plays a crucial role in the economic development of the country.

a) **Arranging Short Term Funds:** Money market ensures supply of short term finance to the public and private institutions in an economy. Every organization requires finance for short term purpose to meet their working capital requirement. Money market thus helps businesses to continue their operation without any interruption.

b) **Utilization of Surplus Funds:** Many a times organization also has surplus funds at their disposal which they would like to invest for a short period of time. Money market offer instruments to these institutions to park their surplus funds and earn decent return on their investments.

c) **Less of Dependency on Central Bank:** An efficient money market reduces dependency of commercial banks on the central bank for short term cash. Commercial bank require short term cash to meet the demands of their client, in such situation they can always borrow from money market instead of depending on the Apex bank. This helps banks to concentrate on their lending policy more independently. All these indirectly help development of the economy.

d) **Helps Government Borrowing:** Government also require funds for short term. Government mostly borrows from money market by issuing treasury bills to meet their short term cash requirement.

e) **Development of Capital Market:** The development of money market and its interest rate influence the rate of capital market. So, development of money market is crucial to the development of capital market. Money market also helps to grow and develop the foreign exchange market and derivatives market.

f) Maintains Equilibrium in the Economy: Money market maintains the equilibrium between demand and supply of cash. It helps in channelizing savings from the organization who have excess cash to those who is in need for short term funds. Thus, money market promotes economic development through rational allocation of resources.

g) Economizing the Use of Cash: Money market deals in near money instruments and not exactly in physical cash. Thus it helps in minimizing physical cash in transaction of goods and services. Absence of a strong money market would force government to print more currency notes which will further raise the money supply in the economy.



CHECK YOUR PROGRESS

Q1. State whether the following statements are True or False:

a. There is no formal place for money market transactions.(True/False)

b. It is a retail market for long term debt instruments.(True/ False)

c. The maturity of money market instruments are more than one year.(True/False)

d. It deals with those financial assets which are liquid in nature.(True/False)

e. Money market deals in near money instruments and not exactly in physical cash.(True/False)

3.5 MONEY MARKET INSTRUMENTS

Money market instruments are those financial assets or papers which are transacted in the money market. It involves buying and selling of short term instruments. There are various instruments available in the money market. The important money market instruments are discussed below:

3.5.1 Call and Short Notice Money

These are extremely short period loan varies from one day

to fourteen days. When the money is borrowed or lent for one day it is called call money. Whereas, it is lent or borrowed from more than one day and up to fourteen days, it is known as short notice money. However both types of money are popularly known as call money. The reason they are called call money because these loans are repayable on demand at the option of either the lender or the borrower. The main participants in this market are mainly banks and few big financial institutions like LICI, GIC, UTI etc. They invest their surplus funds in order to earn interest. The interest rate paid on call loans are known as call rate. Call rates are highly volatile in nature; it varies from day to day or even hour to hour.

Features of call and short notice money.

- The call and short money instruments are highly liquid.
- The interest rate/ call rate are extremely volatile.
- These are repayable on demand.
- The funds lent or borrowed in the call money market are unsecured in nature. No collateral is required to borrow funds in the call money market.

3.5.2 Commercial Paper

A commercial bill is also known as bill of exchange. It is a trade bill arises out of a genuine commercial transaction. When seller sells the goods on credit, he draws a bill on the buyer for the amount of goods he sold. The buyer accepts and endorses it, which implies that the buyer agrees to pay the amount mentioned on the bill to the seller on a certain specified date. After accepting it the buyer returns the bill to the seller. The seller may either retain the bill till the due date or discount it at bank and get immediate cash. When trade bills are accepted by commercial banks, they are called commercial bills. The bank discount the bill and pays the buyer immediate cash after deducting certain amount as bank fee.

The Negotiable Instruments Act, 1881, defines bill of exchange as *'an instrument in writing containing an unconditional order, signed*

by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument'.

Features of Commercial Bills

- A commercial bill is a negotiable instrument.
- Commercial bills are generally issued for period of 30 days to 120 days.
- It is a self liquidating and negotiable credit paper.
- Commercial bills can be discounted with banks.
- The creditor who draws the bill is called drawer and the debtor who accepts the bill is called drawee.

3.5.3 Treasury Bill

It is a promissory note issued by RBI on behalf of the Government. Treasury bills are a promise by the government to pay the specified amount to the bearer of the bill on due date. Hence these are freely transferable instruments. Treasury bills are short term credit instruments. At present, the Government of India issues three types of treasury bills through auctions, namely, 91-day, 182-day and 364-day. These are issued at a discount and are repaid at par on maturity. This implies that the price of the bill is below its face value by the amount of interest due on the bill. A treasury bill does not require any endorsement or acceptance as it is issued by the government.

Features of Treasury Bill

- It is a promissory note issued by Government.
- They are highly liquid in nature.
- Treasury bill is considered as highly safe instruments as these are issued by government.
- Treasury bill carries an assured yield
- The transaction cost of T bills is very low as it does not involve stamp fee.
- Treasury bills are readily available for a minimum amount of ' 25000/- and in multiples thereof.

3.5.4 Certificate of Deposits (CDs)

The Government of India introduced Certificate of Deposits (CDs) in June 1989. It is short term deposit instruments issued by banks and financial institutions. It is like fixed deposit of banks, the only difference between CDs and FDs is the CDs are easily transferable from one party to another, whereas FDs are non-transferable. CDs are generally issued to raise large sums of money. CDs are issued by banks to meet their liquidity, at relatively high interest rate. CDs can be issued to individuals, companies, trusts, funds, associates, and others. The major advantages of CDs are their liquidity and marketability. They can be sold and traded in the secondary market.

Features of Certificate of Deposits

- CDs are unsecured promissory notes issued by Banks and Financial Institutions.
- CDs are negotiable instruments.
- The rates of interest on CDs are higher than Treasury bills and FDs.
- They are issued at a discount to face value.
- CDs are virtually risk free instruments in terms of default of payment of interest and principal.
- They require stamp duty.

3.5.5 Repurchase Agreements (REPO)

Repurchase agreements which are also called Repo or Reverse Repo is a transaction in which two parties agree to sell and repurchase the same security. In other words, the seller sells the security with an agreement to repurchase it at a mutually decided future date. Likewise, the buyer purchases the security with an agreement to resell the same to the seller at an agreed price and date. The same transaction is repo from the viewpoint of the seller of the security and reverse repo from the viewpoint of the buyer of

the security. The Reserve Bank of India approves the parties who can participate in repo agreements. Similarly RBI approves certain securities such as central and state government securities, treasury bills, PSU bonds and corporate bonds which can be transacted under repo agreements. Repo is generally used for overnight borrowing.

Repo is collateralized short term borrowing and lending through sale/purchase in debt instruments. The difference between the price at which the securities are bought and sold is the seller profit for lending the money.

Features of Repurchase Agreements

- Repo generally guaranteed principal as repurchase agreement provides collateral in the form of securities to facilitate the transaction.
- The repurchase price of the securities is predetermined in the agreement
- Repo agreements are for short duration ranges between one to fourteen days.

3.5.6 Money Market Mutual Funds (MMMFs)

These funds invest money in the money market instruments such as treasury bills, certificate of deposits, commercial papers, interbank call money. It is ideal for corporate as well as individuals who would like to park their surplus funds for a short period of time. Money market mutual funds provide moderate return with higher liquidity at relatively low risk. The return on these schemes is dependent on prevailing market interest rate.



CHECK YOUR PROGRESS

Q2. Identify the Money Market Instruments on the basis of the features:

a. It is a self liquidating and negotiable credit paper.

b. It is a promissory note issued by Government.

c. These funds provide moderate return with higher liquidity at relatively low risk

d. A transaction in which two parties agree to sell and repurchase the same security.

e. These are extremely short period loan varies from one day to fourteen days.

3.6 RECENT DEVELOPMENTS IN INDIAN MONEY MARKET

Post liberalization of industrial policy in 1991, various economic reforms were introduced in the financial sector of the country. As a result of this, many steps and reforms were introduced to the Indian money market also. The following are some of the major reforms introduced in Indian money market in recent years.

1. **Abolition of Administered Interest Rate:** Since 1991, the interest rate has been deregulated. Earlier, interest rates in India were largely administered interest rates. Following the recommendation of Narasimhan Committee, the ceiling on interest rate has been abolished. Thus, the players in the money market segment can adopt market related rate of interest. Interest rate is now largely determined by the demand and supply of money in the market.
2. **Widening of Call Money Market:** Government has taken steps to widen the call money market by allowing few financial institutions to participate in this market as lenders. Government has also set up Discount and Finance House of India (DFHI) in 1988 to cater the need of discount house in the country. It has allowed DFHI and State Trading Corporation of India (STC) to act as lenders and borrowers in the call money market.

Such steps by the government have increased the number of participants in the call money market.

3. **Integration of Unorganised Sector:** Indian money market was largely an unorganized market dominated by indigenous bankers, money lenders, finance brokers etc. In order to bring uniformity and regulation in to the money market, the activities of the indigenous bankers and village money lenders are being brought under the purview of RBI. Further, RBI has pushed commercial banks to expand their network in rural india. Regional Rural Banks (RRBs) also plays an important role in expanding banking system in remote areas of the country. All these have expanded the organized money market in India.
4. **Introduction of New Money Market Instruments:** Many new financial instruments have been launched in to the money market in recent past. The notable once among them are 91-day Treasury bills, 182-days Treasury bills, 364-days Treasury bills, certificate of deposits, commercial paper etc. With the introduction of new instruments, the volume of transactions ahs also increased significantly.
5. **Developing Bill Market:** In order discourage cash credit and overdraft facility of financing, RBI has taken steps to popularize bill market in the country. In this regard RBI has introduced two bill market schemes in 1952 and in 1970 respectively. Further RBI has allowed more than 25 financial institutions to rediscount commercial bills in the year 1990. All these measures has helped in expanding the bill market in India.
6. **Entry of Private and Foreign Banks:** Post 1991, government has allowed private and foreign banks to start operation in India. This is a big boost to the Indian money market as the entry of new players makes the financial market more efficient and competitive.
7. **Introduction of Money Market Mutual Fund (MMMFs):** In 1992, RBI took initiatives to establish MMMFs in India. MMMFs are allowed to sell units to individuals and corporate houses which has increased the volumes in the money market. Recently RBI has allowed few mutual funds and subsidiaries of commercial banks to participate in money market instruments.

8. **Setting up of DFHI:** In April 1988, Reserve Bank of India set up Discount and Finance House of India (DFHI) to buys bills and other short term credit instruments from financial intermediaries and invest their idle funds for short term. DFHI also provide funds to banks against short term securities. DFHI is jointly owned by RBI, some public sector banks and few financial institutions.
9. **Establishment of Credit Rating Agencies:** The main purpose of credit rating agencies is to judge the creditworthiness of a company seeking credit. They basically assigned ratings to a company seeking to raise funds from public. Generally higher rating signifies better financial strength of the company. Thus credit rating agencies provide important guidance to the investors to take investment decisions. Some of the prominent credit rating agencies of india are Credit Rating Information Services of India Ltd (CRISIL), Investment Information and Credit Rating Agency of India (IICRA) and, Credit Analysis and Research Ltd. (CARE)
10. **Establishment of STCI:** State Trading Corporation of India was established in May 1994 by RBI. It has been set up to provide a secondary market for government securities. With the advent of STCI, the treasury bill and call money market has significantly grown in the country.
11. **Adoption of suitable Monetary Policy:** In recent years the RBI is adopting a more realistic and appropriate monetary and credit policies. The main objective is to increase the availability of resources in the money market and make it more active.
12. **Liquidity Adjustment Facility (LAF):** Under Liquidity Adjustment Facility, RBI sets and resets its repo and reverse repo rates. As already mentioned earlier Repo is the rate at which RBI lends money to Commercial banks and Reverse Repo is the rate at which RBI borrows from the commercial banks. Repos are mainly used to absorb liquidity at a given rate. On the other hand reverse repo is used to infuse liquidity at a given rate. Thus through LAF, Reserve Bank of India adjust liquidity in the money market.
13. **Setting up of Clearing Corporation of India Limited (CCIL):** The Clearing Corporation of India Ltd. (CCIL) was set up in 2001 to provide

an institutional infrastructure for the Clearing and Settlement of transactions in Government Securities, Money Market instruments, Foreign Exchange and other related products. It aimed to pave the way for widening and deepening the financial markets in the country.

14. **Negotiated Dealing System (NDS):** The Reserve Bank of India has created Negotiated Dealing System as an electronic platform for dealing in government securities. The Government securities are issued in the primary market and traded in the secondary market electronically. The NDS platform was launched in 2002. Treasury bills, central government bonds, state development loans are auctioned using the NDS platform.

3.7 DEFICIENCIES AND PROBLEMS IN INDIAN MONEY MARKET

The following are the deficiencies and problems in the Indian money market:

1. **Existence of Unorganized Sector:** Indian money market is still consisting of large unorganized market. The indigenous banker, money lenders, chit funds etc. still plays a big role in the money market segment. They offer loans to farmers, artisans, small business owners at high rate of interest. They follow their own rules of banking and finance. They do not have any specific rule of operation. It varies from region to region and from creditor to creditor. Lack of education among villagers is one of the reasons for the growth of unorganized sector in India.
2. **Disparities in the Interest Rates:** In Indian money market, the rate of interest differs between different regions and centers. This is mainly due to immobility of funds from one region to another. Too many interest rate are prevailing in the market.
3. **Variation in Demand for Funds:** Indian money market is seasonal in nature. The period from October to March is considered busy period and thus demand is high. Whereas the period from April to September is considered to be dull. During the busy season the demand for money is high and so does the rate of interest. On the other hand during the dull season the rate of interest fall as the

demand is low. As a result, the interest rates fluctuate from one period to another in Indian money market.

4. **Underdeveloped Bill Market:** Indian bill market is still underdeveloped compared to the developed economy. The bill market is India is comprised of treasury bills and commercial bills. Although the volume of bill market has increased in recent years but it has not expanded up to the expectation.
5. **Little Contacts with Foreign Money Market:** Developed money market in the world has strong contact with the outside world which attract more funds to their economy. The same is lacking in Indian money market. It has little contacts with money market in other countries. In order to attract foreign funds the money market needs to expand its network with other developed money market.
6. **Limited Number of Instruments:** The number of money market instruments in Indian market is less compared to developed money market. This has resulted in to less volume of transactions in the organized Indian money market.
7. **Limited Number of Participants:** Entry in to the Indian money market is strictly regulated which has resulted in limited number of participants. The organized sector is passive and narrow. On the other hand unorganized sector is quite informal and flexible due to which it attracts more number of participants.
8. **Restricted Secondary Market:** Secondary market for Indian money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills. This is another major drawback for Indian money market.



3.8 LET US SUM UP

In this unit we have discussed the following:

- The financial market of an economy consists of money market and capital market.

- Money market is the market for short financial assets having a maturity of less than one year. On the other hand capital market is the market for long term fund requirements.
- Money market instruments provided high degree of liquidity which can be converted in to cash.
- The money market plays a crucial role in the economic development of the country by arranging short term funds, utilizing short term funds, helping government borrowings etc.
- The common money market instruments are –Money at call and short notice; Commercial paper; Treasury Bills; Repurchase agreements; Money market mutual funds etc.
- Some recent developments in the money market are abolition of administered interest rates; integration of the unorganised sector; entry of private and foreign banks; establishment of credit rating agencies and many more.



3.9 FURTHER READING

i. Financial Services (2011) by Thummuluri Siddaiah; Pearson Education

ii. Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.

iii. Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.

iv. Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.

v. Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education

vi. The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House

3.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1:

a. True

b. False

c. False

d. True

e. True

Ans to Q No.2:

a. Commercial Paper

b. Treasury Bill

c. Money market mutual funds

d. Repurchase agreements

e. Money at call and short notice



3.12 MODEL QUESTIONS

1. Discuss the characteristics and importance of the Money Market.
2. Discuss the recent developments in the Indian money market.
3. What are the issues and challenges in the Indian Money market.
4. Write short notes on:
   a. Commercial paper
   b. Treasury Bills
   c. Certificate of deposits
   d. Repurchase agreements
   e. Call and short notice money

*** ***** ***

UNIT- 4: CAPITAL MARKET

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Concept of Capital Market

- 4.3.1 Characteristics of Capital Market
- 4.3.2 Distinction between Money Market and Capital Market

4.4 Importance of Capital Market

4.5 Components of Capital Market

4.6 Primary Market/New Issue Market

- 4.6.1 Functions of Primary Market/ New Issue market
- 4.6.2 Issue Mechanism of an Initial Public Offer (IPO)
- 4.6.3 Intermediaries and their Role in the New Issue Market

4.7 Shares

- 4.7.1 Difference between Shares and Stock
- 4.7.2 Types of Shares

4.8 Debentures/Bonds

- 4.8.1 Difference between Shares and Debentures
- 4.8.2 Types of Debentures/Bonds

4.9 Let Us Sum Up

4.10 Further Reading

4.11 Answers to Check your progress

4.12 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- state the characteristics and components of the Capital Market.
- know the functions of the Primary Market.
- explain the role of Intermediaries in the Primary Market.
- describe Shares and its types
- describe Debentures and its types

4.2 INTRODUCTION

In this unit we are going to discuss about the concept of capital market. Capital market is a financial market in which long term debt or equity - backed securities are bought and sold. In this unit we will discuss the importance of capital market, components of capital market, primary market, shares and debentures etc.

4.3 CONCEPT OF CAPITAL MARKET

Capital market simply refers to the market for medium to long- term financial assets. It is a market for buying and selling equity, debt and other securities. The term medium and long term refers to a period of more than one year. While money market deals with securities having tenure of less than one year, capital market provide funds to corporate and government for the long- term. In other words, capital market is a vehicle through which long term finance is channelized for the requirements of industry, commerce, government and local authorities.

4.3.1 Characteristics of Capital Market

The following are the main characteristics of capital market

- It is a vehicle through which long- term capital flows from investors to borrowers.
- All operations relating to new issues and existing securities takes place in the capital market.
- Capital market deals with various types of securities such as equity shares, preference shares, debentures and bonds etc.
- A number of intermediaries such as banks, underwriters, merchant bankers, brokers, registrars etc. are involved in the capital market.

- The participants in the capital market includes individual investors, public limited companies, investment and trust companies, banks, stock exchange, various financial institutions etc.

4.3.2 Distinctions between Money Market and Capital Market

	Money Market	Capital Market
1	It deals with short-term funds having maturity of less than one year.	It deals with medium to long-term funds having maturity of one year and above.
2	It caters to the working capital requirements of firms and government.	It supplies long term funds to firms and government.
3	Main instruments of the money market are call money, treasury bills, certificate of deposits, commercial paper, bill of exchange etc.	Main instruments include shares, debentures, government bonds etc.
4	The face value of money market instruments are large.	The face value of capital market instruments are generally small.
5	Main players includes RBI, commercial banks and selected financial institutions.	Development Banks, mutual funds and insurance companies are the major players in capital markets.
6	There is no formal place for money market transactions.	Transactions in capital market mostly take place in stock exchanges.
7	Usually brokers are not involved in money market transactions.	Transactions have to be conducted only through authorized dealers.

4.4 IMPORTANCE OF CAPITAL MARKET

The importance of capital market can be summarized as below:

i. **Mobilisation of savings:** Capital market helps in mobilizing savings of the economy. It provides scope to individuals and organizations to invest their surplus funds in more attractive securities to earn higher return.

ii. **Attracting funds from foreign country:** A well-developed capital market attracts Foreign Institutional Investors to deploy their funds in the country.

iii. **Promote Capital Formation:** Capital market enables a country to achieve economic growth as it promotes capital formation. Large amount is required to invest in infrastructural foundation. Such a large amount cannot be collected from one individual or few individuals. Capital market provides an opportunity to collect funds from a large number of people who have investible surplus.

iv. **Diversification of Business:** Existing companies, will be able to expand their industries and also go in for diversification of business due to capital market.

v. **Helps Government to take suitable actions:** Capital market is the barometer of the economy. It reflects the economic condition of a country. It enables the Government to take suitable actions.

4.5 COMPONENTS OF CAPITAL MARKET

The capital market may broadly be divided into two categories a) Government securities market and b) Private/ Industrial securities market. We shall briefly discuss both.

a) **Government Securities Market:** It is also known as Gilt-edged securities market. To finance its expenditure in excess of its revenues, the government needs to borrow from banks, financial institutions and public through issue of government securities. There are both short term and long term government securities available in the market. The short term government securities are traded in the money market and the long term are traded in the capital market. The Government securities are mainly issued by Central Government, State Governments, Public Sector Undertakings (PSU), Local bodies of the Government and so on.

   Long term government securities are mainly available in three forms in India. They are i) Stock certificates ii) Promissory notes and iii) Bearer bonds. They are sold through Public Debt Office of the RBI.

b) **Private/ Industrial Securities Market:** In order to expand and grow,

industries/ companies need fund. In industrial securities market companies issue securities to raise funds. The main securities transacted in private/ industrial securities market are (i) Preference shares (ii) equity shares and (iii) Bonds or debentures. The industrial security market comprise of two parts, they are

1. **Primary Market/ New Issue Market:** Primary market is the market where new issues are traded for the first time. That is why it is also known as New Issue Market (NIM). It is a market for fresh capital. Corporate houses and government raises long term funds by issuing securities in the primary market. Whenever any organization issues securities it is called Initial Public Offer (IPO).There are three ways of raising funds from primary market. They are through (a) Public issue (b) Rights issue and (c) Private placement. We shall discuss these in detail in later part of this unit.
2. **Secondary Market:** Secondary market is a market for old and existing securities. It deals with buying and selling of existing securities which has already been issued through IPO. Secondary market is also known as stock market. It operates through stock exchanges. Hence, all the securities are transacted in secondary market through stock exchanges. Secondary market provides liquidity by easing selling and purchase of securities. The secondary market in India consists of all the stock exchanges recognized by the Government of India. The major stock exchanges in India are Bombay Stock Exchange (BSE), National Stock Exchange (NSE) and Over-the-Counter Exchange of India (OTCEI). All the stock exchanges are regulated by Securities and Exchange Board of India (SEBI)



CHECK YOUR PROGRESS

Q1. What are the two main components of the Capital market?

_____

_____

Q2. What are the various forms of long term government securities?

_____

_____

Q3. Name the major stock exchanges in India?

_____

_____

4.6 PRIMARY MARKET/ NEW ISSUE MARKET

The new issue market or primary market primarily facilitates the transfer of resources from the savers to the entrepreneurs, who need funds to establish or expand their businesses. The ultimate user of funds in the capital market need not only be the private parties; the government also raises funds from the capital market.

4.6.1 Functions of Primary Market/ New Issue Market

The main functions of the new issue market can be split into three services, viz.,Origination, Underwriting and Distribution.

1. **Origination:** Origination refers to the work of investigation, analysis and processing of new project proposals. The work of origination starts before an issue is floated in the market. It is mainly done by merchant bankers which include commercial banks, financial institutions, private firms etc. The process of origination mainly involves studying of the project and providing advisory services related to type of issue, size of the issue, launching time of the issue, price band of the issue, distribution of the issue etc.

2. **Underwriting:** Underwriting is an important aspect related to the new issue. No matter how efficiently the process of origination is done by merchant bankers, the success of a new issue cannot be guaranteed. Therefore underwriting is an agreement between the company and underwriter whereby the underwriter promises to subscribe to a specified number of unsold securities (shares, debentures etc.). If the issue is fully subscribed by the public, the underwriter will have no liability of purchasing the issue. However if an issue is not fully subscribed, the underwriter will purchase the unsold amount of securities as prescribed in the agreement.
3. **Distribution:** Underwriting is only a kind of assurance by third party in case the issue is not fully subscribed. But the ultimate success of an issue depends upon full subscription by the investing public. The sale of securities to the investing public is known as the process of distribution. This distribution service is performed by eligible brokers and agents in the securities market.

4.6.2 Issue Mechanism of an Initial Public Offer (IPO)

The success of an IPO depends largely on its issue mechanism. The methods by which new issues are made are explained below:

1. ***Public Issue through Prospectus:*** One of the common methods of raising capital from the public by corporate houses is through issuing securities by means of a prospectus. A prospectus is a document containing all the relevant information (as specified by the regulator) about the company seeking to raise fresh capital from the market. Under this method, the issuing company offers specified number of securities at a stated price to the general public. The foundation of the public issue method is a prospectus. The minimum contents to be disclosed in a prospectus are prescribed by the Companies Act, 1956. Any misstatement in the prospectus would amount to civil or criminal offence to the promoters of the company. Additional

disclosure requirements are also prescribed by SEBI. Some of the important contents to be printed on a prospectus are:

i. Name and registered office of the company.
ii. Existing business and proposed activities.
iii. Board of Directors of the company.
iv. Location of the industry.
v. Authorized capital, subscribed capital and proposed issue of capital to public.
vi. Dates of opening and closing of the issue.
vii. Name of broker, registrar, underwriters and other relevant parties to the issue.

2. ***Book Building Method:*** Under this method of pricing the company does not fix the price of the securities in advance, rather it gives an opportunity to the investors to bid and arrive at a consensus price band. The merchant bankers in consultation with the issuing company fixes a minimum floor price; the floor price is the minimum price at which the bid can be made by the investors. The price band of the issue cannot be more than 20% of the floor price. Once the issue is offered to the public, the application received is arranged and a final offer price is arrived at. This final offer price is known as cut off price. It is usually the weighted average price at which majority of investors are willing to buy the securities. The merchant bankers to the issue acts as a book runner. They prepare and obtain approval for the draft of the offer document from SEBI.

3. ***Offer for Sale Method:*** In this method of distribution, instead of issuing the securities directly to the public, the issuing company sells the securities to the intermediaries such as issue houses/ merchant banks/ investment banks or firms of stock brokers at an agreed price. The intermediaries then resell the securities to the ultimate investors at a higher price. The difference between the purchase price and the selling price of the securities by the intermediaries are known as the 'spread' or the 'turn'. The spread/

turn is the profit margin for the intermediaries.

4. ***Private Placement Method:*** Under this method, the securities are acquired by intermediaries just like the offer for sale method, but instead of being subsequently offered to the public, the intermediaries offer the securities for sale to their clients, both individual and institutional investors. Every intermediary has a list of large private and institutional investors who would like to subscribe to an issue offered in this manner. Thus the floatation of securities involves two stages: in the first place securities are acquired by the issuing houses and in the second place they are made available to the selected clients.
5. ***Right Issues:*** It is a method of raising funds in the market by an existing company whose shares are already listed in the stock exchange. Here, the existing company issues shares to its existing shareholders in proportion to the number of shares already held by them. In other words, the existing shareholders are given pre-emptive rights to subscribe to the new issue on a pro-rata basis. The existing shareholders may accept or reject the right. The shareholders may transfer their rights to another person. If the shareholder neither subscribes the shares nor transfers the rights, then the company can offer the shares to the public.

4.5.3 Intermediaries and their Role in the New Issue Market

There are many players in the new issue market. The prominent ones among them are:

1. **Merchant Bankers:** A merchant banker means any person or institution who is engaged in the business of issue management.The management of the issue involves buying, selling or subscribing to the securities or acting as managers/ consultants/advisors in relation to such issue. The major functions of the merchant bankers includes:
   - Deciding the composition of the capital structure i.e, type of

securities to issued.

- Preparing the draft of prospectus and application forms.
- Compliance with procedural formalities.
- Appointment of registrars to handle share application and transfer
- Listing of securities.
- Arrangement of underwriting
- Placing of issue
- Selection of bankers and brokers to the issue.
- Fixing of advertising agency, printers and other publicity agencies for the issue.

2. **Registrars to the Issue:** The registrar to an issue, also is an important intermediary in the primary market who carries on the following major activities with respect to the new issue management.

Activities before the Issue

- Drafting of application form for the new issue.
- Choosing of collection centers and collection banks for the application submission by investors.
- Opening of collection accounts with banks.

Activities during the Issue

- Receiving the collection figures every day from the collection centers and bank branches and tabulation and classification of those data.
- Informing the merchant banks and issuing company about the progress of the issue in terms of percentage of subscriptions.
- Informing the stock exchanges about the closure of the issue.

Activities during pre-allotment

- Collection of application forms from the collecting banks.
- Sorting out valid application eligible for allotment.
- Finalization of allotment as per prescribed guidelines of SEBI.

Activities during post allotment

- Mailing letter of allotment and refund orders to the investors/ customers.
- Submitting all statements to the issuing company for their approval.
- Arranging payment of brokerage and underwriting commission.
- Assisting issuing company in listing of shares on the stock exchanges.

3. **Bankers:** Some commercial banks act as collecting banks who collects the subscriptions in cash, cheques, digital banking modes etc. There are few banks who act as coordinating banks who collect information on subscriptions and coordinate the collection works. Both the banks may be the same bank or different banks. They play an important role in transfer, transmission and safe custody of investors' funds.
4. **Underwriters:**Another important intermediary in the new issue market are the underwriters. Underwriters make a commitment to get the issue subscribed either by others or by themselves. In other words, underwriters agree to take a specified number of securities offered to the public, if the issue is not fully subscribed. Underwriters are appointed by the issuing companies in consultation with the merchant bankers. Underwriters may be financial institutions, banks, brokers etc.
5. **Brokers:** Brokers are concerned with marketing of the issue to the prospective investors. The appointment of brokers is not mandatory and the companies are free to appoint any number of brokers. The issuing company pays brokerage to the brokers within the prescribed limits. Generally the brokerage rate applicable to all types of public issue is fixed at 1.5%. The issuing company is expected to pay the brokerage within two months from the date of allotment of shares to the investors.

6. **Other Agencies:** Apart from the above mentioned intermediaries, there are few other agencies involved in the new issue market. The most prominent once are
   - Printers: They print the application forms and all other relevant papers related to the new issue.
   - Advertising Agencies: They make advertisement to inform the general public about the issue.
   - Mailing Agencies: They help investors to send their application forms and subscriptions and to get the issue certificates and other relevant papers.



CHECK YOUR PROGRESS

Q4. Fill in the Blanks:

i. _____is an agreement between the company and underwriter whereby the underwriter promises to subscribe to a specified number of unsold securities (shares, debentures etc.).

ii. The issuing company pays _____to the brokers within the prescribed limits.

iii. A _____banker means any person or institution who is engaged in the business of issue management.

iv. The sale of securities to the investing public is known as the process of_____.

v. Under the _____method, the company does not fix the price of the securities in advance, rather it gives an opportunity to the investors to bid and arrive at a consensus price band.

4.7 SHARES

The total amount of capital of a company is divided into number of units of face value (fixed amounts). These units are called shares. Shares

are a part of owned capital of a company. The person who owns shares are called shareholder. Shareholders are the owners of the company. They are entitled to receive dividends if the company earns profit and management decides to distribute a part of the profit.

4.7.1 Differences between shares and stock

The word shares and stock are often used interchangeably. However, there is a distinction between both these terms. The owned capital of a company when divided into a number of equal parts, it is called shares. On the other hand, the issued capital of a company is called stock. It is in a consolidated form. A stock represents the total of fully paid shares of a member merged into one fund of equal value. Stock is expressed in monetary terms and not as a number of shares.

4.7.2 Types of shares

The following are the main types of shares issued in India by companies. They are:

a. **Equity or Ordinary Shares**: It is the most preferred form of capital by the companies. Equity or ordinary shares are those shares whose dividends are not fixed and depend upon the profits made by the company.The board of directors then decides whether to distribute the profit in the form of dividends or to retain the profits for future expansion of the business. The rate of dividend paid to the shareholder is not fixed and it can vary in subsequent years. Equity shareholders enjoy voting rights in the election of the members of the Board of Directors of the company.

b. **Preference Shares:** Preference shares are such shares where payment of dividend is first made to the preference shareholder and subsequently to the equity shareholders. At the time of the liquidation of the company, preference shareholders get preference over equity shareholder regarding refund of the

capital. However they do not enjoy any voting rights like the equity shareholder. The various types of preference shares are:

i. **Cumulative Preference Shares:** The holder of these shares is entitled to receive past dividends, if any due, in addition to the current year dividends. This happens when the company is not in a position to pay dividends in a particular year due to bad performance or loss incurred.

ii. **Non-Cumulative Preference Shares:** These shareholders are entitled to current year's dividend only. No backlog dividend is payable to such shareholders.

iii. **Participating Preference Shares:** In addition to the pre-declared fixed amount of dividend, the participating preference shareholder also receive a variable amount of dividend. The variable amount is determined at the time of distribution of profits to the equity shareholders.

iv. **Non-Participating Preference Shares:** They are entitled to only pre-declare fixed amount of dividend.

v. **Redeemable Preference Shares:** These are the type of shares where the principal amount of investment is returned to the shareholder at the end of the redemption period. Redemption may take place at par, at a premium or at a discount.

vi. **Irredeemable Preference Shares:** The holder of these shares do not get back the principal amount of investment, they continue to receive dividend at the end of each year.

4.8 DEBENTURES/ BONDS

The term Debenture and Bonds are used interchangeably in India. They are the borrowing instruments for a company. Bond holders are the creditors of the company, they are entitled to receive fixed rate of interest as specified in the bond certificate. The holder of the bond/debentures does not enjoy any ownership right in the company. The company has the obligation to make interest payment to the bond holders irrespective of its

earnings. They are paid before any distribution of dividends to the shareholders.

4.8.1 Differences between Shares and Debentures

	Shares	Debentures/ Bonds
1	Shareholders are the owners of the company.	Debenture holders are the creditors of the company.
2	Shareholders receives profit from the company in the form of dividend	Bond holders receive interest from the company.
3	Dividend is distributed only when the company earns profit and Board of Directors approves payment of dividend.	Interest on debenture or bonds needs to be paid irrespective of company's profit or loss.
4	Shareholders of a company can attend annual general meeting of the company.	Debenture holders cannot participate in the annual general meeting of the company
5	Majority of the shareholders have the voting right to elect or remove the Board of Directors of the company.	No such power is given to bond holders.
6	If a company goes for liquidation, payment to the shareholders will be made after the payment to the bond/debenture holders.	Payment to the bond holders are to be made first.
7	The rate of dividend is not constant. It may vary from year to year.	The rate of interest to be paid on debenture or bonds is fixed throughout the tenure of the bond.
8	Shares can be issued by the new company seeking capital from the public.	A new company cannot issue bonds at the first place. They need to established and earned goodwill to issue bonds.

4.8.2 Types of Debentures/Bonds

The following are the major types of bonds or debentures issued in

India:

a. ***Redeemable Debentures*:** These types of debentures are repaid by the company at the end of a specified period. Most of the debentures issued in the market are redeemable in nature.
b. ***Irredeemable Debentures*:** These debentures are not repayable during the lifetime of the company. They are only repaid if the company goes for liquidation.
c. ***Mortgage Debentures:*** The debentures which are secured against any asset are known as mortgage debentures or bonds. In case the company fail to pay the interest or the principal, the bond holder has the right to liquidate the asset to claim their dues.
d. ***Simple Debentures:*** As opposed to mortgage debentures, simple debentures are issued without any security.
e. ***Registered Debentures:*** In this type of debentures, the name, address and particulars of debenture holders are recorded in a register by the issuing company. In case the debenture needs to be transfered, the execution of transfer deed is mandatory.
f. ***Bearer Debentures/Bonds:*** As opposed to registered debentures, bearer bonds do not require transfer deed. The issuing company does not keep any record of such bond holder or debentures holders. These debentures are transferable by mere delivery. The interest is paid to the bearer of the coupon attached to the debenture.
g. ***Convertible Debentures:*** A convertible bond or debenture allows the investor to convert it into equity shares at a pre-determined pricing formula or at a fixed conversion price.
h. ***Junk Bonds:*** These types of bonds are issued by companies whose ratings are low. In other words they are issued by companies whose financials are not strong

enough. To attract the investors they offer higher rate of interest.

i. ***Foreign Bonds:*** Bonds issued by foreign companies/ entity in the domestic financial market is known as foreign bonds.

j. ***Eurobonds:***When any bonds is issued by entities outside their domestic financial markets, it is called Eurobonds.

k. ***Samurai Bonds and Yankee Bonds:*** Foreign bonds offered in the Japanese bond market are called samurai bonds. Similarly foreign bonds offered in US Bond market are called Yankee Bonds.



4.9 LET US SUM UP

In this unit we have discussed the following:

- Capital market refers to the market for medium to long term financial assets. It is a market for buying and selling equity, debt and other securities.
- While money market deals with securities having tenure of less than one year, capital market provide funds to corporate and government for the long term.
- All operations relating to new issues and existing securities takes place in the capital market.
- The Capital market helps in mobilization of savings, attracting funds from foreign country, promoting capital formation, diversification of business etc.
- The capital market may broadly be divided in to two categories a) Government securities market and b) Private/ Industrial securities market.
- Government Securities Market is also known as Gilt-edged securities market.

- Long term government securities are mainly available in three forms in India. They are i) Stock certificates ii) Promissory notes and iii) Bearer bonds. They are sold through Public Debt Office of the RBI.
- The main securities transacted in private/ industrial securities market are (i) Preference shares (ii) equity shares and (iii) Bonds or debentures.
- The industrial security market comprise of two parts, they are the Primary Market/ New Issue market and the Secondary Market.
- The various intermediaries in the new issue market are Merchant Bankers, Registrars to the Issue, bankers, underwriters, brokers etc.
- The main types of Shares issued in India are Equity Shares and Preference Shares.
- The main types of Debentures include Redeemable and Irredeemable debentures, Simple debentures, Registered debentures, Bearer debentures etc.



4.10 FURTHER READING

i. Financial Services (2011) by ThummuluriSiddaiah; Pearson Education

ii. Indian Financial System and Financial market operations (2017), by JaydebSarkhel&SeikhSalim; McGraw Hill Education (India) Pvt. Ltd.

iii. Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and JitendraMahakud; McGraw Hill Education (India) Pvt. Ltd.

iv. Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.

v. Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education

vi. The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House

4.11 ANSWERS TO CHECK YOUR PROGRESS

Ans Q No.1: The capital market may broadly be divided in to two categories a) Government securities market and b) Private/ Industrial securities market.

Ans Q No.2: Long term government securities are mainly available in three forms in India. They are i) Stock certificates ii) Promissory notes and iii) Bearer bonds. They are sold through Public Debt Office of the RBI.

Ans Q No.3: The major stock exchanges in India are Bombay Stock Exchange (BSE), National Stock Exchange (NSE) and Over-the-Counter Exchange of India (OTCEI).

Ans Q No.4:

i. Underwriting
ii. Brokerage
iii. Merchant
iv. Distribution
v. Book building



4.12 MODEL QUESTIONS

1. State the points of difference between the Capital market and the Money market.
2. What do you understand by Primary and Secondary markets?
3. Discuss the main functions of the new issue market.
4. What are the various methods by which new issues/IPOs may be made?
5. Discuss the main intermediaries in the New Issue Market?
6. State the differences between Shares and Debentures.
7. What are the different types of Share?
8. What are the different types of Debenture?

*** ***** ***

UNIT- 5: SECURITIES TRADING, STOCK EXCAHNGES & SEBI

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Securities Trading

- 5.3.1 Scrip-Based Traditional Trading/ Physical Trading
- 5.3.2 Scripless or Paperless Trading/ Dematerialization (Demat)

5.4 Depository System

- 5.4.1 Activities of the Depository
- 5.4.2 Constituents in a Depository System
- 5.4.3 Role of Depositories in Dematerialization
- 5.4.4 Role of Depository Participants and Process of Dematerialization

5.5 Stock Exchanges

- 5.5.1 Major Stock Exchange of India
- 5.5.2 Functionaries of Stock Exchanges

5.6 Securities & Exchange Board of India (SEBI)

- 5.6.1 Objectives of SEBI
- 5.6.2 Functions of SEBI
- 5.6.3 Organization of SEBI
- 5.6.4 Powers of SEBI

5.7 Let Us Sum Up

5.8 Further Reading

5.9 Answers to Check Your Progress

5.10 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- state the concept of Securities trading

- know the various ways of doing Scrip Based Trading
- explain the concept of a Depository System and its role in Dematerialization
- describe the process of Dematerialization
- know about the major types of Stock Exchanges in India
- know about the various functionaries of Stock Exchanges
- explain the objectives, functions and powers of Securities and Exchange Board of India(SEBI)

5.2 INTRODUCTION

In this unit we are going to discuss about Securities Trading. Trading securities are investments in debt or equity that management plans to actively trade for profit in the current period. In other words, trading securities are stocks or bonds that management plans to purchase and sell in order to make money in the short- term. In this unit we will briefly discuss securities trading, depository system, stock exchange and SEBI.

5.3 SECURITIES TRADING

It is important to understand how securities are traded in the stock exchanges. Most of the security trading takes place in the secondary market. Secondary market is also known as stock exchange or stock market. It is for old and existing securities. On the other hand, new securities or initial public offer (IPO) are traded in the primary market. There are basically two methods of security trading:

1. Scrip-Based Traditional Trading/ Physical Trading
2. Scrip less or Paperless Trading/ Dematerialization (Demat)

These are discussed below:

5.3.1 Scrip-Based Traditional Trading/ Physical Trading

Initially equity shares and other securities were traded by mutual transfer of money and security certificates. The buyer would transfer the fund to the seller for purchase of the security and the seller

would transfer the security certificate to the buyer. This is known as the scrip-based traditional trading or physical trading.

There are four ways of doing physical trading. They are as follows:

- **Spot Trading:** Under spot trading, the seller of the security must deliver the security certificate to the buyer within 48 hours. The seller receives the money immediately after delivery of the security. However, if the security certificate is to be delivered on some future date at a price agreed at the time of the contract, it is known as forward trading/ forward contract.
- **Cash Based Trading:**Under cash based trading, the delivery of the security certificate and the money takes place on the next settlement date. The stock exchanges fixes the settlement date in advance. Settlement generally takes place once in every week.
- **Settlement Trading:**Under this type of trading, securities can be purchased without having requisite amount of money; similarly securities can be sold without having the requisite securities to deliver. If a person expects the price of a security to go up and he wants to buy the security, then he can make a profit by selling the security. Since he has no money to buy it, in that case he can take a loan from his broker and buy the security. If the price of the security goes up, he makes profit. But if the price falls, he suffers loss equal to the loan amount *plus* interest *minus* the sales proceeds. Such interest element on financing is called *'badla'* system in common parlance.
- **Options Trading:** It is a type of trading where the buyer or the seller has an option to buy or sell a security at a specified price by purchasing an options contract. There are two types of options, call option and put option. Call option is the option to buy a security and Put option is the option to sell. The buyer of the option has to pay a premium to the option seller known as option premium.

On the specified date of the option trading, if the market price of the security is higher than the option price of a call option, the buyer will exercise his option to purchase the security at the lower option price. Thus he makes a profit by buying the security at a discount to the

market price. On the other hand, if the market price of the security is less than the option price, than the buyer has to forego his option and the premium amount paid to the seller of the option is the loss on the deal.

Similarly the buyer of a Put option will exercise his right to sell the security if the market price of the security is lower than the option price on the specified date of trading. In this case the buyer of the Put option makes profit by selling the security at the agreed price (higher) than the market price on the date of trading. In case the market price on the day of trading is higher than the agreed option price, the buyer of the Put option loses his premium amount paid under the option contract.

5.2.2 Scripless or Paperless Trading/ Dematerialization (Demat)

Under scripless trading or Dematerialization trading, the securities cease to exist in physical form and all the securities exist in electronic form, there are no physical certificates. All the securities held by a person are in the electronic form in his Demat account to be opened with respective intermediaries. Hence it is also called screen based trading. Dematerialization of securities has many advantages. Some of the advantages are:

- Buyers of securities can avoid many risks such as bad deliveries, forged securities, loss of securities in transit, loss of physical certificates etc.
- Under demat trading, buyer can avoid stamp duty at the time of buying. The buyer needs to pay nominal settlement charges to the depository participants.
- Buyer can avail the advantage of hassle free operations.
- Buyer can also save the postage expenses of mailing the security certificates to the Registrar and Transfer Agents.



CHECK YOUR PROGRESS

Q1. State whether the following statements are True or False:

a. Under scripbased trading, all the securities exist in electronic form.

b. Call option is the option to buy a security at a specified price by purchasing an options contract.

c. Under Spot trading, securities can be purchased without having requisite amount of money; similarly securities can be sold without having the requisite securities to deliver.

d. New securities or initial public offer (IPO) are traded in the Secondary market.

e. Under Spot trading, the seller of the security must deliver the security certificate to the buyer within 48 hours

5.4 DEPOSITORY SYSTEM

A depository can be defined as an institution which transfers the ownership of securities in electronic mode on behalf of its members. It undertakes the role of a custodian. The depository system leads the capital market towards a scrip less system of securities trading through dematerialization of security certificates.

5.4.1 Activities of the Depository

The main activities of the depository are:

- To accept deposit of securities from investors for custody.
- To make computerized book entry of deliveries of securities.
- To make computerized book entry of pledges of securities in its custody.
- To provide withdrawal of securities.
- To facilitate distribution of dividend and interest on behalf of the corporate.
- To arrange for redemption of securities on maturity.

5.4.2 Constituents in a Depository System

Under depository system there are three institutions which actively coordinate and interact with each other. These three institutions are:

- ***The Central Depository:*** It is the nominee who holds the securities on behalf of the investors and maintains records in electronic mode.
- ***Share Registrar and Transfer Agents:*** The share registrar controls the issuance of securities. The transfer agents retain the names and addresses of registered owners and re-registers traded securities in the name of new owners.
- ***Clearing & Settlement Corporations:*** It is the institution which does trade matching, settles funds and exchanges securities.

5.4.3 Role of Depositories in Dematerialization

A depository is an organization that holds securities of investors in an electronic format at the request of an investor through a registered Depository Participant. It assists in the allotment and transfer of securities and securities lending. In a depository, the securities are held in the form of electronic accounts. They carry out their various operations through functionaries called Business Partners or Depository Participants. This system is governed under the Depositories Act by the Government. The enactment of this act paved the way for the establishment of the National Securities Depository Ltd (NSDL) and the Central Depository Services India Ltd (CDSL). They are both share depositories in India.

- **National Securities Depository Ltd (NSDL):** It is the first depository in India.It was registered by SEBI on June 7, 1996. NSDL was promoted jointly by IDBI, UTI and NSE (National Stock Exchange).
- **Central Depository Services Limited (CDSL):** It was formed in February 1999. It is promoted by Bombay Stock Exchange and Bank of India.

Both NSDL and CDSL have a network of Depository participants (DPs) which are further electronically connected to their clients. So, DPs act as a link between the depositories and the clients.

The Depository system to some extent works like the banking system. While a bank holds cash and fixed deposits of clients, depositories hold shares, debentures, bonds etc., for all shareholders in the electronic form. Like an investor can have a bank account with more than one bank, similarly one can have more than one Demat Account with different Depository Participants (DP).

5.4.4 Role of Depository Participants and ProcessofDematerialization

A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The client's Depository Participant will maintain his securities account balances and intimate the status of the holding from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become depositoryparticipants. DP is one with whom a client needs to open an account to deal with securities in electronic form. While the Depository can be compared to a Bank, DP is like a branch of a bank with which one can have an account. Therefore, DPs are authorized to maintain accounts of dematerialized shares. They help in instantaneous electronic transfer of shares held in Demat form through electronic book entry system.

The following steps may be followed for getting physical securities converted into Demat form.

- *Step 1:* Client/Investor submits the DRF (Demat Request Form) and physical certificates (to be dematted) to the DP. DP checks whether the securities are available for demat. Client defaces the certificate by stamping 'Surrendered for Dematerialization". The DP upon receipt of the shares and the DRF, will issue the client an acknowledgement and will send an electronic request to the Company.

- *Step 2:* DP enters the demat request in his system to be sent to Depositories.
- *Step 3:* DP dispatches the physical certificates along with the DRF to the Registrar and Transfer Agent (R&T Agent).
- *Step 4:* Depositories records the details of the electronic request in the system and forwards the request to the R&T Agent.
- *Step 5:* R&T Agent, on receiving the physical documents and the electronic request, verify and check them. Once the R&T Agent is satisfied, dematerialization of the concerned securities is electronically confirmed to depositories.
- *Step 6:*Depositories credits the dematerialized securities to the beneficiary account of the investor and intimates the DP electronically.
- *Step 7:* The DP issues a statement of transaction to the client.

5.5 STOCK EXCHANGES

Stock exchange is an institution where existing shares are traded. It is also known as secondary market or stock market. In India, stock exchanges are to be registered with the Central Government. They function within the purview of the Securities Contracts (Regulation) Act, 1956. The Act governs the organization, management, membership and functioning of stock exchanges. Moreover stock exchanges are governed by their own set of rules and bye- laws. The Securities and Exchange Board of India (SEBI) overviews, regulates and governs the stock exchanges and their participants and functionaries.

The secondary market operates through two mediums; they are:

I. **The Over- The-Counter (OTC) Market:** The OTC markets are informal market; most of the trades in government securities take place in the OTC market.

II. **The Exchange Traded Market:** Trading which are executed using the infrastructure provided by the organized stock exchanges are known as exchange traded market. Each organized stock exchange has trading floor where traders execute transactions for their clients.

Individuals and firm can become member of the exchange and obtain the right to trade in securities. Any member of exchange can act both as seller and buyer.

Presently there are 20 organized stock exchanges existing in India. Among them three are national and others are regional stock exchanges. The regional stock exchanges are mostly present in major cities of India. There are primarily two prominent stock exchanges in India, Bombay Stock Exchange (BSE) and National Stock Exchange (NSE)

5.5.1 Major Stock Exchange of India

- **Bombay Stock Exchange (BSE):** The Bombay Stock Exchange, popularly known as BSE is Asia's first stock exchange established in the year 1875. BSE provides an efficient and transparent market for trading in equity, debt, derivatives and mutual funds. S&P BSE SENSEX is India's most widely tracked stock market benchmark index.
- **National Stock Exchange of India (NSE):** NSE was incorporated in November 1992. NSE is a fully automated, electronic, screen based trading system. It offers trading in capital market, derivatives market and currency derivatives segments including equities, equity based derivatives, currency futures and options, equity based exchange traded funds (ETFs), Gold ETF and retail government securities.

NSE has two separate segments

a) The wholesale debt market segment which caters to banks, financial institutions and other institutional participants

b) The capital market segment which deals in equities, convertible debentures and so on. The most popular index on NSE is CNX Nifty.

- **Over-the-Counter Exchange of India (OTCEI):** OTCEI was set up in 1992. It is promoted by UTI, ICICI, IDBI, IFCI, LIC, GIC, SBI Caps and Canara Bank as a company with headquarters in Mumbai.

- The objectives behind establishing OTCEI are:
  a) To cater to the needs of companies which cannot be listed on others exchanges.
  b) To help such companies which cannot be listed in other exchanges, raise capital from the market at the cheapest cost and optimal terms.
  c) To eliminate the problems of illiquid securities, delayed settlements etc.

The securities which are traded on OTCEI cannot be traded on other exchanges. They can only be bought and sold at any OTCEI counters spread across the country.

Its members includes scheduled commercial banks, mutual funds, financial institutions, merchant bankers, venture capital funds, NBFCs but not the finance and leasing companies. The minimum networth to become a member of OTCEI is Rs3 crores.

- **Other Stock Exchanges in India:** Apart from the above mentioned three stock exchanges in Mumbai, there are 17 other national and regional stock exchanges spread across major towns and cities in India.

5.5.2 Functionaries of Stock Exchanges

There are various functionaries in stock exchange who perform different roles. We shall briefly discuss some of the major functionaries of stock exchange.

- **Broker:** A broker is also known as a stock broker, who is a commission agent transacts securities on behalf of his client. A broker is a registered member of the stock exchange. A broker can be an individual, corporate and institutions. In order to become a broker, they have to officially apply to the SEBI through the stock exchange where he wants to be the member. Brokers are selected by the selection committee of the exchange on the basis of their qualifications, experience, financial strength and so on. Once selected by the committee, the certified broker has

to abide by the prescribed code of conduct and pay the registration fee. In the event of any breach of these conditions, the broker may lose his license. The commission payable to the broker is known as brokerage. Hence a broker plays an important role in the stock exchange. Without him, investors cannot buy or sell securities.

- **Sub-broker:** A sub-broker is an agent of the broker. He is not a member of the stock exchange. The sub-broker has a letter of recommendation/ certificate from the broker, on the basis of which he acts as an agent of the broker and helps the investors in trading of securities through the broker. Like the broker, the sub-broker shall maintain fairness, integrity and promptness while conducting trading activities on behalf of the client. A sub-broker has to pay relatively lower annual fees to the exchange. Similarly the brokerage of the sub-broker is relatively less than the broker.
- **Jobbers:** A jobber is an independent dealer in securities. They buy and sell securities in which they specialize on their own account. Unlike brokers who are the member of the stock exchange, jobbers are not members but independent dealers. They do not work on commission basis, but work for making a profit. A jobber gives two quotations for any particular security. Normally he gives lower quotation for buying which is known as ‘bid price’ and higher quotation for selling known as ‘ask price’. The difference between the bid price and the ask price is called spread. The spread is the profit for the jobber. Thus jobber profit is uncertain, it may be positive, negative or nil. Jobbers are generally professional speculators and usually specialize in limited number of shares.
- **Portfolio Consultants:** Portfolio consultants are mainly firms which provide services in relation to building portfolio of various stocks as per the needs of investors. A portfolio can be described as combination of different kinds of financial assets or securities.

The role of the portfolio consultants is to design a portfolio of securities or different assets in such a way that it maximizes the return for the investors at minimum cost of investments. Merchant banks in India mainly perform this job.

- **Institutional Investors:** As the name suggest institutional investors are not individual investors. They are mostly banks, financial institutions, mutual funds, insurance companies, pension funds and so on. When foreign institutions invest in India's security market, they are known as foreign institutional investors (FII). The capacities of investment by institutional investors are huge in comparison to individual investors and hence they can greatly influence the security market.



CHECK YOUR PROGRESS

Q2. Who is a Depository Participant?

_____

_____

Q3. Name two major Stock Exchanges of India?

_____

_____

Q4. Who is a Broker?

_____

_____

5.6 SECURITIES & EXCHANGE BOARD OF INDIA (SEBI)

To develop the Indian capital market and to regulate, supervise and control the activities of various stock exchanges in India, the Securities and Exchange Board of India (SEBI) was set up in April 1988. However through the enactment of Securities and Exchange Board of India Act 1992, the SEBI was given statutory power.

5.6.1 Objectives of SEBI

The main objectives of establishing SEBI are as follows:

- To protect the interest of general investors and to ensure regular flow of savings into the capital market.
- To prohibit unfair practices by brokers, sub brokers etc. of stock exchanges.
- To adhere to guidelines issued by SEBI by companies who issues various securities to raise money from general public.
- To promote efficient services by brokers, merchant bankers and other intermediaries in the security trading.
- To stop insider trading in securities.

5.6.2 Functions of SEBI

As the regulator of capital market, SEBI performs various important functions. Some of the major functions of SEBI are summarized below.

- To protect the interest of investors in securities.
- To regulate the business in stock exchanges.
- To register and regulate the workings of stock brokers, sub-brokers, share transfer agents, bankers to an issue, registrars to an issue, merchant bankers, underwriters and so on.
- To register and regulate the workings of the depositories, custodian of securities, credit rating agencies, foreign institutional investors (FIIs) and so on
- To register and regulate the workings of venture capital funds and investment schemes of various entities including mutual funds.
- To promote and regulate self regulatory organizations (SROs)
- To stop fraudulent and unfair trade practices relating to securities market.
- To promote awareness and educate investors regarding securities market.
- To prohibit insider trading in securities.

- To regulate substantial acquisition of shares and takeover of companies.
- To call for information, conduct inspection, enquiries and audits from stock exchanges, mutual funds, self regulatory organizations and persons associated with securities market intermediaries.

The above mentioned functions of the SEBI can further be classified into regulatory functions and developmental functions. The regulatory functions seek to regulate and control the undesirable activities of various functionaries in the capital market. Whereas, developmental functions seek to promote the growth and development of capital market in India.

	Regulatory	Developmental
1	Registration of brokers, sub brokers and other players in the stock market.	Imparting education to investors
2	Registration of various investment schemes and mutual funds	Imparting training to intermediaries.
3	Regulation of stock exchanges, merchant banks, portfolio managers etc.	Publishing relevant information for market participants
4	Prohibition of all fraudulent and unfair trade practices	Promotion of fair practices and code of conduct for Self-Regulating Organisations (SROs)
5	Regulating insider trading and takeover bids and imposing penalties for such practices.	

5.6.3 Organization of SEBI

The SEBI is a body of eight members comprising

- The Chairman
- Three full time members
- One part time member

- Two officials from finance and law ministries of Central Government.
- One member from RBI

The Government of India appoints all the members except the member from RBI. The Central government is empowered to supersede the SEBI under any of the following circumstances.

- In public interest
- Unable to discharge its duties on account of grave emergency.
- Defaults in complying any directions issued by the government
- Its financial position and administration deteriorates.

The functions of the SEBI have been organized into various operational departments. Each department is headed by an executive director. The chairman of the SEBI is the chief executive of the Board.

5.6.4 Powers of SEBI

The SEBI Act, 1992 entrusted certain powers to the Securities and Exchange Board of India. The following are some of the powers of SEBI:

- The SEBI is empowered to register any intermediary associated with the securities market to prohibit buying, selling or dealing in securities except under and in accordance with the conditions specified by SEBI.
- The SEBI has the power to suspend or cancel certificate of registration issued by it to anyone, after giving reasonable opportunity of being heard.
- The SEBI Act empowers SEBI to lay down the civil and criminal penalties for contravention of the Act.
- SEBI can conduct inquiries into the working of the stock exchanges.
- They can demand explanations, summon attendance, call for documents from all categories of market intermediaries in order to investigate any irregularities.

- The SEBI can also notify its regulations and file complaints in courts without prior approval of the Government of India.



5.7 LET US SUM UP

- Most of the security trading takes place in the secondary market. Secondary market is also known as stock exchange or stock market.
- Scrip-based traditional trading or physical trading is mainly done four ways namely Spot Trading, Cash based trading, Settlement Trading and Options Trading.
- Under scrip less trading or Dematerialization trading, the securities cease to exist in physical form and all the securities exist in electronic form, there are no physical certificates.
- A depository can be defined as an institution which transfers the ownership of securities in electronic mode on behalf of its members.
- Under depository system there are three institutions which actively coordinate and interact with each other, they are, The Central Depository,Share Registrar and Transfer Agents and Clearing & Settlement Corporations.
- The enactment of the Depositories Act by the Governmentpaved the way for the establishment of the National Securities Depository Ltd (NSDL) and the Central Depository Services India Ltd (CDSL). They are both share depositories in India.
- A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors.
- Stock exchange is an institution where existing shares are traded. In India, stock exchanges are to be registered with the Central Government.
- The Securities and Exchange Board of India (SEBI) overviews, regulates and governs the stock exchanges and their participants and functionaries.



5.8 FURTHER READING

i. Financial Services (2011) by ThummuluriSiddaiah; Pearson Education

ii. Indian Financial System and Financial market operations (2017), by JaydebSarkhel&SeikhSalim; McGraw Hill Education (India) Pvt. Ltd.

iii. Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and JitendraMahakud; McGraw Hill Education (India) Pvt. Ltd.

iv. Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.

v. Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education

vi. The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House

5.9 ANSWERS TO CHECK YOUR PROGRESS

Ans. Q1. (a) False (b) True (c) False (d) False (e) True

Ans Q2.A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The client's Depository Participant will maintain his securities account balances and intimate the status of the holding from time to time.

Ans Q3. National Stock Exchange; Bombay Stock Exchange

Ans Q4. A broker is also known as a stock broker, who is a commission agent transacts securities on behalf of his client. A broker is a registered member of the stock exchange. A broker can be an individual, corporate and institutions.



5.10 MODEL QUESTIONS

1) Discuss the two main methods of Securities Trading?
2) What is a Depository? Discuss its main constituents and main activities.
3) List the main steps involved in converting physical securities to Demat form.
4) Discuss the role of the major functionaries of a Stock Exchange.
5) What are the objectives of SEBI? Discuss its regulatory as well as developmental functions.
6) Write Short Notes on:
   a. Options Trading
   b. Role of depository in Dematerialization.
   c. Powers of SEBI

*** ***** ***

UNIT 6: INDIAN BANKING SYSTEM AND RBI

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Bank Its Meaning

6.2.1 Different kinds of Bank

6.3 Banking Structure in India

6.3.1 Types of Scheduled Commercial Banks

6.4 Commercial Banks and its Principles

6.5 Services provided by Commercial Banks

6.6 Reserve Bank of India and its Functions

6.6.1 Traditional Functions

6.6.2 Promotional Functions

6.7 Credit Control Measures of RBI

6.7.1 Quantitative Measures

6.7.2 Qualitatative Measures

6.8 Let Us Sum Up

6.9 Further Reading

6.10 Answers to Check Your Progress

6.11 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- state the meaning and purpose of a Bank
- know what are the different kinds of banks
- explain the banking structure in India
- know the different types of Scheduled commercial banks
- explain the principles of Commercial banking
- know the various services provided by Commercial banks
- explain the functions of the Reserve bank of India
- know the qualitative and quantitative measures of credit control by the Reserve bank of India.

6.2 INTRODUCTION

In this unit we are going to discuss about Indian banking system.The Indian banking sector is broadly classified into scheduled and non-scheduled banks. The scheduled banks are those included under the 2nd Schedule of the Reserve Bank of India Act, 1934. The scheduled banks are further classified into: nationalised banks; Regional Rural Banks (RRBs); foreign banks; and other Indian private sector banks.The term commercial banks refers to both scheduled and non-scheduled commercial banks regulated under the Banking Regulation Act, 1949. In this unit, we will briefly discuss different kinds of banks and functions of Reserve Bank of India.

6.3 BANK: ITS MEANING

A bank is an institution that accepts deposits of money from public which is withdrawable by cheque and uses the deposits collected for lending. Hence, the following four parameters are essential to describe an institution as banks.

I. It has to accept deposits in the form of money.

II. Deposits to be accepted from general public and not from the shareholders of the firm.

III. Deposits are withdrawable on demand by cheque.

IV. The institution must use the deposits to give loans to the general public.

Hence, a bank is an intermediary who accepts deposits from the public who has disposable income or savings and route the money in the form of loan to those public who are in need of money.

However, there are few institutions that accept deposits withdrawable by cheques from public but use the deposits for its own purpose, they are not regarded as banks. Such types of institution are known as *pure deposit system*. Post office savings bank is an example of pure deposit system where the money collected from the public are utilized for governmental work. Similarly there are few institutions that accept deposits from the public and give loans to public and corporate but their deposits cannot be withdrawn

by cheques. They are known as *pure financial intermediaries.* Life Insurance Corporation of India, Unit Trust of India are few examples of pure financial intermediaries. Hence to be a bank it has to fulfill all the above mentioned criteria.

6.3.1 Different kinds of Banks

The following are the various types of banks that exist in an economy:

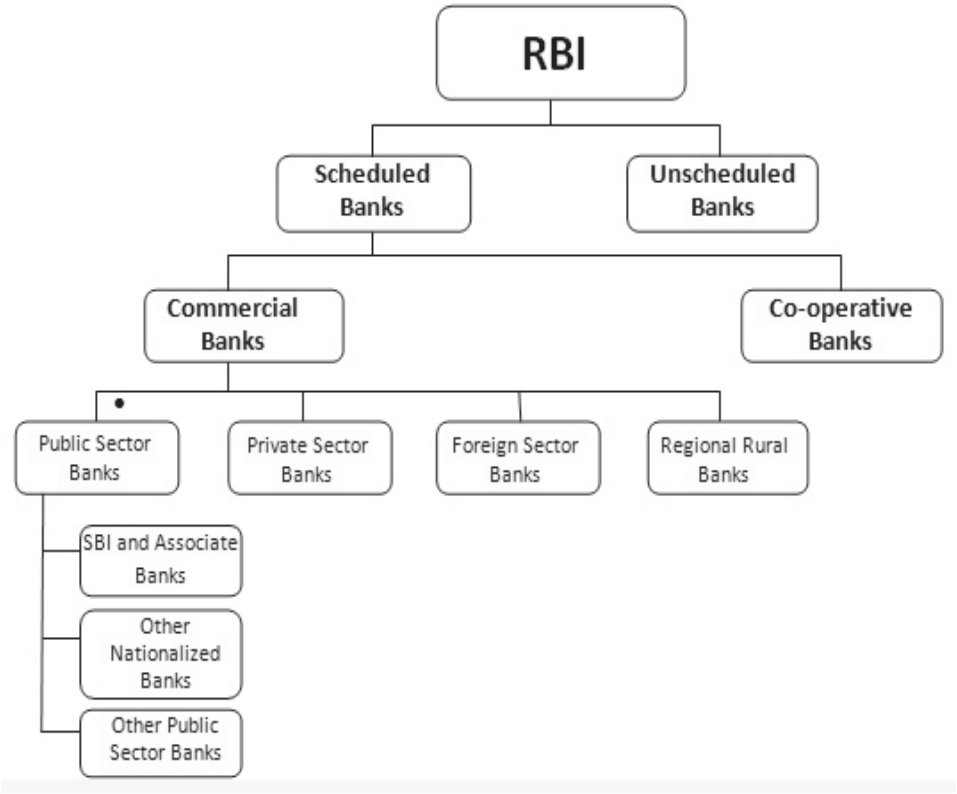
- **Central Bank:** It is the apex bank of a country. The central bank regulates the entire banking system of a country. In India, Reserve Bank of India is the central bank.
- **Commercial Banks:** Among various types of banks, commercial banks are the most important banks in any country. In India, commercial banks are divided into two groups a) Nationalized or Public Sector Banks and b) Private Sector Banks. The private sector banks can further be segregated in to Indian Banks and Foreign Banks.
- **Development Banks:** These are the specialized financial institutions which supply medium to long term finance to the individuals and institutions. They are also known as Development Financial Institutions (DFIs). Whereas commercial banks mainly provide short term and medium term finance, development banks provide medium to long term credit. Few of the DFIs of India are Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), National Small Industries Corporation (NSIC), Small Industrial Bank of India (SIDBI), Northeast Development Financial Institution (NEDFi) and so on.
- **Co-operative Banks:** There are few banks which are organized under the provisions of the law of the co-operative societies, they are called co-operative banks. The co-operative banks in India were set up to provide short-term loans to the

agriculturists for purchase of seeds, harvesting and for other cultivation expenses. However at present, co-operative banks are operating similar to the commercial banks in urban, semi-urban and rural areas.

- **Land Mortgage or Agricultural Banks:** This type of banks offer long term credit to farmers for the development/purchase of agricultural land. National Bank for Agriculture and Rural Development (NABARD) is an example of agricultural bank in India.
- **Foreign Exchange Bank:** This type of bank facilitated international trade. They offer range of services such as buying and selling of foreign exchange, discounting bills, provide advisory service related to international trade and so on. In India, Export -Import Bank (EXIM Bank) is a foreign exchange bank.
- **Merchant Banks:** Merchant banks primarily focused on providing service to business undertakings on various financial matters. It is mainly concerned with providing non fund based services with respect to arranging funds rather than providing them. Merchant banks provide wide range of services to their client with respect to underwriting of new issues, corporate mergers and acquisitions, loan syndication and so on.

6.4 BANKING STRUCTURE IN INDIA

At the core of the banking structure in India is the Reserve Bank of India, which is the central bank of the country. The RBI conducts and regulates the whole banking system of the country. The following figure shows the structure of Indian banking system:



As shown above all the banks in India are divided into two categories i.e, Scheduled Banks and Unscheduled Banks. Scheduled Banks are those banks which are included in the second schedule of the RBI Act, 1934. On the other hand, unscheduled banks are those banks which are not included in the second schedule of RBI Act, 1934. These banks are not controlled by RBI. They are mostly primary credit societies. The Scheduled banks need to have a paid up capital and reserves of not less than ‘5 lakhs. These banks are wholly controlled by the RBI.

6.4.1 Types of Scheduled Commercial Banks

The Scheduled commercial banks are further categorized into Public Sector Banks, Private Sector Banks, Foreign Banks and Regional Rural Banks.

Public Sector Banks: These are the banks where majority of stake is held by the Government of India. In India public sector banks perform about 75% of total bank transaction in the country. At present

there are 19 nationalised banks and 2 new public sector banks which make a total of 21 public sector banks. The 19 nationalised banks include.

- Allahabad Bank
- Andhra Bank
- Bank of Baroda
- Bank of India
- Bank of Maharastra
- Canara Bank
- Central Bank of India
- Corporation Bank
- Dena Bank
- Indian Bank
- Indian Overseas Bank
- Oriental Bank of Commerce
- Punjab and Sind Bank
- Punjab National Bank
- Syndicate Bank
- UCO Bank
- Union Bank of India
- United Bank of India
- Vijaya Bank

Among the public sector banks, the State Bank of India is the biggest bank in India. Till March 2017, State Bank of India had five subsidiaries. They were

I. State Bank of Bikaner and Jaipur (SBBJ)
II. State Bank of Hyderabad (SBH)
III. State Bank of Mysore (SBM)
IV. State Bank of Patiala (SBP)
V. State Bank of Travancore (SBT)

From 1st April 2017, post the approval of Union Cabinet, the State Bank of India merged its all five subsidiaries along with another newly formed public sector bank in 2013, Bhartiya Mahila Bank

(BMB). With the merger of 5 associate banks and one additional public sector bank (Bhartiya Mahila Bank), State Bank of India become top 50 largest banks in the world.

In addition to the above, there is one more public sector bank i.e, IDBI Bank, which was originally set up as development bank in 1964 as Industrial Development Bank of India. In 2004, it has been converted into a commercial bank called IDBI Bank in the public sector.

Private Sector Banks: These are the banks where majority of the stake is held by private shareholder and not government. The Government of India announced the New Economic Policy in 1991 and adopted the policy of privatization and liberalisation. As a result, private and foreign banks started operation in India. Some of the important private sector banks in India are

- ICICI Bank
- HDFC Bank
- Axis Bank
- Kotak Mahindra Bank
- Yes Bank
- IndusInd Bank and so on.

Foreign Banks: Foreign banks are those banks which have head offices abroad. They operate in India as per the guidelines of the Reserve Bank of India. Some of the prominent foreign banks in India are

- HSBC Bank
- Citi Bank
- Standard Chartered Bank
- American Express bank and so on

Regional Rural Banks: Since June 1975 Government of India has set up Regional Rural Banks (RRBs) to provide credit to the weaker sections of the society in the rural areas.The Regional Rural Banks were owned by the Central Government, the State Government and the Sponsor Bank (Any commercial bank can sponsor the regional

rural banks) who held shares in the ratios as prescribed by the Government.

Scheduled Co-operative Banks: Co-operative banks were originally set up to provide credit to the primary agricultural credit societies at lower rate of interest. However at present, co-operative banks not only operate in rural areas but equally compete with the commercial banks in the urban areas. They provide loans not only for agricultural activities but also for variety of other economic activities. Some of the schedule co-operative banks operating in the country presently are

- Assam Co-operative Apex Bank
- Arunachal Pradesh State Co-operative Apex Bank
- Tripura State Co-operative Bank
- Delhi State Co-operative Bank
- Meghalaya Co-operative Apex Bank and so on



CHECK YOUR PROGRESS

Q 1: What are Scheduled and Unscheduled banks?

.....

.....

Q 2: What are Regional Rural Banks?

.....

.....

Q 3: Name Two Foreign banks.

.....

.....

6.5 COMMERCIAL BANKS AND ITS PRINCIPLES

Commercial banks are the most important banks in any country. They primarily accept deposits from the public and lend the money in the form of loans to individuals or institutions. In India State Bank of India is the

biggest commercial bank. Commercial banks are guided by few specific principles. These principles need to be followed for smooth and effective functioning of commercial banks. There are mainly six principles of commercial banking.

I. **Liquidity:** Liquidity refers to the capacity of the banks to meet the cash demands of its clients. In other words, commercial banks must have sufficient cash to meet the cash demand of its depositors. Hence they must maintain liquidity. Bank has to maintain liquidity to gain the trust and confidence of its customers. To ensure liquidity, commercial banks are required to keep certain portion of their deposits in the form of cash, as prescribed by RBI from time to time.

II. **Profitability:** Like any other organization, a commercial bank must earn profit for its existence. In order to earn profit, a bank has to lend money to its clients in the form of loans and advances. However if the bank lends its entire deposits, it runs into liquidity risk. Therefore the commercial bank must maintain a 'trade off' between liquidity and profitability. A successful bank has to strike a right balance between profitability and liquidty.

III. **Safety:** A bank must ensure safety of money of its depositors. A bank accepts deposits from the public; hence safety of the money is one of the prime principles of banking. A bank must ensure due diligence before offering loan to its clients. In case of default by large number of clients, in repaying the loan amount, the bank will run the risk of insolvency.

IV. **Stability:** Stability implies growth of an organization at a steady rate. A sound banking system must operate rationally and judiciously. There should not be undue expansion or undue contraction of credit.

V. **Flexibility:** An efficient bank needs to be flexible. It should be able to expand or contract credit as per the requirement of the economy. In other words it should disburse more loans during depression and contract loans during inflation.

VI. **Expansion:** A sound banking system should not only be concentrated only to urban or semi urban areas but it should be expanded to the

rural areas also. Expansion of banking system to rural areas will increase the inducement to save for the rural people. All these will help in capital formation and economic development of a country.

6.6 SERVICES PROVIDED BY COMMERCIAL BANKS

Commercial banks are the most important financial institutions in any country. They provide various services for the economic development of a country. The major services offered by commercial banks are as follows.

- **Acceptance of deposits**: They accept deposits from the public. People prefer to deposit their savings in bank because bank offer interest on deposits.
- **Advancing Loans**: Commercial banks offer loans to their customers in order to earn profit. After keeping certain percentage as cash reserves, the bank provide short term, medium term and long term loans to needy borrowers.
- **Investment of funds**: Commercial banks are one of the prominent players in the money market and capital market. They invest their surplus funds in the market to generate maximum returns.
- **Remittance of funds**: Banks act as an intermediary in transferring funds from one place to another through various means such as cheques, drafts, online banking etc.
- **Dealing in foreign exchange**: Commercial banks deals with foreign currencies. They facilitates international by buying and selling foreign currencies.
- **Overdraft Facility**: This facility allows customers to withdraw funds more than their deposits against a fee. The overdraft facility helps businesses to expand and grow.
- **Discounting Bills of Exchange**: The commercial banks discounts bills of exchange by paying the value of the bill upfront to the holder, after deducting a percentage as commission. The bank then gets the payment from the party who accepted the bill, when the bill matures.

- **Credit Cards**: Credit cards are innovative instruments in the area of financial services offered by commercial banks. A credit card facilitates the card holder to make purchases of goods and services without making immediate payments within a specified credit limit, which is fixed by the issuer of the card.
- **Debit Cards**: Debit cards are also used to make purchases of goods and services at merchant establishments, however the amount of money spent on purchases are debited from the account of the debit card holder. The debit cards usually require a personal identification number (PIN) to be used to verify the transaction.
- **Automatic Teller Machine (ATM):** The commercial banks have placed ATMs at various important locations to provide the basic banking services such as withdrawal of cash, deposit of cash, account inquiries etc.
- **Online banking**: It is a service that allows account holder to access data through internet. It is also known as internet banking. In order to carry out online banking, the account holder needs to enter specific login identity and password. After log in, the customer can perform various banking transaction such as paying bills, transferring money, download account statement etc.
- **Private Banking:** It is personalized financial and banking services offered specifically to high networth individuals (HNI).
- **Mobile Banking:** Mobile banking enables a customer to do various bank transactions such as balance enquiry, bill payment, transferring money and so on through their mobile handset.

6.7 RESERVE BANK OF INDIA AND ITS FUNCTIONS

As the central bank of the country, the Reserve Bank of India (RBI) regulates and promotes financial transaction of various financial intermediaries. The RBI was set up under the Reserve Bank of India Act, 1934. It has started its operation from 1st April 1935. The functions of RBI can be divided into two broad categories namely Traditional Functions and Promotional Function.

6.7.1 Traditional Functions

The following are the traditional functions performed by the RBI since its inception.

- **Issue of currency:** The top most function of RBI is to issue currency notes. The RBI is the sole authority to issue all types of paper currency except few notes of small denominations which are now circulated in the form of coins. The small denomination notes and coins are circulated by the Government of India. Presently RBI issue notes of denominations of ‘10, 20, 50, 100, 200, 500 &2000. At present, one-rupee, two-rupee and five-rupee are issued in the form of coins, RBI no longer issue these currencies in the form of notes. However Ten-rupee notes are issued both in the form of notes and coins. Though the metallic coins are issued by Government of India, their amount is determined by the RBI. Thus by issuing currency, RBI regulates the volume of money supply in the economy.
- **Bankers to the Government:** As a banker to the government, RBI maintains the accounts of the both central and state governments. The government deposit their revenue as well withdraw funds to meet their expenses from the RBI. The RBI also provide various other services to both central and state governments. Some of such services are management of public debt, repayment of government loans and so on. The RBI also updates government on various financial and economic matters.
- **Banker to Commercial Banks:** All commercial banks need to keep a certain percentage of their deposits in the form of Cash Reserve Ratio (CRR)with RBI. Apart from CRR, commercial banks have to keep a portion of their deposits in the form of approved securities, cash or gold. This portion of reserve is known as Statutory Liquidity Ratio (SLR). RBI also

acts as the lender of last resort to commercial banks. It provides credit to commercial banks. Further, RBI acts as the clearing house of commercial banks. In a nutshell, RBI acts as the banker to commercial banks.

- **Maintain stability of exchange rate:** The RBI acts as a stabilizer of exchange rate. It tries to maintain a stable value of Indian rupee (INR) against major foreign currencies. It is vital to sustain a stable rate of exchange for smooth functioning of foreign trade. For example when value of US dollar rises against INR, the RBI sells US dollar in the market to arrest the upward move of dollar. Similarly when value of dollar falls against INR, RBI purchases US dollar from the market. The RBI keeps the foreign exchange reserves of the country.
- **Controller of credit:** Another major role played by RBI is to control the volume of bank credit. RBI uses different instruments to control the credit in the economy. Few of the common measures adopt by RBI are bank rate, cash reserve ratio, open market operations etc. When inflation is on rise, RBI tries to contract the volume of credit and vice versa.
- **Provider of economic information:** The RBI publishes monthly bulletins on important economic information and statistics on different aspect of Indian economy. The RBI has a strong research wing which provides information on various economic parameters. The finding of these researchesworks are reported in occasional papers published by RBI.

6.7.2 Promotional Functions

The RBI perform various promotional activities, the following are prominent ones.

- Expansion of banking activities in rural areas: The RBI promotes the expansion of banking sector in rural India. By expanding the banking activities in rural areas, the RBI helps mobilization of rural savings.
- Financing agriculture: To provide adequate finance to the small

and marginal farmers, RBI has taken many steps. The RBI has set up National Bank for Agriculture and Rural Development (NABARD) in July 1982. It has also established Regional Rural Banks (RRBs) in July 1975.

- Financing industry: Industrial sector development is also crucial for the development of the economy. In this regard RBI has set up Industrial Finance Corporation of India (IFCI), State Financial Corporation (SFCs), Small Industrial Development Bank of India (SIDBI) and so on.
- Promotion of foreign trade: To promote export and import, the RBI has set up Export-Import (EXIM) Bank in 1982. The setting up of EXIM bank has helped in boosting the foreign trade of the country.

Thus Reserve Bank of India, as the central bank of the country performs various important activities.



CHECK YOUR PROGRESS

Q 4: List two Services of Commercial Banks.

.....

.....

Q 5: List two functions of Reserve bank of India

.....

.....

6.8 CREDIT CONTROL MEASURES OF RBI

The Reserve bank of India plays a crucial role in controlling the volume of credit. It conducts the monetary policy of the Government of India. The monetary policy is prepared to maintain stability in employment, income, price etc. in the economy. The RBI uses various instruments to control the money supply and credit flow. The methods applied by RBI in controlling credit can be broadly classified into a) quantitative method and b) qualitative/ selective method.

6.8.1 Quantitative Measures

The quantitative methods seek to expand or contract the total volume of credit in the banking system. The following are the major instruments under this method to control the credit in the economy.

I. **Bank Rate:** It is the rate at which RBI provide loans to commercial banks and other financial institutions. Hence there is a connection between bank rate and the interest rates charged by commercial banks / financial institutions on the loan issued to their clients. When RBI needs to reduce the volume of credit in the economy, it increases the bank rate. The increase in bank rate leads to increase in the interest rate charged by banks on loan they offer to their clients. Similarly, if RBI decreases bank rate, the market interest rate will also fall and the volume of credit expand. Thus in order to regulate the volume of bank credit, RBI may increase or decrease the bank rate depending on the situation.

II. **Open market operations (OMO):** OMO refers to purchase and sale of government securities by RBI in the open market. The RBI mainly uses this instrument to meet seasonal variations in the demand for credit. India being an agricultural economy, the demand for credit increases during October to April season when crops are harvested. On the other hand the demand decreases during May to September period. Therefore during the busy season i.e, from October to April, the RBI purchases government securities from commercial banks, thus it increases liquidity by supplying money to commercial banks. This enable banks to give more loans to the public. On the contrary, during the slack season, RBI sells government securities so that bank can park their idle funds with RBI and earns interest on it. Thus RBI uses open market operations to meet seasonal demand for credit in the Indian economy.

III. **Cash reserve ratio (CRR):** All scheduled commercial banks

are required to maintain a specific percentage of deposits in the form of cash with RBI as cash reserve ratio. The RBI fixed CRR rate from time to time. When RBI reduces the CRR, commercial banks need to maintain less amount of reserve with RBI, which allows them to lend more in the form of loan. On the other hand when the CRR is raised, commercial banks need to maintain more cash with RBI which leads to less amount of credit disbursement.

6.8.2 Qualitative Measures

Qualitative methods of credit control are those methods which RBI uses to regulate the flow of credit to certain selective sectors, without regulating all types of credit. It is also known as selective method of credit control. The following are the some of the major instruments used by RBI under this method of credit control:

I. **Statutory liquidity ratio (SLR):** In addition to cash reserve ratio (CRR), the RBI also mandated commercial banks to maintain a certain percentage (minimum 25%) of their deposit in the form of cash, gold or approved securities. This percentage is known as statutory liquidity ratio (SLR). The SLR requirements force the commercial banks to invest in government approved securities.

II. **Interest rate structure:** The RBI also regulates the flow of credit by maintaining a differential interest rate structure. The rate of interest is kept low for certain sectors, the government wants to grow these sectors, and hence the rate of interest of interest is minimal. On the other hand, the rate of interest is kept high in undesirable activities where government focus is low.

III. **Direct action:** The RBI can also imply direct action on certain bank or banks by prohibiting entering into specific transaction. If RBI suspect any anomaly in any banks operation, they can also inspect any book and its books of account.

IV. Moral suasion: Under this method, the RBI communicates and directs commercial banks from time to time though circulars or letters. They also held meetings with the representative of banks from time to time to focus on the priorities of the economy.

Through such methods of credit control, the RBI pursues its monetary policy. It can also be termed as the policy of controlled expansion.



6.9 LET US SUM UP

In this unit, we have discussed the following—

- A Bank is at an institution that accepts deposits of money from public which is withdrawable by cheque and uses the deposits collected for lending.
- In an economy different kinds of banks may exist. They may be the Central bank, Commercial banks, Developmental banks, Foreign Exchange banks etc.
- At the core of the banking structure in India is the Reserve Bank of India, which is the central bank of the country.
- All the banks in India are divided into two categories i.e, Scheduled Banks and Unscheduled Banks.
- Scheduled banks may again be categorized as Public sector banks, Private sectors banks, Foreign banks, Regional Rural banks and Scheduled commercial banks.
- There are mainly six principles of commercial banking. They are Liquidity, Profitability, Safety, Stability, Flexibility and Expansion.
- Commercial banks provide various services for the economic development of a country. Some of these services are acceptance of deposits, advancing of loans, dealing in foreign currency, credit cards and debit cards, mobile banking etc.

- The RBI was set up under the Reserve Bank of India Act 1934. It has started its operation from 1st April 1935. The functions of RBI can be divided into two broad categories namely Traditional Functions and Promotional Function.
- The Reserve bank of India also plays a crucial role in controlling the volume of credit in the economy by deploying various quantitative and qualitative techniques like CRR, SLR, Bank rate, OMO's etc.



6.10 FURTHER READING

1) Financial Services (2011) by ThummuluriSiddaiah; Pearson Education
2) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
3) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.



6.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Scheduled Banks are those banks which are included in the second schedule of the RBI Act, 1934. On the other hand Unscheduled banks are those banks which are not included in the second schedule of RBI Act, 1934.

Ans to Q No 2: Regional Rural Banks (RRBs) were set up to provide credit to the weaker sections of the society in the rural areas.They owned by the Central Government, the State Government and the Sponsor Bank (Any commercial bank can sponsor the regional rural banks) who hold shares in the ratios as prescribed by the Government.

Ans to Q No 3: HSBC and Citi bank

Ans to Q No 4 (1) Acceptance of deposits and (2) Advancing of loans

Ans to Q No 5: (1) Issuer of Currency (2) Controller of credit



6.12 MODEL QUESTIONS

Q 1: List four parameters are essential to describe an institution as a bank.

Q 2: Discuss the various types of banks that exist in an economy.

Q 3: Discuss in detail the banking structure in India.

Q 4: What are the principles of Commercial banks?

Q 5: Discuss the various services provided by commercial banks?

Q 6: Discuss the traditional and promotional functions of the Reserve bank of India.

Q 7: Discuss the Quantitative and Qualitative measures of credit control by Reserve bank of India.

*** ***** ***

UNIT 7: MANAGEMENT OF RISK

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Risk in Financial Services

7.3.1 Causes of Risks

7.4 Types of Risks in Financial Services

7.5 Difference Between Systematic and Unsystematic Risks

7.6 Risk Management by Financial Institutions

7.6.1 Typical Causes of Financial Crisis in Banks

7.7 Role of Technology in Risk Management

7.8 Let Us Sum Up

7.9 Further Reading

7.10 Answers to Check Your Progress

7.11 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- state the concept of risk in financial services
- know the types of risks involved in financial services
- explain the differences between systematic and unsystematic risks
- discuss the risk management practices by Financial Institutions
- explain the role of technology in risk management.

7.2 INTRODUCTION

Risk plays an important role in decision making. The business firms operate under the condition of uncertainity and risk which arises due to various reasons. These reasons may be internal or external to the firm but the firm has to manage these risk to ensure its survival in the business environment.

In this unit, we will discuss the various aspects of risk management

practices in case of financial service providing firms. A firm providing financial services expose to various kinds of risks, like fall in interest rate, liquidity crisis, fall of market etc. As a financial manager, you must be well versed with all these kinds of risk and these have to be managed accordingly. In fact, certain risks cannot be avoided and have to be managed to ensure the profitability of the firm. All these aspects make risk management an interesting topic.

7.3 RISK IN FINANCIAL SERVICES

In today's scenario, the financial services industry operates in an increasingly complex and competitive environment. It is not only confined to domestic market but also expands to global markets. Hence the management of risks across geographies, products, asset classes and customer segments is of paramount importance. Inability to manage risk can create panic in the financial services market. The art of managing risk is more challenging than ever.

Risk is exposure to uncertainty. It implies the extent to which any chosen action or an inaction, may lead to a loss or some unwanted outcome. In financial services industry, different types of risk can be classified under two broad categories:

a) Systematic risk and

b) Unsystematic risk

7.3.1 Causes of Risks

Risk arises due to various reasons, some of the common causes of risks are:

- **Wrong Decisions:** Wrong timing or wrong decision by the management.
- **Tenure of investments:** Long term investments are more riskier than short term investments as future is unpredictable.
- **Quantum of investments:** Heavy investments are more risky. Any default of large investments affects to a large extent the profitability of the organization.

- **Nature of industry:** Risk is relatively higher in speculative and cyclical industry compared to defensive and growth industry.
- **Political and legal factors:** Risk may arise due to change in government or government policy of a country.

7.4 TYPES OF RISKS IN FINANCIAL SERVICES

a) **Systematic Risk:** Systematic risk arises due to the influence of external factors. Such factors are normally uncontrollable from an organization's point of view. It is mostly macro in nature as it affects large number of organizations operating under financial services industry. It cannot be planned by an organization.

Systematic risk can be of following types:

1. **Interest rate risk:** Interest rate risk is the possibility that the value of an investment will decline as the result of an unexpected change in interest rates. This risk is most commonly associated with an investment in fixed-rate instruments like bond or debentures. Interest rate risk affects the value of bonds more directly than stocks. It is a major risk to all bondholders. As interest rates rise, the prices of bond fall, and vice versa. This happens because if the interest rates increase, the opportunity cost of holding the bond decreases, since the bond holder can earn higher interest by switching to other investments that reflect the higher interest rate. For example, a 10% bond is worth more if interest rates decrease, because the bondholder is entitled to receive 10% interest compared to the market, which is offering a lower rate of return as a result of the decrease in rates.

2. **Market risk:** Market risk is the risk that the value of an investment will decrease due to changes in market factors. These factors will have an impact on the overall performance on the financial markets and can only be reduced by diversification into assets that are not correlated with the market. There are several different risk factors that make up market risk.

- Currency risk: The risk that exchange rates will go up or

possibly down

- Equity risk: The risk that share prices will go up or down
- Inflation risk: the potential for inflation to increase the price of all goods and services such that it undermines the value of money
- Commodity risk: the possibility of commodity prices such as metals change value dramatically
- Interest rate risk: the risk that comes from an increase or decrease in interest rates

3. Inflationary risk: Inflationary risk, also called purchasing power risk, is the chance that the cash flows from an investment will not be worth as much in the future because of changes in purchasing power due to inflation. Bonds are the one investment that is most vulnerable to inflationary risk. Inflation can destroy the net worth of a bond investor. Most bonds receive a fixed coupon rate that doesn't increase. Therefore, if an investor buys a 30-year bond that pays a 4 percent interest rate, but inflation skyrockets to 10 percent, the investor is in serious trouble. With each passing year, the bond holder loses more and more purchasing power, regardless of how safe they feel the investment is. To illustrate with an example, ‘1,00,00,000 in bonds with a 10% coupon might generate enough interest payments for a retiree to live on, but with an annual 3% inflation rate, every ‘ 10,00,000 produced by the portfolio will only be worth ‘ 9,70,000 next year and about ‘ 9,40,000 the year after that. The rising inflation means that the interest payments have less and less purchasing power and the principal, when it is repaid after several years, will buy substantially less than it did when the investor first purchased the bonds.

b) Unsystematic Risk: Unsystematic risk is due to the influence of internal factors prevailing within an organization. Such factors are normally controllable. It is micro in nature as it impacts only a particular organization. It can be planned and through proper planning unsystematic risks can be mitigated to a large extent.

The type of unsystematic risks are as follows:

1. **Financial risk or Credit risk:** Financial risk is also known as credit risk. It is the probable risk of loss resulting from a borrower's failure to repay a loan or meet contractual obligations. It refers to the risk that a lender may not receive the owed principal and interest on time which results in an interruption of cash flows and increased costs for collection. Although it is impossible to know exactly who will default on obligations, properly assessing and managing credit risk can lessen the severity of loss. When lenders issues credit cards, or offer other types of loans, there is a risk that the borrower may not repay the loan. Similarly, if a company offers credit to its client, there is a risk that its clients may not pay their invoices. Credit risk also describes the risk that a bond issuer may fail to make payment either interest or the principal at the maturity. Similarly an insurance company fails to pay claims falls under credit risks.
2. **Liquidity risk:** Liquidity risk is the risks that arise from the lack of marketability of an investment or security that cannot be bought or sold quickly enough. Liquidity risk occurs when an individual investor, business or financial institution cannot meet short-term debt obligations. The investor or entity may be unable to convert an asset into cash without giving up capital and/or income due to lack of buyers or an inefficient market. For example, a '50 lacs home may have no buyer when the real estate market is down. When the market improves, the home may sell above its listed price. However, if the owner needs cash quickly when the market is down, he may sell the home for less and lose money in the transaction. Due to liquidity risk, investors should consider whether they can cover their short-term debt obligations into cash before investing in long-term illiquid assets. Similarly, during the 2008 stock market crash across the globe, due to severe selling pressure of stocks resulted to market illiquidity, as there were lacks of buyers in the market.
3. **Operational risk:** Operational risk is the risk not inherent in

financial, systematic or market-wide risk. It is the risk resulting from breakdowns in internal procedures, people and systems. Operational risk can be summarized as human risk; it is the risk of business operations failing due to human error. It changes from industry to industry, and is an important consideration to make when looking at potential investment decisions. Industries with lower human interaction are likely to have lower operational risk. One area that may involve operational risk is the maintenance of necessary systems and equipment. Other areas that qualify as operational risk tend to involve the human element within the organization. If a sales-oriented business chooses to maintain less efficient sales staff, due to its lower salary costs or any other factor, this is considered an operational risk.

7.5 DIFFERENCE BETWEEN SYSTEMATIC AND UNSYSTEMATIC RISKS

1. Systematic risk is a loss associated with the financial market as a whole or a market segment. Unsystematic risk is associated with a particular organization or security.
2. Systematic risk is uncontrollable whereas the unsystematic risk is controllable in nature.
3. Systematic risk arises due to macroeconomic factors, whereas unsystematic risk arises due to micro economic factors.
4. Systematic risk affects a large number of securities in the market. On the other hand, unsystematic risk affects securities of a particular company.
5. Systematic risk can be eliminated through various ways such as hedging, asset allocation etc. Whereas unsystematic risk can be eliminated through portfolio diversification.



CHECK YOUR PROGRESS

Q. No 1: State True or False

a) Risk is relatively lower in speculative and cyclical industry compared to defensive and growth industry

b) Risk may arise due to change in government or government policy of a country.

c) Operational risk is also known as credit risk

d) Systematic risk is controllable.

e) Equity risk is the risk associated with share prices going up or down.

Q. No 2: Define systematic risk.

7.6 RISK MANAGEMENT BY FINANCIAL INSTITUTIONS

Risk is the probability of financial loss. It's not a certainty. Hence it is important to measure and manage risk. Risks can arise both from causes internal to a business (such as employee fraud) or externally from the environment. Risk Management for financial institutions like banks and NBFCs has gained large significance, as there are a lot of parties and processes dependent on them. If a bank fails, hundreds of thousands of depositors' money will be at stake and the confidence of the public on financial institutions get shattered. Therefore Risk management is a process which involves

- **Identifying the risk:** The first step in the risk management process is to identify the sources of risk. Credit Risk, Market Risk and Operational Risk encompass over 90% of the risk faced by banks and other financial institutions today.
- **Measuring and implementing risk management measures:** The next stage in risk management process is to measure and implement risk management measures. Risk can be defined as probability of occurrence and deviation from expectation. There are various

parameters used by banks and NBFCs to measure the risk element such as 'Value at Risk (VaR)', 'Duration' – used for bonds, 'Beta'- used for equities, 'Factor sensitivity' - used for currencies etc.

7.5.1 Typical causes of financial crisis in banks

- **Asset (Loan) Quality:** The U.S subprime crisis in 2008-09, caused by poor credit risk management by banks and financial institutions, is a case of poor asset quality. In the past also, Indian NBFCs have been found of not having stringent lending norms which has resulted in a lot of Non Performing Assets (NPAs) during the economic downturn.
- **Asset-Liability Mismatch:** Banks and financial institutions have assets and liabilities of different maturities. This exposes them to Interest Rate Risk and Liquidity Risk.
- **Fraud:** Poor risk management processes have also resulted in frauds in large institutions.

7.7 ROLE OF TECHNOLOGY IN RISK MANAGEMENT

For many financial services institutions such as banks, insurance companies, mutual funds brokerage firm etc. Technology plays an important role in managing risk. It is important to recognize that the risk management is primarily about people – how they think and how they interact with one another. Technology is just a tool. Technology in the wrong hands can lead to catastrophe but if its applied appropriately, it can transform an organization. A good approach would be to start by planning a risk management strategy focusing on procedural and cultural issues of risk management. Technology can reshape corporate cultures and facilitate innovative procedures. Today, technology makes it possible to effectively communicate information – across desks, across departments and across globe. This technology is called data aggregation.

In order to manage risks, organizations need to be able to measure those risks prospectively. They need to know, based on their current position, how much risk are they taking. Organizations are addressing this challenge

with statistical risk measures. For market risk, value at risk is being used. For credit exposure, measures such as expected exposure or maximum exposure are being used.

Risk management is a continuously evolving mix of science and art. Losses are inevitable, but one must keep learning from the past. Risk itself is not bad, but risk that is misplaced, mismanaged, misunderstood, or unintended is bad. Each institution needs to assess which method best suits its objectives, its business, its view of the world and its pockets. A clear distinction should be made between risk management and risk taking. Risk management oversees and ensures the integrity of the process with which risks are taken. To maintain the objectivity, risk management cannot be a part of the risk taking process. Individuals who manage risk need to be completely independent from individuals who are responsible for taking risk.



7.8 LET US SUM UP

The following aspects have been discussed in this unit:

- Risk is exposure to uncertainty.
- It implies the extent to which any chosen action or an inaction, may lead to a loss or some unwanted outcome.
- In financial services industry, different types of risk can be classified under two broad categories:
  a) Systematic risk and b) Unsystematic risk
- Systematic risk arises due to the influence of external factors.
- Systematic risk may be interest rate risk, inflationary risk, market risk etc.
- Unsystematic risk is due to the influence of internal factors prevailing within an organization.
- Unsystematic Risk may be operational risk, credit risk, liquidity risk etc.
- Risk Management for financial institutions like banks and NBFCs has gained large significance, as there are a lot of parties and processes dependent on them.



7.9 FURTHER READING

1) Financial Services (2011) by Thummuluri Siddaiah; Pearson Education.
2) Indian Financial System and Financial market operations (2017), by Jaydeb Sarkhel & Seikh Salim; McGraw Hill Education (India) Pvt. Ltd.
3) Financial Institutions and Markets, Structure, Growth and Innovations 6th Edition (2017) by L M Bhole and Jitendra Mahakud; McGraw Hill Education (India) Pvt. Ltd.
4) Financial Services 9th Edition (2018) by M Y Khan; McGraw Hill Education (India) Pvt. Ltd.
5) Management of Banking and Financial Services 3rd Edition (2014) by Padmalatha Suresh and Justin Paul; Pearson Education.
6) The Indian Financial System and Development , Innovating Success 4th Edition (2012) by Vasant Desai; Himalaya Publishing House.

7.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) False b) True c) False
d) False e) True

Ans to Q No 2: Systematic risk arises mainly because of external factors. These factors are uncontrollable and all the firms in an industry have to operate under these macro factors.



7.11 MODEL QUESTIONS

Q 1: Discuss the concept of risk in financial services.

Q 2: Describe the types of risks involved in financial services.

Q 3: Discuss the difference between systematic and unsystematic risks.

Q 4: Write a note on the risk management practices by Financial Institutions.

Q 5: Write a note on the role of technology in risk management.

*** ***** ***