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Indian Financial Systems
(Finance Specialisation)

SEMESTER- VI

BUSINESS ADMINISTRATION

BLOCK - 2

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BACHELOR OF BUSINESS ADMINISTRATION

INDIAN FINANCIAL SYSTEMS

DETAILED SYLLABUS

BLOCK-2

Page No:

UNIT 8. Financial Institutions **107-131**

Financial Institutions: An Introduction;Assistance of Financial Institutions; Types of financial institutions;Merchants Banks;Money Market Institutions;Insurance Companies, Importance or need of Insurance Organisations and Foreign Institutional Investors (FIIs)

UNIT 9. Mutual Fund **132-150**

Meaning and Definition of Mutual Funds;Objectives of Mutual Funds;Features of Mutual Fund Investment;Importance of mutual funds;Types of mutual unds;Constituents of mutual funds; Systematic Investment plan (SIP); SEBI (Mutual Funds) Regulation, 1996; Growth of Mutual Funds in India and Challenges faced by the mutual funds in India

UNIT 10. Derivative Markets **151-166**

Meaning of Derivatives; Types of Derivatives;Traders in Derivatives Market; Foreign Exchange Market: Meaning and Scope;Dealers in Foreign Exchange Market and Exchange Rate

UNIT 11. Foreign Exchange Market **167-176**

Meaning of Foreign exchange market;Evolution of foreign exchange market in India; Components of foreign exchange market;Importance of Foreign exchange market; Functions of Foreign exchange market;Structure of Foreign exchange Market in India and Measures initiated to develop foreign exchange market in India

UNIT 12. Credit Rating **177-199**

Meaning of credit Rating; Types of Rating; Benefits of Credit Rating; Benefits of Credit Rating to the Company; Disadvantages of Credit Rating; Users of Credit Rating; Credit Rating Methodology: Business Risk Analysis, Financial Risk Analysis, Management Evolution, Fundamental Analysis; Steps involved in Credit Rating; Credit Rating in India: Credit Rating Information Services of India Limited (CRISIL), Investment Information and Credit Rating Agency of

India Limited (ICRA), Credit Analysis and & Research Ltd. (CARE), Fitch India Limited, ONICRA Credit Rating Agency of India Limited (ONICRA), Brickwork Ratings India Pvt. Limited (BWR), SME Rating Agency of India Limited (SMERA); SEBI Code of Conduct; SEBI Regulations of Credit Rating Agencies.

UNIT 13: Depository Services **200-210**

Meaning of Depository; Benefits of Depository; Depository Participant; International Securities Identification Number; Depository Process; Depositories in India.

UNIT 14: Regulation of Financial Markets in India **211-230**

Concept of Regulation of Financial Market; Objective of Financial Market Regulation; Regulators of Indian Financial Market; Reserve Bank Of India; Securities and Exchange Board of India; Insurance Regulatory and Development Authority; Pension Fund Regulatory and Development Authority.

BLOCK INTRODUCTION:

This is the second block of the course “Indian Financial System”. This block consists of seven units.

The eighth unit explains Financial Institutions: An Introduction; Assistance of Financial Institutions; Types of financial institutions;Merchants Banks;Money Market Institutions;Insurance Companies, Importance or need of Insurance Organisations and Foreign Institutional Investors (FIIs)

The ninth unit explains the meaning and Definition of Mutual Funds; Objectives of Mutual Funds; Features of Mutual Fund Investment;Importance of mutual funds; Types of mutual funds; Constituents of mutual funds; Systematic Investment plan (SIP); SEBI (Mutual Funds) Regulation, 1996; Growth of Mutual Funds in India and Challenges faced by the mutual funds in India

The tenth unit is about derivatives; Types of Derivatives; Traders in Derivatives Market; Foreign Exchange Market: Meaning and Scope; Dealers in Foreign Exchange Market and Exchange Rate The eleventh Meaning of Foreign exchange market; Evolution of foreign exchange market in India; Components of foreign exchange market; Importance of Foreign exchange market; Functions of Foreign exchange market; Structure of Foreign exchange Market in India and Measures initiated to develop foreign exchange market in India

The twelfth unit enlighten us with the meaning of credit Rating; Types of Rating; Benefits of Credit Rating; Benefits of Credit Rating to the Company; Disadvantages of Credit Rating; Users of Credit Rating; Credit Rating Methodology: Business Risk Analysis, Financial Risk Analysis, Management Evolution, Fundamental Analysis; Steps involved in Credit Rating; Credit Rating in India: Credit Rating Information Services of India Limited (CRISIL), Investment Information and Credit Rating Agency of India Limited (ICRA), Credit Analysis and & Research Ltd. (CARE), Fitch India Limited, ONICRA Credit Rating Agency of India Limited (ONICRA), Brickwork Ratings India Pvt. Limited (BWR), SME Rating Agency of India Limited (SMERA); SEBI Code of Conduct; SEBI Regulations of Credit Rating Agencies.

The thirteenth unit explains the Meaning of Depository; Benefits of Depository; Depository Participant; International Securities Identification Number; Depository Process; Depositories in India.

The fourteenth unit explains about concept of Regulation of Financial Market; Objective of Financial Market Regulation; Regulators of Indian Financial Market; Reserve Bank Of India; Securities and Exchange Board of India; Insurance Regulatory and Development Authority; Pension Fund Regulatory and Development Authority.

The structure of Block 2 is as follows :

UNIT 8 : Financial Institutions

UNIT 9 : Mutual Fund

UNIT 10 : Derivative Markets

UNIT 11 : Foreign Exchange Market

UNIT 12 : Credit Rating

UNIT 13 : Depository Services

UNIT 14 : Regulation of Financial Markets in India

UNIT 8: FINANCIAL INSTITUTIONS

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Financial Institutions: An Introduction

8.4 Assistance of Financial Institutions

8.5 Types of financial institutions

- 8.5.1 Banking Institutions
- 8.5.2 Non-Banking Institutions

8.6 Merchants Banks

- 8.6.1 Importance of Merchant Banking in India
- 8.6.2 Role of a Merchant Banker

8.7 Money Market Institutions

8.8 Insurance Companies

- 8.8.1 Importance or need of Insurance Organisations

8.9 Foreign Institutional Investors (FIIs)

8.10 Let Us Sum Up

8.11 Further Reading

8.12 Answer to Check Your Progress

8.13 Model Questions

8.1 LEARNING OBJECTIVES

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

- learn the meaning of Financial Institution
- know the assistance provided by the financial institutions
- understand the concept of Merchant banking
- discuss the role of FIinancial Institutional Investors
- know the need of insurance companies.

8.2 INTRODUCTION

In this unit we are going to discuss about Financial Institutions.

Financial Institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet.

In this unit we will discuss about meaning of Financial Institution, the assistance provided by the financial institutions,concept of Merchant banking.

At the end of the unit we will get a fair idea about the role of Financial Institutional Investors and the need of insurance companies

8.3 FINANCIAL INSTITUTIONS: AN INTRODUCTION

Financial institutions also provide services to entities (individual, business, government) seeking advice on various issues ranging from restructuring to diversification plans.

These institutions are also termed as financial intermediaries because they act as middlemen between the savers and borrowers. Financial intermediaries mobilize the savings of the surplus units and lend them to the borrowers in the form of loans and advances (i.e. by creating a financial asset). They also meet the short term and long term needs of the borrowers and provide the liquidity to the savers. Deposits are payable on demand by the customers. Banks are in a position to avoid the situation of illiquidity while borrowing for short periods and lending for long term by mobilizing savings from diversified set of depositors. RBI also has made it mandatory for the banks to keep a certain percentage of deposits as cash reserves with itself to avoid the situation of ill-liquidity.

There is a need of financial institutions not only for providing financial assistance to the industrial undertakings but also help in creating infrastructural facilities. Basically, financial institutions are required for the economic development of a country.

Financial institutions provide means and mechanism of transferring resources form those who have an excess of income over expenditure to those who can make productive use of the same. For the economic development of a country it needs resources, adequate infrastructural facilities and persons who can take the initiative of setting up units for

providing goods and services.

8.4 ASSISTANCE OF FINANCIAL INSTITUTIONS

Financial institutions provide all types of assistance required for development. They help in the following ways:

a. **Providing funds:** These institutions help large number of people for taking up some industrial activity. Due to low incomes, people are not able to save sufficient funds which are needed for setting up new units and also for expansion, diversification, and modernization of existing units. These people approach financial institutions for help. And these financial institutions have large investible funds which are used for productive purposes.

b. **Infrastructural facilities:** For economic development of a country there is a need for roads, water, sewerage, communication facilities, electricity etc. Financial Institutions prepare their investment policies by keeping national priorities in mind. The institutions invest in those areas which can help in increasing the development of the country. All India institutions are giving priority to invest funds in projects generating electricity in areas facing these problems. Financial institutions are developing industrial estates and provide shed at state level at easy instalments. So financial Institutions are helping in the creation of all those facilities which are required.

c. **Promotional Activities:** for setting up a new unit an entrepreneur faces many problems like undertaking a feasibility report, complete registration formalities seeking approval from agencies etc, which require a lot of money, time and energy. Financial institutions have the expertise and manpower resources for undertaking the exercise of starting a unit. These institutions take this work on behalf of the entrepreneurs. Some units are set up jointly with the financial institutions were the formalities are completed collectively. This role of financial institution is very helpful for the development of the country.

d. **Development of Backward areas:** Some areas remain neglected

because facilities needed for setting up new units are not available. In order to help the backward areas, financial institutions, provide special assistance to entrepreneurs for setting up new units in these areas. IDBI, IFCI, ICICI give priority in giving assistance to units set up in backward areas and even charge lower interest rates on lending. These units also improve basic amenities and create employment opportunities. And these measures will help in increasing the economic development of backward areas.

e. **Planned development:** Financial institutions help in planned development of the economy. Different institutions earmark their spheres of activities so that every business activity is helped. Some institutions like SIDBI, etc help especially small scale sector while IFCI and SIDC's Finance large scale sector. The institutions also follow the developments priorities set by central and state governments. They give preference to those activity which are specifies in industrial policy statements and in five year plans.

f. **Accelerating Industrialization:** The setting up of more and more industries will generate direct or indirect employment, making available goods and services in the country. These institutions provide required financial, managerial, technical, help for setting up new units. Since 1947, financial institutions have played a significant role in accelerating the pace of industrialization. The country has progressed in almost all areas of economic development.

g. **Employment generation:** These institutions not only generate direct or indirect employment but also they need the services of experts which help them in finalizing leading proposals. They help in creating employment opportunities in the backward areas by encouraging the setting up of units in those areas. It also creates new and better job opportunities.

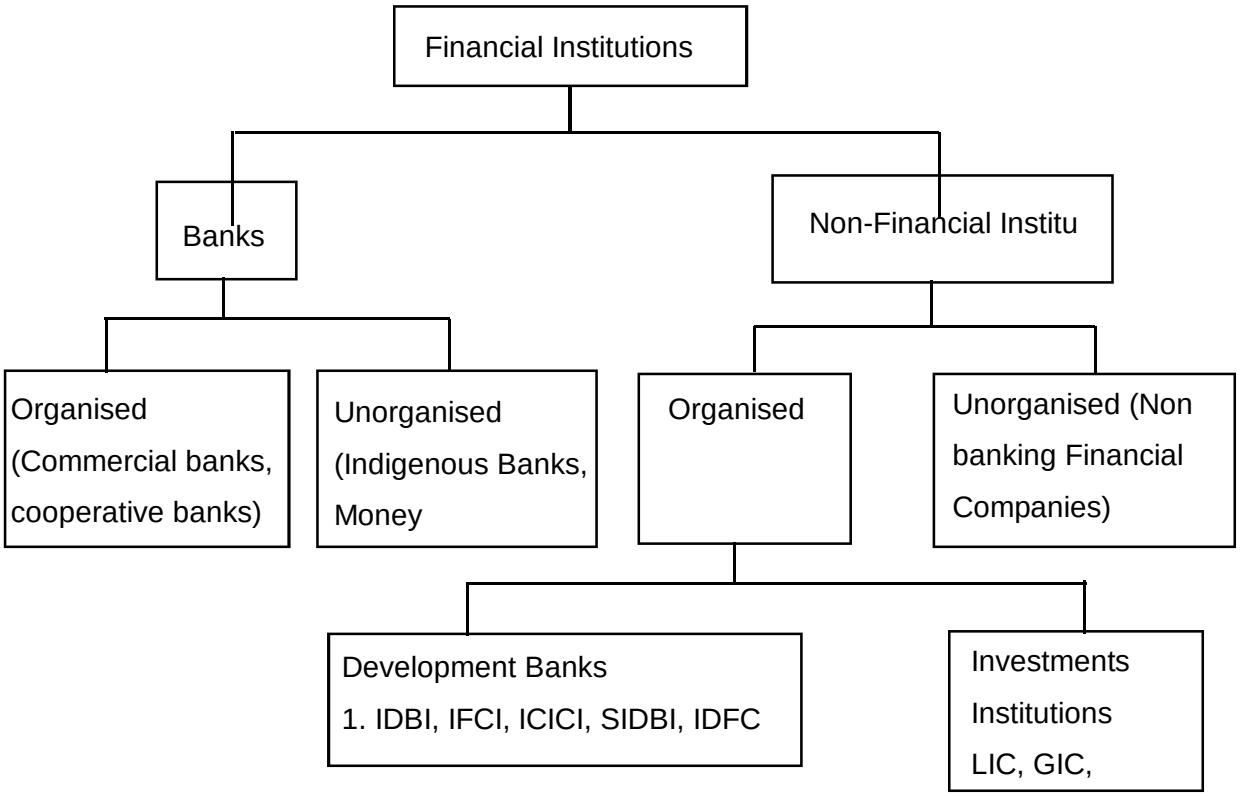
8.5 TYPES OF FINANCIAL INSTITUTIONS

Financial Institutions are of two types. They are:

a. Banking Institutions.

b. Non-Banking Financial Institutions.

Let us now discuss the types of Financial Institutions in the following ways:



8.5.1 Banking Institutions

The RBI as the apex institution organizes runs, supervises, regulates and develops the monetary system and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulations Act 1949. The Indian Banking Institutions can be broadly classified into two categories:

Organized Sector:

a. Commercial banks: The commercial banks may be scheduled banks or unscheduled banks. At present only one bank is a non – scheduled bank. All other banks are scheduled banks. The commercial banks consist of 27 public sector banks, private sector banks and foreign banks. Prior to 1969, all major banks

with the exception of State bank of India were in the private sector. An important step towards public sector banking was taken in July, 1969, when 14 major private banks with the deposit base of Rs 50 crores or more were nationalized. Later in 1980, another 6 were nationalized bringing up the total number of banks nationalized to 20. Commercial banking system in India consisted of 297 scheduled banks, including foreign banks and one non scheduled bank at the end of December 2000. Traditionally, commercial banks accept deposits and met the short and medium term funding needs of the industry. But now, since 1990, banks are also funding the long term needs of the industry, particularly the infrastructure sector.

A major development in the Indian Banking system was the entry of major banks in merchant banking. The merchant bankers are financial intermediaries providing a range of financial services to the corporate and investors. Some of the merchant banker activities include issue management and underwriting, project counselling and finance, mergers and acquisition advice, portfolio management services etc.

b. Co-operative banks: An important segment of the organized sector of Indian banking is the co-operating banking. The segment is represented by a group of societies registered under the acts of the states relating to co-operating societies. In fact, co-operative societies may be credit societies or non credit societies.

Different types of co-operating credit societies are operating in the Indian economy. These institutions can be classified into two broad categories: a. rural credit societies which are primarily agricultural. b. Urban credit societies which are primarily non-agricultural. For the purpose of agricultural credit there are different co-operative credit institutions to meet different kinds of needs. For example, short and medium term credit is provided through three-tier federal structure. At top is the apex body, i.e.

state co-operative bank, in the middle there are district co-operative banks or central co-operative banks, at the grass root level i.e. village level there are primary agricultural credit societies. For medium to long term loans to agriculture, specialised co-operatives societies have been formed. These are called "Land Development Banks". The Land Development Banks movement started in 1929.

c. Regional Rural Banks (RRBs): *R*egional Rural Banks were set up by the state government and the sponsoring commercial banks with the objective of developing the rural economy. Regional Rural Banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas. The RRB was set up with the view to provide credit facilities to weaker sections. They constituted an important part of the rural financial architecture in India. There were 196 RRBs at the end of June 2002, as compare to 107 in 1981 and 6 in 1975. IDBI, NABARD and SIDBI are also required to provide managerial and financial assistance to RRBs under the Regional Rural Bank Act.

   The State Bank of India took several measures of managerial and financial restructuring including enhancement of issued capital and placements of officers of proven ability to head the RRBs. NABARD took several policy measures such as quarterly/ half yearly review of RRBs by the sponsor banks, framing of appointment and Promotional Rules 1998 for the staff of RRBs, introduction of Kisan Credit Cards, introduction of self help groups etc. for improving the overall performance of RRBs.

d. Foreign Banks: Foreign banks have been in India from British Days. ANZ Grindlays Bank has its presence in number of places with 56 branches. The Standard and Chartered Bank has 24 branches and Honkong Bank 21. All other foreign banks have branches less than 10. Obviously, these banks have concentrated on corporate clients and have been specializing in areas relating to international banking.

Unorganized Sector:

a. **Indigenous Bankers:** Indigenous bankers are the forefathers of modern commercial banks. These are the individuals or partnership forms performing the banking functions. They also act as financial intermediaries. As the term indigenous indicates, they are the local bankers. The geographical area covered by the indigenous bankers is much larger than the area covered by the commercial banks. They can be found in all parts of the country although their names, styles, of functioning may differ. In West India they may be known as Gujarati shroffs or Marwari, in south India they may be called Chettiars, in the north India they may be called sahukars etc.

   The dominance of indigenous bankers can be seen from the fact that they not only provide credit to trade and commerce but at times to the government of the day also.

   According, to the Indian Central Banking Enquiry Committee (1931), an indigenous banker is any individual or private firm receiving deposits and dealing in hundies or lending money. Although deposit side is emphasized, these banks do not necessarily depend upon this source entirely, like modern commercial banks. Many among them also use large funds of their own. As against this, money lenders are those whose primary business is money lending, such essential banking functions as receiving of deposits or /and dealing in hundies are outside their operation.

   Indigenous bankers provide finance for productive purposes directly to trade and industries and indirectly, through money-lenders and traders to agriculturists with whom they find it difficult to establish direct relations. They keep in touch with traders and small industrialists and finance marketing on a sizeable scale.

b. **Money Lenders:** Money lenders depend entirely on their own funds for the working capital. Money lenders may be rural or

urban, professional or non-professional. They include large farmer's merchants, traders, goldsmiths village shopkeepers, sardars of labourer etc. The methods and areas of operation differ from the money lender to money lender. The main characteristics of money lender are as follows:

a. Their funds are own funds.
b. Their clients are mainly the weaker section of society.
c. Their loans are highly exploitative. They charge very high rates of interest.
d. Their operations are entirely unregulated.
e. The credit is prompt and flexible.

Money lenders can exploit the weaker sections as they are fully dependant on them. They enjoy monopoly in their area of operation.



CHECK YOUR PROGRESS

Q 1: Define Financial Institutions.

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Q 2: Mention two types of assistance provided by the financial Institutions.

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8.5.2 Non-banking Institutions

The non banking Institutions may be categorized broadly into two groups:

a. Organised Financial Institutions
b. Unorganised Financial Institutions

Organized Financial Institutions: The organized Non banking

Institutions include:

A. Development Finance Institutions: Which include the institutions like IDBI, IFCI, IIBI, IRDC at all India Level, State Finance Corporations (SFCs), State Industrial Development Corporations at the state level, Agricultural Development Finance Institutions as NABARD, etc.

Development banks provide medium and long term finance to the corporate sector and industrial sector also takes up promotional activities for economic development of the country.

B. Investment Institutions: It includes those financial institutions which mobilize savings of the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC, UTI and mutual funds.

Unorganised Financial Institutions: The unorganized non-banking financial institutions include number of non-banking financial companies (NBFCs) providing whole range of financial services. These include hire purchase and consumer finance companies, leasing companies, housing finance companies, factoring companies, merchant banking companies etc. NBFCs mobilize public funds and provide loan able funds.

8.6 MERCHANT BANKS

Merchant banking is a service-oriented industry specializing in investment and financial decision making. It also assists in making corporate strategies, assessing capital needs and helping in procuring equity and debt funds for corporate sectors and ultimately helping in establishing a favourable economic environment. Moreover, merchant bankers perform capital issue management activities-as Lead Managers/ Book Running Lead Managers in intermediary, consultant and liaison services- in India.

A merchant banker, according to the Securities and Exchange Board of India (Merchant Bankers) Regulations 1992, “is a person who is engaged in the business of issue management either by making arrangements

regarding selling, buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management".

A merchant banker also plays the role of a rehabilitator at the time of acquisition, merger, take over, amalgamation, etc. Many merchant banks also acts as agents for their clients companies for maintaining registers of shareholders and debentures holders and to act as transfer agents and paying agents for interests and dividend, etc.

Merchant bankers' role extends to such a services as company formation, syndication of projects finance, workings capital management, FERA activities, global loans, international finance, feasibility explorations, mergers, capital restructuring, corporate tax planning, leasing finance, venture capital, etc. But to provide this large variety of services, the merchant bank has to possess a number of qualities. He should be an expert in the financial market and well versed with the activities involved in the promotion of an enterprise. Merchant banker should possess high integrity to inspire trust and confidence.

8.6.1 Importance of Merchant Banking in India

In fact, merchant bankers are regarded as specialized banks with expertise in areas like: (i) corporate counseling; (ii) project counseling and pre-investment study; (iii) credit syndication and project finance; (iv) corporate re-structuring; (v) capital issue management; (vi) underwriting; (vii) portfolio management; and (viii) venture capital financing. These institutions also render exclusive services to clients in procuring and managing funds from the public. Merchant bankers in India play a major role in the capital issue management of corporate securities.

The following are the importance of Merchant Banking in India is:

- ***Incapability of Managing Agency House:*** In India, during the pre-Independence period, managing agency houses also functioned as issue houses in: managing securities; planning

long-term investments; and contributing risk capital in project development. Managing new issues of corporate securities was performed by a few prominent houses and, as a consequence, investment practices of common investors were not so encouraging;

- ***Demand for Economic Development:*** The post-Independence era was faced with an under-developed capital market and economy because of a static economic environment and a monopolistic managing agency system. The services-rendered by these managing agency houses- were found to be inadequate and their performance was subjected to rigorous criticism resulting in the abolition of the system in 1956 when the Indian Companies Act was drastically amended.
- ***Growing Industrialization:*** Developmental activities, in the late sixties, carried on by Indian trade and industries led to excess demand for fund for expansion, modernization and for diversification of corporate entities. However, this requirement could not be met by the financial institutions including banks, which ultimately prompted those entities to enter into the capital market for generating long-term funds.
- ***Developing Technologically Advanced Industries:*** With the process of economic as well as technological development in India, the absence of specialized institutions was seriously felt at every stage and the Government of India started to make a search for the like institutions and subsequently the outcome was the emergence of such institutions rendering financial services to the corporate sectors.
- ***Recommendation for Specialized services****:* The Banking Commission, in its report in 1972, recommended the necessity of merchant banking services in financial institutions. The recommendation opened up new vistas for commercial banks and financial institutions to enter into merchant banking activities with specialized skills, expertise and updated knowledge.

- ***Gap between Managing Agency System & Specialized Services:*** The gap- in the area of the managing agency system- was filled up by merchant bankers.
- ***Economic Reforms:*** The capital market in India has been in a state of transformation and growth since the early 1990s. The process of economic liberalization was also accompanied by a corresponding and parallel growth of financial institutions including that of merchant bankers.
- ***Positive initiative from the Government:*** The boost from the Government and the initiation of the de-bureaucratization process allowed merchant banking institutions to help industries in undertaking financial engineering effectively.
- ***Inadequacy of Entrepreneurs and Promoters:*** Entrepreneurs and promoters failed to arrange finance from the general public. They then approached the merchant bankers who took this opportunity to assist corporate sectors in rendering multifarious financial advisory services.
- ***Initiative from Regulatory Authority:*** The concept of merchant banking assumed a serious concern only after the Securities and Exchange Board of India (SEBI) felt it was an important intermediary in the functioning of capital market.
- ***Speedy Mobilization of Funds:*** With the growth of this specialized profession, corporate sector were able to raise the required finance, from capital markets, to meet the growing requirements for funds. Other core areas of work included expansion, modernization and diversification programmes to deal with increasing competition.
- ***Need for Encouragement of Small and Medium Industrialists:*** Merchant banks help industries and trade – including small and medium industries- to rise. They also help investors to invest saved money in sound and healthy concerns with confidence, safety and the expectation for higher yields. Merchant bankers make available finance for business

enterprises acting as intermediaries.

- ***Promoting the Role of New Issues Markets in Mobilizing Savings:*** The need for merchant banking was felt in the wake of huge public savings lying untapped. Merchant banking can play a highly significant role in mobilizing the funds of savers to invisible channels assuring promising returns on investment. They also assist in meeting the widening demand for invisible funds for economic activities.

8.6.2 Role of a Merchant Banker

From the above mentioned services rendered by a merchant banker, it can be observed that he is the most critical link between a company raising funds and the investors. He plays the role of a promoter, advisor, rehabilitator and an agent or intermediary for corporate enterprises. He translates the ideas into ventures by providing a number of promotional services such as identification of projects, preparing feasibility reports, obtaining Government approvals, raising funds for the project, etc.

After the project is promoted, a merchant banker acts as a **corporate advisor** and renders a number of services for the successful running of the enterprise. His expert advice on certain issues such as financial planning, tax planning, issues management, credit syndication, investment management, etc is of immense help to the entrepreneurs.

As a **managerial economist,** he guides the client on the aspects of organizational goals, location factors, organisation's size and operational scale, choice of a product and market survey, forecasting of products, cost reduction and cost analysis, allocation of resources, investment decision, capital management and expenditure control, pricing methods and marketing strategy, etc.

As a **financial and investment expert, a** merchant banker has to guide the corporate clients in areas covering financial

reporting, projects measurement, working capital management, financial requirements and the sources of finance, evaluating financial alternatives, rate of return and cost of capital besides basic corporate changes of financial rearrangements, reorganizational, mergers and acquisitions, etc.

Merchant banker, acting as **' Manager' to the issue** settles the fee for advocate/solicitors' advice, accountants certification, broker's and bank's charges, underwriters' commission, printers' charges and advertising & publicity expenses and coordinates with syndicated merchant bankers and principal brokers, stock exchanges, etc. The responsibility for all this rests upon the merchant banker. If proper coordination is not done, the success of the issue may be rendered unassured.

8.7 MONEY MARKET INSTITUTIONS

The Institutions of money market are those which deal in lending and borrowing of short term funds. The Institutions of Money market are not the same in all the countries of the world; rather they differ from country to country. The commercial banks, central banks, acceptance houses, non-banking financial intermediaries (NBFI), brokers etc. are the major institutions of money market.

These are discussed as under:

a. ***Commercial Banks:*** These are the back bone of the money market. They form one of the major constituents of money market. These banks use their short term deposits for financing trade and commerce for short periods. The commercial banks lend against promissory notes and through advances and overdrafts. The call money loans are also provided by these banks to the bill brokers and dealers in the stock exchange market. The commercial banks put their excess reserves in different forms or channels of investments which satisfy their conflicting principles of liquidity and profitability.

b. ***Central Banks:*** It plays a vital role in the money market. It is the

monetary authority and is regarded as an apex institution. No money market can exist without the central bank. The central bank is the lender of the last resort and controller and guardian of the money market. The member banks may approach the central bank for loans and advances during emergency. It controls and guides the institutions working s in the money market. It helps in averting the possibilities of inflation and deflation. The central banks controls the money market through changes in the bank rate and open market operations, it does not enter into direct transactions.

c. ***Acceptance Houses:*** The institutions of acceptance houses developed in England where merchant bankers transferred their headquarters to London Money Market in the late 19th and the early 20th century. They function as intermediaries between importers and exporters and between lenders and borrowers in the short period. The acceptance houses performed a very useful role as merchant bankers. These houses specialized in the acceptance of trade bills/ commercial bills. A noteworthy point is that by accepting a trade bill they guaranteed the payment of the bill on maturity.

d. ***Non-Banking Financial Intermediaries:*** These also resort to lending and borrowing of short term funds in the money market. In Non-banking Financial intermediaries we include savings banks, Investment houses, insurance companies, building societies. Provident funds and other business corporation like chit funds.

e. ***Bill Brokers:*** In the developed money markets like the London Money Market and the New York Money Market, private companies act as discount houses. The main function of these companies is to discount bills on behalf of others. Besides these companies, there are bill-brokers who work as intermediaries between the borrowers and lenders by discounting bills of exchange at a small commission.



CHECK YOUR PROGRESS

Q 3: Give the definition of merchant banker.

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Q 4: Mention two institutions of money market.

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8.8 INSURANCE COMPANIES

Risk and uncertainties also prevail in the activities and professions of the individuals. Naturally, the people always try to stay secured against these risks and uncertainties. This requirement of individuals and entrepreneurs generates the need of the insurance. There exist numerous insurance companies who undertake the responsibility of covering the risk and uncertainties associated with human life and activities against a normal premium. These insurance companies company provide compensation to the individual or business concerns or theirs nominees in case of any accident. Thus, insurance is a contract of indemnity between insurer and insured. It can be treated as a contract that provides protection against a possible eventuality.

As per the oxford dictionary, insurance can be termed as 'an arrangement by which a company or the state undertakes to provide a guarantee of compensation for specified loss, damage, illness, or death in return for payment of a specified premium'.

Investopedia thinks, 'insurance is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from an insurance company.'According to 'The Economic Times', the insurance is 'a financial risk management tool in which the insured transfers a risk of potential financial loss to the insurance company

that mitigates it in exchange for monetary compensation knows as the premium'.

To sum up, the concept of insurance can be better explained through the following information:

(i) Insurance is a contract of indemnity between insurer and insured.

(ii) It comprises two parties- insurer and insured.

(iii) It ensures compensation for the insured in case of any losses due to illness and accident within a specific time period against a specified premium.

In India, the insurance sector is colossal and growing at a speedy rate of 15-20 per cent. Along with banking services, insurance services add approximately 7 percent to the colony's GDP. A well- developed and evolved insurance sector acts as unmixed blessings for economic development as it provides long-term finance for infrastructure development.

8.8.1 Importance or need of Insurance organizations

The importance of insurance is felt in every aspects of the modern life. We have already mentioned that insurance refers to a contract by which an individual by which he can minimize the risk associated with his life. Similarly, an entrepreneur can ensure smooth running of his business by availing the facilities of insurance.

Now, we will discuss the importance of insurance in the following way:

1. **Minimization of risk:** An individual as well as a business person always has the experience of risk associated with his life or business. Different types of risk are involved in a person's life or business. A person can suffer from accident and illness. An entrepreneur can suffer from losses due to fire, labour unrest, theft, government policy etc. Insurance provide compensation to the individual or an entrepreneur against payment of premium. An individual can opt for life insurance policies to cover the risk of death or a general insurance policy to cover the possibilities of losses due to illness. Thus, insurance minimizes the risk associated

with a person's life and business.

2. **Supply of finance:** The industrial concerns require a huge amount for smooth functioning. The premium collected by the insurance company is a great source of capital for the industries. In fact, the insurance companies are profit-making organizations who invest the accumulated premium of the insured into profitable sectors for good returns.
3. **Encouragement for saving:** Apart from banking institutions, the savers can easily put their savings into various insurance policies introduced by the companies. People with different income level can opt for policies specially designed for them. Thus, people are encouraged to save more. The investment in different policies not only creates the possibilities of higher return but also covers the risk associated with a person's life.
4. **Social security:** The insurance companies introduce various policies that comprise social security measures. The people in society are not free from risks such as loss of life and loss of body parts especially for the labourers of the factories. The different insurance schemes of the companies ensure social security and, thus, improve the quality of life of the insured.
5. **Scope of the employment:** Since the insurance business is expanding, the requirement of qualified staff increases. The spread of insurance business is possible through the agents and sub-agents who work in the company on the commission basis. Apart from this, numerous branches of all reputed insurance companies, including the foreign insurance companies, are established in recent times, which require experienced and highly qualified professionals. Thus, there are huge opportunities of new employment generating from the insurance sector.
6. **Provisions of loan:** The insurance companies are not only selling insurance policies to the individuals or entrepreneurs to protect them from the risk associated with their life and business but also provide loans to the individuals and business corners. This makes the insurance companies more relevant in the financial market.
7. **Assistance to the government:** The insurance companies accumulate the premiums paid by the insured and invest it in various sectors for

higher returns. With this huge fund, they also purchase government securities that will give assured returns. On the other hand, the purchase of government bonds improves the financial status of the government.

8. **Acting as a financial intermediary:** The insurance organizations act as a fianancial intermediary in the financial system. They accumulate the premiums paid by the insured and provide this fund as loans to the industries. This transfer of funds from savers to investors is essential for the growth of the financial system.
9. **Industrial development:** The insurances organizations collect the premiums for the insured and, with this accumulated fund, provide finance to the industries. We know, without finance, the industries cannot perform. The insurance organizations provide necessary finance to the industries, which leads to industrial development.
10. **Tax benefits:** As per Income Tax Act, 1961, there will be an income tax benefits for the premium paid for the life insurance. This tax rebate encourages the people to invest more in the insurance sector, and this contributes in the development of the insurance sector.
11. **Assistance in the foreign trade:** Sometimes, the traders in the foreign exchange market suffer from exchange risk and finally end up with huge amount of losses. Thus, a huge risk is involved in the foreign exchange market, which affects the exports and importers. Thus, foreign trade of a nation is adversely affected. In this context, various insurance policies provide the opportunities to the foreign traders to reduce the risk. This acts as a boost to the expansion of the foreign trade.
12. **Tension-free life:** Being insured, the risk associated with life and business can be minimized or mitigated. In recent times, the changing lifestyle of the individuals increases the risks of lifestyle –related diseases and even death from this. The job-oriented tension and work-stress are responsible for these diseases. The insurance policies sold by the insurance companies reduce the risk, which include the policy-holders to enjoy a stress-free life. Thus, the quality of the life of the individuals improves with insurance.

13. **Maintenance of normal profit:** Without insurance, the business corners may suffer from huge losses and may not cover the average variable cost. Then, they have no option other than closing down.
14. However, **proper insurance policies** protect them from possible losses and ensure the compensation ion case of losses, so that they can be able to maintain their normal profit position.
15. **Economic development**: The insurance policies not only motivate the individuals to perform better but also act as an encouragement to the entrepreneurs. The individual can raise their productivity and the entrepreneurs can expand their business. This will definitely improve and develop the industrial base of the country. All these act as preconditions for the economic development.

Thus, from the aforementioned analysis, we can realize the importance of insurance business and the insurance organizations in the modern financial and economic systems.

8.9 FOREIGN INSTITUTIONAL INVESTORS (FIIs)

A number of measures were taken by the SEBI to increase liquidity in the stock market. The stock market was opened to **foreign institutional investors** (FIIs) for investment and this was one of the important characteristic too. FIIs were allowed to participate in the Indian capital market in September 1992. Earlier FIIs could investment in Indian securities only through the purchase of GDR, foreign currency convertible bonds (FCCBs) and foreign currency bonds issued by Indian issuers.

The SEBI Regulations, 1995, define *foreign institutional investor*, "as an institution established or incorporated outside India, which proposes to make investment in India in securities. They are eligible to purchase shares and convertible debentures issued by Indian Companies under the Portfolio Investment Scheme (PIS)."

FIIs commenced their operations in the Indian Stock markets with a token investment of Rs 0.6 crores in January 1993. They have become active investors since 1993. FIIs such as mutual funds, pension funds and

country funds are operating in Indian Capital Market.

Routes for Investment in Indian Stock Markets

There are three routes through which FIIs can invest in the Indian stock market. They are as follows:

a. Direct route
b. Participatory notes
c. FII sub-account

In the direct route, the foreign entity applies to the SEBI for registration as FII.

Participatory notes are overseas derivative instruments issued by SEBI registered FII to foreign investors for trading in the Indian stock market. These derivative instruments derive value from underlying securities such as equity and equity linked instruments. These foreign investors do not get registered with SEBI out of choice or regulatory issues. And as they are not registered with SEBI, the identity of the actual investor and source of funds remain disguised. The notes are generally issued by the India-based foreign brokerage houses. Citigroup, Morgan Stanley etc are some of the issuers of participatory notes. From February 2004, these notes against underlying Indian Securities can be issued only to regulated entities and further transfers can be made to other regulated entities only subject to compliance with 'know your client requirements.' In other words the participatory notes cannot be issued to unregulated entities like overseas corporate bodies and non-residents by FIIs.

Thirdly, FII sub-account means any person resident outside India, on whose behalf investment are proposed to be made in India by a foreign institutional investor and who is registered as a sub-account under SEBI (FII) regulations. The names of the sub-accounts on whose behalf the FII is investing are to be disclosed to SEBI by the foreign institutional investor. An institution or fund or portfolio established or incorporated outside India, A broad based fund can register as sub-accounts.

Again, FIIS must clearly segregate their account with that of sub-accounts. SEBI has also made in mandatory for FIIS to disclose all information relating to sub-accounts through joint undertakings. This also

includes a submission in writing that the sub-account is not a NRI and the source of income is from known and legitimate means. FIIS can set up sub-account in Mauritius to enter India. While these account have a little administrative cost which is less expensive than the participatory notes. Finally, India has a double taxation avoidance agreement (DTAA) with Mauritius which makes it an attractive platform for flow of investment to India.

Role of FIIs in the Indian Stock Market: The face of Indian stock market has changed due to the influence of FIIs. It was FIIs who eased the pressure on the rupee from the balance of payments position and lowered the cost of capital to Indian business. In the Indian companies the concept of corporate governance in adopted increasingly due to FIIs, which is benefiting domestic investors also. The FIIs were the first ones to identify the potential of the Indian technology stocks. FIIs have become the driving force behind the movements of stock indices in the Indian stock markets.

Rolling settlement was introduced at the insistence of FIIs, as they were uncomfortable with the badla system. The major beneficiaries of the rolling-settlement system are FIIs, as short-settlement cycles offer them a quick exit from the market.

Today, financial institutions and mutual funds including UTI can do little to help the stock markets at a time of crisis. FIIs inflows create a bull run which encourages participation of small investors. FIIs caused the bull run of 2003 which enabled the government to carry out its disinvestment programmes.



CHECK YOUR PROGRESS

Q 5: Define Foreign Institutional Investors.

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Q 6: What are the different routes of investment in the stock market?

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8.8 LET US SUM UP

After going through the unit we have come through the following:

- The various definitions of financial institutions, merchant banker etc.
- Also the importance of Insurance organizations.
- The role of FII in the Indian Stock Market.
- The various assistance of the financial institution for the development of the economy.
- Also about banking and non banking financial institutions.



8.9 FURTHER READING

1) Bharati V. Pathak (2018); I*ndian Financial System*; Pearson Education;Fifth edition.

2) Sujatra Bhattacharya(2017); *Indian Financial System* ;Oxford University Press.

3) M.Y.Khan(2017); *Indian Financial System*;McGraw Hill Education; Tenth edition.

4) Shashi. K. Gupta & Nisha Aggarwal (2014);*Indian Financial System;* Kalyani Publishers; 6 edition.



8.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Financial Institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet.

Ans to Q No 2: (1) Promotional Activities (2) Planned development.

Ans to Q No 3: A merchant banker, according to the Securities and Exchange Board of India (Merchant Bankers) Regulations 1992, “is a person who is engaged in the business of issue management either by making

arrangements regarding selling, buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management".

Ans to Q No 4: (1) Commercial Banks and (2) Central Banks.

Ans to Q No 5: The SEBI Regulations, 1995, define *foreign institutional investor*, "as an institution established or incorporated outside India, which proposes to make investment in India in securities. They are eligible to purchase shares and convertible debentures issued by Indian Companies under the Portfolio Investment Scheme (PIS)."

Ans to Q No 6: The different routes are: a) Direct route

b) Participatory notes and c) FII sub-account.



8.11 MODEL QUESTIONS

Q 1: Explain the meaning of Money market.

Q 2: Explain the term Financial Institutions.

Q 3: Explain the importance of Insurance Organization.

Q 4: What are the different institutions of money market? Elaborate.

Q 5: Define the following:

a. FII
b. Commercial Banks
c. Money lenders
d. Insurance

Q 6: Write a note on Non-Banking Institutions.

Q 7: Write a detailed note on Banking Institution.

Q 8: What are the different types of assistance provided by financial institutions?

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UNIT 9: MUTUAL FUND

UNIT STRUCTURE

9.1 Learning objectives

9.2 Introduction

9.3 Meaning and Definition of Mutual Funds

9.4 Objectives of Mutual Funds

9.5 Features of Mutual Fund Investment

9.6 Importance of mutual funds

9.7 Types of mutual funds

9.8 Constituents of mutual funds

9.9 Systematic Investment plan (SIP)

9.10 SEBI (Mutual Funds) Regulation, 1996

9.11 Growth of Mutual Funds in India

9.12 Challenges faced by the mutual funds in India

9.13 Let us Sum Up

9.14 Further Reading

9.19 Answer to Check your progress

9.16 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of mutual fund
- discuss the objectives and features of mutual fund
- discuss the types of mutual fund
- describe the provisions of SEBI (Mutual Funds) Regulation

9.2 INTRODUCTION

Investing money in securities market is risky for the common people. It requires special knowledge and expertise to deal in securities market. To invest in the securities of big corporate houses the investor also must have a huge amount of investable fund. In such situations, investment in the

securities market becomes difficult for the common people. Here, the mutual fund plays an important role by giving the opportunity of investment in securities market to the small investors. It works on the principle of 'small drops of water make a big ocean'. Hence, a mutual fund is a form of collective investment.

In this unit we will discuss the concept of mutual fund, features and importance of mutual fund, different types of mutual funds, constituent and regulation of mutual fund.

9.3 MEANING AND DEFINITION OF MUTUAL FUNDS

Mutual fund is special types of investment institutions which pools the savings of investors for collective investment in a diversified portfolio of securities. It acts as financial intermediaries who collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and government bonds and equity shares of joint stock companies. It serves as a links between the investors and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns.

The Securities and Exchange Board of India (Mutual Funds) Regulation, 1996 defines mutual fund as 'a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instrument or real estate assets'

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be set up in the form of a trust under the Indian trust Act.

9.4 OBJECTIVES OF MUTUAL FUNDS

Mutual funds have specific investment objectives, which are stated in their prospectus. Growth funds strive for large capital gains, while growth-income funds seek both dividend income and capital gains from the

common stocks. The balanced fund generally holds a portfolio of diversified common stocks, preferred stocks and bonds with the hope of realising capital gains, dividend and interest income, while at the same time, conserving the principal. Income funds concentrate heavily on high interest and high dividend yielding securities. The industry specific mutual funds, obviously specialise in selected industries such as chemicals, petroleum or power stocks.

The main advantages of investing in mutual fund are:

1. **Professional management:** The investor can avail the service from dedicated investment research team. They analyze the performance of the companies and select the suitable investment to the investor.
2. **Diversification:** Diversification reduces the risk. The mutual fund helps in investing a number of companies across a broad cross-section of industries and sectors.
3. **Convenient Administration:** It reduces many problems like less paper work, delay payments, bad delivery etc.
4. **Return Potential:** It provide higher return as mutual fund invests in diversified securities.
5. **Low costs:** Mutual fund is relatively low expensive as it directly invests and does not require paying brokerage and other fees.
6. **Transparency:** The investment in mutual fund is more transparent as the investor can get regular information on the value of their investment, the proportion of investment in each class of assets etc.

The mutual fund may face the following risks:

1. The fund manager may not be accountable for poor result.
2. Faulty planning of investment may result in minimum return.
3. The different risks associated with the scheme may not be clearly identified.
4. The Fund may be unable to focus on the securities of the key segments due to excessive diversification of portfolio.

9.5 FEATURES OF MUTUAL FUND INVESTMENT

The following features have made the mutual fund an attractive investment avenue -

(a) Funds for all reasons and seasons that include variety of products as per the suitability of investors.

(b) Aggressive investing that emphasizes on high profits with moderate risks.

(c) Focus on dividend yield with the help of equity income fund.

(d) Mobilization of savings from small investors to profitable avenues.

(e) Protection of investor's interest.

9.6 IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. The following are some of the important advantages of mutual funds industry:

a) Channelizing savings for investment: A number of schemes are being offered by mutual funds so as to meet the varied requirement of the investors and thus saving are directed towards capital investments directly. In the absence of mutual funds, these savings would have remained idle.

b) Offering wide portfolio investment: The investors can enjoy the wider portfolio of the investment held in the mutual fund. The fund diversified its risks by investing on large variety of shares and bonds which cannot be done by small and medium investors.

c) Rendering expertise investment service at low cost: The management of the fund is generally assigned to professionals who were well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus the investors are always assured of quality services in their best interest.

d) Offering tax benefit: Certain fund offer tax benefits to its customers. Under Section 80 c of the Income Tax Act, investment in equity mutual

fund up to Rs. 1,50,000 is tax exempted. No tax is to be paid by the investors on the dividend that is received from such mutual fund.

e) **Providing greater affordability and liquidity:** Even a very small investor can afford to invest in mutual funds. They provide an attractive and cost effective alternative to direct purchase of shares. In absence of mutual funds, small investors cannot think of participating in securities market.



CHECK YOUR PROGRESS

Q 1: What is meant by mutual fund?

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Q 2: Mention two features of mutual fund investment.

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9.7 TYPES OF MUTUAL FUNDS

1. **According to ownership:**

a) **Public sector mutual fund**: Mutual funds which are established by the Government of India or by public sector undertaking are known as public sector mutual fund.

b) **Private sector mutual fund**: Mutual fund set up by private sector companies are termed as private sector mutual fund. For example, Reliance Mutual Fund, Kotak Mahindra mutual fund, Escorts India Mutual Fund, etc.

2. **According to location:**

a) **Domestic fund**: Domestic mutual fund operates within the boundary of a country. This fund mobiles savings of the nationals within the country and invest only in the securities which are issued and traded in domestic financial markets. For example, in India, UTI Mutual Fund, SBI Mutual

Fund, Can Bank mutual fund, etc.

b) Offshore fund: Offshore mutual fund facilitates cross border fund flow. This fund attracts foreign capital for investment in the market of a specific country or countries. Offshore Mutual Fund opens up domestic markets to the international investment and global portfolio investments. This fund is regulated by the provisions of foreign countries where it is registered. India Investment Fund sponsored by Standard Chartered Bank, Common Wealth Equity fund sponsored by Canara Bank, etc. are examples of offshore fund.

3. According to portfolio:

a) Income fund: Income fund aims at maximising the current income of the investor from investment. There are two aspects of income fund, low risk with constant income and high risk with maximum income.

b) Growth fund: Growth fund invests major parts of its corpus in equities with the objective of capital appreciation over medium to long term period. It is a high risk investment fund with high capital gains potential and low current income assistance. This fund is best suited to young salaried and business people who have high risk bearing capacity and ability to defer liquidity of investment.

c) Balanced fund: This is income-cum-growth fund and its uses its corpus to invest in equities as well as fixed income securities in proportion indicated in the offer documents. The aim of balance fund is to provide regular income as well as capital appreciation. The fund's exposure to risk is moderate and it offers a reasonable rate of return.

d) Bond fund: Bond fund invests in various kinds of bonds so as to ensure regular and fixed income to investors. The main thrust of this fund is earning regular income rather than capital appreciation.

e) Equity fund: Equity fund invests in equity shares of companies. Such funds are for those investors who are willing to take risk in the hope of very high returns.

4. According to operation:

a) Open - ended mutual fund: An open - ended mutual fund is available for subscription and repurchase on a continuous basis. Under this

scheme, the size of the fund or the period of the fund is not pre-determined. The investors are free to buy and sell units at Net asset Value (NAV) related price at any point of time. Open- ended schemes enable investors to switch over from one scheme to another. The main objective of this fund is income generation for investors.

Net Asset Value: NAV is value per share of a mutual fund.

b) **Close - ended mutual fund**: A close - ended mutual fund has a fixed corpus and a definite maturity period. The fund is open for subscription only during a specified period. The investor can subscribe directly to the scheme only at the time of initial issue and subsequently a person can buy or sell the units in the stock market where they are listed. The main objective of this fund is capital appreciation. After the expiry of the stipulated period the entire corpus is disinvested and the proceeds are distributed to the unit holders in proportion to the number of units held by them.

c) **Internal fund**: Internal fund is one that has features of both open-ended and close-ended funds. The fund remains open for sale or redemption for a specific interval at NAV related prices and subsequently it operates as a close-ended fund and the units are traded in the stock markets.



CHECK YOUR PROGRESS

Q 3: What is income fund?

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Q 4: What is domestic fund?

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Distinguish between open-ended and close-ended fund

The difference between open-ended and close-ended fund is as follows:

Open-ended fund	Close-ended fund
i) Open-ended fund do not have a fixed corpus.	i) In Close-ended fund corpus is fixed.
ii) Open-ended fund are open for public subscription on a continuing basis. The investors can join and come out from the fund as and when they desire.	ii) Close-ended fund are open for public subscription only during a specific period at the time of launch of the fund.
iii) The units of open-ended funds are not publicly traded. The units are repurchases by the fund at NAV related prices.	iii) The unit of close-ended fund is traded at the stock market.
iv) Open-ended fund do not have a definite maturity period.	iv) Close-ended fund have a definite maturity period.
v) The main objectives of open-ended fund are income generation.	v) The main objective of close-ended fund is capital application.

5. Miscellaneous Mutual funds:

a) Gilt fund: It is a fund that exclusively deals with government securities. It is usually risk free because government securities have no default risk.

b) Sectoral fund: The Sectoral fund invest in specific sectors like power, telecommunications, information technology, natural resources, entertainment, etc.

c) Index fund: It is a mutual fund which invests in securities that represent a specific index, e.g., Bombay Stock Exchange, Sensex, etc.

d) Leveraged fund: Leveraged fund is common stock fund which aims at maximising capital appreciation of the unit holders by the use of borrowed funds.

e) Taxation funds: Taxation fund is designed to provide tax exemption benefits to the investor. The investor in such a fund gets some concession in income tax. These funds are growth oriented and invest predominantly in equities and are suitable for salaried people who wish to avail of tax rebates.

f) Money market mutual fund: Money market mutual fund is set up to invest exclusively in short term money markets instruments like treasury bills, commercial paper, certificate of deposits, etc. The main objective of this fund is generation of income and provides easy liquidity. A money market fund invests in a pool of short-term, interest-bearing securities. Money market funds are most appropriate in situations where you seek to preserve the value of your investment while still earning income. After the remarkable success of mutual funds set up by the banks and financial institutions in India, the Reserve Bank of India (RBI) permitted the establishment of the Money Market Mutual Funds (MMMF) in the year 1992. The basic idea is the deployment of mutual funds' surplus funds in the money market. MMMF ensures high liquidity, adequate surety and high returns. What distinguishes the money market mutual funds from the existing mutual funds is the difference in their investment portfolios. A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments, whereas, a mutual fund largely invests in capital market securities and "parks" its surplus funds in money market instruments for short period.

9.8 CONSTITUENTS OF MUTUAL FUNDS

Mutual funds in India are governed under the Securities and Exchange Board of India (Mutual Fund) Regulation, 1996. The four tier system of managing mutual funds as designed by the SEBI is discussed below:

(a) The Sponsor: Any corporate body which initiates the launching of mutual fund is referred to as the "sponsor". According to SEBI norms, the sponsor should have professional competence, financial soundness and a general reputation for fairness and integrity in business transactions. The sponsor appoints trustee, an asset management company and custodian in compliance with the regulations.

(b) The trustees: Persons who hold the property of mutual fund in trust for benefit of the unit holders are called "trustees". Trustees look after

the mutual fund, which is constituted as a trust under the provision of the Indian Trust Act, a company is appointed as a trustee to manage the mutual fund with prior approval from SEBI.

(c) Asset Management Company (AMC): The investment manager of mutual fund is technically known as the "Asset Management Company" and is appointed by the sponsor or trustees. The AMC is a company formed and registered under the Companies Act, 1956, the AMC is responsible for operating all the schemes of the fund, one company can act as the AMC of only one mutual fund. An Investment Company Management Agreement is executed between the trustee and the asset management company to manage the mutual fund. It charges a fee for the services it renders to the Mutual fund trust. It acts as the investment manager to the trust under the supervision and direction of the trustees.

(d) Custodians: An agency that keeps custody of the securities that are brought by the mutual fund managers under the various schemes is called the custodian. The custodian should in no way be associated with the AMC and cannot act as sponsor or trustee to any mutual fund. A custodian is supposed to act only for a single mutual fund unless otherwise approved by SEBI.

9.9 SYSTEMATIC INVESTMENT PLAN (SIP)

An investor may invest a lump sum in a particular scheme of mutual fund. But he needs to correctly predict the movement of market, which is difficult even for professionals. If the investment is done when the market is at high level, his risk increase on account of volatility of markets. There is an alternative mode of investment available known as "systematic investment plan" (SIP).In SIP, Instead of making one lump sum investment, a fixed sum of money is invested periodically in equality and equity oriented mutual fund schemes. This plan avoids the problem of market timing and usually gives high returns if the investor has a long term investment horizon. Systematic investment plan is, thereby, a popular investment strategy employed by a large number of investors.



CHECK YOUR PROGRESS

Q 5: Who is a trustee?

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Q 6: What is meant by SIP?

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9.10 SEBI (MUTUAL FUNDS) REGULATION, 1996

SEBI announced the amended mutual fund regulations on Dec 9, 1996 covering registration of mutual funds, constitution and management of mutual funds and operation of trustees, constitution and management of Assets Management Committees (AMCs) and custodian schemes of MF's, investment objectives and valuation policies, general obligations, inspection and audit. The revision has been carried out with the objective of improving investor protection, imparting a greater degree of flexibility and promoting innovation.

The increase in the number of MFs and the types of schemes offered by them necessitated uniform norms for valuation of investments and accounting practices in order to enable the investors to judge their performance on a comparable basis. The mutual fund regulations issued in Dec, 1996 provide for a scheme – wise report and justification of performance, disclosure of large investments which constitute a significant portion of the portfolio and disclosure of the movements in the unit capital. The existing assets management companies are required to increase their net worth from Rs. 5 Crores to Rs. 10 Crores within one year from the date of notification of the amended guidelines. AMCs are also allowed to do other fund based business such as providing investment management services to offshore funds, other mutual funds, venture capital funds and insurance

companies. The amended guidelines retained the former fee structure of the AMCs weekly average NAV up to Rs. 100 crores and 1% of NAV.

The consent of the investors has to be obtained for bringing about any changes in fundamental attributes of the scheme on the basis of which the unit holders had made initial investments. The amended guidelines require portfolio disclosure, standardization of accounting policies, valuation norms for NAV and pricing. The regulations also sought to address the areas of misuse of funds by introducing prohibitions and restrictions on affiliate transactions and investment exposure to companies belonging to the group of sponsors of mutual funds. The payment of early bird incentive for various schemes has been allowed provided they are viewed as interest payments for early investment with full disclosure.

The various mutual funds are allowed to mention an indicative return of schemes for fixed income securities. In 1998-99 the Mutual Funds Regulations were amended to permit mutual funds to trade in derivatives for the purpose of hedging and portfolio balancing. SEBI registered mutual funds and fund managers are permitted to invest in overseas markets, initially within an overall limit of US $ 500 million and a ceiling for an individual fund at US $ 50 million.

In October, 1999 SEBI made investment guidelines for MFs more stringent. The new guidelines restrict MFs to invest not more than than 10% of NAV of a scheme in share or share related instruments of a single company. MFs investment in rated debt instruments of a single issuer is restricted to 15% of NAV of the scheme (up to 20% with prior approval of Board of Trustees or AMC). The new norms also specify a maximum limit of 25% of NAV of any scheme for investment in listed group companies as against an umbrella limit of 25% of NAV for all schemes taken together earlier. SEBI increased (June 7, 2000) the maximum investment limit for MFs in listed companies from 5% to 10% of NAV in respect of open – ended funds. Changes in fundamental attributes of a scheme was also allowed without the consent of three fourths of unit holders provided the unit holders are given the exit option at NAV without any exit load. MFs are also not to

make assurance or claim that is likely to mislead investors. They are also banned from making claims in advertisement based on past performance.

ASSET MANAGEMENT COMPANY (AMC)

A mutual fund is managed by an Asset Management Company that is appointed by the sponsored company or by the trustees. The asset management company has to be registered under the Companies Act and has to be approved by the SEBI. The AMC manages the affairs of the mutual funds and its schemes. AMCs are registered by the Registrar of Companies only after a draft memorandum and articles of association are cleared by the SEBI. An AMC has to follow a number of obligations. They are as follows:

- The AMC shall take all the steps and exercise due diligence to ensure that any scheme is not contrary to the provisions of the trust deed and provisions of investment of fund pertaining to any scheme is not contrary to the provisions of resolution and trust deed.
- The AMC shall exercise due diligence and care in all its investment decision. The AMC shall be responsible for the acts of commission or omissions by its employees or the person whose services have been procured.
- An AMC shall submit reports to the trustees quarterly.
- The trustees at the request of an AMC can terminate the assignments of the AMC.
- An AMC shall not deal in securities through any broker associated with a sponsor or a firm which is an associated of sponsor beyond 5 per cent of the daily gross business of the mutual fund.
- No AMC shall utilise services of the sponsor of any or any of its associates, employees, or their relatives for the purpose of any securities transaction and distribution and sale of securities, unless disclosure is made to unit holders and brokerage/ commission paid is disclosed in half-yearly account of the mutual fund.
- No person, who has been found guilty of any economic offence or involved in violation of securities law, should be appointed as key personal.

- The AMC shall abide by the code of conduct specified in fifth schedule.
- The asset management company shall not carry out its operations including trading desk, unit holder servicing and investment operations outside the territory of India, Provided that the asset management company having any of its operations outside India shall wind up and bring them within the territory of India within a period of one year from the date of notification of Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2011.
- The AMC has to make a continuous effort to remind the investor thought letters to take unclaimed amounts. The information on amount unclaimed and number of such investors for each scheme is required to be disclosed in the annual reports of mutual funds. The unclaimed redemption and dividend amounts can be deployed by the mutual funds in call money market or money market instruments and the investors who claim this amount during a period of three years from the due date shall be paid at the prevailing net assets value. After a period of three years, the amount can be transferred to a pool account and the investors can claim the amount at NAV prevailing at the end of the three year. The income earned on such funds can be used for the purpose of investor education.

9.11 GROWTH OF MUTUAL FUNDS IN INDIA

The Indian mutual fund industry has evolved over distinct stages. The growth of the mutual fund industry in India can be divided into four phases: phase I (1964-87), phase II (1987-92), Phase III (1992-97) and Phase IV (beyond 1997).

- **Phase I** - The mutual fund concept was introduced in India with the setting up of UTI in 1963. The Unit Trust of India (UTI) was the first mutual fund set up under the UTI Act, 1963, a Special act of the parliament. It became operational in 1964 with a major objective of mobilising savings through the sale of units and investing them in corporate securities for maximising yield and capital appreciation. This

phase commenced with the launch of the unit scheme 1964 (US-64), the first open-ended and the most popular scheme. Master share, the equity growth fund launched in 1986, proved to be a grand marketing success. Master share was the first real close-ended scheme floated by UTI. It launched the India Fund in 1986- the first Indian off shore fund for overseas investors, which was listed on the London Stock Exchange (LSE). UTI maintained its monopoly and experienced a consistent growth till 1987.

- **Phase II**: The second phase witnessed the entry of mutual fund companies sponsored by nationalised banks and insurance companies. In 1987, SBI Mutual Fund and Can bank Mutual Fund were set up as trusts under the Indian Trust Act, 1882. In 1988, UTI floated another off shore fund, namely, The India Growth Fund which was listed on the New York Stock Exchange (NYSE). By 1990, the two nationalised insurance giants, LIC and GIC, and nationalised banks, namely, Indian Bank, Bank of India and Punjab National Bank had started operations of wholly-owned mutual fund subsidiaries. The assured return type of schemes floated by the mutual funds during this phase was perceived to be another banking product offered by the arms of sponsor banks. Subsequently the Government of India issued comprehensive guidelines in June 1990 covering all mutual funds. These guidelines emphasised compulsory registration with the SEBI and a close relationship be maintained between the sponsor and asset management company (AMC). With the entry of public sector funds, there was a tremendous growth in the size of the mutual fund industry.
- **Phase III**: The year 1993 marked a turning point in the history of mutual funds in India. The Securities and Exchange Board of India (SEBI) issued the Mutual Fund Regulations in January 1993. The SEBI notified regulations bringing all mutual funds except UTI under a common regulatory frame work. Private domestic and foreign players were allowed entry in the mutual fund industry. The Kothari group of companies, in joint venture with pioneer, a US fund company, set up the

first private mutual fund, the Kothari pioneer Mutual Fund, in 1993. Kothari Pioneer introduced the first open-ended fund Prima in 1993. Several other private sector mutual funds were set up during this phase. UTI launched a new scheme, Master-gain, in May 1992, which was phenomenal success with a subscription of Rs.4, 700 crore from 63 lakh applicants. The industry's investible funds at market value increased to Rs. 78,655 crore and the number of investor accounts increased to 50 million. However, the year 1995 was the beginning of the sluggish phase of the mutual fund industry. During 1995 and 1996, unit holders saw erosion in the value of their investments due to a decline in the NAVs of the equity funds. Moreover, the service quality of mutual funds declined due to a rapid growth in the number of investor accounts and the inadequacy of service infrastructure. A lack of performance of the public sector funds and miserable failure funds like Morgan Stanley eroded the confidence of investors in fund managers. Investor's perception about mutual funds gradually turned negative. Mutual funds found it increasingly difficult to raise money. The average annual sales declined from about Rs. 13,000 crore in 1991-94 to about Rs. 9,000 crore in 1995 and 1996.

- **Phase IV** : During this phase, the flow of funds into the kitty of mutual funds sharply increased. This significant growth was aided by a more positive sentiment in the capital market, significant tax benefits, and improvement in the quality of investor service. Investible funds, at market value, of the industry rose by June 2000 to over Rs. 1, 10,000 crore with UTI having a 68 percent of the market share. During 1999-2000 sales mobilisations reached a record level of Rs. 73,000 crore as against Rs. 31,420 crore in the preceding year. The effect of these problems was felt strong in India also. Pioneer ITI, JP Morgan and Newton Investment Management pulled out from the Indian market. The Bank of India MF liquidated all its schemes in 2002.

9.12 CHALLENGES FACED BY THE MUTUAL FUNDS IN INDIA

Mutual funds in India have not been able to perform up to the desired level and in many cases have expressed their financial inability to repay the invested capital along with promised rate of returns. The following are some of the main problems that are being faced by the Indian mutual funds.

(a) Lack of innovation: Mutual funds in India have not been able to provide innovative schemes in terms of risk, liquidity and choice of the investors.

(b) Conventional pattern of investment: Mutual funds in India have been following conservative pattern of investment. They have not been able to diversify the risk to a large extent, which has caused low return in investment.

(c) Poor risk management: As per the recent survey, about 50% of mutual funds are not managing the risk properly and another 50% do not have documented risk procedures or dedicated risk managers.

(d) Liquidity crises: Mutual funds in India face liquidity problems. Investors are not able to draw back some of the scheme, there is no easy exit route.

(e) Lack of transparency: Mutual funds in India are not providing adequate information and materials to the investors. Unfortunately, most of the funds are not able to send even quarterly report to their members. For the success of mutual funds it is very essential that they should create a good rapport with the investors by declaring their holdings to them.

(f) Delay in service: Mutual funds in India have not been able to provide quick and adequate services to the investors. Mutual funds have failed to build up investor- confidence by rendering poor services.



9.13 LET US SUM UP

In this unit we have discussed the following points:

- Mutual fund is special types of investment institutions which pools the savings of investors for collective investment.

- A number of schemes are being offered by mutual funds so as to meet the varied requirement of the investors and thus saving are directed towards capital investments directly.
- A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments
- A mutual fund is managed by an Asset Management Company that is appointed by the sponsored company or by the trustees.



9.14 FURTHER READING

1) Batra G.S. (2002). *Financial services and markets*. New Delhi, Deepand Deep Publication Pvt. Ltd.
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9.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Mutual fund is special types of investment institutions which pools the savings of investors for collective investment in a diversified portfolio of securities.

Ans to Q No 2: Two features of mutual fund are -

(a) Funds for all reasons and seasons that include variety of products as per the suitability of investors.

(b) Aggressive investing that emphasizes on high profits with moderate risks.

Ans to Q No 3: Funds which aims at maximising the current income of the investor from investment are called income fund.

Ans to Q No 4: Mutual fund operates within the boundary of a country are called domestic fund.

Ans to Q No 5: Persons who hold the property of mutual fund in trust for benefit of the unit holders are called “trustees”.

Ans to Q No 6: In SIP, Instead of making one lump sum investment, an investor may put in a fixed sum of money, over a period of time regardless of the mutual fund’s unit price.



9.16 MODEL QUESTIONS

Q 1: Define mutual fund.

Q 2: What is SIP?

Q 3: Discuss the different types of mutual fund.

Q 4: Discuss the constituent of mutual fund.

Q 5: Discuss the obligations of Asset Management Company.

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UNIT 10: DERIVATIVE

UNIT STRUCTURE

10.1 Learning objectives

10.2 Introduction

10.3 Meaning of Derivatives

10.4 Types of Derivatives

10.5 Traders in Derivatives Market

10.6 Foreign Exchange Market: Meaning and Scope

10.7 Dealers in Foreign Exchange Market

10.8 Exchange Rate

10.9 Let us Sum Up

10.10 Further Reading

10.11 Answer to Check your progress

10.12 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit you will be able to

- explain the meaning of derivative, advantages and disadvantages
- explain the different types of derivatives
- discuss the current scenario of derivatives market in India
- explain about forex market
- discuss the structure of foreign exchange market.

10.2 INTRODUCTION

In this unit we are going to discuss the various concepts related to derivatives.Derivatives are securities that derive their value from an underlying asset or benchmark. A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset.

At the end of this unit you we will get some idea about the advantages and disadvantages of derivatives, the different types of derivatives.Also we will discuss the current scenario of derivatives market in India.We will get

some idea about forex market and the structure of foreign exchange market.

Let us now discuss the meaning and its concepts in the following sections.

10.3 MEANING OF DERIVATIVES

The word 'derivative' originates from mathematics and refers to a variable, which means derived from another variable. A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset. The variables underlying derivatives are the prices of traded assets. For e.g. price of a stock (share), price of commodities like wheat, rice, pulses, interest rates, currency prices etc. Derivatives do not have value of their own. In finance the word derivative is used to mean a contract between dealers of financial assets where value is derived from the value of the underlying assets that is any financial assets.

The financial assets are dealt in financial market. The prices of financial assets like shares, stock, bonds, foreign currency, interest rate of loans etc. are always keeps on changing. It creates uncertainty regarding future prices of financial assets and parties involved are also exposed to market risk. To avoid such risk/ uncertainty from fluctuation in prices of financial assets parties in financial market entered into a contract which is known as derivative. For example investor may purchase shares with the intention of increasing the share prices but in reality share prices may decline. Uncertainty is involved in future price of shares which exposed investors towards risk. Again Importer and exporter also face similar kind of risk. An importer while importing goods from other country may face problem in the time of payment of foreign currency when payment is due. As foreign currency exchange rates keeps on fluctuating the importer may have to pay more Indian rupee for purchase of necessary foreign currency if the value of that particular foreign currency appreciates. Similarly the exporter is also exposed to similar kind of risk and may receive less Indian rupee after due time if the value of foreign currency depreciates. The importer and exporter would like to protect the risk that arises due to fluctuation in

foreign currency which can be avoided through derivatives.

Financial derivative is a contract between dealers of financial assets. Here the value is derived from the value of the underlying assets i,e; assets dealt in the financial market like share or foreign currency. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Dealers entered into a contract to protect themselves or hedge the risk that may arise from the changes in the value of the financial assets. It is one kind of instrument for the management of the risk that arise due to uncertainity prevailing in the financial market. The importance of derivative is increasing day by day because of high volatility in market.

Financial derivative are designed to protect dealers of financial market from the adverse movement of prices of financial assets in future. With the help of financial derivative dealers can easily deal in financial assets in future at predetermined agreed rate. Financial derivative 'lock in' the price of a particular financial asset for a future date. It effectively protects them from future uncertainities.

The main advantages of derivatives are:

- Risk Management: It is a risk management tool for the dealers of financial market. They can protect the future uncertainties that arise in the financial market due to fluctuation in market.
- High Profit: The ability and chances to make huge and extreme profits is high in derivatives than primary securities or mutual funds.

Disadvantages of derivatives

A disadvantage of financial derivative is the possibility of loss of money. While financial derivatives help increase profits and reduces risks it may also lead to lose out a lot of money or other assets. For example a cotton farmer enters into a contract with a weaver. Both the parties need the cotton as a resource to continue in their business. Thus, they can enter into a contract for the benefit of both of them. The cotton producer may agree on a fixed price to sell the cotton to the weaver on harvest time. This ensures a fixed income and a sure customer for the cotton farmer. On the other hand, the weaver is also ensured of a supply of cotton. This agreement

could be a disadvantage when the price of cotton fluctuates. If the price of cotton goes up, the farmer would still have to sell the cotton at the earlier agreed cost. This makes the farmer lose out on the profit. Price fluctuations on the cotton could affect the weaver too. If the price of cotton goes down, he still has to pay the high cost that was agreed in the contract, regardless of the decrease in cotton's price or value.

Features of Derivative Market

a. Derivatives, by themselves, have no independent value. Their value is derived out of the underlying instruments.
b. Derivative contract have a specific lifespan or fixed expiry date.
c. A derivative requires little or no initial investment because it is an investment in a change in value rather than an investment in the actual asset or liability.
d. Derivatives enable price discovery, improve the liquidity of the underlying asset, serve as effective hedge instruments and offer better ways of raising money.
e. Generally the parties to the contract, the counterparties, are not required to actually deliver an asset that is associated with the underlying.



CHECK YOUR PROGRESS

Q 1: What is derivative?

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10.4 TYPES OF DERIVATIVES

The most commonly used derivatives contracts are forwards, futures, options and swap. Here we take a brief look at various derivatives contracts that have come to be used.

Forward: It is the simple and most old form of derivative. Here a contract is made between parties to sell something in future at today's rate.

Here price is agreed at present rate but actual deal takes place at future. On the day of the contract time of delivery of the asset, quality and quantity of the asset is fixed. Simply it can be said that here contract is initiated in one time but actual execution takes place at a later date.

Forward contracts are informal and it is not traded in exchange thus it is also known as Over – the- counter derivative (OTC). These types of contracts are actually some commitment between two parties. The assets which are traded in forward contracts include commodities like grain, precious metals, electricity, vehicle etc. For example: A farmer is growing 500 tons of wheat . Now, he could sell his wheat next year at that time rate or he could fix the price now by selling it through forward contract. Forward contract binds farmer to sell 500 tons of wheat after the harvest for a fixed price. By locking the price, the farmer eliminates the risk of falling wheat prices in the future. But on the other hand, if prices rise later, the farmer will get that price only what contract fixes.

Future: A future contract is very similar to a forward contract. The main similarity is that in both of the contract actual deal is executed at a future date but the rate is pre determined. However, futures contracts are listed on the exchange. Exchange act as intermediary between dealers. Hence, future contracts are of standard nature and the agreement cannot be modified in any way. Exchange contracts come in a pre-decided format, pre-decided sizes and have pre-decided expirations. Also, since these contracts are traded on the exchange they have to follow a daily settlement procedure. An important point that needs to be mentioned is that in case of a future contract, the buyer and seller do not enter into an agreement with one another. Rather both of them enter into an agreement with the exchange.

Forwards and futures are similar type of financial contracts but there exist some differences. The main difference between futures and forward contracts is that futures are standardized contracts which are traded on an exchange. While forwards are some private transactions which are traded over - the - counter.

Differences between future and forward contract

Following are the main point of differences between future and forward contracts :

	Forward	Future
1	Forward Contract is an agreement between parties to buy and sell the underlying asset at a specified date at and agreed rate in future.	A contract in which the parties agree to exchange the asset for cash at a fixed price and a future specified date, is known as future contract
2	It is a tailor made contract.	It is a standardized contract.
3	It is an over the counter contract, i.e. there is no secondary market.	It is an exchange traded contract.
4	In forward contract Risk is high.	In future contract Risk is low.
5	It is a Self regulated Contract	It is regulated by stock exchange
6	Contracts are settled on maturity date	Contracts are settled on daily basis.

Option: An Option contract provides choices to the parties to buy/ sell the assets at a predetermined price before predetermined time. But unlike forward and future, parties are not under obligation to buy or sell the assets. Parties can exercise their right or may not, thus it is known as option contract. For exercising right the purchasing party must have to bear a cost which is known as premium. Options can be traded in both OTC market and exchange traded markets.

Options can be of two types - call and put. Call option provides a right to buy the asset at a given price within a pre determined date. The seller is under obligation to sell the asset to the buyer if the buyer wants to exercise the right. A put option gives the right to sell the asset at a given price by a specified date. The buyer is under obligation to buy the asset from the seller at the price specified in the contract. The price listed in the contract is called the “strike price”. If the parties do not exercise their rights within the specified time period then remain ‘unexercised’

Options contracts are often used in securities, commodities

and real estate transactions. Options help to make profit from changes in share prices without putting down the full price of the share. It can also be used to protect from fluctuations in the price of a share by enabling parties to buy or sell the shares at a pre-determined price for a specified period of time. Though it has advantages but trading in options is not so easy like trading in regular shares.

Swap: Swaps are financial agreements to exchange a series of cash flows between two parties. Here one party agrees to pay fixed interest payments on a predetermined date and the other party agrees to return interest payments that float with the underlying assets. Swaps are used in interest rates, stock indices, foreign currency exchange rates and even commodities prices.

The mechanism of swap is different from other form of derivative contract like forward , future and option. Forward, future and option will have one trade at the end of the contract but the swap will have multiple exchanges during the life of the contract. Unlike future and option this swap contracts are not traded on exchanges thus not regulated. So it involve a higher default risk then exchange traded contract.

One of the party will make a fixed series of payments based on the swap agreement, but the other party will make payment on floating rate on the basis of the underlying assets like foreign currency exchange rate etc.

Types of Swap:

Swaps are generally of the following types:

- An interest rate swap is an agreement between two parties where floating interest rate is exchanged for fixed interest rate. This type of contract allow two parties to exchange fixed and floating cash flows on an interest-bearing investment or loan. One party makes payment on fixed rate which is pre determined at the time of the contract and the other party makes payment on future rate that is floating rate. Simply it is an agreement to exchange a series of cash flows.
- A currency swap is an agreement to make a currency exchange between two parties. Here cash flows in one currency are exchanged for cash flows in another currency.

Interest rate swaps and currency swaps are the most popular swap contracts, which are traded over the counters between financial institutions.



CHECK YOUR PROGRESS

Q 2: What are the different forms of derivatives?

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Q 3: Define option contract.

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Q 4: What is swap?

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10.5 TRADERS IN DERIVATIVE MARKET

Following three types of traders operates in derivative market:

Hedgers: Hedger is someone who faces risk associated with price movement of an asset and who uses derivatives as a means of reducing that risk. Hedgers enter into a derivative contract to cover risk associated with the business deal. For example farmer growing paddy is not sure about the price he would get during harvest season. Similarly a rice mill is not sure about the price at which it may have to procure the rice in future. Both the farmer and the rice meal owner would enter into a forward contract where the farmer agrees to sell his paddy to the rice mill at a predetermined price. The farmer is expecting a price fall during harvest season and the rice meal is expecting a price rise. Hence both the parties face price risk. The forward contract in which they have entered into would eliminate the price risk for both the parties. This is called as hedging and the participants are called as hedgers.

Speculators: While hedgers enter in to derivative contract for reducing risk, Speculators enter into a derivative contract to make profits. The speculators have an independent view of future price behavior of the underlined asset and take appropriate position in derivatives with the intention of making profit later. Speculators render liquidity to the market and make markets competitive and expand the market size.

Arbitrageurs : Arbitrageurs are persons who simultaneously enter into transactions in two or more markets to take advantage of price discrepancy between both the markets. The markets could be physical market and the commodity exchange. Arbitrageurs constantly monitor the prices of different assets in different markets and identify opportunities to make profit that emanate from mispricing of products in the different markets. For example if the share price of Tata is Rs. 1550/- in National Stock Exchange and Rs. 1570/- in Bombay Stock Exchange the arbitrageurs will buy at NSE and sell at BSE simultaneously and pocket the difference of Rs. 20/- per share.

10.6 FOREIGN EXCHANGE MARKET: MEANING AND SCOPE

The foreign exchange market is a market in which currencies are bought and sold against each other. In other words, foreign exchange market is the market where the currency of one country is exchanged for the currency of another country. The market is an over the counter market. There is no single market place or an organized exchange (like a stock exchange) where traders meet and exchange currencies. According to Kindelberger, “Foreign exchange market is a place where foreign money are bought and sold.”

Foreign exchange market is the largest financial market. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt. The markets are situated throughout the different time zones of the globe in such a way

that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

There are two foreign exchange markets. Viz. the retail market and the wholesale market

In the retail foreign exchange market, Retail traders buy or sell currency for their genuine business/personal requirements. Individuals like tourists, foreign students, patients traveling to other countries for medical treatment; small companies, small exporters and importers operate in the retail foreign exchange market. Money transfer companies are also major players in the retail market. The wholesale foreign exchange market is also called the inter-bank market. In the wholesale market Commercial banks are the market makers. This market serves to smoothen the excessive purchases or sales made by individual banks.

Functions of Foreign Exchange Market

The foreign exchange market performs the following three functions:

a) Transfer function: The foreign exchange market transfer purchasing power between two countries. It is the primary function of this market. Various instruments such as telegraphic transfers, bank drafts and foreign bills are used for transferring the purchasing power.

b) Credit function: Another function of foreign exchange market is provide credit for promotion of foreign trade. Foreign exchange market provide credit by discounting bills of exchange arising out of foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

c) Hedging function: The third function of foreign exchange market is to hedge foreign exchange risk. The exchange rates (price of one currency expressed in another currency) under free market situation can go up and down. Under this condition, a person or a firm undertakes a great

exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign currency. Through hedging, the foreign exchange market tries to protect the interest of the persons dealing in the market from any such unforeseen changes in the exchange rate.

10.7 DEALERS IN FOREIGN EXCHANGE MARKET

Following are the important dealers of foreign exchange market in India:

1. **Banks:** Commercial banks operate in the foreign exchange market either at retail level for individual exporters and corporations or at wholesale level in the interbank market. The banks dealing in foreign exchange maintain substantial foreign currency balances to serve the need of the customers. These banks discount and sell foreign bills of exchange, issue bank draft, make transfer etc.
2. **Central Bank:** Central banks of the country intervene in the foreign exchange market in order to maintain the exchange rate within a certain range. The central banks also execute the policies of the government.
3. **Brokers:** In the foreign exchange market banks do not deal directly with each other. The brokers bring together the buyers and sellers of foreign exchange. If a bank wants to buy or sell foreign exchange, it informs the broker the amount. If the broker succeeds in carrying out the transaction, he receives a commission from the selling bank.
4. **Acceptance Houses:** Acceptance houses also operate in foreign exchange market. They accept bills on behalf of their customers and helps in foreign remittance.



CHECK YOUR PROGRESS

Q 5: Mention two functions of foreign exchange market.

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Q 6: Name the dealers of foreign exchange market.

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10.8 EXCHANGE RATE

The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another. The rate of exchange expresses the external purchasing power of a home currency. E.g.- If one US dollar can be exchange for 60 Indian Rupees, than the rate of exchange is 1US $ = Rs.60 or Rs.1=1/60 US $=0.017 $. In a foreign exchange market, there exist different types of exchange rates. Following are the some major exchange rates:

1. **Spot Rate:** A spot foreign exchange rate is the rate of a foreign exchange contract (buying and selling of foreign exchange) for immediate delivery. This rate is also known as cable rate or telegraphic transfer rate. The spot rate is quoted differently for buyers and sellers. For example, $1=60.31 for buyers and $1=Rs60.15 for the seller. This difference arises because of transportation charges, dealer's commission, insurance etc. These costs are to be borne by the buyers.
2. **Forward Rate:** Forward rates are exchange rates for currency exchanges that will occur at a future date. The forward exchange rate is settled now but the actual exchange of foreign exchange take place in the future. Forward dates are typically 30, 90, 180 or 360 days in the future.
3. **Long Rate:** Long rate of exchange is the rate at which the banks purchase or sells foreign currency bills which are payable at a specific future date.

Exchange Rate Regime

There are two types of exchange rate systems; namely- Fixed exchange rate system and flexible exchange rate system.

Fixed exchange rate: Under fixed exchange rate system the rate of exchange between two or more countries does not vary or varies only within

narrow limits. Under this system, the government or the Central Bank intervenes in the foreign exchange market so as to maintain the exchange rate stays close to an 'exchange rate target'. By intervening in the foreign exchange market, through the process of buying and selling foreign assets and currencies, Central Banks keep the exchange rate at the "target fixed level".

Advantages of Fixed Exchange Rate

- Exchange-rate stability promotes globalization –more trade and investment by making prices of goods involved in trade more predictable.
- Since there is no fear of currency fluctuations, fixed exchange rate creates confidence in the strength of the domestic currency and there is no fear of adverse effect of speculation on the exchange rate.
- Since uncertainty and risk of exchange rates volatility is rare in case of fixed exchange rate, hence it promote long-term capital flows.
- Fixed exchange rate serve as an anchor and imposes a discipline on monetary authorities to follow responsible financial policies within countries.

Disadvantages of Fixed Exchange Rate

- Fixed exchange rate may achieve exchange rate stability but at the expense of domestic economic stability.
- In fixed exchange rate system, country needs to have significant foreign exchange reserves and this imposes heavy burden on the monetary authorities for managing foreign exchange reserves.
- Monetary authorities lose the independence of monetary policy formulation to maintain exchange rate stability.

Flexible exchange rate: In flexible exchange rate system value, of one currency in terms of another is determined through the forces of demand and supply. Under the flexible exchange rate system, the rate of exchange is allowed to vary to suit the economic policies of the government. There are no restrictions on buying and selling of foreign exchange and the exchange rates are free to change according to the change in the demand and supply of foreign exchange. A currency that uses a floating exchange rate is known as a floating currency.

Advantages of Flexible Exchange Rate

- The fundamental argument in favour floating exchange rate system is that it allows country's autonomy with respect to their use of monetary, fiscal and other policy instruments and at the same time external equilibrium is ensured because of flexible exchange rate.
- Floating exchange rates gives the government and monetary authorities' flexibility in determining interest rates. This is because interest rates do not have to be set to keep the value of the exchange rate within pre-determined bands.
- Balance of Payments on current account disequilibrium can automatically be restored to equilibrium floating exchange rate regime and the scarcity or surplus of any currency is eliminated under floating exchange rate regime.



CHECK YOUR PROGRESS

Q 7: What is meant by exchange rate?

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10.9 LET US SUM UP

In this unit we have discussed the following points:

- A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset. The variables underlying derivatives are the prices of traded assets. For e.g. price of a stock.
- The most commonly used derivatives contracts are forwards, futures, options and swap.
- Forward contracts are informal and it is not traded in exchange thus it is also known as Over – the- counter derivative (OTC).
- Options can be of two types - call and put. Call option provides a right

to buy the asset at a given price within a pre determined date. A put option gives the right to sell the asset at a given price by a specified date.

- Foreign exchange market is the market where the currency of one country is exchanged for the currency of another country. The market is an over the counter market.
- The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another.



10.10 FURTHER READING

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10.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A derivative could be defined as a financial instrument whose value depends on the values of an underlying asset.

Ans to Q No 2: The most commonly used derivatives contracts are forwards, futures, options and swap.

Ans to Q No 3: An Option contract provides choices to the parties to buy/ sell the assets at a predetermined price before predetermined time.

Ans to Q No 4: Swaps are financial agreements to exchange a series of cash flows between two parties.

Ans to Q No 5: Two functions performed by foreign exchange market are

transfer purchasing power between two countries and to provide credit for promotion of foreign trade.

Ans to Q No 6: Important dealers of foreign exchange market are banks, central bank, brokers and acceptance houses.

Ans to Q No 7: The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another.



10.12 MODEL QUESTIONS

Q 1: What is derivative? Discuss the different types of derivative.

Q 2: Mention the features of derivative market.

Q 3: What is foreign exchange market? Discuss the participants of foreign exchange market.

Q 4: What is meant by exchange rate? Discuss the different types of exchange rates.

Q 5: Discuss the fixed exchange rate system.

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UNIT 11: FOREIGN EXCHANGE MARKET

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Meaning of Foreign exchange market

11.4 Evolution of foreign exchange market in India

11.5 Components of foreign exchange market

11.6 Importance of Foreign exchange market

11.7 Functions of Foreign exchange market

11.8 Structure of Foreign exchange Market in India

11.9 Measures initiated to develop foreign exchange market in India

11.10 Let us Sum up

11.11 Further Reading

11.12 Answers to Check Your Progress

11.13 Model Questions

11.1 LEARNING OBJECTIVES

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

- discuss the meaning of foreign exchange market
- know the evolution of foreign exchange market in India
- discuss the importance of foreign exchange market
- learn the structure of foreign exchange market
- outline the functions of the foreign exchange market.

11.2 INTRODUCTION

The foreign exchange market is one of the important components of the international financial system. Especially, for the developing economy, the foreign exchange market is necessary for the conversion of currencies for short term capital flows or long- term investments in the financial physical assets of another country. The services of the foreign exchange markets are necessary not only for trade transactions but also for other financial

receipts or payments between countries involving a foreign exchange transaction.

Globally, operations in the foreign exchange market started in a major 'way after the breakdown of the Bretton woods system in 1971, which also marked the beginning of floating exchange rate regimes in several countries. Over the years, the foreign exchange market has emerged as the largest market in the world. The decade of the 1990s witnessed a perceptible policy shift in many emerging markets towards reorientation of their financial markets in terms of new products and instruments, development of institutional and market infrastructure and realignment of regulatory structure consistent with the liberalised operational framework. The changing contours were mirrored in a rapid expansion of foreign exchange market in terms of participants, transactions volumes, decline in transaction costs and more efficient mechanisms of risk transfer.

11.3 MEANING OF FOREIGN EXCHANGE MARKET

The term foreign exchange refers to the process of converting home currencies into foreign currencies and vice versa. According to Dr. Paul Elinzing, "foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another".

The market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a market place in the physical sense of the term. In fact, it consists of a number a dealers banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central banks of each country and the treasury authorities who enter into his market as controlling authorities. Those engaged in the foreign exchange business are controlled by the Foreign Exchange Maintenance Act (FEMA)



CHECK YOUR PROGRESS

Q 1: Define foreign exchange market.

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Q 2: Why foreign exchange market is necessary for the developing economy?

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.....

11.4 EVOLUTION OF FOREIGN EXCHANGE MARKET

The origin of the foreign exchange market in India could be traced to the year 1978 when banks in India were permitted to undertake intra-day trade in foreign exchange. However, it was in the 1990s, that the Indian foreign exchange market witnessed far reaching changes along with the shifts in the currency regimes in India.

The exchange rate of the rupee that was pegged earlier was floated partially in March 1992 and fully in March 1993, following the recommendations of the Report of the High Level Committee on balance of payments (Chairman: Dr. C. Rangarajan). The unification of the exchange rate was instrumental in developing a market determined exchange rate of the rupee and an important step in the progress towards current account convertibility, which was achieved in August 1994.

A further impetus to the development of the foreign exchange market in India was provided with the setting up of an Expert Group on Foreign Exchange Market in India (Chairman: Shri O.P. Sodhani), which submitted its report in June 1995. The Group made several recommendations for deepening and widening of the Indian foreign exchange market. Consequently, beginning from January 1996, wide-ranging reforms have been undertaken in the foreign exchange market. After almost a decade, an

internal technical group on the Foreign Exchange Market (2005) was constituted to undertake a comprehensive review of the measures initiated by the reserve bank and identify areas for further liberalisation or relaxation of restrictions in a medium-term framework.

The momentous developments over the past few years are reflected in the enhanced risk-bearing capacity of banks along with rising foreign exchange trading volumes and finer margins. The foreign exchange market has acquired depth (Reddy, 2005). The conditions in the foreign exchange market have also generally remained orderly. While it is not possible for any country to remain completely unaffected by developments in international markets, India was able to keep the spillover effect of the Asian crisis to a minimum through constant monitoring and timely action, including recourse to strong monetary measures, when necessary to prevent emergence of self-fulfilling speculative activities.

11.5 COMPONENTS OF FOREIGN EXCHANGE MARKET

There are three major components in this market, depending upon the transaction:

(i) Transactions between the public and the banks at the base level;

(ii) Transactions between the banks dealing in foreign exchange involving conversion of currencies; and

(iii) Transactions between banks and the central bank involving purchase and sale of foreign currencies.

11.6 IMPORTANCE OF FOREIGN EXCHANGE MARKET

India's foreign exchange market is one of the fastest growing across countries-a likely consequence of strong economic growth and the increasing depth and openness of domestic financial markets in the economy.

The Indian foreign exchange market has witnessed far reaching

changes since the early 1990s, following the phased transition from a pegged exchange rate regime to a market determined exchange rate regime in 1993 and the subsequent adoption of current account convertibility in 1994. Market participants are provided with greater flexibility to undertake foreign exchange operation and manage their risks. There has been significant improvement in market infrastructure in terms of trading platform and settlement mechanisms. As a result the depth and liquidity of the market have improved significantly over the years.

Empirical evidence shows that foreign exchange markets in India are efficient, in the sense that while over the medium term, forward premier and interest differentials move together; in the short run deviations from uncovered interest pacify indicate that sterilised foreign exchange market intervention and monetary tightening can be effective in ensuring orderly conditions.

With the economy moving towards fuller capital account convertibility in a calibrated manner, focused regulation and monitoring of the foreign exchange market assumes added importance. In this context, there is a need to strengthen infrastructure, transparency and disclosure and product range in the forex derivatives segment. Strengthening the trading infrastructure, market conduct, transparency of OTC derivatives in the forex market, accounting and disclosure in line with international practices, including disclosures by non-bank corporate, needs to be done on a priority basis.

In the years to come, the foreign exchange market is likely to play a pivotal role in strengthening the Indian financial system and accelerate the process of economic development.

11.7 FUNCTIONS OF FOREIGN EXCHANGE MARKET

The most important functions of this market are:

(i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

(iii) To cover foreign exchange risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorized brokers.

(iii) Trading with banks abroad.



CHECK YOUR PROGRESS

Q 3: Give two importance of foreign exchange market?

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Q 4: Mention the functions of foreign exchange market.

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11.8 STRUCTURE OF FOREIGN EXCHANGE MARKET IN INDIA

The foreign exchange market in India is a three-tier structure comprising (a) the Reserve Bank at the apex, (b) Authorised Dealers (ADs) Licensed by the Reserve bank, and (c) customers such as exporters and importers, corporates and other foreign exchange earners. Apart from these main market players, there are foreign exchange money chargers who bring buyers and sellers together but are not permitted to deal in foreign exchange on their own account. The ADs are governed by the guidelines framed by the Foreign Exchange Dealers Association of India (FEAI). Dealings in the foreign exchange market include transactions between transactions between ADs and the exporters, importers and others customers, transactions among ADs themselves, transactions with overseas banks and transaction between ADs and the exporters, importers and other

customers, transactions among ADs themselves, transactions with overseas banks and transactions between ADs and the Reserve Bank.

As on March 31, 2008 there are 83 (category 1) Authorised dealers (ADs) operating in india-27 public sector banks 15 old private sector banks, 7 new private loans, 5 cooperative banks and 29 foreign banks. All Ads are required to become members of the FEDAI. All merchant transactions in the foreign exchange market have to be necessarily undertaken directly through Ads. However, to provide depth and liquidity to the inter-bank segment, ADs have been permitted to utilise the services of foreign exchange brokers who acts as intermediaries. All upgraded fully fledged money changers (FFMCs) and select regional rural banks (RRBs) and cooperative banks belongs to category 11 of ADs. Select financial institutions belong to category 111 of ADs.

Foreign Exchange Dealers Association of India (FEDAI) sets ground rules for fixation of commercial and other charges and involves itself in matters of mutual interest of ADs. The market trades freely in spot and forward exchange contracts, and to a limited extent in derivatives. The efficiency/ liquidity of the market is often gauged in terms of bid/offer spreads.

The total turnover in the foreign exchange market has been showing an increasing trend over the years.



CHECK YOUR PROGRESS

Q 5: Write some lines on the structure of Foreign exchange market.

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Q 6: Write two components of foreign exchange market.

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.....

11.9 MEASURES INITIATED TO DEVELOP THE FOREIGN EXCHANGE MARKET IN INDIA

Institutional framework

- The Foreign Exchange Regulatory Act (FERA), 1973 was replaced by the market friendly Foreign Exchange Management Act (FEEMA), 1999. The reserve Bank delegated powers to authorised dealers (ADs) to release foreign exchange for a variety o9f purposes. Capital account transactions were also liberalised in a calibrated manner.
- In purchases of the Sodhani committee recommendations, the clearing corporation of India limited (CCIL) was set up in 2001.
- To further the participatory process in a more holistic manner by taking into account all segments of the financial markets, the ambit of the technical advisory committee (TAC) on money and Securities Markets set up by the Reserve Bank in 1999 was expanded in 2004 to include foreign exchange markets and the Committee was rechristened as TAC on Money, Government Securities and Foreign Exchange Markets.

Increase in Instruments in the Foreign Exchange Market

- The rupee-foreign currency swap market was allowed.
- Additional hedging instruments such as foreign currency-rupee options, cross currency options, interest rate swaps (IRS) and currency Swaps, caps/collars and forward rate agreements (FRAs) were introduced.

Liberalisation Measures

- Authorised dealers were permitted to initiate trading positions, borrow and invest in overseas market, subject to certain specifications and ratification by respective bank's Boards. Banks were also permitted to (i) fix net overnight position limits and gap limits (with the Reserve Bank formally approving the limits); (ii) determine the interest rates (subject to a ceiling) and maturity period of FCNR (B) deposits with exemption of inter-bank borrowings from statutory pre exemptions; and (iii) use derivatives products for asset- liability management.
- Participants in the foreign exchange market, including exporters, Indians investing abroad, and FIIs were permitted to avail forward cover and

enter into swap transactions without any limit, subject to genuine underlying exposure.

- FIIs and NRIs permitted to trade in exchange-traded derivative contracts, subjects to certain conditions.



11.10 LET US SUM UP

After going through the unit we have come through the following:

- The meaning of foreign exchange market in detail.
- Also the functions of foreign exchange market.
- The importance of foreign exchange market.
- The various components of foreign exchange market.
- The structure of foreign exchange market in India.
- Various measures initiated to develop foreign exchange market in India.



11.11 FURTHER READING

1) Bharati V. Pathak (2018); I*ndian Financial System*; Pearson Education;Fifth edition.
2) Sujatra Bhattacharya(2017); *Indian Financial System* ;Oxford University Press.
3) M.Y.Khan(2017); *Indian Financial System*;McGraw Hill Education; Tenth edition.
4) Shashi. K. Gupta & Nisha Aggarwal (2014);*Indian Financial System;* Kalyani Publishers; 6 edition.



11.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another.

Ans to Q No 2: The foreign exchange market is necessary for the conversion of currencies for short term capital flows or long-term investments in the financial physical assets of another country.

Ans to Q No 3: (1) There has been significant improvement in market infrastructure in terms of trading platform and settlement mechanisms.

2. Market participants are provided with greater flexibility to undertake foreign exchange operation and manage their risks.

Ans to Q No 4: (i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

Ans to Q No 5: The foreign exchange market in India is a three-tier structure comprising (a) the Reserve Bank at the apex, (b) Authorised Dealers (ADs) Licensed by the Reserve bank, and (c) customers such as exporters and importers, corporates and other foreign exchange earners.

Ans to Q No 6: (i) Transactions between the public and the banks at the base level;

(ii) Transactions between the banks dealing in foreign exchange involving conversion of currencies



11.13 MODEL QUESTIONS

Q 1: Explain the meaning of foreign exchange market.

Q 2: What are the components of foreign exchange market?

Q 3: Explain the evolution of foreign exchange market.

Q 4: Write the functions of foreign exchange market.

Q 5: What is the importance's of foreign exchange market?

Q 6: Describe in detail the structure of foreign exchange market.

Q 7: What are the various measures taken to develop foreign exchange market in India?

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UNIT 12 : CREDIT RATING SERVICES

UNIT STRUCTURE

12.1 Learning objectives

12.2 Introduction

12.3 Meaning of Credit Rating

12.4 Types of Rating

12.5 Benefits of Credit Rating

12.6 Benefits of Credit Rating to the Company

12.7 Disadvantages of Credit Rating

12.8 Users of Credit Rating

12.9 Credit Rating Methodology

- 12.9.1 Business Risk Analysis
- 12.9.2 Financial Risk Analysis
- 12.9.3 Management Evolution
- 12.9.4 Fundamental Analysis

12.10 Steps involved in Credit Rating

12.11 Credit Rating in India

- 12.11.1 Credit Rating Information Services of India Limited (CRISIL)
- 12.11.2 Investment Information and Credit Rating Agency of India Limited (ICRA)
- 12.11.3 Credit Analysis & Research Ltd. (CARE)
- 12.11.4 Fitch India Limited
- 12.11.5 ONICRA Credit Rating Agency of India Limited(ONICRA)
- 12.11.6 Brickwork Ratings India Pvt. Limited (BWR)
- 12.11.7 SME Rating Agency of India Limited (SMERA)

12.12 SEBI Regulations of Credit Rating Agencies

12.13 SEBI Code of Conduct

12.14 Let us Sum Up

12.15 Further Readings

12.16 Answer to check your progress

12.17 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of credit rating
- discuss the benefits and disadvantages of credit rating
- describe the types of credit rating
- discuss the methodology of credit rating
- discuss with different credit rating agencies
- analyse the provisions of SEBI regarding credit rating

12.2 INTRODUCTION

It is very difficult for a general investor to know the authenticity, creditworthiness and profitability of an instrument or institution. To take an efficient investment decision, investors perceive the need of an independent and credible agency, which judges impartially and in a professional manner, the credit quality of different companies and assist investors in making their investment decisions. Credit Rating Agencies, by providing a simple system of gradation of corporate securities, assist the investors/lenders to form an opinion on -the relative capacities of the borrowers to meet their obligations. Credit rating is used' extensively for evaluating debt instruments. With the passes of time rating agencies have diversified their area of works. Besides rating bond issues they have diversified into rating of asset-backed securities, commercial papers, bank loans, etc. Credit rating agencies also rate financial institutions like-banks, insurance companies, mutual funds and sovereign government.

The concept of credit rating originated in the United States of America in 1909 AD when John Moody, the founder of Moody's Investor Service rated the US Rail Road Bond. However, importance of the concept was realized after the great depression of 1929 to 1939. After that the concept of credit rating gets popularity. Moody's Investor Service, Standards and Poor's (S&P), Fitch Investor Service are the leading credit rating agencies of the world.

In this unit, we will discuss the meaning, types, benefits, disadvantages, methods and regulatory aspects of credit rating. We will

also have an idea about some credit rating agencies operating in India.

12.3 MEANING OF CREDIT RATING

A credit rating is an opinion on the relative degree of risk associated with timely payment of interest and principal on a debt instrument. The credit worthiness of an individual, company or even country is assessed through credit rating. It is an evaluation made by a credit rating agency about the debtor's ability to pay back the debt and likelihood of default. It tells an investor, whether the debt instrument is safe or risky. It tells whether the issuer will be able to pay the interest and repay the principal amount in time.

The rating is expressed in alphabetical or alphanumeric symbols. For example, CRISIL has prescribed the following symbols for debenture issues:

AAA indicates highest safety of timely payment of interest and principal.

AA indicates high safety of timely payment of interest and principal.

A indicates adequate safety of timely payment of interest and principal.

BBB offers sufficient safety of payment of interest and principal for the present.

BB offers inadequate safety of timely payment of interest and principal.

B indicates great propensity to default.

C indicates vulnerability to default.

D indicates that the debenture is in default in payment of arrears of interest or principal

Before issuing the instrument, the issuing company asks the credit rating agency to rate its instrument. Credit rating is not permanent, it is reviewed periodically.

12.4 TYPES OF RATING

Following are the different types of rating:

i. **Sovereign credit rating**: Sovereign credit rating is the credit rating of a sovereign entity like a national government. A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating.

ii. **Short term credit rating**: Short term rating is a probability factor of an individual going in to default within a year. Now a day's short term rating is very common.

iii. **Corporate credit rating**: Corporate credit rating is the rating of financial instruments issued by corporate entities. The credit rating of a corporation is a financial indicator to potential investors of debt securities such as bonds. Investor looks at the credit rating of instrument and issuer before investing.

12.5 BENEFITS OF CREDIT RATING

Credit rating is beneficial for both investors and issuing company. Following are the benefits of credit rating to the investor.

i. **Helps in investment decision**: Credit rating gives an idea of creditworthiness of the issuing company and the risk associated with a particular security. Depending upon the credit rating investor can decide whether to invest in such company or not.

ii. **Freedom of investment decisions**: For common people it is very difficult to take investment decision. Before taking investment decisions they seek advice from the stock brokers, merchant bankers or the portfolio managers. Credit rating service makes the task easy by attaching rating symbols to a particular security. Rating symbol assigned to a particular instrument suggests the creditworthiness of the instrument and indicates the degree of risk involved in it.

iii. **Assurance of safety**: A high rating assures the investor about the safety of the instrument. Companies having high ratings of their instruments maintain healthy financial discipline.

iv. **Choice of instruments**: By rating the securities, credit rating agencies enables an investor to select a particular instrument from many alternatives available.

v. **Dependency on rating**: The ratings assigned to the instruments are authentic and reliable. The rating firms are independent of issuing company and have no business connection with. Hence, they give a fair rating to the instruments. This brings confidence among the investors.

vi. **Continuous monitoring**: Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols depending upon performance and position of the company.

12.6 BENEFITS OF CREDIT RATING TO THE COMPANY

A company who has got its credit instrument or security rated is benefited in the following ways:

i. **Easy to raise fund**: It become very easy for a company to raise fund from the market if the instruments issued by the company are highly rated. A high rating gives confidence to the investors. Many investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return.

ii. **Good corporate image:** High credit rating of securities helps in improving the corporate image of a company. A high credit rating increases the level of confidence among the investors. This helps in creating a good corporate image of the company.

iii. **Lower the cost of public issue**: A company with highly rated instruments has to make least efforts in raising funds through public issue. A good credit rating gives good publicity to the company. Companies with highly rated instrument enjoy better goodwill and

corporate image in the eyes of customers, shareholders, investors and creditors. Investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

iv. **Easy and Lowers Cost of Borrowing:** A company with highly rated debt instruments has to make least efforts in raising funds from the market. A high rating indicates low risk. High rated instrument will enable the company to offer low rate of interest. The investors will accept low interest because of low risk involvement. High credit rating gives the company wider spectators for borrowing. It can easily approach financial institutions, banks, investing companies, public etc. for borrowings.

v. **Help Non-popular Companies:** Good credit rating gives exposure to the company. If the instruments issued by a company get publicity, the company with low publicity gets popularity. It will now become easy for the company to raise fund from the market.

vi. **Rating facilitates growth:** Rating motivates the management of the company to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future.

12.7 DISADVANTAGES OF CREDIT RATING

i. **Non-disclosure of important information**: The firm being rated may not furnish all material or important information to the credit rating agency. Any decision taken in absence of such important information may put investors at a loss.

ii. **Possibility of biasness**: The rating given by credit rating agency is based on the information collected from the company. The information collected by the rating agency may be subject to personal bias of the rating team.

iii. **Problems for new company**: Rating agencies give ratings on the basis of information supplied by the company. But, a new company may not be able to provide sufficient information to prove its financial soundness. Therefore, it may get lower credit rating. A low credit rating may create problem in raising funds from the market.

iv. **Static in Nature**: Rating is done on the basis of a static study of present and past data of the company at one particular point of time. There are numbers of political, economical, social and environmental factors which have direct bearings over the affairs of the company. Any changes after the rating may defeat the very purpose of rating.

v. **Rating is not certificate of soundness**: Rating grades by the rating agencies are only an opinion about the capability of the company to meets its interest obligations. Rating symbols do not pinpoint towards financial soundness or quality of products or management or staff etc. In other words rating does not give a certificate of the complete soundness of the company.

vi. **Difference in rating grades:** Same instrument may be rated differently by different rating agencies because of many factors. This may create confusion among the investors.



CHECK YOUR PROGRESS

Q 1: What is meant by credit rating?

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Q 2: Mention different types of credit rating.

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12.8 USERS OF CREDIT RATING

The users of credit rating include the following:

Investors

Investors are the prime users of credit rating. They often use credit ratings to assess credit risk and to compare different issuers and debt issues when making investment decisions. Individual investors, for example,

may use credit ratings in evaluating the purchase of a municipal or corporate bond from a risk tolerance perspective.

Institutional investors, including mutual funds, pension funds, banks, and insurance companies often use credit ratings to supplement their own credit analysis of specific debt issues.

Intermediaries

Intermediaries like Investment bankers help to facilitate the flow of capital from investors to issuers. They may use credit ratings to benchmark the relative credit risk of different debt issues, as well as to set the initial pricing for individual debt issues and to help determine the interest rate these issues will pay. Intermediaries that structure special types of debt issues may look to a rating agency's criteria when making their own decisions about how to configure different debt issues, or different tiers of debt

Issuers

Issuers use credit ratings to provide independent views of their creditworthiness and the credit quality of their debt issues. Issuers may also use credit ratings to help communicate the relative credit quality of debt issues, thereby expanding the universe of investors. In addition, credit ratings may help them anticipate the interest rate to be offered on their new debt issues. As a general rule, if creditworthiness is more the issuer need to pay lower interest rate to attract investors and issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors.

Businesses and financial institutions

Businesses and financial institutions may use credit ratings to assess counterparty risk, which is the potential risk that a party to a credit agreement may not fulfill its obligations. For example, in deciding whether to lend money to a particular organization or in selecting a company that will guarantee the repayment of a debt issue in the event of default, a business may wish to consider the counterparty risk. A credit rating agency's opinion of counterparty risk can therefore help businesses analyze their

credit exposure to financial firms that have agreed to assume certain financial obligations and to evaluate the viability of potential partnerships and other business relationships.

12.9 CREDIT RATING METHODOLOGY

Credit rating requires throughout analysis and investigation of relevant factors that affect creditworthiness of the issuer or borrower. Rating methodology of each rating agency usually includes business risk analysis, financial risk analysis, management evolution and fundamental analysis.

12.9.1 Business Risk Analysis

To ascertain the business risk the rating agency makes an assessment of the company's environment focusing on the strength of the industry prospects, business cycle as well as competitive factors affecting the industry. The vulnerability of the industry to country risk is also assessed by evaluating political factors, economic factors, industry specific factors and foreign exchange risk. If a company is involved in more than one business, each segment is analyzed separately. The main factors include company position such as - market position, size, diversification, management, operating efficiency and legal position etc; Industry factor such as– industry trend, industry structure, market size, growth potential, competition, technological changes, regulatory environment etc.

12.9.2 Financial Risk Analysis

To assess the financial risk the rating agency takes in to consideration various aspects of the financial management. Financial risk analysis includes accounting quality, earnings protection, adequacy of cash flow and financial flexibility.

Accounting quality is evaluated by analyzing accounting regime, reporting and discloser norms, methods of income recognition, depreciation policy etc. Earnings protection is examined

with the help of ratios. Adequacy of cash flow is determined by study of future cash flow, working capital need and capital budgeting. Financial flexibility is measured in terms of whether alternative financial plans have been developed or not.

12.9.3 Management Evolution

This involves a study of the track record of the management, evaluation of management goal, strategies and philosophies, planning and control system, evaluation of capacity to overcome adverse situations.

12.9.4 Fundamental Analysis

This includes analysis of liquidity management, asset quality, profitability and interest and tax sensitivity. Liquidity management of a business organization can be known through a study of capital structure, liquid assets, matching of assets and liabilities etc. Asset quality analysis includes study of credit management policies, credit monitoring policies and composition of assets. Profitability is examined through profitability ratio, reserve and non-business incomes. Interest and tax sensitivity is measured in terms of exposure to interest rate change, tax provisions and changes in tax laws.

12.10 STEPS INVOLVED IN CREDIT RATING

- Information is collected and then analysed by a team of professionals in an agency.
- If necessary, meetings with top management suppliers and dealers and a visit to the plant of proposed sites are arranged to collect additional data. This team of professionals submits their recommendations to the rating committee.
- Committee discusses this report and then assigns rating.
- Rating assigned is then notified to the issuer and only on his acceptance,

rating is published.

- Assures confidentiality of information.
- Once the issuer decides to use and publish the rating, agency has to continuously monitor it over the entire life of instrument, called surveillance.

12.11 CREDIT RATING IN INDIA

The history of credit rating agency (CRA) in India is not very old. India was first among the developing world to set up a credit rating agency. Credit Rating Information Services of India Limited (CRISIL) is the first credit rating agency established in India in the year 1988. Second is Investment Information and Credit Rating Agency of India (ICRA) established in the year 1990. During this short span of time, the major rating agencies have instilled confidence in the minds of the Investors and Regulatory bodies. The Indian Rating Agencies are providing training and technical assistance in setting up rating agencies in many other countries. In India, credit rating service gets more importance and become popular after 1990 when the Reserve Bank of India and Securities Exchange Board of India made credit rating mandatory for the issue of Commercial Paper and some kinds of debentures and debt instruments. In the following paragraph we will discuss some credit rating agencies of India.

12.11.1 Credit Rating Information Services of India Limited (CRISIL)

CRISIL is the largest and first credit rating agency of India and a global leader in research, ratings and risk & policy advisory services. It was established in the year 1987 and commences operations in the year 1988. CRISIL has been promoted by ICICI and UTI as a public limited company with its head quarters at Mumbai. It is one of the top credit rating agencies in India. CRISIL had assessed more than 61000 entities and more than Rs. 47 trillion of debt. It Rates two-thirds of bonds outstanding in India and highest number of

outstanding Small and Medium Enterprises in India.

CRISIL's services include credit ratings and risk assessment; research on India's economy, industries and companies; financial research and outsourcing; fund services; risk management and infrastructure advisory services. CRISIL provides rating and risk assessment services to manufacturing companies, banks, non banking financial companies, and financial institutions, housing finance companies, municipal bodies and companies in the infrastructure sector. It rates long term instruments such as debentures, bonds, preference shares, structured obligations, fixed deposits, commercial paper and short term deposits. It makes credit assessments of various entities including state governments and subsidiaries and joint ventures of multinationals. It also assigns ratings of financial strength to insurance companies.

12.11.2 Investment Information and Credit Rating Agency of India Limited (ICRA)

ICRA was incorporated on January 16, 1991 and launched its services on August 31, 1991. ICRA was promoted by Industrial Finance Corporation of India jointly with other leading financial/ investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency. ICRA is a Public Limited Company, with its shares listed in the Bombay Stock Exchange and National Stock Exchange. International Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The primary objective of ICRA is to provide information and guidance to the investors and creditors for determining the credit risk associated with a debt instrument and credit obligation.

ICRA undertakes credit assessment for small scale industries, rating of collective investment schemes and claim paying ability of insurance companies. ICRA rates rupee-denominated debt

instruments, such as bond and debentures, fixed deposit, commercial paper, certificates of deposit and sector specific debt obligations issued by infrastructure companies. Since 1995, ICRA has been rating equity instruments.

ICRA offers rating services to a wide range of issuers which includes banks and other financial instructions, service company, insurance company, non-banking financial companies, telecom companies, manufacturing companies, power companies etc. ICRA has developed highly specialized rating methodologies for grading of different entities.

12.11.3 Credit Analysis & Research Ltd. (CARE)

CARE was incorporated in April 1993 as a credit rating information and advisory services company. CARE Ratings' registered office and head office is located at Mumbai. In addition, CARE Ratings has regional offices at Ahmedabad, Bengaluru, Chandigarh, Chennai, Coimbatore, Hyderabad, Jaipur, Kolkata, New Delhi, Pune and Mauritius. It is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI) jointly with financial institutions, public / private sector banks and private finance companies. It is offering a wide range of services such as rating services, advisory services, information services and equity research services. CARE ratings are recognized by Government of India, Reserve Bank of India and Securities Exchange Board of India. CARE provides rating to industrial companies, public utilities, financial institutions, infrastructure projects, state government and municipal bodies. CARE rates all types of instruments like commercial papers, fixed deposits, bonds, debentures and structures obligations. Apart from rating services, CARE provides advisory services such as project advisory services and financial restructuring services. CARE also prepares confidential reports for companies, which may be useful in taking decisions with regard to

financial options, joint ventures, acquisitions and collaborations.

12.11.4 Fitch India Limited

With the acquisition of Duff and Phelps Credit Company in April 2000 by Fitch Ratings, Duff and Phelps Rating India Private Limited became Fitch India Limited. Duff and Phelps Credit Rating India Private Ltd was the first joint venture rating company promoted by JM Financials, Alliance Group and the international rating agency Duff and Phelps. At present Fitch Group is comprised of: Fitch Ratings - a global leader in credit ratings and research; Fitch Solutions - a leading provider of credit market data, analytical tools and risk services; BMI Research - an independent provider of country risk and industry analysis specializing in emerging and frontier markets; and Fitch Learning - a preeminent training and professional development firm. It has dual headquarters in London and New York. Majority of Fitch Group is owned by Hearst.

Fitch introduced a rating scale to meet the growing demand for independent analysis of financial securities. Fitch was one of the three rating agencies that were first declared as nationally recognized statistical rating organizations by the Securities and Exchange Commission in 1975. Fitch Group is a global leader in financial information services with operations in more than 30 countries. Fitch has 49 offices worldwide with the coverage of more than 3,000 financial institutions, more than 1,200 corporate issuers. The company has over 8,600 structured finance transactions and also maintains surveillance of more than 1,200 European structured finance transactions and 200 Asian structured finance transactions. Fitch India analysis have access to Fitch internationals large global information network. The credit rating of Fitch apply to a variety of entities and issues which includes Financial Institutions, Insurance, Sovereigns and Supranational, Corporate Finance, Public Finance, Structured Finance, Islamic Finance, Global Infrastructure and Project Finance.

12.11.5 ONICRA Credit Rating Agency of India Limited

ONICRA Credit Rating Agency is one of the leading Credit and Performance Rating agencies in India. The company is based in Gurgaon and founded in 1993. It provides ratings, risk assessment and analytical solutions to Individuals, MSMEs and Corporates. Third party credit and performance rating and assessment help to create "trust" between players in markets that underpins transactions. ONICRA has pioneered individual credit rating services in India. ONICRA plays a central and critical role in collecting and analyzing a variety of financial, operational, industry and market information, synthesizing that information, and providing autonomous, reliable assessments of the entity, thereby providing stakeholders with an important input into their decision making process. It has developed over the years the methodology to assess the financial risks in respect of various types of transactions related to individuals and small and medium enterprises. ONICRA is presently operating at commercial scale. It provides pre and post disbursement and activation solutions so as to bridge the gap between the principals and their customer. It also serves clients in auto finance, consumer finance, credit card issues and cellular phones service provider.

12.11.6 Brickwork Ratings India Pvt. Limited (BWR)

Brickwork Rating India Pvt. Ltd. was founded in 2007 by group of professionals to provide rating of public issues and others to help investors take information decisions. BWR has its corporate office in Bangaluru and a countrywide presence with its offices in New Delhi, Chandigarh, Chennai, Guwahati, Hyderabad, Kolkata, Mumbai and Ahmedabad along with representatives in more than 150 locations. Brickwork Ratings (BWR) is registered with SEBI accredited by RBI and empanelled by National Small Industries Corporation. It offers bank loan, Commercial papers, MSME rating and grading services. NABARD has empanelled Brickwork for MFI

and NGO grading.

Brickwork assigns two types of credit ratings- one to the issuers and the other to specific debt issues or other financial obligations. The rating of issuer, which is called "Brickwork counterparty credit rating", reflects the current opinion about an issuer's overall capacity to fulfill its financial obligations. The other type of rating is the rating of issues, mainly the debt issues. Four types of analysis were made on debt issues namely business analysis, industry analysis, financial analysis and management analysis.

BWR has rated debt instrument such as bands, bank loans, securitized paper of over Rs.9, 30,000 Crore. BWR has also rated about 5000 MSMEs, Fixed Deposit and Commercial Papers of over 19,700 crore.



Basel II is a set of international banking regulations put forth by the Basel Committee on Bank Supervision, which leveled the international regulation field with uniform rules and guidelines.

12.11.7 SME Rating Agency of India Limited (SMERA)

SMERA commenced its operations in 2005 as a full service Credit Rating Agency, registered with the Securities and Exchange Board of India (SEBI), and accredited by Reserve Bank of India (RBI) as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms. SMERA is a joint venture started by Small Industrial Development Bank of India (SIDBI), Dun & Brand Street Information Services India Private Limited (D& B) and several leading banks in India. SMERA is the country's first rating agency that focuses primarily on small and medium enterprises (SME) in India. The main objective of rating SMEs is to facilitate greater and easier flow of credit to SMEs from the banking sector. SMERA is empanelled with National Small Industries Corporation (NSIC), the nodal agency of the Ministry of MSME, Government of India to provide SMERA-D&B-NSIC Micro & Small Enterprises Rating for MSEs in India. SMERA makes two types of analysis- business risk analysis and financial analysis. SMERA has assigned more than 44,000

ratings since inception.

SMERA has achieved the reputation of providing comprehensive, transparent and reliable ratings, thus providing comfort and confidence to lenders and investors alike in decision making. SMERA ratings have gained wide acceptability and are now an integral part of the risk assessment process within the lending and investing community.

SMERA has its Registered and Head Office in Mumbai, branches at 9 cities and representatives in more than 50 clusters across India.



CHECK YOUR PROGRESS

Q 3: Name two credit rating agencies in India.

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Q 4: Name two users of credit rating service.

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12.12 SEBI REGULATIONS OF CREDIT RATING AGENCIES

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. Following are the some regulatory provisions related to Credit Rating Agencies in India:

Registration of Credit Rating Agencies: Registration with SEBI is mandatory for carrying on the rating business in India. The application for the certificate of registration should be made to the SEBI in Form A of first schedule of Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 and shall be accompanied by a nonrefundable fee of

Rs.25000.

Promoter of Credit Rating Agency: A credit rating agency can be promoted by a:

(i) Public financial institutions as defined in section 4-A of the companies Act.

(ii) Scheduled Bank included for the time being in the second schedule to the Reserve Bank of India Act, 1934.

(iii) Foreign Bank Operating in India with RBI approval

(iv) Foreign credit rating agency having at least five years experience in rating securities and

(v) Any company incorporated under the companies Act/ body corporate, having continuous net worth of a minimum of Rs.100 crores as per its audited annual accounts for the previous five years prior to filling of the application with the SEBI for registration.

Grant of Certificate of Registration: The SEBI will grant a certificate of registration to eligible applicants on the payment of a fee of Rs.5, 00,000, subject to the following conditions:

(A) The CRA would comply with the provisions of the SEBI Act/ regulations and guidelines/ directions/circulars and instructions issued by the SEBI, from time to time, on the subject of credit rating.

(B) (i) where any information/particulars furnished to the SEBI by a CRA is found to be false/misleading in any material particular or has undergone changes subsequent to its furnishing at the time of application, it would immediately inform SEBI in writing and

(ii) The certificate of registration is valid for a period of three years, renewable for subsequent three years.

Renewable of Certificate: An application for renewal of certificate of registration shall be made not less than three months before expiry of the period of validity of the certificate. The application shall be accompanied by a renewal fee of Rs. 3, 00,000.

Restrictions on Rating of Securities: Credit Rating Agencies are Restricted from rating of securities issued by (i) promoters and (ii) certain other entities such as a borrower of its promoter; or a subsidiary of its

promoter; or an associate of its promoter and the associate or subsidiary of the Credit Rating Agency.

General Obligations: Following are the some of the general obligations specified in the SEBI (Credit Rating Agencies) Regulations which need to be followed by the credit rating agencies.

- Code of Conduct stipulated by SEBI
- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating
- Internal procedures to be framed by the CRA
- Disclosure of rating definitions and rationale by the CRA
- Submission of information to the board
- Compliance with circulars etc., issued by the board
- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Confidentiality
- Rating process

12.13 SEBI Code of Conduct

SEBI's code of conduct for CRAs is designed to ensure transparent and independent functioning of CRAs. Some of the provisions of the Code of Conduct are:

1. A credit rating agency shall make all efforts to protect the interests of investors.
2. A credit rating agency, in the conduct of its business, shall observe high standards of integrity, dignity and fairness in the conduct of its business.
3. A credit rating agency shall fulfill its obligations in a prompt, ethical and professional manner.
4. A credit rating agency shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.

5. A credit rating agency shall have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in depth rating researches. It shall also maintain records to support its decisions.
6. A credit rating agency shall have in place a rating process that reflects consistent and international rating standards.
7. A credit rating agency shall not indulge in any unfair competition nor shall it wean away the clients of any other rating agency on assurance of higher rating.
8. A credit rating agency shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further a credit rating agency shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.
9. A credit rating agency shall disclose its rating methodology to clients, users and the public.
10. A credit rating agency shall, wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further it shall ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.
11. A credit rating agency shall not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
12. A credit rating agency shall not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to the board, stock exchange or public at large.
13. A credit rating agency shall ensure that the Board is promptly informed about any action, legal proceedings etc., initiated against it alleging any material breach or non-compliance by it, of any law, rules, regulations and directions of the Board or of any other regulatory body.

14. A credit rating agency shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations and circulars, which may be applicable and relevant to the activities carried on by the credit rating agency. The credit rating agency shall also comply with award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
15. A credit rating agency shall ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
16. (a) A credit rating agency or any of his employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media.

    (b) A credit rating agency shall not offer fee-based services to the rated entities, beyond credit ratings and research.
17. A credit rating agency shall ensure that any change in registration status/ any penal action taken by board or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.
18. A credit rating agency shall maintain an arm's length relationship between its credit rating activity and any other activity.
19. A credit rating agency shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a part of the industry. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of shareholdings and interests, etc. Such a code shall also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.

20. A credit rating agency shall provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
21. A credit rating agency shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.
22. A credit rating agency shall ensure that good corporate policies and corporate governance are in place.
23. A credit rating agency shall not, generally and particularly in respect of issue of securities rated by it, be party to or instrumental for—(a) creation of false market; (b) price rigging or manipulation; or (c) dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded.



12.14 LET US SUM UP

In this unit we have discuss the following points:

- Credit rating is an opinion on the relative degree of risk associated with timely payment of interest and principal on a debt instrument.
- The rating is expressed in alphabetical or alphanumeric symbols.
- Credit rating is beneficial for the issuing company, investors and lenders.
- Investors, intermediaries, issuer, Businesses and financial institutions are the users of credit rating.
- Rating methodology of each rating agency usually includes business risk analysis, financial risk analysis, management evolution and fundamental analysis.
- Credit Rating Information Services of India Limited (CRISIL) is the first credit rating agency established in India in the year 1988.
- The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India.

12.15 FURTHER READING

1) Arora, M. (2003) "Credit Rating in India –Institutions, Methods and Evaluation", New Century Publications, Delhi.
2) Verma, J.C. (2000) "Credit Rating Concepts: Practices and Procedures", Bharat Publishing House, New Delhi.

12.16 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Credit rating is an opinion on the relative degree of risk associated with timely payment of interest and principal on a debt instrument.

Ans to Q No 2: Different types of credit rating are Sovereign credit rating, short term credit rating, and corporate credit rating.

Ans to Q No 3: Two credit rating agencies in India are Credit Analysis and & Research Ltd. and SME Rating Agency of India Limited.

Ans to Q No 4: Investors and issuers are the two users of credit rating service.

12.17 MODEL QUESTIONS

Q 1: What are the benefits of Credit Rating for both investors and issuing company?

Q 2: Discuss the Credit Rating Methodology.

Q 3: Discuss the SEBI regulations issued to regulate the Credit Rating Agencies in India.

Q 4: Write a brief note on CRISIL.

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UNIT 13: DEPOSITORY SERVICES

UNIT STRUCTURE

13.1 Learning objectives

13.2 Introduction

13.3 Meaning of Depository

13.4 Benefits of Depository

13.5 Depository Participant

13.6 International Securities Identification Number

13.7 Depository Process

13.8 Depositories in India

13.9 Let us Sum Up

13.10 Further Reading

13.11 Answers to Check your progress

13.12 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the meaning of depository
- explain the benefits of depository
- discuss the process of depository
- describe about NSDL and CDSL.

13.2 INTRODUCTION

In earlier days securities were in the form of physical certificates, due to which trading and settlement system of Indian stock exchanges was very slow and inefficient. Speedy and quick transfer of security was very difficult. Besides delay in settlement, there were some other problems like, theft, forgery, mutilation, bad deliveries of securities etc. To overcome the problems associated with physical securities, the Depositories Act, 1996 was passed. It was formed with the purpose of ensuring free transferability of securities with speed, accuracy & security. The first depository set up in

India is National Securities Depository Limited (NSDL) and is promoted by IDBI, UTI and NSE.

In this unit, we will discuss the concept, benefits and functioning of depositories, demat account and other areas associated with depositories.

13.3 MEANING OF DEPOSITORY

Depository is an organisation which holds securities of an investor in electronic form, in the same manner as a bank holds our money. Depository hold securities in book entry form in the account of the investor. Besides holding securities, a depository also provides services related to transactions in securities. A depository interfaces with its investors through its agents called Depository Participants (DPs). If an investor wants to utilize the services offered by a depository, the investor has to open an account with a DP.

According to Section 2 (e) of Depositories Act, 1996, "depository" means a company formed and registered under the Companies Act, 1956, and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992.

Depositories can be in two forms- dematerialized or immobilized. In dematerialized form paper certificates are completely eliminated after verification by the custodians. In immobilized form initial paper certificates are preserved in safe vaults by custodians and further movement of papers are discontinued.

13.4 BENEFITS OF DEPOSITORY

Following are the benefits of participating in depository system:

- Depository system enables immediate allotment, transfer and registration of securities.
- In depository system no stump duty is required on transfer of securities.
- Depository system eliminate the risks associated with physical certificates such as bad deliveries, fake securities etc.
- Depository system makes considerable reduction in the handling of

large volumes of paper.

- Reduction in transaction cost.
- Faster disbursement of corporate benefits like rights and bonus shares.
- Periodic status reports to investors on their holdings and transactions, leading to better controls.



CHECK YOUR PROGRESS

Q 1: Define depository.

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Q 2: Name the first depository of India.

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13.5 DEPOSITORY PARTICIPANT

A depository participant (DP) is an agent of the depository through which it interfaces with the investor and provides depository services. Public financial institutions, scheduled commercial banks, foreign banks operating in India with the approval of the Reserve Bank of India, state financial corporations, custodians, stock-brokers, clearing corporations / clearing houses, NBFCs and registrar to an issue or share transfer agent complying with the requirements prescribed by SEBI can be registered as DP.

13.6 INTERNATIONAL SECURITIES IDENTIFICATION NUMBER

The International Securities Identification Number (ISIN) standard is used worldwide to identify specific securities such as debt securities, equities, options, derivatives and futures. Each security issued bears a unique ISIN issued by the International Organization for Standardisation

(ISO). ISIN is a twelve-character long identification mark. An ISIN consists of three parts: Generally, a two letter country code, a nine character alpha-numeric national security identifier, and a single check digit. For example, ISIN for Indian securities is like INE009A01021. In India, the task of issuing ISIN of various securities has been assigned to SEBI. For Government securities, allotment of ISIN is done by Reserve Bank of India.

13.7 DEPOSITORY PROCESS

The depository process consists of the following steps-

Opening an Account: It is mandatory to open an account with the depository to avail the services of a depository. The account is to be open through depository participant. At the time of opening an account, the DP will sign a standard agreement with the investor, which details the rights and duties of both investor and DP. A client account number or client ID number is issued to the investor which is to be quoted in all future correspondences. With effect from 1st April, 2006, SEBI has made PAN Card compulsory for all categories of investors for opening a Demat Account.

There are no restrictions on the number of depository participants, one investor can open account with. Depository accounts are similar to bank accounts. Just as you can have accounts with more than one bank, you can open accounts with more than one DP. In case of joint holdings, the investor needs to open accounts in the same order of names in which they hold the securities.

Dematerialization

Dematerialization is the process of converting physical securities into electronic form. An investor can dematerialise only those certificates that are already registered in his name and belong to the list of securities admitted for dematerialization in the depository. For converting physical securities into electronic form, the following process is followed:

First step, The Investor submits the Demat Request Form(DRF) and physical certificates to the DP. DP checks whether the securities are

available for demat. 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.

Second step, DP enters the demat request in his system to be sent to the depository electronically and dispatches the physical certificates along with the DRF to the respective issuer or its registrar and transfer Agent.

Third step, Registrar and transfer agent, on receiving the physical documents and the electronic request, verify and check them. Once the registrar and transfer agent is satisfied, dematerialization of the concerned securities is electronically confirmed to the depository.

Fourth Step, the depository credits the dematerialized securities to the demat account of the investor and intimates the DP electronically.

Fifth Step, The DP issues a statement of transaction to the client.

Demat Account

A demat account is that account where the investor (holder of securities) can hold his securities in electronic or dematerialize form. Like the bank account, a demat account holds the securities like shares, bonds, government securities, mutual funds and exchange traded funds. One cannot trade in the stock market without a demat account.

Benefits of demat account

Following are the some benefits of demat account:

- It is a safe and convenient way to hold securities compared to holding securities in physical form.
- No stamp duty is required to pay for transfer of securities in the electronic form.
- Risks associated with physical certificates such as delays, loss, in transit, theft, mutilation, bad deliveries, etc. are eliminated.
- Dematerialized securities are most preferred by the financiers for providing credit against securities.
- Shares bought or sold are transferred in the name of the investor on the very next day of pay out.
- Change of address, registration of Power of Attorney –can be effected across companies by one single instruction to the DP.

- Eliminate the postal cost for sending share certificates and transfer deeds.

Rematerialization

The process of converting electronic form of security to physical form is known as rematerialization. If one investor want to withdraw his security in physical form balance with the depository, in such a case the investor makes an application to the depository in rematerialization request form (RRF) through the depositor participant. The DP will forward the request to the depository after verifying that the investor has the necessary balances. The depository in turn will intimate the registrar who will print the certificates and dispatch the same to the investor.

Distributing Dividend

The registrar or share transfer agent shall inform the depository about the corporate actions such as dates for book closer, redemption or maturity of securities etc. The depository will then electronically provide a list of the holdings of the investors. The company can then distribute dividend, interest and other monetary benefits directly to the investors on the basis of the list.

Closing an account

If a client wants to close an account, he shall make an application in the specified format. The client can close his account if no balance is outstanding to his credit. If any balance exists in the account, he may close the account in the following manner:

a. By rematerialization of all its existing balance in the account,
b. By transferring his security balances to his other account held either with the same DP or with other DP.



CHECK YOUR PROGRESS

Q 3: What is demat account?

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Q 4: What is meant by rematerialization?

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13.8 DEPOSITORIES IN INDIA

To wipeout these problems associated with physical certificates, the Depositories Act 1996 was passed in India. The Act was passed with the purpose of ensuring free transferability of securities with speed, accuracy and security by-

a) Making securities of public limited companies freely transferable, subject to certain exceptions;
b) Dematerializing the securities in the depository mode; and
c) Providing for maintenance of ownership records in a book entry form.

For performing the above tasks, two depositories viz, National Securities Depository Ltd. (NSDL) and Central Depository Services (India) Ltd. (CDSL) have come up.

National Securities Depository Ltd. (NSDL)

The NSDL is the first depository of India set up in the year 1996. It is the largest depository of the country promoted by Industrial Development Bank of India (IDBI), Unit Trust of India (UTI) and National Stock Exchange (NSE). As on July, NSDL has eliminated 2764 crore certificates and more than 75% shares of 7678 companies are dematted. NSDL open 3713 accounts per day on an average. The NSDL interacts with investors through Depository Participants. It has 266 DP as on August, 2017 with 27539 DP service centre. NSDL provides a wide range of security related services to its clients (the investors) through the DPs. These services are can be classified into two categories: Basic services and value added services.

Basic services

Following are the basic services offered by NSDL:

- **Account Opening**: To avail the services provided by NSDL an investor/ a broker/ an approved intermediary has to open a NSDL depository account with any of its DPs. There are three types of accounts.

i) Beneficiary Account: An investor who wants to hold securities in dematerialized form and receive or deliver securities by inter-account transfers must have a depository account called beneficiary account with a DP of his choice.

ii) Clearing Member Account: Member brokers of those stock exchanges which have established electronic connectivity with NSDL need to open a clearing member account, with a DP of his choice, to clear and settle trades in the demat form. This account is popularly known as Settlement account or "Pool account". This account is meant only to transfer securities to and receive securities from the clearing corporation/ house and hence, the member broker does not have any ownership rights over the shares held in such an account.

iii) Intermediary account: Any person who wants to act as an approved 'intermediary' for stock lending and borrowing needs to open an intermediary account with any DP of his choice. An intermediary account may be opened with the DP only after the intermediary has obtained registration from the Securities & Exchange Board of India and with the prior approval of NSDL. This account is meant only to deposit the securities received from the lender and lend them to the borrower under stock lending and borrowing scheme. The intermediary does not have any ownership rights over the shares held in such an account.

- **Dematerialisation:** Dematerialisation is the process by which a client can get physical certificates converted into electronic balances. This we had already discussed in the earlier section.
- **Rematerialization:** The process of converting electronic form of security to physical form is known as rematerialization. This we had already discussed in the earlier section.
- **Market Transfers:** Trading in dematerialised securities is quite similar to trading in physical securities. The major difference is that at the time of settlement, instead of delivery/receipt of securities in the physical form, the same is affected through account transfers. Delivery of securities to or from a clearing member is called "Market Trades". If, either source or target in a transfer instrument is a Clearing Member

Account; such a transfer is a “Market Trade”.

- **Off Market Transfer:** Trades which are not settled through the Clearing Corporation/ Clearing House of an exchange are classified as “Off Market Trades”. Delivery of securities to or from sub brokers, delivery for trade-for-trade transactions, by this definition are off-market trades.
- **Inter-Depository Transfers:** Transfer of securities from an account in one depository to an account of another depository is termed as an inter-depository transfer. It can be done only for securities that are available for dematerialisation on both the depositories. Government securities cannot be transferred from one depository to another using this facility.
- **Transmission:** The Companies Act distinguishes transmission of shares from transfer of shares. While transfer of shares relates to a voluntary act of the shareholder, transmission is brought about by operation of law. The word ‘transmission’ means devolution of title to shares otherwise than by transfer, for example, devolution by death, succession, inheritance, bankruptcy, marriage, etc. While transfer of shares is brought about by delivery of a proper instrument of transfer duly stamped and executed, transmission of shares is done by forwarding the necessary to the company.

  In case the deceased was one of the joint holders, then the surviving holders have to request the DP vide a form called the transmission form along with a copy of notarised death certificate to transmit the securities lying in the account of the deceased to the account of the surviving holders. For this purpose, the surviving clients must have a depository account, which can be with the same DP or with a different DP.

  In case of death of the sole holder, the legal heir(s) or legal representative(s) of the deceased must request the DP to transmit the balances lying in the Client account of the deceased to the account of the legal heir(s) or legal representative(s). For this, the legal heir (s) or the legal representative(s) of such securities must submit an instruction called the transmission form to the DP along with the following

documents:

1. A copy of the death certificate duly notarised
2. A copy of the Succession certificate duly notarised or an order of a court of competent jurisdiction where the deceased has not left a Will; or
3. A copy of the Probate or Letter of Administration duly notarised.

- **Corporate Actions:** Corporate actions are benefits given by a company to its investors. These may be either monetary benefits like dividend, interest or non-monetary benefits like bonus, rights, etc. NSDL facilitates distribution of corporate benefits.

Central Depository Service (India) Ltd. (CDSL)

The second depository Central Depository Services Limited (CDSL), has been promoted by Bombay Stock Exchange and Bank of India. It was formed in February 1999. CDSL was set up with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants. CDSL has a wide network of DPs, operating from over 17,000 sites, across the country. The DPs are directly connected to CDSL thereby providing on-line and efficient depository service to investors. The services offered by CDSL is same with the NSDL.



13.9 LET US SUM UP

In this unit we have discussed the following points:

- Depository is an organisation which holds securities of an investor in electronic form, in the same manner as a bank holds our money in accounts.
- A depository participant (DP) is an agent of the depository through which it interfaces with the investor and provides depository services.
- Dematerialization is the process of converting physical securities into electronic form.
- A demat account is that account where the investor (holder of securities) can hold his securities in electronic or dematerialized form.
- The process of converting electronic form of security to physical form

is known as rematerialization.

- In India there are two depositories viz, National Securities Depository Ltd. (NSDL) and Central Depository Service (India) Ltd. (CDSL)



13.10 FURTHER READING

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4) Khan, M. Y. (2007). *Indian Financial System.* New Delhi. Tata McGraw Hill.
5) Pathak, Bharati V (2006). *The Indian Financial System : Markets, institutions and services.* New Delhi, Pearson Education Ltd.



13.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Depository is an organisation which holds securities of an investor in electronic form, in the same manner as a bank holds our money.

Ans to Q No 2: National Securities Depository Ltd. (NSDL)

Ans to Q No 3: A demat account is that account where the investor (holder of securities) can hold his securities in electronic or dematerialize form.

Ans to Q No 4: The process of converting electronic form of security to physical form is known as rematerialization.



13.12 MODEL QUESTIONS

Q 1: State the meaning and benefits of depository.

Q 2: Define depository participant.

Q 3: Discuss the depository process.

Q 4: Discuss the services provided by NSDL.

Q 5: What are the benefits of demat account?

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UNIT 14: REGULATION OF FINANCIAL MARKETS IN INDIA

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Concept of Regulation of Financial Market

10.4 Objective of financial market regulation

14.5 Regulators of Indian Financial Market

14.6 Reserve Bank Of India (RBI)

14.6.1 Regulatory Functions of RBI

14.7 Securities and Exchange Board of India

14.7.1 Objectives of SEBI

14.7.2 Functions of SEBI

14.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act,1956

14.7.4 SEBI and Regulation of Securities Market

14.8 Insurance Regulatory and Development Authority (IRDA)

14.8.1 Powers/Functions of IRDA

14.9 Pension Fund Regulatory and Development Authority (PFRDA)

14.9.1 Functions and Powers of PFRDA

14.10 Let Us Sum Up

14.11 Further Readings

14.12 Answer to Check Your Progress

14.13 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- define the concept of regulation of financial markets
- know the objectives of financial regulation
- identify the importance of Indian financial markets
- describe the various regulators of financial system

- outline the regulatory role of various regulatory bodies in the financial System
- describe the various initiatives for Regulation of financial market.

14.2 INTRODUCTION

A significant development of the 20th century, particularly in its later part, is expansion of financial market world over which mostly was driven by globalization, technology, innovations and increasing trade volume. India has not been an exception with probably largest number of listed companies with a very large investor population and ever increasing volumes of trades. Since the economic development of an economy is directly linked with the development of financial market, the effectiveness of monetary policies largely depend on the performance of financial market. A well-regulated financial market increases the level of confidence among the investors and insures them against the potential risk.

The regulation and supervision of the financial markets in India is carried out by different regulatory authorities. The Reserve Bank of India (RBI) regulates and supervises the major part of the financial system. The supervisory role of the RBI covers commercial banks, urban cooperative banks (UCBs), and nonbanking finance companies (NBFCs). Some of the financial institutions, in turn, regulate or supervise other institutions in the financial sector, for instance, Regional Rural Banks and the Co-operative banks are supervised by National Bank for Agriculture and Rural Development (NABARD); and housing finance companies by National Housing Bank (NHB). Department of Company Affairs (DCA), Government of India regulates deposit taking activities of corporate, other than NBFCS registered under companies Act, but not those which are under separate statutes. The Registrar of Cooperatives of different states in the case of single state cooperatives and the Central Government in the case of multi-state cooperatives are joint regulators, the RBI for UCBs, and NABARD for rural cooperatives. Whereas RBI and NABARD are concerned with the banking functions of the cooperatives, management control rests with the

State/ Central Government. This "dual control" impacts the supervision and regulation of the cooperative banks. The capital market, mutual funds, and other capital market intermediaries are regulated by Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) regulates the insurance sector; and the Pension Funds Regulatory and Development Authority (PFRDA) regulates the pension funds.

India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, IRDA and PFRDA – was not designed; it has evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time. Each regulator has their own rules on registration, code of conduct, commissions and fees to monitor the product providers and distributors. RBI, SEBI and IRDA have grievance redress procedures through sector financial Ombudsmen services. The Securities and Exchange Board of India (SEBI) is the regulatory authority established under the SEBI Act, 1992, in order to protect the interests of the investors in securities as well as promote the development of the capital market. It involves regulating the business in stock exchanges; supervising the working of stock brokers, share transfer agents, merchant bankers, underwriters, etc; as well as prohibiting unfair trade practices in the securities market.

14.3 CONCEPT OF REGULATION OF FINANCIAL MARKET

The functioning of financial markets is regulated by several legislations that include Acts, Rules, Regulations, Guidelines, Circulars, etc. Understanding the legislations governing the financial markets in India will give the reader a fair idea of how the financial markets in India are regulated. The regulators of the financial market lay down specific rules of behaviour for participants in the financial system and provide for the monitoring of the observance of the rules and regulation. Such regulations became more important in the situations of far reaching technological

progress, liberalization and greater integration in the financial system.

14.4 OBJECTIVES OF FINANCIAL MARKET REGULATION

Following are the objectives of financial market regulation :-

(A) To protect the interest of the investor and consumer of the financial services.

(B) To maintain stability in the financial system.

(C) To reduce the fraudulent activities in the financial system.

(D) To provide confidence to the small investors to invest in the financial market

(E) To provide easy and flexible financial transaction.

14.5 REGULATORS OF INDIAN FINANCIAL MARKET

In Indian financial system each financial services is regulated by the individual regulators.The following table will give us an India about who regulate what.

Regulator	Financial Services and Schemes
RBI (Reserve Bank of India)	Fixed deposits and other banking products and services
SEBI (Securities and capital Exchange Board of India)	Services in the capital market and market intermediaries
Insurance Regulatory and Development Authority (IRDA)	Insurance Sector
Pension Fund Regulatory and Development Authority	New Pension Scheme

14.6 RESERVE BANK OF INDIA (RBI)

The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system. In

exercise of the powers under these Acts, the RBI regulates the entry into banking business by licensing, exercise controls over shareholding and voting powers of shareholders, exercises control over managerial persons, and regulates the business of the bank by permitting and prohibiting certain business. RBI also supervises the functioning of the banks operating in the country by inspecting and issuing directions from time to time in public interest and in the interest of the banking system as a whole. It also gives directions to the bank to adhere the norms laid down by it or by the Bank for International Settlement for maintaining an international standard in the operations of banks relating to capital adequacy, asset classification, income recognition, management quality, efficiency, liquidity and surveillance. The bank also regulates the functions of other banks by giving directions in respect of interest rates, lending limits, investment limit and other matter. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. Under the Reserve Bank of India (Board of Financial Supervision) Regulations 1994, a separate Board for Financial Supervision (BFS) was set up within the Bank. The objective of this Board is to strengthen supervision and surveillance over the financial system and to provide a sharper focus to supervisory policy and skills. This Board covers banks, non-banking financial institutions and other para-banking institutions.

14.6.1 Regulatory functions of RBI

The regulatory and supervisory functions of the RBI may be summed up as follows:

1. **Power to issue license:** The RBI grants license to banks for carrying out banking business. License is given to the new banks as well as to the existing banks for branch expansion and for opening extension counters, new branches, even to close down existing branches.
2. **Power of appointment and removal of banking board/ personnel:** An amendment Act passed in 1963, which became

effective February 1, 1964, gave further powers to the Reserve Bank, particularly to restrain the control exercised by particular groups of persons over the affairs of banks and to restrict loans and advances as well as guarantees given by banks. It also enlarged the Reserve Bank's powers of control in the appointment and removal of banks' executive personnel. Further, The RBI is empowered to supersede, after consultation with the central government, the Board of Directors of banking companies and to appoint an Administrator. On recommendation of RBI, the central government may supersede the Board of Directors of nationalized banks, SBI and subsidiary banks of SBI under certain circumstances and appoint Administrator.

3. **Powers to regulate the business of banking:** The Reserve Bank of India Act, 1934 (RBI Act) empowers the Reserve Bank of India (RBI) to issue rules, regulations, directions and guidelines on a wide range of issues relating to banking and the financial sector.
4. **Power to give directions to banks:** The RBI is empowered to give directions from time to time to other banks operating in India regarding various banking and other activities. Section 21 (3) of RBI act further lays down that every bank shall be "bound to comply with any direction given by Reserve Bank".
5. **Power to inspect and supervise banks:** The Reserve Bank at any time may, and on being directed so to do by the Central Government shall, cause an inspection to be made by one or more of its officers of any banking company and its books and accounts; and the Reserve Bank shall supply to the banking company a copy of its report on such inspection.
6. **Power to conduct audit of the banks:** Where the Reserve Bank is of opinion that it is necessary in the public interest or in the interest of the banking company or its depositors to do so, may at any time by order direct that a special audit of the banking company's accounts, for any such transaction or class of

transactions or for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order either appoint a person duly qualified under any law for the time being in force to be an auditor of companies or direct the auditor of the banking company himself to conduct such special audit and the auditor shall comply with such directions and make a report of such audit to the Reserve Bank and forward a copy thereof to the company.

7. **Powers relating to moratorium, amalgamation and winding up:** The RBI can make an application to the High Court for the winding up of the banking company, in respect of which an Order of Moratorium has been issued by the High Court.
8. **Power to impose norms of practice and maintenance of accounts:** The RBI can impose norms of practice and maintenance of accounts to other banks operating in India from time to time in accordance to the changing scenario of accounting practices prevailing in India.
9. **Power to collect and furnish credit information:** The RBI may at any time direct any banking company to submit to it such statements relating to such credit information and in such form and within such time as may be specified by the Bank from time to time
10. **Power to impose penalty:** The RBI can impose penalty on any banking company if it violates norms and practices as defined under banking law prevailing in India.

Recently a provision was incorporated by the Information Technology Act, 2000 which enabled the RBI to make regulations for regulating payment systems of banks and financial institutions.



CHECK YOUR PROGRESS

Q 1: Mention two objectives of financial regulation.

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Q 2: Mention two regulatory functions of RBI.

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14.7 SECURITIES AND EXCHANGE BOARD OF INDIA

The Securities and Exchange Board of India was established on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India Act, 1992.

The reason the SEBI was constituted was because before the SEBI law relating to the securities market in India was contained in different enactments like Companies Act, 1956, Securities Contract (Regulation) Act, 1956, and the Capital Issues (Control) Act, 1947. The capital market witnessed a tremendous growth during 1980's, characterised particularly by the increasing participation of the public. This ever expanding investor's population and market capitalisation led to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants and others involved in the securities market. The glaring examples of these malpractices include existence of self –styled merchant bankers, unofficial private placements, rigging of prices, unofficial premium on new issues, non adherence of provisions of the Companies Act, violation of rules and regulations of stock exchanges and listing requirements, delay in delivery of shares etc. These malpractices and unfair trading practices have eroded investor confidence and multiplied investor grievances. The Government

and the stock exchanges were rather helpless in redressing the investor's problems because of lack of proper penal provisions in the existing legislation. In view of the above, the Government of India decided to set-up a separate regulatory body known as Securities and Exchange Board of India.

14.7.1 Objectives of SEBI

The overall objective of SEBI is to protect the interests of investors and to promote the development of, and regulate the securities market. This may be elaborated as follows:

1. To regulate stock exchanges and the securities industry to promote their orderly functioning.
2. To protect the rights and interests of investors, particularly individual investors and to guide and educate them.
3. To prevent trading malpractices and achieve a balance between self regulation by the securities industry and its statutory regulation.
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc., with a view to making them competitive and professional.

14.7.2 Functions of SEBI

Keeping in mind the emerging nature of the securities market in India, SEBI was entrusted with the twin task of both regulation and development of the securities market. It also has certain protective functions, Which are mention bellow :-

Regulatory Functions

1. Registration of brokers and sub brokers and other players in the market.
2. Registration of collective investment schemes and Mutual Funds.
3. Regulation of stock brokers, portfolio managers, underwriters

and merchant bankers and the business in stock exchanges and any other securities market.

4. Regulation of takeover bids by companies.
5. Calling for information by undertaking inspection, conducting enquiries and audits of stock exchanges and intermediaries.
6. Levying fee or other charges for carrying out the purposes of the Act.
7. Performing and exercising such power under Securities Contracts (Regulation) Act 1956, as may be delegated by the Government of India.

Development Functions

1. Training of intermediaries of the securities market.
2. Conducting research and publishing information useful to all market participants.
3. Undertaking measures to develop the capital markets by adapting a flexible approach.

Protective Functions

1. Prohibition of fraudulent and unfair trade practices like making misleading statements, manipulations, price rigging etc.
2. Controlling insider trading and imposing penalties for such practices.
3. Undertaking steps for investor protection.
4. Promotion of fair practices and code of conduct in securities market.

14.7.3 Additional functions of SEBI under the Securities Contracts (Regulation) Act,1956

The Securities Contracts (Regulation) Act, 1956 (SCRA) which was enacted to prevent undesirable transactions in securities and to regulate the business of securities had given certain powers to the Central Government, under the provisions of that Act. The functions of the Central Government under that Act have been granted to SEBI.

These Functions are:

(a) Power to call for periodical returns or direct enquires to be made (Section 6): SEBI will receive from every recognized Stock Exchange such periodical returns relating to its affairs as may be prescribed by SCRA rules.

(b) Power to approve the bye-laws of stock exchanges: Section 9 of SCRA provides that any stock exchange may make bye-laws for the regulation ad control of contracts with the previous approval of SEBI.

(c) Power of SEBI to make or amend bye-laws of recognized stock exchanges (Section 10, SCRA): SEBI may either on a request in writing received by it in this behalf from the governing body of a recognized stock exchange or in its own motion make bye-laws on matters specified in Section 9 of SCRA or amend any bye laws made by stock exchange.

(d) Licensing of dealers in securities in certain areas (Section 17 SCRA): SEBI has been empowered to grant a license to any person for the business of dealing in securities in any State or area to which Section 13 of SCRA has not been declared to apply.

(e) Power to delegate: Section 29A of SCRA provides that the Central Government may, by order published in the Official Gazette, direct that the powers exercisable by it under any provision of the SCRA shall, in relation to such matters and subject to such conditions, if any as may be specified in the order, be exercisable also by SEBI or the Reserve Bank of India.

More Powers for SEBI: Certain additional powers with regard to certain provisions under the Companies Act, 2013, related to issue and transfer of securities and non-payment of dividend, in the case of listed public companies intending to get their securities listed on any recognized stock exchange, shall be administered by SEBI.



CHECK YOUR PROGRESS

Q 3: Mention two powers of SEBI.

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14.7.4 SEBI and Regulation of Securities Market

SEBI prescribes the conditions for issuer companies to raise capital from the public so as to protect the interest of the suppliers of capital (investors). The extensive disclosures prescribed for issuers facilitate informed investment decision making by investors while simultaneously ensuring quality of the issuer. Further, it has prescribed norms for such corporates on 'on going' basis and also during their restructuring (like substantial acquisition, buy back and delisting of shares) to safeguard the interest of investors. To ensure fair and high standards of service to investors, SEBI allows only fit and proper entities to operate in the capital markets as intermediaries. In this regard, it has prescribed detailed and uniform norms of their registration. Further, to ensure market integrity, it has prescribed norms for fair market practices including prohibiting fraudulent and unfair trade practices and insider trading. Detailed norms for safeguarding the interest of investors in secondary markets have also been prescribed. SEBI also prescribes conditions for operation of collective investor schemes, including Mutual Funds. SEBI tries to create favourable situation for the entry of investors with confidence in the market with a purpose to expand capital market particularly security market. SEBI's intervention has resulted into improvements in proper methods of transaction and to minimize defects and manipulations in them. But infrequently large improper transactions are taking

place. For example, in 1992 Harshad Mehta used money from banks to make personal gains via investment in shares; in 1996 C R Bhansali raised public money through FDs, MFs and debentures via nonexistent firms and invested them in stocks for personal gains; in 2001 Ketan Parekh made Circular trading in selected stocks via borrowed money from banks to manipulate share prices; and in 2010 Sahara Chief Subrata Roy issued Sahara Housing Bonds to 29.6 million investors without following Sebi regulations and investor protection measures mentioned therein.

Activities of SEBI

The focus area of SEBI's activities are as follows:

- Increasing market transparency through further improvement of disclosure standards
- Improving the standards of corporate governance
- Improving market efficiency by speeding up the process of dematerialization and introducing rolling settlement in a phased manner.
- Reducing transaction costs by refining the margin system
- Enhancing the market safety through an efficient margin system and stepping up surveillance.

SEBI has identified the following areas for focusing its attention for the overall growth and the development of the stock market in India:

- Registration of the stock brokers
- Authorization of Merchant Banker
- Monitoring and controlling of the mutual funds business.
- Issue of portfolio managers regulations.
- Issue of guidelines for disclosure and investor protection.

14.8 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY(IRDA)

The government in order to provide better insurance cover to citizens

and also to augment the flow of long term sources of financing infrastructure, initiated reforms in the insurance sector by setting up of committee under chairmanship of R. N. Malhotra, former Governor of RBI. The Committee on reforms of the insurance sector recommended for the creation of a more efficient and competitive financial system in tune with global trends. It recommended amendments to regulate the insurance sector to adjust with the economic policies of privatization. The government in pursuance of the recommendation of the committee, decided to establish a Provisional Insurance Regulatory and Development Authority in 1996, to replace the erstwhile authority called the Controller of Insurance constituted under the Insurance Act, 1938, which initially worked under the Ministry of Commerce and later transferred to the Ministry of Finance. Finally, the decision to establish the Insurance Regulatory and Development Authority was implemented by the passing of the Insurance Regulatory and Development Authority Act, 1999. In India, presently after the opening up of the insurance sector, the regulator for the monitoring of the operations of the insurance companies is the IRDA, having its head office in Hyderabad. The regulatory framework mainly aims to focus on three areas, viz.,

- The protection of the interest of the consumers
- To ensure the financial soundness of the insurance industry
- To pave the way to help a healthy growth of the insurance market where both the government and the private players play simultaneously.

Need of IRDA in Regulation of Insurance Businesses

Any industry wherein the stakes of the public are high would come within the purview of a Regulation – reason being that failure of such companies could result in serious implications on the economy of the country at large. Insurance business involves collection of money from various Policyholders, investing them properly, honouring the obligations of the Policyholders and providing an efficient service. It is important to ensure that the entities providing these services stick to their commitments. Failure to honour commitments by such entities could have major repercussions on the financial services industry. After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers

and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.

14.8.1 Powers/Functions of IRDA

Under Section 14 of the IRDA Act, IRDA has the following powers:

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

(c) Specification of requisite qualifications, practical training and code of conduct for insurance agents and intermediaries.

(d) Specification of code of conduct for surveyors and loss assessors.

(e) Promoting efficiency in the conduct of insurance business.

(f) Promoting and regulating professional organizations connected with insurance and reinsurance business.

(g) Levying fees and other charges for carrying out the purposes of the Act.

(h) Calling for information from or undertaking inspection of insurance companies, intermediaries and other oganisations connected with insurance business.

(i) Control and regulation of rates, terms and conditions that may be offered by general insurance companies.

(j) Specifying the form and manner in which books of account shall be maintained by insurance companies and intermediaries.

(k) Regulation of investments of funds by insurance companies.

(l) Regulation of maintenance of margin of solvency.

(m) Adjudication of disputes between insurers and insurance intermediaries.

(n) Supervising the functioning of Tariff Advisory Committee.

(o) Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations.

(p) Specifying the percentage of insurance business to be undertaken by insurers in rural or social sectors.

(q) Such other powers as may be prescribed.

14.9 Pension Fund Regulatory Development Authority (PFRDA)

Pension Fund Regulatory and Development Authority (PFRDA) was established by the Government of India on 10th October 2003 to promote old age income security and to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental there to. The Central Government has introduced the National Pension System (NPS) with effect from 1st January 2004. The NPS covers, at present, new entrants to Central Government services (excluding Armed Forces), some State Government services and autonomous bodies at their discretion and all citizens of India on a voluntary basis with effect from 1st May 2009. PFRDA has since been constituted under the provisions of the PFRDA Act 2013 w.e.f. 1st February 2014. PFRDA is responsible for appointment of various intermediate agencies such as Central Record Keeping Agency (CRA), Pension Fund Managers, Custodian, NPS Trustee Bank, etc. Currently, PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.

14.9.1 Functions and Powers of PFRDA

- Regulate and ensure orderly growth of NPS and other pension schemes.
- Registering and regulating intermediaries.

- Protecting interest of subscribers by ensuring safety of contribution and by ensuring that intermediation and operational costs under NPS are economical and reasonable.
- Promoting professional organisations connected with pension system, research and projects.
- Adjudicating of disputes between intermediaries and between intermediaries and subscribers.
- Residuary powers like inspection, conducting inquiries, investigation, audit.
- Powers of Civil Court for the purpose of examining persons, inspection of books, register etc.
- Powers of restrain, impounding and retaining proceeds etc.



CHECK YOUR PROGRESS

Q 4: Mention two powers of IRDA.

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Q 5: Mention two powers of PFRDA.

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14.10 LET US SUM UP

The main aspects covered in this unit are -

- The major aim of financial regulation is to maintain integrity of the financial market.
- The RBI is the primary regulator of banks. The Reserve Bank of India Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over the entire banking system.
- The SEBI was given statutory powers to regulate the capital market on 30 January 1992 through the Securities and Exchange Board of India

Act, 1992.

- After liberalisation and entrance of Private players in Insurance business and seeing the large numbers of customers and high risk potential, Government of India constituted the Insurance Regulatory and Development Authority in Year 1999.
- PFRDA is regulating and administering the National Pension System (NPS) along with administering the Atal Pension Yojana (APY) which is a defined benefits pension scheme for the unorganized sector, guaranteed by the Government of India.



14.11 FURTHER READING

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14.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two Objectives of financial market regulation are:

(a) To protect the interest of the investor and consumer of the financial services.

(b) To maintain stability in the financial system.

Ans to Q No 2: Two powers of RBI are-Power to issue license and Powers

to regulate the business of banking.

Ans to Q No 3: Following are the two powers of SEBI:

(a) To regulate stock exchanges and the securities industry to promote their orderly functioning.

(b) To protect the rights and interests of investors, particularly individual investors and to guide and educate them.

Ans to Q No 4: Following are the two powers of IRDA

(a) Issue of Certificate of Registration to insurance companies, renew, modify, withdraw, suspend or cancel the certificate of registration.

(b) Protection of interests of policyholders in matters concerning assignment of policies, nomination, insurable interest, claim settlement, surrender value and other terms and conditions of insurance contract.

Ans to Q No 5: Following are the two powers of PFRDA

(a) Regulate and ensure orderly growth of NPS and other pension schemes.

(b) Registering and regulating intermediaries.



14.13 MODEL QUESTIONS

Q 1: Discuss the functions of SEBI.

Q 2: Discuss the regulatory powers of RBI.

Q 3: Discuss the powers and functions of IRDA and PFRDA.

Q 4: Explain the regulatory environment of financial markets in India.

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Name of the Paper: **Course Code:**

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Learner's Feedback on Course

Dear Learner,

Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

The Director, Centre for Internal Quality Assurance, KKHandiqui State Open University
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1. Approximately how many hours did you spend for studying the units in the course? | | | |
2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II.	The units of the SLM could satisfy my academic needs and expectations					
III.	The Unit writers have excellent knowledge about the course contents					
IV.	Language and contents of the units were presented at a level which I could readily understand					
V.	Ample opportunity for participation in the activities provided in the units					
VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
VII.	Quality of content is engaging, relevant, and up-to-date					
VIII.	The self check questions are very helpful					
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot					

Additional Comments: *(Please feel free to provide your open comments)*

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

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2. What sort of changes/improvements do you feel KKHSOU could implement to improve the overall quality of the SLM?

Thank you for taking the time to complete this form.

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