

Overview of the Indian Financial System; Financial Institutions and Financial Markets are only required from this Module (Page: 1-127).

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Module 1

Overview of the Indian Financial System

FINANCIAL SYSTEM

Unit structure

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1. 0 Objectives

- 1. To understand the meaning and structure of a financial system.
- 2. To study the functions of a financial system
- 3. To examine the role of financial system in an economic system.

1.1 Introduction

An economy can attain welfare of the people through production and proper distribution of goods and services. The basic economic activities like production and distribution of goods and services require funds or finance. The financial system consist of the ways and means whereby it can render service to the real sectors for their operations and growth.

The financial system consist of the institutions, markets and services. It ranges from credit societies, money lenders, banks, insurance companies, investment trusts to stock exchanges. Its instruments ranges from coins, currency notes, cheques, bills, bonds, stocks to futures and swaps. Market for these instruments may be organized or unorganized consisting of money market, capital market and others.

A financial system also provide services which are essential for the economic development of the country. Therefore it is said that money, credit and finance are the life blood of an economic system. Given the resources, a well developed financial system can contribute of fast development of an economy.

1.2 Meaning of Financial System

“The financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which **savings are transferred into investments**” (by Prof. Prasanna Chandra).

Financial system of any country is made up of specialized and non-specialised financial institutions. It also consists of organized and unorganized money markets, which provide services and facilitate transfer of funds with the help of financial instruments.

According to S.B. Gupta, “Financial system is a set of institutional arrangements through which financial surpluses available in the economy are mobilized.”

The above definitions draws our attention to the following points.

- (i) Constituents of financial system.
- (ii) Structure and aspects of financial system, and
- (iii) Functions of financial system

1.3 Structure of Financial System (Inter-relations)

Structure of financial system consists of parts and sub-parts of the system is simple and narrow in scope. In modern economy, the structure of the financial system gets complex in terms of its broad network and instruments.

Structure of financial system has organized and unorganized components.

The organized component consists of diverse institutions providing wide choice to savers to lend their funds. The financial assets in organized system are bank deposits, P.O. deposits, corporate deposits, shares, debentures, insurance policies, units of UTI, etc.

Inter-relationships:

The structure of financial system helps to understand inter-relationships within the system. For instance, commercial banks which are ‘core’ institutions operate in both money market as well as capital market. As such, there exists close inter-relationship between interest rate of funds for different time period. Similarly, there are close

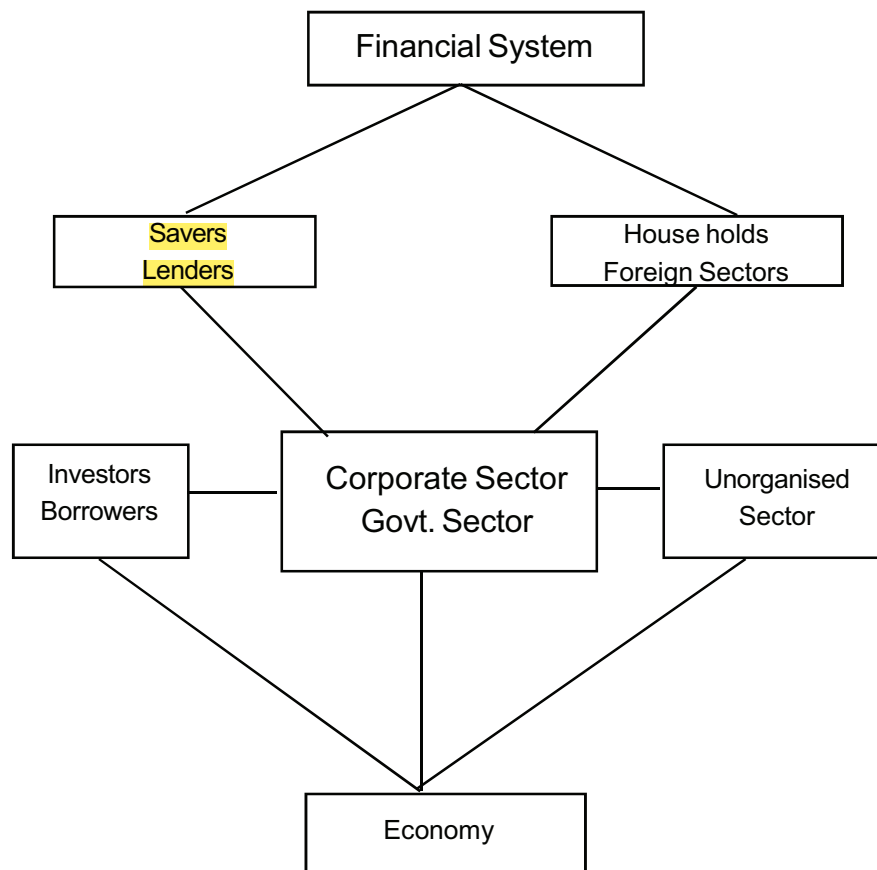


Chart 1 Interrelation between the Financial System and the Economy

market (stock exchange). So also there is interdependence of financial assets i.e. suppliers have wide choice among bank deposits, insurance policy, P.O. deposits, company deposits, shares, etc.

The financial system also induces people (savers) to convert their surplus into financial assets. For example people holding unproductive assets may convert them into physical assets like housing, land, etc.

Banks play an important role in credit creation monitored or controlled by the RBI.

The structure of Financial System:

The structure of financial system consists of following :

- (a) Financial Institutions (FIs).
- (b) Financial Markets (FMs)
- (c) Financial Instruments and Services:

Financial institutions are also called as intermediaries. Such institutions are called : institutions and non-banking institutions.

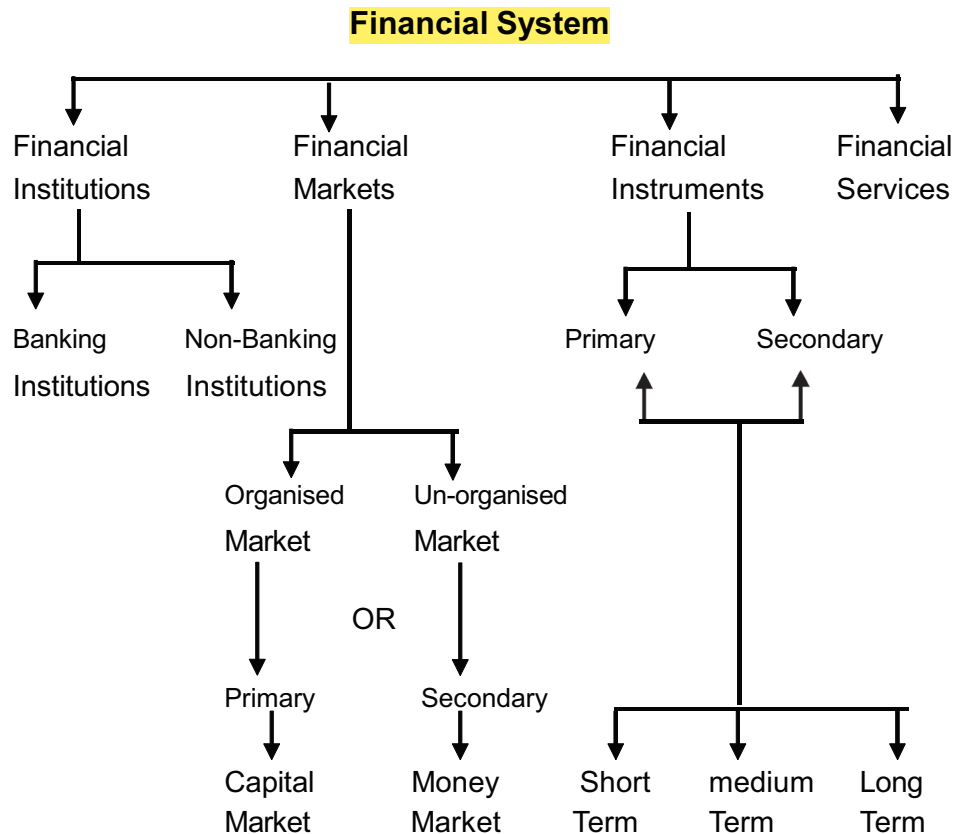


Chart 2 : Structure of Financial System

In India, the banking system comprises of commercial banks and co-operative banks. Non-banking institutions comprise of Life Insurance Corporation (LIC), Unit Trust of Indian (UTI), and Industrial Development Bank of India (IDBI). These financial intermediaries intermediate between savers and investors. They lend money as well as mobilize savings. Their liabilities are towards the ultimate savers while their assets are from the investors or borrowers.

Non-intermediaries do the lean business but their resources are not directly obtained from the savers.

(b) Financial Markets :

Financial system operates through financial market and institutions. Financial market is “a centre that provides facilities for buying and selling of financial claims and services”. It deals with the financial instrument such as currency, deposits, cheques, bills and bonds.

Analytically, financial markets are very much like market for goods and services. They have two sides, viz. demand for money and supply of money.

The structure of financial market can be classified as follows :

- (i) Primary and secondary markets

- (ii) Money and capital markets
- (iii) Organised and unorganized markets

(i) Primary and Secondary Market :

The primary markets deal in the new financial claims or new securities. They are also known as 'New Issue Market'.

The secondary market deals in securities already issued or existing on outstanding.

Primary markets supply fresh capital to business units. Secondary markets supply capital indirectly to the business unit.

(ii) Money and Capital market :

Financial market can also be classified into money market and capital market. There is no essential difference between the two markets because both perform the same function of transferring the money resources to the businessmen or producers.

Money market deals in short term claims (with a period of maturity of one year or less).

Capital market deals in the long term claims (with a period of maturity of one year or above).

(iii) Organised and Unorganised Market :

Organised market is a well integrated market. It consists of foreign banks, cooperative banks, commercial banks, other finance companies, mutual funds etc. The RBI is an apex organization in the Indian money market.

Unorganised sector of money market comprises of the indigenous bankers, the money lender and unregulated non-bank financial intermediaries such as finance companies like chit funds and nidhis.

(c) Financial Instruments and Services :

Financial system deals in financial instruments or assets or services.

Financial assets or claims can be classified into two -viz.

- (i) Primary or direct securities, and
 - (ii) Secondary or indirect securities
- (i) Primary or direct securities** are financial claims against real sector units. For example, bills, bonds, equities, debentures etc. They are created by real sector units as ultimate borrowers for raising funds to finance their deficit spending.
- (ii) Secondary or indirect securities** are financial claims issued by financial institutions or intermediaries against themselves to raise

funds from the public. For example, the bank deposits, life insurance policies, UTI units, IDBI bonds, bank deposits etc.

Indian economy has important financial assets like currently, bank deposits, post office saving deposits, life insurance policies, provident fund, bonds, bills, hundies, UTI units, NIDHIs, chit funds etc.

Financial instruments differ from each other in respect of their investment. The important characteristics of financial assets are:

(i) Liquidity (ii) Marketability (iii) Reversibility (iv) Transferability (v) Transaction cost (vi) Risk and uncertainty and (vii) Maturity period.

Thus, as stated above financial system is a set of complex and interrelated financial institutions, markets, instruments, services, practices etc.

A financial system is a set of institutional arrangements through which financial resources can be mobilized from surplus units to deficit units.

Financial system can be categorized into

(a) The organized segment, and

(b) The unorganized segment

(A) The organized segment:

It comprises the RBI, commercial banks, co-operative banks, NBFIs, foreign bank etc. It is called organized because its parts are systematically co-ordinated by the RBI. Non bank financial institutions (NBFIs) such as LIC, GIC, UTI etc. also operate in their market. Similarly big companies also make financial transaction through banks.

Besides, commercial banks, there are cooperative banks as well. They play important role in the organised sector. Cooperative credit societies have a three-tier structure i.e.

- (i) At an apex level, there are state cooperative banks,
- (ii) At the district level, there are central cooperative banks, and
- (iii) At the lowest or village level, there are primary credit societies or Urban cooperative banks.

The functioning of cooperative banking is regulated by the RBI. The RBI deals with state cooperative banks. The RBI control the size, methods of operation of the cooperative banks.

The organised sector of the Indian money market is fairly developed yet it is not comparable to the New York or London money market. Let us discuss the main constituents of Indian money market.

Constituents of Indian money market:

- (i) The Call Money Market

- (ii) The Treasury Bill Market
- (iii) The Repo Market
- (iv) The Commercial Bill Market
- (v) The Certificate of Deposits Market
- (vi) The Commercial Paper Market
- (vii) Money Market Mutual Fund
- (viii) Government Securities Market

(i) The Call Money (CM) market :

The call money market exists in almost all developed money markets. In India CM market is centered mainly at Mumbai, Kolkata and Chennai. Among these, Mumbai is the most important CM market. In the call money market, borrowing and lending transactions are carried out for one day. These loans are often called as 'Call Loans'. They may or may not be renewed the next day. The CM market is also known as 'inter-bank' call money market. It consists of scheduled commercial banks, cooperative banks and Discount and Finance House of India (DFHI). Institutions like the UTI, LIC, GIC, IDBIs are operating in this market as 'Lenders'. Brokers Play an important role in CM market.

(ii) The Treasury Bill (TB) Market :

The market which deals in Treasury bills known as Treasury Bills market. In India TBs are short term (14-day, 91-day, 182-day and 364-day) liability of the Central Government. TBs should be issued for meeting temporary deficits which a government faces due to its excess expenditure over revenue. Treasury bills market is less developed in India. Except the RBI, there are no major holder of TBs. The other holders of TBs are commercial banks, State Governments, non-bank finance Intermediaries such as, the LIC, the UTI.

(iii) The Repo Market :

Repo is a money market instrument which helps in short-term borrowing and lending. Under a repo transaction, securitise are sold by their holder to an investor with an agreement to repurchase them at a predetermined rate and date.

(iv) The Commercial Bill (CB) market :

The commercial bill market is a sub-market in which trade bills or the commercial bills are handled. CB is a bill drawn by one merchant firm on the other. Generally, CBs arise out of domestic transaction.

In India commercial bill market is highly underdeveloped due to:

- (a) Popularity of cash system in bank lending, and
- (b) The un willingness of the larger buyer to bind himself to Payment discipline associated with the commercial bill.

Thus, commercial bills act as an important instrument of credit to both business firms and banks.

(v) The Certificate of Deposit (CD) Market :

A Certificate of Deposit (CD) is a certificate issued by a bank to depository of funds that remain on deposit at bank for a specified period. Thus, CDs are similar to the deposit but CDs are negotiable and tradable in short-term money markets.

Since 1989, CDs are introduced with the objective of widening the range of money market instruments and to provide flexibility to the investors.

CDs are issued by the commercial banks in multiples of Rs.25 lakhs. The maturity of CDs varies between three months to one year as in the case of government securities.

The interest rate paid on CDs by commercial banks is high. Since its introduction, CDs have gained considerable popularity.

(vi) The Commercial Paper (CP) Market :

The commercial paper (CP) is a short-term instrument of raising funds by corporate. It is a kind of unsecured promissory note sold by the issuer to a banker or a security house. In India, the CP was introduced in Jan. 1990. The CP can be issued by a listed company which has a working capital of not less than Rs.5.00 crore with maturity ranging from three months to six months. They would be issued in multiples of Rs.25 lakhs subject to minimum size of an issue being Rs.1 crore.

The interest rate of CPs varies between 11 to 21 per cent. The amount of money under CPs was Rs.2,040 crores in June, 1993. Till today 556 companies have issued CPs.

(vii) Money Market Mutual Funds (MMMF):

A money market mutual funds (MMMFs) was introduced by the RBI in April, 1992. The objective of the scheme was to provide an additional short-term avenue to the individual investors.

The RBI permitted certain relaxations in November, 1995, with a view to make the scheme more flexible. The ceiling of Rs.50 crore on the size of MMMFs are allowed to issue units to corporate enterprises and others on par with mutual funds. The lock-in-period for the scheme is now 15 days. Resources mobilized by the MMMFs are now required to be invested in call Money, CDs, CPs, Commercial Bills, TBs and government securities. The MMMfs have been brought under the purview of the SEBI regulations since March, 2000.

(viii) Government Securities Market:

The government securities market is known as the gilt-edged market. Since the government cannot default on its payment obligations, the Government securities are risk-free and hence known as gilt-edged.

Features of Government Securities:

- (1) Risk-free and returns are guaranteed.
- (2) The Government securities market consists of two parts viz;
 - (i) New issue market, and
 - (ii) Secondary market
- (3) The RBI plays an important role in the government securities market. The RBI is the sole dealer in government securities market.
- (4) The investors in the gilt-edged market include the institutions like, the LIC, the GIC, commercial banks and provident funds. They mobilize the savings of the people through their various schemes.
- (5) Government Securities are the most liquid debt instruments.
- (6) For several years, government securities market in India has been an 'over the counter market', since June 1992 it has become discriminatory auction market.

(B) Unorganised segment:

The unorganized segment is called the unorganized market. It is made up of indigenous bankers and money lenders. (Professional and non-professional) It is unorganized because activities of their market are not systematically co-ordinated by the RBI or any other authority.

The main participants in the unorganized money market are money lenders, indigenous bankers, nidhis and chit funds. They give loans to the borrowers who are not able to obtain loan or credit from the institutions under organized segment of the money market. The characteristics of unorganized money market are :

- (i) Informal procedures to get loan
- (ii) Flexible and attractive interest rates to the depositors, and
- (iii) High rate of interest to the borrowers.

Unorganised money market consists of following:

- (a) Unregulated non-bank financial intermediaries
- (b) Indigenous bankers
- (c) Money lenders

Let us discuss the constitution of unorganized money market stated above in detail.

(a) Unregulated Non-Bank Financial Intermediaries:

The unregulated non-bank financial intermediaries consist mainly of-

- (i) Finance companies,
- (ii) Chit funds
- (iii) Nidhis

(i) Finance companies: Often succeed in raising a large part of funds in the form of deposits, borrowings and other receipts. Finance companies give loans to retailers, wholesale traders, artisans and other self-employed people. Finance companies under unorganized segment, charge a very high rate of interest ranging from 36 to 48 per cent.

(ii) Chit Funds are saving institutions, which lack any standardized form. Unit's funds have regular members who make periodical subscriptions to the funds.

Kerala and Tamil Nadu account for the major part of the chit funds business.

(iii) Nidhis operate particularly in South India. They are similar to the mutual funds in some respects because their dealings are restricted only to members.

Since the Nidhis operate in the unregulated credit market, a very less information is available about the amount of money transacted in the lending business by them.

(b) Indigenous Bankers:

Indigenous Bankers and individuals or private firms who get deposits and give loans and thereby operate as banks. Since the monetary activities or transactions are not regulated by the RBI on any other authority, they belong to the unorganized sector of the money market. Like money lenders, indigenous bankers are flexible, informal in their approach and are quick in their operations.

Their accounts are simple and accurate. Indigenous bankers accepts deposits from the public for short-term as well as for long-term. The interest rate paid by them ranges between 3 to 9 percent. Generally, the indigenous bankers follow certain methods in conducting the business such as following.

(i) To lend money on written demand promissory notes. If the amount of loan is large in size, the Promissory notes have to be attested by the sureties. In the absence of attestation, high interest rate is charged.

(ii) Loans are also made against mortgage of lands, houses or properties. Indigenous bankers who make use of indigenous exchange

bills called Hundis and discount them for the purpose of the supply of credit.

However, with the growth of modern organized banking and the institutionalization of financing activities, indigenous bankers have started declining.

(c) Moneylender:

Money lending business is very much common in Indian money market, in both rural as well as urban areas.

Generally, money lender are of the types :

- (i) Professional money lenders.
 - (ii) Non-professional money lenders.
 - (iii) inherent money lenders
- (i) Professional money lenders :** Main activity is money lending i.e. giving loans to the people in rural and urban areas.
- (ii) Non-professional money lenders** undertake money lending as a secondary activity of their business.
- (iii) Inherent money lenders** are also included in lending business. They are mainly Pathans and Kabulis

Main features of Money lenders :

- (i) They charge a very high rate of interest.
- (ii) They indulge in mal-practices like charging of compound interest, manipulation in loan records, exploitation of labour from the poor barrowers.
- (iii) They give loans to illiterate or uneducated people who are poor and can not get loans from organized money market.
- (iv) They give loans for productive as well as unproductive uses.
- (v) They do not create or accept hundis, commercial bills etc.

Since the nationalization of commercial banker and development of banking institutions, the role and importance of unorganized financial institutions is declining in rural as well as urban areas in India.

Check your progress

1. Define a financial system.
 2. What are the main functions of financial institutions in India ?
 3. Classify the financial market in India
 4. Differentiate between Primary securities and Secondary securities.
 5. Write a note on unorganized segment of money market ?
-
-
-

1.4 Constituents and Role of Indian Financial System

Constituents of Indian financial system are as follows

- (1) Institutions
- (2) Markets
- (3) Instruments (or Services)

The constituents of financial system are varied in nature i.e. financial institutions, market, instrument and services are interrelated and not mutually exclusive.

(A) Financial Institutions :

According to Dr. LM.Bhole, “Financial institutions are business organisations that act as mobilisers and depositories of savings and as purveyors of credit or finance.”

Financial institutions are also called as financial intermediaries. They are classified into (a) banking institutions.

(b) non banking institutions

(a) Banking institutions or banks- Banks mobilize savings by accepting deposits and granting loans to the people and firms. They are called as “creators” of credit e.g. the RBI, commercial banks and co. operative banks.

(b) Non-banking institutions : Non banking institutions also mobilize financial resources directly or indirectly from the people and lend funds but they do not create credit. They are called as “purveyors” of credit.

Example : Like Insurance Corporation (LIC), Unit Trust of India (UTI) and Industrial Development Bank of India (IDBI).

Financial institutions can be also classified into **intermediaries and non-intermediaries**. Financial intermediaries intermediate between savers and investors. They lend money as well as mobilize savings. All banking institutions are intermediaries. Non-banking intermediaries give financial assistance for specific purpose, sectors and regions. For example, non-banking institutions like LIC, GIC, UTI, PF channelize the funds from savers under the various schemes and lend the funds for investment.

(B) Financial Markets :

Financial system operates through financial markets and institutions. Financial markets are the centers which provide the services for the financial transactions. They deal with different financial assets or instruments such as currency, cheques, bills and bonds.

Financial markets are classified into : (a) Primary market. and
(b) Secondary market.

(a) Primary market :deals with new financial claims and securities. So, they are also know as '**New Issues Market**'. Thus, they mobilise saving and supply additional capital.

(b) Secondary Market:deal with the assets which are already issued. They do not contribute to the supply of capital directly.

Financial markets are also classified into: (a) Money and (b) Capital Markets.

Money market deals in short-term claims (with maturity period of one year).

Capital market deals in **long-term claims** (with maturity period above one year).

Thirdly, financial markets are classified into:

(1) Organised market.and

(2) Unorganised market.

- Organised money market consists of commercial banks, co-operative banks and the RBI.
- Unorganised money market consists of money lenders, Shroffs, and indigenous bankers. They are beyond the purview of coordination and control.
- **Organised Capital Market** consists of banks and non-banking financial institutions such as IDBI, Development Financial Institutions (DFIs), insurance Companies, UTI and stock market.
- Unorganised capital market consists of Nidhis funds And informal financial companies.

(C) Financial instrument (assets) or services :

Financial instrument are the financial assets or claims which form an important part of the financial system. For example (i) deposits with the banks, companies, corporate and post office, (ii) Insurance Policies,(iii) the National Saving Certificates (NSCs), (iv) Provident Fund, (v) Pension funds, (vi) equity shares and debentures and securities.

Primary Securities are the financial claims issued to actual savers for the mobilization of savings e.g. securities issued by companies, corporate and government and subscribed by people with surplus banks and other financial institutions.

Secondary Securities : The banks and other financial institutions (LIC, UTI) which issue financial claims against themselves are called secondary securities. This enables them to generate resources out of which they create direct funds for subscribing to primary securities.

1.5 Role of Financial System

The financial system plays a crucial role in the functioning of the economy because it helps the transfer of resources from the depositors to the households, businessmen, traders, and governments. In general, it accelerates the process of economic growth.

The financial system provides instruments and services that are essential for a modern developing economy. Economic development of a country is determined by the financial structure markets and its instruments. Saving and investment act as a fuel for the development. Consistent and complete mobilization of financial resources facilitate the economic growth.

Balanced development of a financial system guarantees the improvement in the performance of the financial institutions and the instruments used by them. Macro economic stability better accounting regulatory system are the foundation of a good financial system

The main function of a financial system are 1) To promote savings and its mobilization. 2) Efficient distribution of saving from the social and economic points of view and 3) To facilitate the activities like exchange of goods and services like trade and commerce in the economy.

In the post reform period after liberalization the finance sector has witnessed a huge change in the function. Deregulation measures consisted in freeing the direct controls, liberalizing interest rates and credit allocation, deregulating foreign exchange, transaction controls, free entry of new firms, broadways the base of financial system.

Thus, financial system establishes a link between depositors and investors and thereby encourages savings and investment in an economy. Its allocates the resources efficiently. Its ultimate goal is to attain an economic development of country.

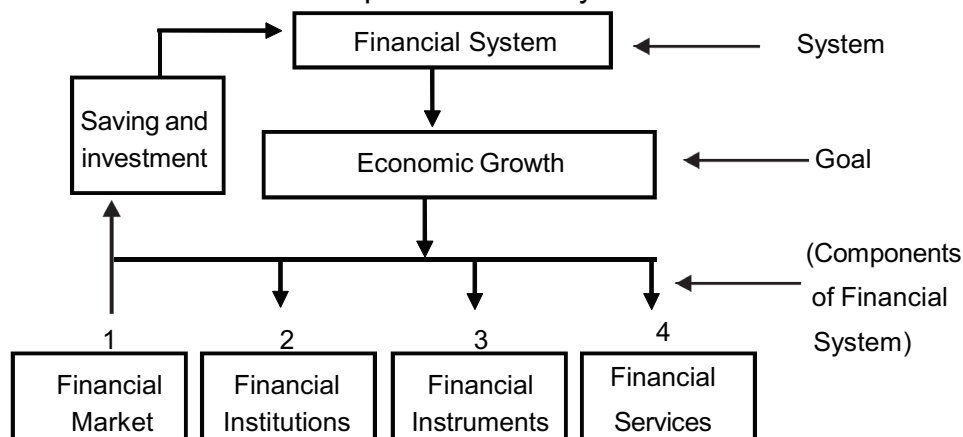


Chart 3

The important role of financial system is to mobilize savings and generate resources for productive uses. The financial system has to co-ordinate the decision of savers and convert savings into financial assets. The financial system acts as a circuit of transformation of financial resources (savings) into investment. Financial system therefore, provides a mechanism to mobilise the resources into assets.

To play this important role in the economic system, the financial system has to perform the following functions:

Check your progress

1. Discuss the role of financial system in the functioning of the Indian economy.

1.6 Functions of Financial System

- (1) Financial system helps exchange of goods and services by providing credit, loan and other related services.
- (2) It mobilizes funds or financial resources and transform them
- (3) It invest into assets which helps to raise the production of goods and services.
- (4) It also provide arrangements for the transfer of finance across time and space.
- (5) It provides ways and means for managing uncertainty and risks.
- (6) It helps in generating information and helps decision-making.

Functions (in detail)

(1) Exchange of goods and services: Transactions can take place by the payment, which are helped by the financial system through the instruments like Hundi, bills of exchange, etc. Thus, buying and selling of goods and services seek access to bank credit which help them to undertake their exchange activities more conveniently and freely. The commercial banks play an important role in helping the transaction of goods and services by providing the people credit facilities. The banks also create credit and extend facilities to the people in different forms of credit.

(2) Promotion of savings and investment: In order to promote capital formation, funds or resources have to be channelized from savers to the

investors. It is the function of the financial system to mobilize the funds and transform them into financial securities and assets to meet the capital needs of the production units. The banks and financial institutions, thus, act as a link between savers and investors by the mobilization of resources into investment for production.

(3) Mechanism for the transfer of financial resources: The people sell their labour and earn incomes which they spend on the fulfillment of daily requirement (consumption) and keep aside a part of their income as 'savings'. This saving forms as an important source of finance for the real sector for the production of goods and services.

The financial system has to play the role of transforming funds from surplus holders to the borrowers. This is nothing but the function of banks in terms of accepting deposits and lending the money to the borrower. Thus, financial system helps not only in the transfer of savings (financial resources) but promotes savings by offering wide options to the investors to invest in the real sector.

(4) Risk and Uncertainty Management: Future is unknown for everyone. The risk and uncertainty involved in future investment urge for the management of risk. Mostly people save or invest in low risk options, such as bank deposits, post office or busy saving certificate. People prefer short-term lending, so they can manage risks. The financial system including banks and non-bank institutions deal with different assets, consider and provide the option for risk and uncertainty management.

(5) Generation of Information: Financial system also generates information relating to different options of lending and borrowing. Thus, the savers as well as borrowers get the knowledge of financial opportunities and channelize investment.

In the present day world, the developments in the field of Information Technology (IT) have expanded the scope of investment at a global level. Domestic financial markets also have closer link with the international market because of electronic communication system.

Interrelation between finance and development:

The relationship between finance and development could be viewed as "Virtuous circle" between, them. Availability of finance encourages economic growth, which in turn leads to financial growth.

Savings and investment are motivated by the financial institutions when the saving rate is raised the savings are enhanced and they get channelized into investment into productive projects. So also financial development is accompanied by formation of human capital (with new skills and capabilities). Financial market mitigated capital (with new skills

and capabilities). Financial market mitigate risks, reduce uncertainties and raise efficiency of investment leading to increased production.

Thus, an efficient financial system contributes towards economic growth in a number of ways.

- (i) It provides different financial assets to attain a good return on investment.
- (ii) It minimize risk and uncertainty.
- (iii) It leads to capital productivity through efficient allocation of resources.

1.7 SUMMARY

In this unit we have understood that a financial system is a set of financial institutions, markets, instruments and services. Financial institutions can be classified as banking and non-banking institutions or intermediaries. Financial markets can be classified in many ways. Such as money market and capital market or primary and secondary market or domestic and foreign markets.

Financial system deals with various instruments and services. Organized sector deals call money (CM) , commercial paper (CP) Certificate of deposits (CDS) repos and treasury bills (TBs) . On the instruments like Chit funds, Nidhis loan etc. Thus financial services offer services that are essential in a modern economy. The main function of a financial system is to transfer the funds from savers or depositors to the borrowers.

1.8 Questions

1. Define financial system and discuss the important functions of it ?
2. How does financial development influence the economic development ?
3. Explain the components of financial system
4. Explain the instruments of financial markets .
5. Discuss the role of financial system.



INDICATORS OF FINANCIAL DEVELOPMENT

Unit structure

- 2.0 Objectives
- 2.1 Introduction
- 2.2 Financial system and economic development
- 2.3 Indicators of financial development
- 2.4 Summary
- 2.5 Questions

2.0 Objectives

1. To understand the role of a financial system in economic development.
2. To study the meaning and importance of the indicators of financial development.

2.1 Introduction

This unit throws light on the role of financial system in economic development. It has been discussed by the production theories that money or capital being the input in the process of production and influence the economic development through savings and investment.

The Indian financial system has grown tremendously since 1950. The indicators like Finance Ratio (FR), Financial Interrelation Ratio (FIR), New Issue Ratio (NIR) and Intermediation Ratio (IR) have shown the growth of our financial system. These ratios not only measure the performance of a financial system but also help to determine the corporate value.

The Indian Financial system has widened and deepened significantly and has shown great ability towards mobilization of savings and meeting needs of trade and industry.

2.2 Financial System and Economic Development

Financial system plays an important role in economic development of a country. Economic development of a country is possible only when National Income, saving, investment and employment show an increase. A strong financial system allows a risk in saving and investment and thereby can promote employment, production and income. Thus it can bring all-round planned economic development in the country.

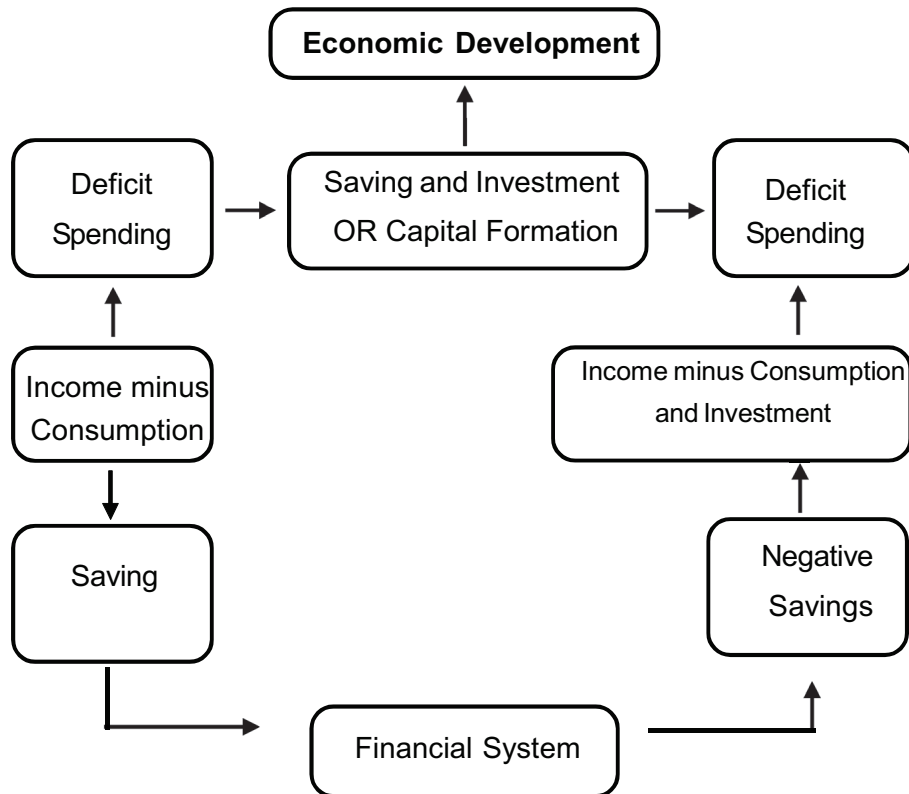


Chart 1 Financial System and Economic Development

The Indian financial system through its network of banks and other financial institutions offers wide range of service which function in both money and capital markets.

One significant aspect of the financial system is that it has a mechanism to facilitate both production and exchange of goods and services by using the resources for lending as well as creating the credit. The commercial banks help the production of goods and services by granting loans or credit to the producers (borrowers). The financial institutions like banks then create credit in anticipation of mobilization of savings. Thus, financial system accelerates economic development. Due to an increase in saving and investment the income also rise in future.

In brief, financial system helps economic development in following ways :

- (a) Encouraging savings through different investment options to the deposits.
- (b) Distributing savings in effective manner.
- (c) Facilitating trade, commerce, industry, agriculture towards the attainment of economic development.

Interrelation between finance and development : The relationship between finance and development could be viewed as 'Virtuous circle' between them. Availability of finance encourages economic growth; economic growth in turn lead to financial growth.

Check your progress :

1. Explain the role of financial system in economic development.

2.3 Indicators of Financial Development

Development of finance in India can be studied by following indicators.

(a) **Finance Ratio (FR)**, which is the ratio of sum of issues of primary and secondary claims to the National Income.

$$\text{i.e.} \quad \left[\text{FR} = \frac{\text{Total Issues}}{\text{National Income}} \right]$$

(b) **Financial Inter-relation Ratio (FIR)** is the ratio of financial assets to physical assets.

$$\text{i.e.} \quad \text{FR} = \left[\frac{\text{Total Issues}}{\text{Net Capital Formation}} \right]$$

(c) **New Issue Ratio (NIR)** is the ratio of primary issues to the physical capital formation

$$\text{i.e.} \quad \text{NIR} = \left[\frac{\text{Primary Issues}}{\text{Net Capital Formation}} \right]$$

(d) **Intermediation Ratio (IR)** is the ratio of secondary issues to primary issues

$$\text{i.e. IR} = \left[\frac{\text{Secondary Issues}}{\text{Primary Issues}} \right]$$

These indicators are presented in the following table. All have shown significant rise, implying that the importance of financial system has grown in India.

(Amount in Rs. Crores)				
ITEMS	1951-52	1965-66	1980-81	1995-96
1. Secondary Issues	-71	1108	15098	179116
2. Primary Issues	140	2409	19824	255192
3. Total Issues	69	3517	34921	434308
4. Net capital formation	829	3161	23373	-
5. NNP at factor cost at Current prices	9141	20.637	10.5743	941861
6. Finance Ratio	0.007	0.1704	0.3303	0.493
7. Financial Inter-relation Ratio.	0.08	1.11	1.49	2.26
8. New issue ratio	0.17	0.71	0.85	1.328
9. Intermediation ratio	-	0.46	0.76	0.702

Chart 2.1

The levels and changes in FIR indicate that the growth of financial structure had been then the growth of National Income in India. Similarly, there has been remarkable rise in the institutionalization of financing investment and gap between saving and investment has grown.

Sectors of Economy and the Financial System :

- (i) Corporate sector and Financial system
- (ii) Household sector and Financial system
- (iii) Govt. or public sector and Financial system
- (iv) External or Foreign sector and Financial system

(i) Corporate sector and Financial system :

Corporate sector consists of private limited companies and public limited companies and co-operatives. These units are relatively large-scale companies engaged in production, trading and financial services. This sector requires short-term and long-term capital, These sector units faces shortage of funds for their investment. The private sector units

have access to credit from the commercial banks and new issues market. So also they have to follow other modes of finance as equity issues, public deposits, debt financing or borrowing, etc.

(ii) Household sector and financial system :

Household sector includes individuals, their families, small enterprises in trade, industry and agriculture. Their savings are large and small, out of surplus income (after spending income on consumption). The prime function of financial system is the mobilization of savings in country.

There are two components of household sector saving : (i) **Physical assets** including equipment, machinery, construction etc. and (ii) **Financial assets** like bank and non-bank deposits, LIC policies, units of UTI, shares, debentures, etc.

Savings in an economy cannot be maintained at a steady rate. It is affected by economic conditions, interest rates, size of income, motives for savings, govt. policies, tax rates etc.

Regarding the mobilization of savings to meet investment requirements, the developing countries give rise to saving-investment gap, showing their dependence on the flow of capital from abroad. Among all sectors, the household sector generates a surplus i.e. net saving, as against the deficit arising in the private corporate sector and the govt. sector or public sector.

In brief, the household sector saving and the financial system are inter-linked in regard to their progress and growth.

(iii) Govt. or Public sector and Financial system :

Government plays an important role in economic development of developing countries. Govt. or public sector includes govt. companies and corporations. The govt. has to undertake different expenditures on public capital project, defence, education, poverty eradication, health programmes, roadways, communication, etc. The sources of govt. revenue such as taxation, levies, duties do not generate sufficient income to the govt. to fulfill, govt expenditure. There are additional sources of income such as RBI, UTI, IDBI, GIC, LIC and other institutions or external sources like foreign borrowing. In India, debt market is becoming more important. It would enable banks and financial institutions to fulfill the financial needs of the govt. sector. The RBI would follow OMO (Open Market Operations). The debt market would encourage development in new products for risk management enabling market participants to manage interest rate risk. Thus, debt market fulfills the requirement of govt's expenditure on infrastructure, housing, etc.

(iv) External or Foreign Sector and Financial System :

Foreign investment in big industries and economic sectors has increased in recent years. Foreign investment takes place in following three ways :

- (a) Investment by MNCs and NRIs
- (b) Foreign aid or assistance
- (c) Assistance from international financial institutions.

As the private corporate sector and public sector are unable to mobilize funds required for investment, external sector gets importance in getting access to capital. The loans from international institutions and Non-resident Indian (NRI) deposits have a high burden of servicing and repayment. The policies of liberalization encouraged raising of funds by financial instruments like Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Convertible bonds etc. Further Foreign Institutional Investors (FIIs) have been given entry to investment in India. In 1996-97 Foreign Direct Investment (FDI) at \$ 2,587 million has overtaken net portfolio investment by FIIs and forms 40.22% of total foreign investment.

The 'deficit' sectors are the public sector and the private sector as they give rise to saving-investment gap so they are not able to create finance for their own investments. The household sector is net 'surplus' sector and offers its saving held in financial assets as the prime source of capital for nation and help to reduce gap between saving and investment. This gap can also be reduced by debt and non-debt creating foreign capital inflows.

2.4 SUMMARY

There has been enormous growth in Indian Financial System in terms of innovations diversity, modernization and technology. The economic development of a country depends on functioning of a financial system. Finance being a source factor in developing or less developed country like India, plays a crucial role in the economic development. A well developed financial system with adequate institutions to mobilise savings as well as transformation of savings into financial assets.

The Indian Financial System comprising impressive banks, NBFC, offer wide range of products and services in both capital as well as money markets. As such it occupies an important place in the process of economic development of India.

All the indicators of financial development namely Finance Ratio (FR) , Financial Institution Ratio (FIR), Intermediation Ratio has significantly increased.

2.5 Questions

- 1 Explain the relation between financial system and economic development.
2. Explain the following :
 - i. Financial Inter-relation Ratio (FIR)
 - ii. Finance Ratio (FR)
 - iii. Intermediation Ratio (IR)
 - iv. New issue Ratio (NIR)
- 3 Discuss the indicators of financial development



FINANCIAL SECTOR REFORMS

Unit structure

- 3.0 Obejctives
- 3.1 Introduction
- 3.2 Narsimham Committee Report, 1991-92
- 3.3 Narsimham Committee Report, 1998
- 3.4 Summary
- 3.5 Questions

3.0 Objectives

1. To study the importance of financial sector reforms.
2. To understand the Nationalism Committee Report, 1991 and 1998.
3. To Examine the recommendations of Narsimham Committee.

3.1 Introduction

The New Economic Policy (NEP) introduced structural Adjustment and Stabilisation programme. It has brought about major changes in the financial sector of India. Immediately after the initiation of NEP, the government of India had appointed a committee under the chairmanship of M. Narsimham in August 1971 to examine the aspect relating to the Indian Financial System. The committee needed to cover the structure, organization, functions and the procedures of the Indian Financial system. The committee submitted its report within 3 months in 1991. In 1998 another committee was appointed under the chairmanship of M. Narismham on Banking Sector Reforms which submitted its report in April 1998.

The main concept of committees was based on the belief that the funds of the banks come from the general public and so the funds should be used in such a manner that they generate maximum benefit to the depositors.

The reformers have positively influenced the Indian financial system as well as its banking sector by making them healthy and more competitive.

3.2 Narismham Committee Report, 1991-92.

In 1991, a high level committee was appointed under the chairmanship of M. Narsimham, which examined the aspects relating to the structure, organization, functions and procedures of the financial system and submitted its report in November, 1991.

The Committee drew attention to the progress made and the achievements of the Indian Financial System, as well as defects of the financial system. It expressed that the financial system has to be more competitive and effective to meet the requirements of the real sector during the period of New Industrial Policy (NIP), 1991.

In recommending the financial sector reforms, the focus of the committee was on ensuring that the financial services operate on the basis of operational flexibility and functional autonomy to enhance efficiency, productivity and profitability.

Recommendations are as follows :

- (1) Operational Flexibility and Functional Autonomy :** According to Narsimham Committee, financial service industry should operate on the basis of operational flexibility and functional autonomy. The internal organization of banks should be left to the judgement of managements of the individual banks. Similarly, for functional autonomy, instead of having common recruitment system for officers, individual banks should be free to make their own recruitments.
- (2) Depressed Income of banks (Low profitability) :** Factors responsible for low profitability were
 - (i) Low rate of interest.
 - (ii) System of directed investment in terms of SLR requirement. So the committee recommended that -
 - (i) SLR to be brought down to 25% over the period of five years.
 - (ii) CRR may be progressively reduced.
 - (iii) Interest rates paid to the banks on their SLR investment and on CRR should be raised and fixed at the level of bank's 1 year deposit rate.
- (3) Reduction of High level of CRR:** Since 1989, CRR was 15% of the net demand deposits and time deposit of banks. The committee has recommended that interest rate under CRR should be above

the basic minimum of 3%. It is also recommended progressive reduction in CRR.

- (4) **Reduction in Priority sector credit:** The priority sector's credit limit has to be brought down from 40% to 10%. Similarly, priority sector should be redefined and include small and marginal farmers, small business, village and cottage industries. Committee also recommended to phase out directed credit programme.
- (5) **Deregulation of interest rates :** The committee found that interest rate structure is complex and rigid. So, the interest rates should be deregulated. The concessional rates should be phased out.
- (6) **Removal of capital inadequacy:** Banks in India suffer from capital inadequacy. The committee recommended that it is to be removed within the next three years.
- (7) **Income Accounting and Loss Provisioning :**
Deterioration in the quality of loan portfolio has caused adverse effect on income generation. So, the committee has recommended -
 - (i) The assets of banks should be evaluated on the basis of their reliable values.
 - (ii) The banks and Financial Institutions should follow 'realisation' system of accounting. No income should be recognized in the accounts in respect of non-Performing Assets (NPAs)
 - (iii) An asset is to be considered non-performing if interest on such assets remains due for a period exceeding 180 days on the balance sheet.
- (8) **Special Tribunals :** Special Tribunals are to be set up to speed up the process of recovery so that the dues to the credit institutions could be realized without delay.
- (9) **Establishment of ARF:** The committee recommended that Asset Reconstruction Fund (ARF) is to be established which would take over from banks and Financial Institutions (FIs) and doubtful debts at a discount. The Govt. of India plans to provide loan to the banks and FIs in this regard.
- (10) **Erosion of Profitability on Expenditure side:** Due to massive expansion of branches, overstaffing, etc., the committee recommended (i) Abolition of branch licensing, (ii) Opening and closing of branches should be left to the commercial judgement of banks, (iii) Evolving policies for 'right sizing', (iv) Voluntary Retirement Scheme (VRS) with appropriate incentives, (v) Use of computerized system.

- (11) **Recommendation on Banks** : The committee proposed that there should not be further nationalisation of banks and new banks in the private sector to be welcomed.
- (12) **Structure of Rural Credit** : To improve the viability of Regional Rural Banks (RRBs) the committee recommended that each public sector bank should take over rural bank. Interest rate structure of RRBs should be in line with those of commercial banks.
- (13) **RBI** : Regulating agency : The committee opposed the duality of the control over the banking system by the RBI and Banking Division of Ministry of Finance. The committee recommended that the RBI should be made primary regulating agency. Further, separate authority is to be set up under the RBI for supervision of banks and DFIs.
- (14) **Foreign Banks** : The committee recommended that foreign banks should be allowed in India. There should be joint venture between foreign banks and Indian Banks. Further there is a need to lay down Prudential norms and guidelines for the functioning of new institutions like merchant banks, Mutual Funds, Leasing Companies.

3.3 Narsimham Committee Report, 1998

The Second Narsimham Committee report on financial sector reforms was submitted on 23rd April, 1998.

The following are the recommendations of the second Narisimhan Committee:

(1) Three-tier system of banking system:

The committee recommended an active movement towards a system of two or three large Indian banks with international character. On the second tier, there should be eight to ten national banks. At the third tier, there should be the remaining banks of regional or local character. This is for full convertibility and greater integration with global financial system.

(2) Separate treatment for the weak banks:

Problems of weak banks should be tackled separately. If necessary, these banks may be closed down.

(3) Solving the Problem of NPAs:

Non-performing Assets of nationalized banks are considered as bad debts and some measures will be taken to solve the huge backlog of BPAs, because it has severely affected the performance and profitability of banks.

(4) Merger of DFIs:

The committee also suggested regarding the functioning of Development Financial Institutions (DFIs) vis-a-vis commercial bank's functioning. So the committee suggested mergers of DFIs in India.

(5) Operational Flexibility for Public Sector Banks :

The committee recommended operational flexibility for public sector banks. It suggests functional autonomy to the bank management and to fix accountability for their non-performance.

(6) New Principles by BIS :

The committee recommended that new core principles set out by Bank for International Settlement (BIS) would need to be exercised. Similarly, appropriate legal framework is necessary to protect the interest of the secured creditors, especially in the bankruptcy cases.

(7) Review of sick industrial units :

As per the banking amendments, it is necessary to review the sick industrial units. The committee, therefore, recommends to review their performance.

(8) Depoliticisation of Banking Boards:

The committee has suggested that appointment of chairman and banking boards should be totally depoliticized. The committee reviewed that politicization affected the appointment of top officials of the banks. There was no such thing happened with the appointment of non-official people.

(9) Enhancing the inherent strength of the banks :

As per the committee, the second phase of financial and banking sector reforms in the country would have to emphasize enhancing the inherent strength of bank, review the structure of the system taking into account the institutional and technological dimensions.

Consequent to economic reforms took place in 1991, Indian economic system demanded for suitable banking and financial sector environment. To gain maximum benefits from global economy the financial sector needs to be given an international character as it is the backbone of the economy.

3.4 SUMMARY

The main objective of financial sector reforms is to improve the allocative responsibility of resources and accelerate process of economic growth. Reforms in banking as well as non-banking sector concentrated on the creation of degulated environment and try to strengthen the prudential norms and supervisory system.

The recommendations of Narsimham committee 1991 and 1998 were very much effective . 1991 report of the committee found the problems relating to the profitability , efficiency, quality of loan , structure of rural credit and financial services. These problems are countered by recommendations like operational flexibility financial autonomy, reduction in CRR, deregulation of interest rates, capital adequacy, norms etc. Second Narsimham committee 1998 proposed recommendations like treaties system of banking, merger of DFI, BIS principles , NPA reforms, operational flexibility etc.

3.5 Questions

1. Discuss in detail the financial sector reforms.
2. Explain the recommendations of Narsimham Committee 1991.
3. Explain the recommendations of Narsimham Committee 1998.



Module 2

Financial Institutions

Central Bank and Monetary Policy

Unit structure

- 4.0 Objectives
- 4.1 Introduction
- 4.2 Meaning of Central Bank
- 4.3 Functions of RBI
- 4.4 Monetary Policy of the RBI
- 4.5 Evaluation of Monetary Policy of RBI
- 4.6 Performance of the Monetary Policy of RBI
- 4.7 Summary
- 4.8 Questions

4.0 Obejctives

- 1. To understand the functions of the Central Bank.
- 2. To study the meaning of monetary policy.
- 3. To analyse the instruments of monetary Policy of the R.B.I.
- 4. To know the recent changes in RBI's monetary.

4.1 Introduction

Central Bank of a country plays an important role in the economic development of a country. The main function of a central bank particularly in underdeveloped country is to facilitate the work of financial institutions by promoting and maintaining a healthy atmosphere for investment and development. Similarly financial regulations is necessary to maintain faith and confidence of the people in banking.

The financial regulation in India is carried by the government, the Reserve Bank of India, the securities and Exchange Board of India (SEBI), Insurance Regulation Authority, IDBI, SIDBI and other important authorities.

4.2 Meaning of Central bank

The Reserve Bank of India (RBI), is the central Bank of Indian financial and monetary system. It is the apex level institution which has been guiding, regulating, promoting the Indian Finance since its establishment. It started functionally from April 1, 1935 as per RBI act 1934.

The RBI's origin started in the year 1773, when Warren Hastings (The Governor of Bengal) felt the need of a central Bank in the country. Following pyramidal chart given for a reference.

Evolution of the RBI

April 1 1935 The Reserve Bank of India was inaugurated

Jan 1, 1935 Certain Sections of the Reserve bank of India Act were brought into force.

March 6, 1934 The RBI Act received the Governor General assent.

Feb. 16, 1934 The RBI Bill passed by the Council of States.

Dec. 22, 1933 The RBI Bill was passed by the legislative Assembly

Sept. 8, 1933 A fresh RBI Bill was introduced in the Indian Legislative Assembly.

Jan 1927. Gold Standard and the Reserve Bank of India Bill were introduced. But it did not make any headway.

1921 Imperial Bank of India was formed with the amalgamation of the three Presidency Banks.

1843 The Establishment of the Bank of Madras.

1840 The Establishment of the Bank of Bombay.

2nd June, 1806 The Establishment of the Bank of Calcutta.

Jan, 1773 Warren Hastings recommends the establishment of a Central Bank in Bengal and Bombay.

Chart 4.1. Evolution of the Reserve Bank Of India

Source : Vasant Desai, Fundamentals of Indian Financial System. New challenges, New Initiatives, Himalaya Publishing House 2007.

The Reserve Bank of India Act, 1934, states that main function of it as 'to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage' (Ref. Vasant Desai), The RBI was earlier constituted as shareholders bank with a

share capital of Rs. 5 crore. In 1949 the RBI was nationalized. The entire shareholding was transferred to the Central Bank .

Objectives of the Central Bank

1. To maintain the internal value of the country's currency.
2. To maintain the external value of the currency
3. To establish price stability
4. To promote economic growth
5. To support the maintaining of employment, output and income of the country.

These objectives are almost same for different countries of the world. In India the RBI has another important objective i.e. to remain free from political influence and be successful in operation or maintaining financial stability and credit

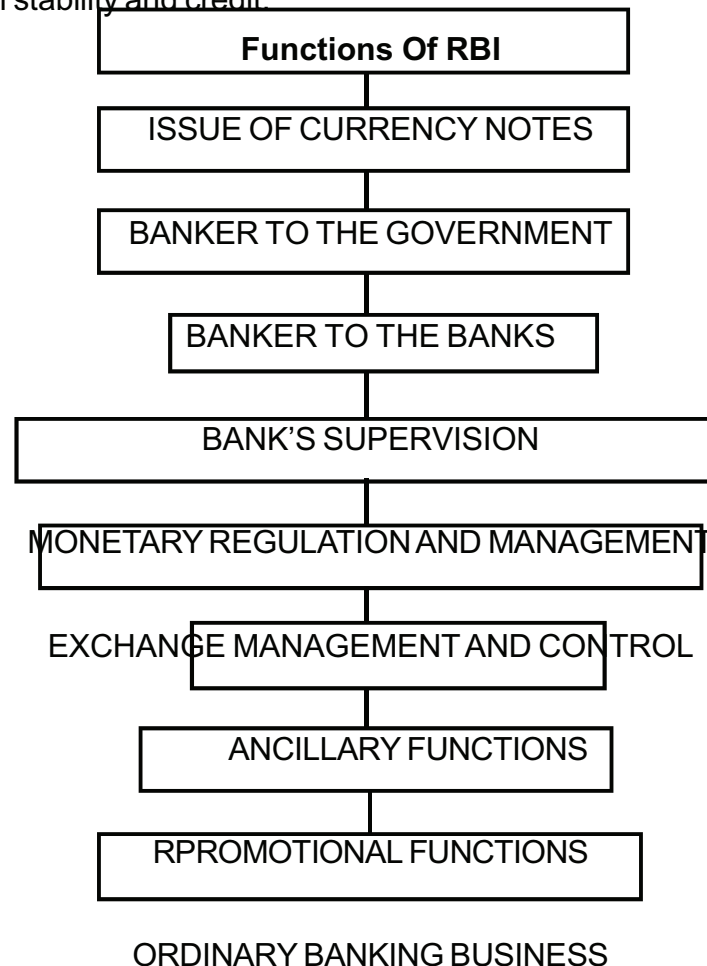


Chart 4.2 Functions The Reserve Bank of India

4.3 Functions of the RBI

The Reserve Bank of India (RBI) is the central bank of our country. It is the apex financial institution of India. It guides, monitors, regulates, controls and promotes the financial system in India. It started functioning from April 1, 1935. Over the period important developments took place in India. India became independent on August 15, 1947, and government decided to initiate the process of planned economic development. It was felt that a state-owned central bank was better to suit the requirements of economic development. Hence, the RBI was nationalized on January 1, 1949.

(A) Functions of the RBI

(1) Issue of currency notes :

The RBI has, since its inception, the sole right to issue currency notes other than one rupee notes, coins and coins of smaller denominations. One rupee notes and coins are issued by the government of India and they are put into circulation by the RBI. Under the original Act, the note issue was of proportional reserve system but later on it was replaced by minimum reserve system. According to the RBI Act of 1957, a minimum reserve of Rs.200 crore (of which Rs.115 crore in gold and bullion and rest in foreign-securities) is to be kept.

(2) Banker to the Government :

The RBI is a banker to the Central and state governments. It provides all types of banking services to the government, such as acceptance of deposits, making payments, withdrawal of funds by cheques, transfer of funds and management of public debt. The RBI has a good knowledge of the financial market and thus it offers an advice to the government.

(3) Banker's bank :

The RBI has the power to control the commercial banking system under the RBI Act, 1934 and the Banking Regulation Act, 1949. As per this, all banks required to maintain a certain percentage of their deposits with the RBI. All scheduled banks are under a statutory obligation to maintain a certain minimum of cash reserve with the RBI against their demand and time liabilities. The RBI provides financial assistance to scheduled banks and state cooperative banks in the form of loans against securities. The RBI has other regulatory functions relating to banks such as licensing of banks, branch expansion, liquidity of assets, their management, amalgamation, etc.

(4) Controller of Credit :

Credit control is considered to be the main function of the central bank. The RBI, like any other central bank, controls credit by using

quantitative and qualitative methods, Quantitative, methods include Open Market Operations (OMO), Bank Rate Policy (BRP) and. Cash Reserve Ratio (CRR). Qualitative methods include margin requirements, moral suasion, rationing of credit, direct action, etc. The RBI has been using CRR and Statutory Liquidity Ratio (SLR) as potential instruments of credit control. Bank rate is used to change the volume of lending of the banks. Similarly, the RBI is also using Selective Credit Control methods for qualitative credit control.

(5) Exchange Management and Control :

One of the important-functions of the RBI is to maintain the stability of the external value of rupee. The RBI functions as the custodian of nation's foreign exchange reserves. In 1947, the Foreign Exchange Regulation Act (FERA) was passed, along with-this, foreign exchange management and control became the important function of the RBI. Thus, it has to (i) administer the foreign exchange control; (ii) choose the exchange rate system and fix the exchange rate between the rupee and other currencies; .(iii) manage the exchange reserves; and (iv) interact with international monetary authorities, Asian Clearing Union, Sterling area, IMF, World Bank, etc.

(6) Credit Control :

Credit control is considered to the the main function of the central bank of a country. The Reserve Bank regulates and controls the volume and direction of credit by using quantitative and qualitative methods of credit control. Quantitative methods consists of (Open Market Operations (OMO), Bank Rate Policy (BRP) and Credit Reserve Ratio (CRR). Qualitative methods consist of moral suasion, rationing of credit, margin requirements, direct action, etc.

(7) Agricultural Finance :

To provide finance to the agricultural sector is an unique function of the RBI. Through this it promotes agricultural development of India. The National Bank for Agriculture and Rural Development (NABARD) was set up on July 12,1982, which performs major functions of the Agricultural Credit department of the RBI.

(8) Development and Promotional functions :

The RBI's functions are not only restricted to credit control and other regular functions, but also to a broader perspective of development and promotion.

The promotional services of the RBI has helped in mobilizing savings and directing credit flows to the desired uses to achieve economic development. The RBI promotes banking habits and facilities to rural and semi-urban areas.

The development of institutional credit has been a major function of the RBI. It has established the Agricultural Refinance and Development Corporation (ARDC) in 1963 and NABARD in 1982. The RBI has also been responsible for the industrial development and various industrial finance institutions, like Industrial Finance Corporation- of India (IFCI), State Financial Corporations (SFCs), Industrial Development Bank of India (IDBI).

Objectives of Monetary policy :

Monetary policy is a part of a broader macroeconomic policy which includes the fiscal policy and trade policy of the government. As such the macroeconomic objectives of the country constitute the objectives of monetary policy too.

The basic objectives of monetary policy are as follows.

- (1) Neutrality of money (2) Price stability or Economic stability
- (3) Economic Growth (4) Social justice, and
- (5) Full employment.

Let us discuss the above said objectives of monetary policy in detail.

(1) Neutrality of Money :

Money should be a passive factor or neutral in the monetary system. It should not be allowed to interfere with the real economic factors. This objective has been stated by Prof. Hayek. According to him money should not be allowed to produce any effect on volume of income, output and employment. It should be allowed to function only as a 'Medium of Exchange'. Money should not be allowed to influence the price level. Money supply should be allowed to change with changing demand for money. But quantity of money is to be so adjusted that effective supply of money is kept constant. If velocity of circulation increases, then quantity of money should be reduced. So money should be a neutral factor in the monetary system. It should not be allowed to interfere with real economic factors.

(2) Price stability or Economic stability :

Price stability implies that the monetary policy should aim at avoiding price fluctuations or changes. Price fluctuations can lead to either inflation or deflation in the economy. Developing economies face mainly inflationary situation whereas developed countries face the problem of deflation. The process of development itself generates the inflationary tendencies in the economy. Unless timely or prompt measures are undertaken to control inflation or deflation in the economy there may be hyper-inflation or depression in the economy. Therefore, the monetary policy has the objective of controlling inflation and maintaining price stability in the economy.

In the context of a developed country, the objective of stability has a wider meaning. It implies avoiding business fluctuations and business cycle. The depression and recession are two main phases of the business cycle which are avoided to ensure full employment. The monetary policy is therefore expected to take suitable measures that will stabilize the business.

(3) Economic Growth :

This is the most important objective for the monetary policy in a developing economies. But monetary policy is not much suitable to fulfill this objective because unlike fiscal policy, it directly cannot influence the investment expenditure in the economy. It operates indirectly by providing incentives through variations in the rate of interest, easy availability of credit etc.

(4) Social Justice :

Recently, social justice as an objective of monetary policy has been mentioned by many economists. This is one of the desirable macro-economic goals of the country. Monetary policy can fulfill this objective by its selective credit control instruments. For instance, the use of selective credit control to direct easy credit to small and marginal farmers. Similarly unsecured small loans can be provided to the needy people to start productive activity under the monetary policy. This will lead to self employment, more jobs can be created. Thus, the gap between the rich and the poor can be minimized and 'an economy can fulfill the objective of social justice.

(5) Full Employment :

The objective of full employment is very popular in advanced countries. Full employment implies full utilization of all resources in an economy. Thus, it can create more employment opportunities and reduce unemployment. Monetary policy can fulfill this objective by encouraging the investment in an economy. The monetary measures like Bank Rate Policy and Selective Credit Control measures can achieve this objective.

This objective is important because :

- (i) It promotes social welfare, and
- (ii) It encourages economic stability and control cyclical fluctuations.

The above-mentioned discussion enumerated the general objectives of the monetary policy, let us now discuss the objectives of the monetary policy of the RBI in India.

Check your progress

1. Explain evolution of the RBI.
2. What are the basic objectives of the monetary policy?

4.4 Monetary Policy of the RBI

Monetary policy refers to the use of techniques of monetary control by the central bank of the country to fulfill certain economic objectives.

The main objectives of monetary policy in India are :

- (i) To attain economic development with price stability or economic stability.
- (ii) To promote monetary and financial institutions.
- (iii) To attain equity and social justice.

Monetary, policy often refers to a regulatory policy whereby, central bank maintain its control over the supply of money or credit to attain economic objectives. However, in less developed countries, monetary policy is not limited only to control the supply of money or credit. In a developing economy like India, the RBI's responsibility is not just credit restriction but also to see continuous expansion of credit and money supply, so that, industrial and trade development takes place. Monetary policy has also to check the credit given for unproductive uses.

During the planning period, monetary policy had the following objectives

- (i) To promote savings,,
- (ii) To mobilise savings for capital formation and to increase the level of investment,
- (ii) To create inductive investment climate for the fulfillment of economic objectives,
- (iv) To provides finance to economic sectors like agriculture, industry, trade, commerce, etc.
- (v) To maintain price stability to control inflation.

Thus, monetary policy in India is not restricted to objective of regulation of money supply alone, but also other objectives like price stability, economic growth, etc.

In order to ensure complete control over the supply of money and credit the RBI has been given exclusive power to issue currency notes.

The nature of monetary system in India is like French monetary system, wherein the legal tender money (coins and paper money) is the medium of exchange. On Jan. 10, 2003 the total money supply (M) in India was Rs.4,54,490 crore and time deposits were Rs.12,34,596 crore.

The objective of monetary policy in our country has been two fold. It has to facilitate the flow of an adequate volume of bank credit to industry and agriculture and trade to meet their credit requirements. It also has selective instruments which provide credit to the weaker sections of the community and the neglected sectors in the country. At the same time, to keep inflationary pressures under check it has to restrain undue credit expansion and also ensure that credit is not diverted for undesirable purposes.

The Instruments of Monetary Policy

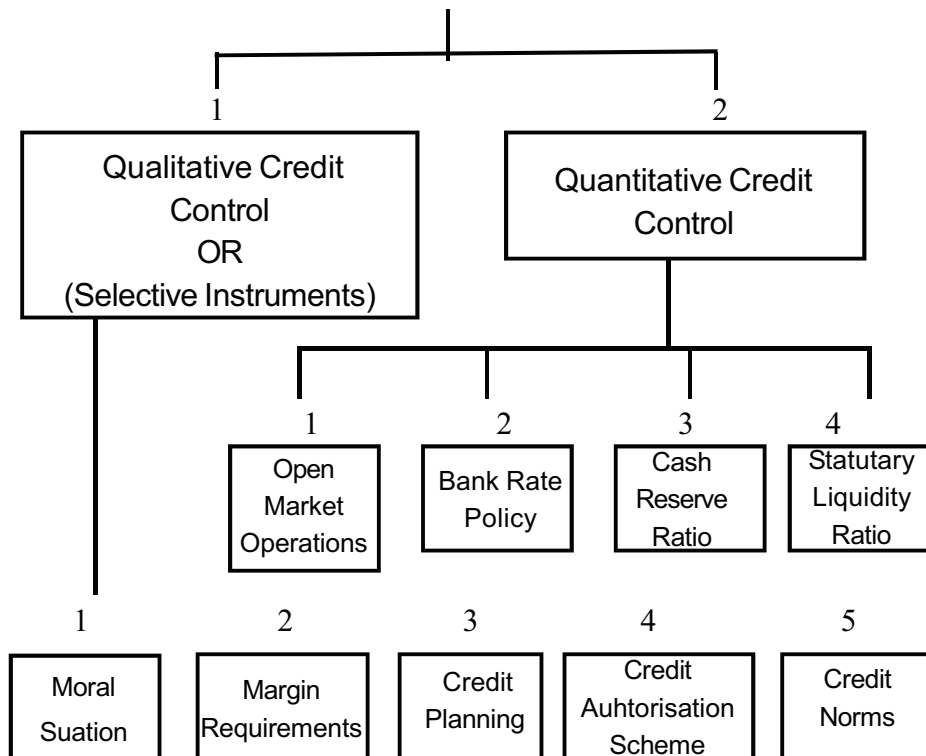


Chart 4.3

Instruments of Monetary Policy :

- (1) Quantitative Methods
- (2) Qualitative methods or Selective credit control

1] Quantitative methods :

Quantitative methods of credit control controls the volume or size of credit or money supply in the economy. These methods consist of following :

(i) Open Market Operations (OMO) :

OMO refers to the sale and purchase of government securities. This method of credit control is widely used in developed countries such as USA and UK. By undertaking purchases and sales of government securities, the RBI can affect the reserve position of the banks/ volume and cost of bank credit. There is no restriction on the quantity and maturity of government securities which it can buy or sell. With this instrument, the RBI can influence the reserve position of the commercial banks and, thereby, their capacity to create credit. In India, where the institutional set-up is generally suitable for open market operations, the RBI should have placed greater reliance on this technique. The RBI is continuously in the market, selling government securities and buying them in switch operations; it generally does not purchase them against cash. In India, since government securities are held by institutional investors like commercial banks, IDBI, NABARD, insurance companies, etc. the dealings regarding, OMOs are confined to them only.

So also, the effectiveness of OMO is undermined because OMO technique is largely used for debt management. Similarly, government securities market is not well-organized and broad-based; the interest rates on them are very low. Thus, the importance of OMOs has been lowered. :

Prior to World War II the use of OMO was limited but afterwards the RBI made a greater use of OMO to support gilt-edged market and to meet defence requirement. Since 1951-52, the use of this technique is continuously increasing from Rs. 116 crore to Rs. 10,572 crore in 1991-92 to Rs. 53,780 crore in 2002-03. Thus, during this period OMOs have helped in regulating the flow of credit to the private sector.

(ii) The Bank Rate Policy (BRP) :

This technique is used to regulate the cost and availability of refinance and change the amount of credit to banks and other financial institutions. The bank rate is the discount rate for commercial banks' and other banks' advances.

The RBI is empowered to use this as a technique to control the credit. The effectiveness of the BRP depends on the following :

- (a) The commercial banks should not avert the rediscounting facilities from the RBI.
- (b) Banks do not maintain any excess cash reserves against deposits and if demands are made by the depositors, they should have no option but to rediscount bills from the central bank.

- (c) Banks must hold adequate quantity of credit instruments which will be rediscounted by the central bank.

Up to 1951, the bank rate was 3% which resulted into large expansion of credit and deficit in Balance of Payments (BOPs). In 1964, Bank Rate (BR) was raised to 4.5%; in 1968 it was brought down to 5%. In 1991, it was raised to 11% and, then, fixed at 12% in the same year. This was considered to be necessary to contract the inflationary pressure.

Since the introduction of new economic reforms in 1991, the RBI has taken steps to strengthen the Bank rate policy. So, the bank rate has been brought down to 10% in 1998 and 6% in 2003.

(iii) Cash Reserve Ratio (CRR) :

The CRR is an effective instrument of monetary policy. As per the RBI (Amendment) Act, 1962 the RBI is empowered to determine CRR for the commercial banks in the range of 3% to 15 % for the total demand and time deposits. In late 1980s, the CRR was raised from 10% to 15%. Narsimham Committee report, however, did not favour CRR as an instrument to fight against inflation, because it adversely affected the profitability of the banks and forced them to charge high rate of interest for commercial banks' advances. So government had to reduce CRR for 4 year period below 10%. The final reduction was made to 4.5% in June, 2003.

(iv) The Statutory Liquidity Ratio (SLR) :

As per the Banking Regulation (Amendment) Act, 1962, SLR of 25% is to be maintained by the banks against their net demand and time deposits. The Act also empowers the RBI to raise SLR to 40%, if necessary to control liquidity. SLR has three objectives - (a) to restrict the expansion of bank credit, (b) to raise the banks' investment in government securities, and (c) to ensure solvency of the banks.

In 1990, SLR was raised up to 38.5% and remained at that level till Jan. 1993. As per Narshimham Committee, high SLR is not good because it becomes an instrument in the hands of government to mobilize resources for Central government and state government budgets. So, SLR was reduced to 25% in the period of 1994-96. Thus, the reduction of SLR as a part of financial sector reform has been successfully implemented.

2] Qualitative Methods or Selective Credit Control (SCC) :

Qualitative methods or selective credit control are generally meant to regulate credit for specific purposes. In developing countries, the use of selective credit control can check the misuse of borrowings. It can

also prevent speculative hoarding of essential commodities and check undue rise in the prices.

The RBI uses SCC in three forms :

- (i) Fixation of Margin Requirements.
- (ii) Fixation of separate minimum lending rates.
- (iii) Fixation of ceiling on credit flows.

During last four and a half decade, the RBI has relied mainly on the above-said three techniques of SCC. Apart from these measures, the RBI may give direction to the banks or a particular bank for which loans may or may not be given.

For more than 40 years, the RBI has been using the technique of

- (1) **Margin requirement** to check the hoarding of essential commodities. SCC covered the commodities namely, food grains, oilseeds, sugar, gur (or knandsari), vegetable oil and cotton. The rate of interest on advances against the security of these commodities was generally kept higher than on loans on securities not covered under SCC.
- (2) **The Credit Authorisation Scheme:** introduced in 1965 was also a kind of Selective Credit Control. Under this, the RBI controls the credit given to different large borrowers. However, this scheme was withdrawn as a part of financial sector reforms.
- (3) **Fixation of credit norms :** The RBI, since 1970s has been issuing important guidelines and instructions to banks to remove defects of banking system such as : (i) Under-utilisation of credit; (ii) Sanction of excess credit or over-financing; (iii) Over-reliance on cash credit system; (iv) over-accumulation of inventories by industrial units (borrowers).
- (4) **Credit Planning :** It was a product of economic planning. Credit planning was introduced by the RBI for the purpose of
 - (i) Regulation of credit for desired uses and
 - (ii) Direction of credit flows to the desired sectors, areas. Thus, the quality and allocation of credit was regulated for desired purposes.
- (5) **Moral Suasion :** This is also an important tool of credit control. This is in the form of writing the letters to the banks or to persuade the banks to follow the RBI's guidelines or monetary policy. This started in 1949 when the RBI sent a letter to commercial banks urging them to exercise restraint in giving advances for speculative purposes. The method of moral suasion was made effective after the nationalization of 14 major commercial banks in 1969. In

addition to this, the RBI has been giving instructions regarding the defects of the Banks.

4.5 Evaluation of Monetary Policy of the RBI

The Reserve Bank of India, being mainly concerned with money matters, by making the use of its monetary instruments can attain the objective of stability, growth and social justice.

The monetary policy has been much concerned with economic growth and inflation in the economy. The other concerns of the policy have been about the distribution of credit among different sectors, as also for the weaker sections of population.

Since 1951, two sets of objectives have been pursued.

- (1) **Expansion of money:** It sought to achieve the twin objectives of meeting the needs of production and trade at the same time moderating the growth of money supply to contain the inflationary pressures in the economy.
- (2) **Sectoral Development of funds :** The RBI has determined, the allocation of funds as also the interest rates, among the different sectors. The sectors which have received special attention are core industries (coal, iron and steel, engineering etc), food grains, priority sectors (agriculture, small scale industries) and weaker sections of the population.

In the nineties, the control of inflation has become more urgent concern of the policy. The thrust of the policy has been restrictive in nature so as to reduce the fast growing money supply. The aim has been to reduce the inflation to the single digit. The other important concern of the policy has been the development of funds among sectors like agriculture, small-scale industries, public distribution system and export.

Use of monetary instruments by the RBI:

One principal instrument used by the RBI has been, the Bank rate or discount rate i.e. the rate at which RBI lends to the banking system through changes in it, the RBI affects the short-term interest rates in the money market, and through it the long-term rates, and through it the level of economic activity in the economy. It also influences the international capital movements i.e. higher rates attract capital inflows and vice versa.

Another important instrument, much in use at present to reduce the growth of money supply due to rapidly rising foreign exchange assets is the open market operations. The operation involves the sale and purchase of government securities. Through the sale of securities, RBI

withdraws part of deposit resources of the banking sector thereby reducing resources available with the banks for lending. The opposite happens when the RBI undertakes open market purchases of securities from the market. As a result the stock of securities with the seller banks is reduced and cash with them expands. The device of Cash Reserve Ratio (CRR) has also been much used to affect the money supply. A higher ratio i.e. Statutory Liquidity Ratio (SLR) has also been used for long time by the government to get funds against securities carrying low rates of interest.

Check your progress

1. Distinguish between Quantitative and Qualitative Credit Control instruments.
2. Which instruments are mainly used by the RBI to control the money supply in an economy ?

4.6 Performance of the Monetary Policy of the RBI

The monetary policy has been partially successful. Following discussion will highlight its success and failure.

Monetary policy has been successful in meeting the requirements of economic growth of the country with respect to priority sectors, for instance the short fall from the target of 40 percent of the total bank credit, have not been very large. Similarly, the financing of the several important development programmes for the weaker sections of population has been reasonably satisfactory. Even in respect of the control of inflation, the monetary policy has been successful.

Failures of Monetary Policy :

The most unsatisfactory result has been in respect of the expansion, of money supply. This has been the case throughout the long period of planning. The growth rate of money has been much in excess of the growth in the real product. This has been an important cause of the large rise in prices, so that the rate of inflation stayed at high levels for most of the time causing much damage to the economy and people's living. It also gave rise to other evils like black market, speculation etc .

Similarly, the distribution of funds as between rural and urban areas as also between developed and less developed areas is far from satisfactory with urban areas and developed regions. These imbalances

in credit allocation are more pronounced when one considers agriculture and small industry on one hand and the large organised industry and service sector on the other. Agriculture continues to be dependent upon money lenders to a considerably extent for its credit needs.

Limitations of the Monetary policy of the RBI :

Most of the limitations of the monetary policy arise from the underdeveloped character of the economy. Let us discuss these limitations in detail.

(1) Restricted scope of the policy :

It should be kept in mind that the monetary policy is not meant to combat every evil. Every economic problem is to be tackled from all angles including monetary side. Even in case of inflation problem, where money seems to be a major factor, it needs to be stressed that monetary policy can at best influence the demand for goods. For an effective use of the monetary policy to fight inflation, a much larger policy profile is necessary.

(2) Predominance of currency :

With currency forming a large proportion of money supply, banks have to face the problem of large outgo of currency every time they create credit. By habit and custom associated with the paucity and backwardness of appropriate institutions, people prefer to make use of cash rather than cheques. This means that a major portion of cash generally percolates in the economy without returning to the banking system in the form of deposits. This reduces the capacity of the banking system to create fresh credit on the basis of an increase on its reserves.

However, it is to be noted that, the effectiveness of the monetary policy is on the increase.

(3) Underdeveloped money market :

Another inhibiting factor in the Indian situation is the weak money market which limits the coverage, as also the smooth working of the monetary policy. One part of the money market is the organised one, consisting of the RBI, the State Bank foreign banks, cooperative banks etc. while other part is unorganized consisting in indigenous banks, money lenders etc. The linkages between these sectors are not so well developed.

In this regard too, things are improving with the further expansion of organised market, and a larger number of indigenous bankers associating with modern institutions including the Reserve Bank, uniformity over a larger part is being witnessed.

(4) Existence of black money :

A serious obstacle in the efficient working of monetary policy is the circulation of large amount of money in the black market. The activities under this market are not reported, the demand for money and supply of money do not remain as desired by the RBI. This means that a significant part of money economy remains outside the orbit of the RBI's monetary policy.

(5) Subservient role :

The task of monetary policy in India is further made difficult because the RBI could not pursue an independent line in monetary affairs. For example, most of the interest rates being fixed or administered and mutually unrelated, the scope of the instruments remained confined to financing the fiscal deficits. And this at low administered rates of interest to minimize the cost of government.

Recent Major change in Monetary Policy of the RBI :

- (1) Greater Operational Flexibility to the banks.
- (2) Integration of money market, government securities market and the forex market.
- (3) Government securities market is made an important part of Indian Financial System.
- (4) Reforms in fiscal-monetary systems by an agreement between the Indian Government and the RBI.
- (5) Deregulation and simplifications of Interest Rate Structure.

An appraisal of the Monetary Policy of the RBI :

Monetary policy in, India has been formulated in the context of economic planning whose main objective has been to accelerate the growth process in the country.

According to C. Rangarajan, three factors guided the conduct of the monetary policy -

- (1) Monetary policy has been in response to the fiscal policy,
- (2) Monetary policy has been used to control inflationary situation and
- (3) More direct involvement of monetary authority in the allocation of credit to the non-government Sector. Since the introduction of economic reforms in 1991 the lowering of CRR and SLR and Bank Rate clearly suggest that the monetary policy has expanded credit for industrial development and price stability.

4.7 SUMMARY

The Central Bank performs two important functions namely

- i) Deposit the money and lend at the time of emergency. and
- ii) Priority sector lending (to the poor and weaker section).

However over the passage of time, the function of credit Bank have changed. In developing countries , the Central Bank has to perform a dual role of promotional as well as regulatory institutions.

The RBI has taken a number of steps to strengthen the promotional and regulatory aspects of banking. At the same time it has ensured and maintained the flexibility to respond to current situation. So also it has taken efforts to improve the efficiency of the banking system as a whole.

In order to perform the both functions, the promotional as well as regulatory, the Central Bank uses the quantitative and qualitative instruments. Broadly speaking, the RBI's monetary policy has the objectives namely

- i) Price stability.
- ii) Expansion of bank credit.
- iii) Promotion of investment.
- iv) Equitable distributions of credit
- v) Promotion of exports and the procurement of food activities.

The RBI operates quantitative techniques of credit control like Bank rate, open market operations and qualitative techniques like moral suasion.

The reforms in monetary policy focus its attention to management of finance at a macro level. The old instruments of monetary policy are continued along with new ones like Liquidity Adjustment Facility (LAF) . This has been due to liberalization , development and integration of financial markets.

4.8 Questions

1. Discuss the functions of Central Bank.
2. What is Policy ? State its objectives.
3. Explain the monetary policy of the RBI.
4. Evaluate the monetary policy of the RBI.
5. Discuss the major changes in monetary policy of the RBI.



COMMERCIAL BANKING

Unit structure

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Commercial Banking Since Independence
- 5.3 Growth of Commercial Banks Since 1806 upto 1969 onwards
- 5.4 Classification of Assets (Balance sheet of Bank)
- 5.5 Summary
- 5.6 Questions

5.0 OBJECTIVES

1. To understand the functions, growth of commercial banks.
2. To review the performance of commercial banks since their nationalization.
3. To study the changes in the performance of commercial banks after 1991.
4. To study the liabilities and assets of the commercial banks.

5.1 INTRODUCTION

Economic thinkers have frequently stressed the importance of commercial banks in the process of economic development. It is simple and oldest form of banking. They are the life lines of the financial structure of a nation. Under the supervision and control of the Central Bank, they add to the money supply of a country. Commercial bank's activities like lending, investing facilitate the economic process of production, distribution and consumption.

Over the period of time banking as an institution has changed in character and content . Commercial bank is very unique in India. This has been reflected from its evolution, its programmes and operations in India.

Definitions of Commercial Bank

Banking regulation act , 1949 defines banking as ‘ accepting for the purpose of lending or investment of deposit money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.’

According to Oxford dictionary “It is an establishment for custody of money received from or on behalf of its customer.” It performs the basic functions of accepting deposits and lending the money to its borrowers. According to Crowther ‘A banker is a dealer of in debts of his own and other people. The debts of other to offer his own in exchange and thereby create money.” Thus, a commercial bank is a financial intermediary which accepts deposits from public and lends them with a view to make profit. Let us now discuss the various functions of commercial banks in recent times. By performing these functions, banks help in the process of economic growth of a country.

5.2 COMMERCIAL BANKING SINCE INDEPENDENCE

Commercial banks and creation of credit

Commercial banks are basically business concerns with the objective of profit maximisation. However, the major difference between other business concerns and commercial bank is that, the banks in India have also other obligations such as social welfare, social justice, regional balance . The banks also have to maintain a proper balance between profitability and liquidity. The commercial banks are expected to hold a part of their deposits in the form of liquid cash i.e. cash reserves. The RBI is empowered to prescribe a Cash Reserve Ratio (CRR) to be maintained by the banks.

Creation of credit :

Unlike the other financial institutions, banks can create money or credit. Other financial institutions just transfer the funds, but banks create as well as transfer the funds. Loans or advances given by the banks create a deposit. This has given rise to the concept of deposit multiplier or money multiplier.

For example : If banks are supposed to maintain CRR of 10% and Bank receives a deposit of Rs. 1,000. Of this Rs. 1,000. the bank maintains 10% (Rs.100) as cash reserve and can give loan of Rs.900 (the balance amount). The borrower who borrows Rs.900 may deposit the amount in the same bank or another bank; so the total deposit with the banks now will be Rs. 1,000+ Rs.900 (i.e. Rs.1,900). This process may continue till no bank in the banking system has, reserves in excess of the required 10% reserve. Thus, total money supply (credit creation)

in the economy will be Rs. 10,000 (Rs. 1,000 x 10). The ratio of new deposits to the original increase in the reserves is called money multiplier or deposit multiplier. As the reserve ratio is 10/100 (10%), the multiplier is the reciprocal of it, i.e. 1/10. However, in reality, due to leakages in the form of cash holding the banking system may not work up to the full capacity.

Functions of the commercial banks (in brief)

Functions of a commercial bank are :

- (i) Accepting deposits, and
- (ii) Advancing loans

By performing these functions, banks promote the mobilization of savings, and its productive utilization.

- (i) **Accepting Deposits** : Commercial banks accept deposit from individuals, firms and other institutions. Deposits are maintained in three different types of accounts i.e. fixed deposit account, current account and savings bank account. Fixed account is that where money is deposited for a fixed period. Current account is operated by business firms, in which, they can make deposit and withdrawals every day. Savings bank accounts are mostly operated by individuals who earn interest on their deposits.
- (ii) **Advancing Loans** : Banks give or advance loans out of the deposits. Commercial banks, usually, give loans for productive purposes and for short period. After the nationalisation of the commercial banks, there are drastic changes in the role of the banks. The banks with the RBI guidelines have to work in line with the monetary policy in order to attain economic objectives. Banks give a large share of credit to priority sectors such as small scale industries, agriculture and exports.

5.3 GROWTH OF COMMERCIAL BANKS SINCE 1806 UPTO 1969 ONWARDS

Modern commercial banking made its beginning in India with the setting up of the three Presidency banks, namely the Bank of Bengal in Calcutta in 1806, the Bank of Bombay in 1840 and the Bank of Madras in 1843. Some exchange banks were also set up in the second half of 19th century. The RBI was set up in 1935. In 1950, the banking system consisted of the RBI, the Imperial bank, cooperative banks, exchange banks and Indian joint stock banks. Afterwards, the banks were categorized into scheduled banks. In 1955, the Imperial Bank was converted into the State Bank of India and was nationalized in 1959. The SBI had its branches in both urban and rural areas.

In 1969, fourteen major commercial banks were nationalized. Lead bank scheme was introduced to provide banking services to all parts of the country. In 1975, Regional Rural Banks were established to fulfill the credit needs of the weaker sections of the rural areas.

The following tables will explain the growth of commercial banking since 1951 to 1990 and 1996 to 2002. Table 5.3 explains the Annual growth rate of all commercial banks in India over the period of 1951 to 2002.

Table- 5.1

Particulars	1951	1961	1969	1990
1. Total number of Banks	566	292	85	271
(a) Scheduled Banks	92	82	71	268
(b) Non-scheduled Banks	474	210	14	03
2. Total number of branches of Banks	4,150	5,000	9,000	60,000
3. Total deposits in India.(Rs. Crore)	908	2,01	5,173	1,93,000
4. Rural deposits (% to total)	33	60	56	82
5. Total number of employees (in thousand)	—	115	220	1000

(Source : RBI statistical tables relating to Banks in India.)

Table - 5.2

Particulars	1996	2002
1. Total number of Banks	298	298
(a) Scheduled Banks	287	294
(b) Non-scheduled Banks	02	04
2. Total number of offices of all commercial banks	63,092	66,208
3. Total deposits of banks (Rs. Crore)	4,36,956	11,31,187
4. Deposits of Regional Rural Banks (Rs. Crore)	1.3,835	42,494

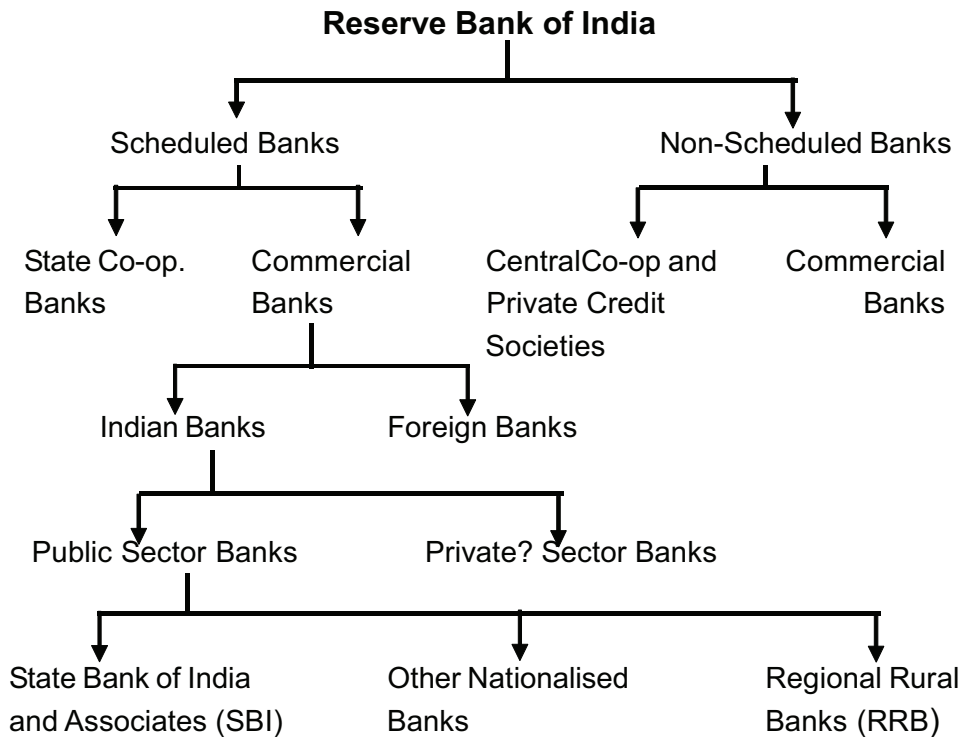
(Source: The RBI publication)

Table-3**(in Percentage)**

Period	No. of Offices	Deposits	Credit	Invt. in Govt. Securities
1951-1969	4.39	10.31	9.64	7.13
1969-1986	9.31	20.09	18.65	21.92
1986-1996	4.43	13.83	14.17	18.35
1996-2002	8.03	17.17	15.06	17.71
1951-2002	5.58	14.99	14.11	15.32

(Source: The RBI publication)

The Structure of Banking System in India

**Chart 5.1**

The RBI is the apex level bank. Scheduled banks are those which are included in the second Schedule of the Banking Regulation Act, 1965 (each having paid-up capital of Rs.5 lakh).

Thus, there has been a tremendous growth of commercial banks during last 50 to 55 years in terms of their deposits, credit, offices, etc. The nationalisation of banks also has contributed the most to the growth of banking in India.

Impact of Nationalisation of commercial bank :

Nationalisation of 14 major commercial banks has been the main factor in the development of banking system in India. In July 1969, fourteen major commercial banks in the private sector (each having deposits of Rs.50 crore and above) were nationalized. It aimed at the provision of banking facilities to remote areas and priority sector such as agriculture, small scale industries and export.

The bank deposits as percentage to the national income rose from 15.5% in 1969 to 48.7% in 1999. In August 1969, the RBI appointed a committee, under the chairmanship of F.K.F. Nariman, which recommended the establishment of Lead bank to expand the banking facilities in the areas lacking adequate banking facilities. Under this lead bank scheme, the districts were allotted to the SBI, 14 nationalised banks and three private sector banks. At the end of 2002, the Lead bank scheme covered 580 districts in the country.

Before nationalisation, offices of commercial banks were located in urban areas. After nationalisation, 60% of offices of banks were established in rural areas. Further the banks were also established in backward regions like Orissa, Bihar, Madhya Pradesh, Assam, etc.

Similarly there has been a massive rise in the deposits of the banks (Rs.7,37,003 crore in 1999). The credit or advances also went up to Rs.3,21,81 crore in 1998 from Rs. 3,399 crore in 1969. The share of priority sector in total credit was 32%.

An appraisal of Banking since Nationalization :

Although the performance of the commercial banks in terms of deposit, credit, offices, etc. had been impressive, there were certain inadequacies and problems of the banking system.

Main problems of commercial banks :

- (1) **Problem of Recovery of loans and advances in the rural areas:** According to one study the overdues amounted to 50% of total bank loans in 1993.
- (2) **Inadequate bank offices and bank facilities :** Even after the nationalisation of banks, still our country faces the inadequacy of banks and banking facilities particularly in the rural areas.
- (2) **Unsatisfactory performance of banks:** The directed investment and directed credit programmes along with rising expenditures completely eroded the profitability of the banks. Many public sector banks and foreign banks incurred losses in 1990.
- (4) **Low profitability :** Due to the problem of overdues and misallocation of credit and inefficiency, the profitability of commercial banks was low.

- (5) Non Performing Assets (NPA) : Between 1998-99 and 2001-02, the NPA increased from Rs. 28,020 crore to Rs. 35,546 crore at the percentage of 9.5. The loans were classified as doubtful and sub-standard.

Functions of Commercial Banks (in detail) :

A modern commercial bank performs many functions. It renders many services, to its customers and also to the public.

Functions of a commercial bank :

The functions of a commercial bank can be classified as :

- (1) Main functions
- (2) Agency services
- (3) General utility services.

1] Main functions :

- (a) **Acceptance of deposits from public :** Bank accepts deposits from public. These deposits are of three types-viz.

- (i) Current
- (ii) Saving, and
- (iii) Fixed deposits

- (i) Current deposits are the current account deposits. The transactions are undertaken day-to-day basis by the businessmen, traders.
- (ii) Saving account are the deposits by the general people. These deposits are withdrawable any time by the depositors by means of cheques.
- (iii) Fixed deposits are those deposits, which are withdrawable only after a specific (maturity) period.

Fixed deposits earn a higher rate of interest. For current deposit there is no interest or nominal interest For saving deposit, interest varies with time period and ranges from 4 to 6 percent.

Another form of deposits is the recurring deposit. In recurring deposits individual deposits a fixed sum every month for a fixed period of time.

(b) Advancing Loans :

Out of the money received from the depositors, banks give loans. This is the most important function of modern economies. Commercial Banks have been giving loans for productive purposes and usually for short term. Now a days banks also give consumers credit. It is the credit given by the banks to purchase consumer durables. Usually banks grant

short-term or medium term loans to its customers. There are various ways in which banks grant loans to its customers. These are as follows:

- (i) Overdraft
- (ii) Direct Loans, and
- (iii) Cash Credit.

Banks do not give loans in the form of cash. They make the customer open an account and transfer loan amount in customer's account.

(c) Credit Creation :

It is another important function of a commercial bank. It is remarked by Sayers that "Banks are merely purveyors of money but also manufacturers of money",

(d) Other banking functions :

The drawing, making, accepting, discounting, buying, selling .collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts etc.

2] Agency Services :

Banks perform certain function for and on behalf of their customers. These are as follows :

- (a) The issuing on commission and underwriting stock, funds, shares etc. investment of all kinds.
- (b) The purchasing and selling of shares, bonds, debenture etc. on behalf of customers.
- (c) The negotiating of loans and advances.
- (d) The transmitting of money i.e. by demand draft, mail and telegraphic transfer.
- (e) The granting and issuing of letters of credit, traveller's cheque
- (f) The buying and selling of foreign exchange including foreign bank notes.
- (g) Acting as agents for any government, local authority etc.
- (h) Contracting for public and private loans.
- (i) Undertaking and executing trusts
- (j) Undertaking the administration of estates as executor, trustee or otherwise.

3] General Utility Services :

Some general utility services of commercial bank are as follows:

- (i) The receiving of all kinds of bonds, scrips or valuables on deposits or for safe custody or otherwise.

- (ii) The providing of safe deposit vaults.
- (iii) The lending of money for the purpose of issuing stocks, shares, debentures etc.
- (iv) The carrying on and transacting every kind of guarantee and indemnity business.

Apart from these kinds of services that are being extended by commercial banks in our country, banks have been competing with each other in introducing newer kinds of services. Banks have been permitted to set up Money Market Mutual Funds. Housing finance has also been taken as a focused banking activity. Credit card business is yet another activity undertaken by certain banks. Again, the government has permitted eight banks to undertake trading in gold and silver.

Thus, it is clear that bank performs many valuable services to the public as well as to the trade and industry of a country. Its most important service is that it pools together the scattered savings of a community and makes them available to those also need funds for productive purposes. Businessmen are also benefited by the advice and information which banks are always ready to give.

Check your progress :

1. Define a commercial bank.
2. What are the main functions of a commercial bank ?
3. Explain the structure of Banking System in India.
4. Discuss the impact of Nationalisation of commercial banks.

5.4 Classification of Assets (Balance Sheet of Bank)

Banks have different categories of assets as following

- i) Cash in hand and balances with the RBI
- ii) Assets with the banking system
- iii) Investment in Govt. and other securities.
- iv) Bank credit or Advances.

Among the above mentioned assets, cash and govt. securities fulfill the liquidity requirement of the banks. And the other assets like bank credit and investment in government securities are the most important assets of the banks.

There are three types of the investments by the commercial banks as following :

- i) Investment in govt. securities.
- ii) Investment in other approved securities and
- iii) Investment in non approved securities.

The first two types of securities are statutory requirement of banks. Investment in govt. security accounts for more than 95 % of banks total investment and investment in the other approved securities is marginal. However due to high fiscal deficit, effect of capital adequacy norms and other reasons, the investment in the govt. securities is in the excess of its statutory requirement.

Thus these investment by banks are not necessarily determined by the ideology of the public v/s private sector, but it is determined by the volume of govt. expenditure, resources of banks, foreign capital inflows, demand for credit etc.

The third stage of investment covers commercial paper, mutual funds, shares and debentures of public as well as private sector firms. These are non-statutory requirements of banks. The scheduled commercial banks invested Rs. 81000 crore and Rs. 92854 crore in these securities in 2001-02 and 2002-03 respectively (RBI)

Bank credit or advances has been a major source of finance to industry and commerce. Under this banks provide credit to agriculture, education, small scale industries. The main types of Bank creditors i) cash credit ii) loans iii) demand draft iv) commercial bills and others.

5.4.1 Classification of liabilities of Banks

Liabilities consist of

- i) Demand deposits
- ii) Term deposits
- iii) Borrowings from other banks
- iv) Borrowing from the RBI.

Indian banks accept two types of deposits; demand deposits and term deposits. Demand deposits are further classified into current deposit, saving deposits and call deposits.

- **Current deposits** are payable on demand. They can be withdrawn by cheque with no restriction. These deposits are mainly held by business firms. Banks do not pay interest on such deposits. But banks extend their services to the account holders such as free collection of out station cheques, issue of demand drafts , dividend warrants and postal orders.
- **Saving deposits** get interest. Generally speaking the interest rate on these deposits ranges from 4 % to 6 % cheques can be drawn on saving account. However there are restrictions on the number of withdrawals from this account.

- **Call deposits** also form a part of demand deposits. They are accepted from other banks and are repayable on demand. These deposits get an interest. However, these deposits form a very small part of total deposits.
- **Term deposits** also known as time deposits. They are deposits for a fixed time which may vary from a few days to few years. They are not payable on demand and they do not enjoy cheque facility. The money deposited under this account can be payable only on the completion of maturity period for which these deposits are made. However these deposits can be withdrawn before maturity with a cut in the interest rate.

Borrowings from other banks also constitute liability side of balance sheet of commercial bank. Borrowings from the RBI is an important constituent of banks's liabilities. Because it measures the banks adequacy in terms of its resources. Borrowings from the RBI form 3 % to 6% of total liabilities . Apart from these banks also borrow from IDBI, NABARD EXIM bank etc.

Reserves and share capital also form a part of banks liabilities. These liabilities come from accumulated undistributed profits of banks.

The abstract format of a balance sheet of a bank given below (Which is as per banking Regulation Act 1949)

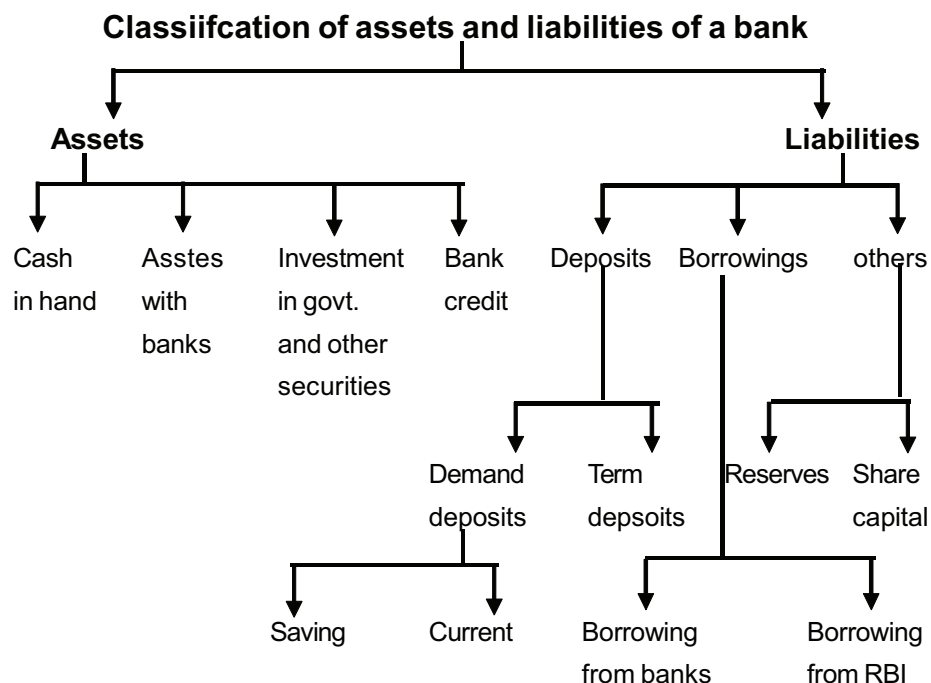


Chart No. 5.2
Balance sheet of a Commercial Bank

Capital and Liabilities	Property and Assets
1. Capital	1. Cash
2. Reserve fund and other Reserves	2. Balances with other banks
3. Deposits	3 Advances
4. Borrowings	4 Investment in Govt. Securities
5. Other liabilities	5 Other assets
6. Profit and loss	6 Profit and loss

Every year commercial banks are required to prepare Balance Sheet (as per Banking Regulation Act 1949)

5.5 SUMMARY

On the whole, the banking system in India consists of the RBI at the apex level, commercial banks and co-operative banks. These banks are further classified into scheduled and non scheduled , Indian and foreign , public and private sector banks and Regional Rural Banks. The main functions of commercial banks are accepting deposits, granting loans, and general utility services. Commercial banks have been playing an important role in India's economic development since independence. Considerable progress has been brought in the deposits mobilization. These banks performed well in rural as well urban areas. The nationalization of 14 major commercial banks in 1969 has been the main factor of development of banks in India. The coverage of area by these has been rapid since their nationalization. Similarly there has been a massive arise in the deposits and advances of the banks.

The businessman of banks and its ownerships pattern is changing fast. New banking environment has been emerged with new technology, data basis and value added services. The regulatory mechanism of the banking system, further ensures good health and performance of the banks in Indian economy.

5.6 Questions

1. Discuss the growth and changes in the structure of commercial banks since their nationalization.
2. Review the performance of commercial banks since their nationalisation.
3. Explain in brief the main problems of commercial banks
4. Define commercial bank. Discuss its main functions.
5. Give an account of the balance sheet of a bank.



Non-Performing Assets and Capital Adequacy Norms (CAN)

Unit structure

- 6.0. Objectives
- 6.1 Introduction
- 6.2 Non-Performing Assets (NPAs)
- 6.3 Meaning of NPAs
- 6.4 Recommendations and Control of Prevention of NPAs.
- 6.5 Capital Adequacy Norms (CAN)
- 6.6 Risk Management in Indian Banks
- 6.7 Summary
- 6.8 Questions

6.0. Objectives

- 1) To understand the issue of non-performing assets (NPA).
- 2) To study the capital adequacy norms (CAN).
- 3) To study the issue of risk management in Indian Banks.

6.1 Introduction

One of the most important problems of banking in India has been the problem of non-performing assets (NPAs). It has received a great amount of attention because it affects the profitability of the commercial banks. This has been considered to be the most challenging problem of the banks which is reflected by the recent financial sector reforms undertaken to resolve it.

As there has been a spread of banking across nations, competition amongst the banks of different countries began. In the Indian context in the view of existence of nationalized banks the Capital Adequacy Norms (CAN) are of great significance. Therefore commercial banks to maintain soundness and profitability in their business have to follow these norms. Basle committee suggested certain norms for minimum capital

requirement and risk management by the banks. Risk management has become one of the new millennium challenges in the banking sector.

6.2 Non-Performing Assets (NPAs)

The issue of NPAs has been given a wide thought in the banking system for a long period. Many efforts have been undertaken to solve the problem of NPA. What is NPA? Why do NPA problem arise? What is the magnitude of it? What are the initiatives for the resolution of these problems? Let us discuss this issue in detail.

One important aspect of banking is in India that has received great attention in the recent years is the most intractable problem of non-performing assets. This has been considered to be the most challenging problem facing the banking and financial sector and the recent years have witnessed great efforts to resolve these problems.

6.3 Meaning of NPAs

For the strengths and stability of banking systems, the assets of banks should give positive returns. The assets which do not yield positive refunds become non-performing assets. In a narrow sense, non-performing assets refer to loans and advances which do not yield any positive returns or contribute to profits of banks. In a broader sense, non-performing assets include the unutilized cash balances, physical assets and the workforce. Holding some cash balances by banks is essential, but it should be kept at a minimum level. Here we are concerned with the earnings on loans and advances and the other assets are not considered, though they are equally important.

Until recently there was no clear idea of NPAs in India. Different banks were considering overdues as NPAs. It was only after the publication of Narsimhan Committee Report that an uniform definition came to be accepted. According to this committee the non-performing assets would be defined as an advances where as on the Balance Sheet date –

- a) In respect of term loans, interest remains past due for a period of more than 180 days,
- b) In respect of bills purchased and discounted the bill remain overdue and unpaid for a period of more than 180 days,
- c) In respect of overdraft and cash credits accounts remain out of order for a period of more than 180 days,
- d) In respect of other accounts any amount to be received remains past due for a period of more than 180 days,

Thus, non-performing assets (NPAs) is essentially an advance where payment of interest and/or principal repayment remain unpaid for a period of two quarters (6 months) or more.

The R.B.I. laid down rules for the NPAs. This means that the banks have to set aside a portion of their funds to safeguard against any losses incurred on impaired loans. Banks have to set aside 10% of sub-standard assets as provision. The provisioning for doubtful assets is 20% and for loss asset, it is 100%.

Magnitude of NPA

Increasing NPA means that the funds locked are not being used properly or are not producing adequate returns. If a bank has high NPAs then it may not earn enough to pay interest to their deposits or repay the principal.

The percentage of gross NPAs to gross advance to schedule commercial banks.

Types of Banks	1999	2000	2001	2002
Public Sector Banks	15.89	13.98	12.39	11.09
Old Private Bankers	13.06	10.78	10.94	11.01
New Private Banks	6.19	4.14	5.13	8.87
Foreign Banks	7.59	6.99	6.84	5.38

(Source : R.B.I. report on Trend and Progress of Banking in India.)

From the above table it is clear that NPA percentage in case of public sector, banks has decreased from 15.89 to 11.09 percent in 2002 and increase in case of old private sector banks from 6.19 to 8.67 percent in 2002.

Sectorwise analysis of NPAs shows that private sector loans account for 44.49 % of the total NPAs of public sector banks and the non-priority sector loans account for 53.54% of the total NPAs of public sector banks. Within the public sector bank group, it is SSIs sector which has the highest share (18.72%) and agriculture with 13.84%. Thus, it is clear that non-priority sector also responsible for high NPAs.

Causes of Growth of NPAs

The accumulation of NPAs is due to following factors :-

- i) **Nationalisation of Banks** : After nationalization of 14 major commercial banks in 1969, the bank lending became popular and the commercial principles of banks were ignored. This laid to the problem of overdues and defaults by the borrowers.

- ii) **Emergency of Wilful Default** : Due to the erosion of credit culture which prevailed earlier times the phenomenon of willful default has been emerged. Even those who had no difficulty to repay loan started defaulting.
- iii) **Industrial Sickness** : Due to industrial sickness, the borrowers in the industrial sector started defaulting. Faulty project planning, lack of infrastructure facilities, management and marketing problems, asserted in business losses. This had an adverse effect on servicing bank loans.
- iv) **Inadequate Credit Monitoring** : Defective appraisal of loan application and inadequate attention given to commercial and financial viability of project and inadequate capacity credit monitoring also laid to the poor performance and inadequate capacity to service, the loans on part of the borrowers.
- v) **Lack of Co-ordination** : Where commercial banks have financed large projects jointly with financial institutions, lack of co-ordination between banks and financial institutions resulted in the problem of NPAs. Thus, a combination of several factors has contributed to the growth of non-performing assets of commercial banks.

Check your progress

1. What do you mean by NPA's ?
2. Explain why NPA's are growing.

6.4 Recommendations and Control of Prevention of NPAs

Recently several measures have been initiated to reduce the volume of NPAs of commercial banks. They are following :-

1. Setting up of debt :

Debt recovery tribunals, Narsimhan Committee had recommended setting up of special tribunals which would cut short time required for setting the cases with regard to defaulters. This could help the banks in enforcing the claims against their clients speedily and the problems can be solved. Accepting the recommendations, debt recovery tribunals (D.R.T.) were established.

2. Securitization Act :

In order to reduce NPAs the Securitization and Reconstruction of Financial Asset and Enforcement of Security Interest bill was passed. The bill proposed the established of Assets Reconstruction Companies (ARCs) based on the recommendation of Narsimhan Committee. This act was a provision for the banks to do away with the bad loans. However, there was no much gain from this act. According to the act, Asset Reconstruction Company of India Ltd. with 8 shareholders i.e. H.D.F.C. Bank, IDBI Bank, Federal Bank, South Indian Bank, S.B.I., IDBI and ICICI Bank with an initial capital of Rs.10000 Crore has been established. This act has a second aspect of enforcement of security of interests. In spite of existence of debt recovery tribunals loan recovery was still a problem. So this act provides for acquisition of security offered for the loan directly 60 days after serving notice on the defaulter and realized the value by setting away the security.

3. Credit Information Bureau :

To prevent loans for turning into NPAs and information system is required. If a borrower is defaulter of one bank, all other banks must be informed about this so that they may avoid lending to him. A Credit Information Bureau can help in this regards. It can maintain a data bank, which can be assessed by all lending institutions. Many developed and developing countries have followed these steps to solve the problems of NPAs.

4. Lok Adalat :

Lok Adalat is also a good measure to resolve the problem of NPAs, particularly it is suitable for the recovery of small loan. Debt recovery tribunals (DRTs) have been authorized to arrange Lok Adalat for NPAs of Rs.10 Lacs and above.

5. Corporate Debt Restructuring (CDR) :

The another way to reduce NPAs is to reduce the burden of debt on corporate sector Debt Restructuring. For this R.B.I. has issued guidelines. Thus, the corporate Debt Restructuring would have three-tier structure.

- i) Tier I : CDR Standing Forum which will lay down the policies and guidelines and monitor the progress of CDR.
- ii) Tier II : CDR empowered group will examine the viability and rehabilitation potential and approve a reconstructing package.
- iii) Tier III : CDR Cell will scrutinize the proposal, collect all relevant information and place it before the CDR empowered group.

6. Compromise Settlements :

Compromise Settlement Scheme also provides a mechanism for the recovery of NPAs. The R.B.I. has issued a guidelines in 1999, 2000 and 2001. This measure applies to advances below Rs.10 Crore. The filed cases of NPAs and pending cases before courts and DRTs are covered under this. The cases of willful default and fraud are excluded. However, response to this scheme was poor and therefore, the R.B.I. issued new guidelines and extended till April 30, 2003. Due to the initiatives taken to tackle the problem of NPAs, the recovery of all scheduled commercial banks increased from Rs.9716 crores in 1999 to Rs.17588 crores in 2002. But not much success is attained in reducing the NPAs.

6.5 Capital Adequacy Norms (CAN)

It has been accepted the capital base of the bank is a very vital factor in determining the soundness of the banking system. Since in India the capital base had become very weak, it is essential to strengthen it by the norms. As per the R.B.I.'s information, the ratio of paid-up capital and reserves to the deposits of banks had declined from 6.7% in 1956 to 4.1% in 1961 and 2.1% in 1980. However, as a result of capital adequacy norms it increased to 7.53% in 1995. Bank for International Settlement (BIS), Switzerland appointed Basle Committee (1988) for Banking supervisor. Basle Committee suggested minimum capital requirements for banks. The Basle Committee has made some principles in consultation with authorities of fifteen emerging economies including India. One of the important issues of the committee had been the capital adequacy ratio. The R.B.I. appointed a committee under the Chairmanship of Narsimham to suggest resources in the financial sector. The recommendations given by the Narsimham Committee were similar to the Basle Committee recommendations.

Prudential Norms are the norms, rules or guidelines prescribed by the Central Bank of the country. The main objective of these norms is to protect the interest of depositors. Such norms vary from country to country. However, these norms are decided according to international standards.

Banks gets their income basically from lending and investment activities. To fulfill these activities banks use deposits money. If there is a loss in the lending and investment decisions, then the interest of depositors are affected. To solve these problems, banks need to use their funds adequately without harming the interest of the depositors. An international and standard recommended capital adequacy ratio. It is a

ratio of the amount of banks capital in relation to amount of credit exposure.

There are two types of capital to establish Capital Adequacy Norms as following :

Tier I Capital : This consists of financial capital which is more liquid and reliable. It consists of paid-up capital, banks statutory reserves, free reserves and capital reserves. This is important capital of a bank since its safeguards the interest of the bank and assures stability of the financial system.

Tier II Capital : Though this capital offers a less protection to the depositors, it can absorb losses of banks. It consist of paid-up value of perpetual preference shares, revaluation of assets, capital investments (which combine the features of equity and debt) and sub-ordinated debt. It is important to note that this. Tier II capital can not exceed 50% of tier I capital to arrive at a prescribed Capital Adequacy Norms.

Minimum CAN.

Basle Committee has set the norms for Capital Adequacy Ratio as following:

- a) Tier I capital to total risk weighted credit exposures to be not less than 4%.
- b) Total capital (i.e. Tier I plus Tier II Capital) to total risk weighted capital exposures to be not less than 8%.

According to Basle Norms, the banks will have to identify their Tier I and Tier II capital and assign risk weights to the assets. Then, the banks will have to assess the Capital to Risk Weighted Assets Ratio (CRAR). The minimum CAR which Indian Banks are required to meet is set at 9%.

$$\text{Capital Adequacy Ratio} = \frac{(\text{Tier I Capital}) + (\text{Tier II Capital})}{\text{Risk weighted asset}}$$

$$\text{OR Capital Adequacy Ratio (CAR)} = \frac{\text{Capital}}{\text{Risk weighted asset}}$$

As shown in the above ratios, CAR measure the amount of bank's capital in relation to the amount of the risk weighted assets. It takes into account the degree of risk in the credit exposures of a bank, the higher the CAR, the greater the level unexpected losses it can absorb before becoming insolvent (or bankrupt).

6.6 Risk Management in Indian Banks

The R.B.I. issued a “Guidance Note on Management of Operational Risk” in October, 2005 to enable the banks to have a smooth and social transition to the CAN. Banks are encouraged to comply with ‘sound practices’ for the management and supervision of operational risk’ issued by the Basle Committee as Banking Supervisor in February, 2003.

Indian banks for the problem of NPAs due to inefficiency to manage credit risk of the banks. Increasing NPAs have a direct impact on banks profitability as they are forced to make provisions on NPAs, as per the guidelines from the R.B.I. Nowadays banking habits among people have improved which resulted into or upward shift in their deposits. However, under the back drop of banking sector reforms (lowering down of Bank rate, CAR & SLR), the banks are worried about the full utilization of excess liquidity due to the fear of growing NPAs.

Following Steps help in the Risk Management in the Banks.

i) Credit Risk Management :

It is an important measure to manage the credit risk of a bank. For this NPA must be reduced. There is a difference between two issues credit risk management and non-performing assets (NPAs). NPAs are the result of past lending policy of a bank where effect falls or the present situation of a bank which forms risk and default to a bank credit risk management is concerned with managing the quality of credit portfolio before the defaults. Thus it is an attempt to avoid the default by proper management of credit.

ii) In order to manage risks :

The banks were advised to maintain capital of at least 9 % of the risk weighted assets for both credit risks and market risk for both Held For Trading (HFT) and Available For Sale (AFS).

iii) In view of growing housing and consumer :

Credit , risk management steps were undertaken. The risk weights were increased in October 2004, from 50% to 75% in case of housing loans and from 100 % to 125 % in case of consumer credit.

iv) Further it was decided :

In April 2006 that bank’s total exposure to Venture Capital funds will form a part of their capital market exposure and banks should henceforth assign a higher risk weight of 150 % to these exposures.

v) Securitizations and Reconstruction :

Of financial Asset and Enforcement of Security Interest Act 2002. To reduce NPAs, and protect the interests of the borrowers the

government of India has enacted this Act of 2002. Under this Act, banks can issue notices to defaulters to pay up the dues. Borrowers have to clear their dues within 60 days. Besides the banker can also take- over the management of the borrowers assets.

Check your progress :

1. What kind of security is provided by Securitization Act ?
 2. What is Compromise Settlement ?
 3. State two types of capital to establish Capital Adequacy Norms.
-
-
-

6.7 Summary

Commercial Banks play an important role in the financial development and eventually economic development of a country, developed as well as developing country.

Indian commercial banks have to play a dual role of facilitation of growth as well as profit making institution. However, it faces a problem of NPAs. Indian banks to meet international standards have to follow Capital Adequacy norms. This has made them to emerge larger in size, technological better equipped and stronger in capital base.

The government of India has taken many steps to improve the banking sector in India. Narsimham Committee in 1991 and 1998 recommended various reforms for the banking improvements. The banks have to follow the prudential and capital Adequacy Norms.

The Regulatory mechanism has ensured the good health of banking sector in India. With proper risk management steps, the R.B.I. has tried to overcome the problem of NPAs. Thus, with CAN and risk management, commercial banks, continue to play an important role in the Indian economy.

6.8 Questions

1. Discuss the issue of non-performing assets.
2. Explain the management of NPA.
3. Explain capital adequacy norms.
4. Write of note on following :
a) Basle Accord 1 and 2. b) Risk Management in Indian Banks.
5. Discuss the causes for the growth of NPAs.



Non Banking Financial Companies (NBFCs)

Unit structure

- 7.0 Objectives
- 7.1. Introduction
- 7.2 Overview of Non Bank Financial Companies (NBFCs)
- 7.3 Growth of NBFCs
- 7.4 Problems of NBFCs
- 7.5 Impact of NBFCs on India's Economic Development
- 7.6 Regulation of NBFCs
- 7.7 RBI's Directive and Guidelines to Regulate the NBFC's
- 7.8 Summary
- 7.9 Questions

7.0 Objectives

1. To take an overview of developing banking in India
2. To understand the meaning, types and growth of Non-Banking Finance Companies
3. To study the regulation of NBFC

7.1 Introduction

Non- Banking Financial Intermediaries (NBFIS) play an important role of adding to the rate of growth of financial market. Due to which the rate of economic growth of a country is accelerated. NBFIs play an important role in increasing saving and investment. It influences the economy by mobilization savings, bridging the credit gaps and channelizing the investments in proper directions.

Indian financial intermediaries are largely privately owned, decentralized and relatively small sized. Some of the NBFIs are engaged in fund based business while others provide financial services to the investors.

The discussion of an overview of NBFIs will be followed by growth and types of NBFCs. A detailed discussion is given on a few types of NBFCs such as mutual funds, UTI & LIC. Finally the regulation non-bank financial companies monetary policy and NBFCs are discussed in this unit.

7.2 Overview of Non Bank Financial Companies (NBFCs)

There has been a radical transformation in the functioning of NBFCs since post 1995 period. There were many small NBFCs working in India, whose information is not available. NBFCs perform a wide range of functions and they also offer financial services to the investors.

Financial intermediary is an institution which collect savings and issue returns by using the funds for productive purposes. They are the links between borrowers and lenders. As an intermediary, NBFIs also maintain safety and liquidity in the process of resource mobilization. They play an important role in the saving - investment process by raising the level of saving and investment and by proper allocation of savings in productive investments. Many a times, commercial bank have the limitations to fulfill the financial requirements of a country and its investors. This leaves a room for growth to the Non - bank financial companies

7.2.1 Definition of NBFs :

Non - Bank Financial Companies is a group of intermediaries other than commercial bank and cooperative banks. They include institutions like development banks, insurance companies, merchant banks etc.

Some of the important NBFIs are

- 1 Development banks such as IDBI, IFCI, ICICI, SFCs etc.
- 2 Unit Trust of India
- 3 Provident Fund and post offices
- 4 Other investment companies like insurance companies, Loan or Finance companies etc.

The RBI (Amendment) Act, 1997 defines NBFCs as “an institution or company whose principle business is to accept deposits under any scheme or arrangement or in any other manner and lend in any manner.”

This definition unlike the earlier definition of NBFCs, is an extensive definition.

7.2.2 Classification of Financial Intermediaries :

The NBFC fall under different forms on the basis of their activities on their business as under.

1. Hire purchase companies (HPFC)
2. Investment Companies (IC)
3. Mutual Fund Companies (MFC)
4. Loan Companies (LC)
5. Housing Finance Companies (HFC)
6. Equipment Leasing Finance Companies (ELC)
7. Residuary non-banking finance companies.
8. Miscellaneous non banking companies (MNBC) or Chit Fund Companies

Let us discuss the meaning and functions of these forms of NBFCs in detail.

1) Hire Purchase Finance Companies :

The sources of hire purchase finance are

- i) Hire purchase finance companies
- ii) Retail and wholesale traders (i.e. sellers) and
- iii) Banks and financial institutions

i) Hire-purchase finance companies are the public or private limited companies or partnership firms who offer credit for acquiring durable goods. Hire purchase finance or credit is a system under which term loans for purchase of goods and services are advanced which have to be liquidated under the installment plan,

The terms of hire purchase credit may vary from product to product. The down payment ranges between 10 percent to 25 percent and may be as high as 40 percent.

The period of credit is generally three years. The hire purchase credit is available for a wide range of product and services. A large part of hire purchase finance is made available for the purchase of commercial vehicles and the borrowers are the transport operators.

ii) The retail and wholesale traders are the other source of hire purchase finance. When the sellers provide hire-purchase credit, their sources of funds are their own capital or borrowing from financial institutions. The financial institutions may finance the sellers or alternatively the buyers by providing instalment loans.

iii) Besides the Non-Banking Financial Institutions, commercial banks, co-operative banks and development financial institutions also operate in the use of hire purchase finance.

These include institutions like IDBI, ICICI, SFCs, Agro Industries Corporation etc.

(2) Investment Companies :

The Investment companies are mostly controlled by large business or industrial groups and their investments are concentrated in the companies of industrial groups to which they belong. The main business of these companies is of acquiring securities and trading in such securities.

These companies provide finance mainly to companies associated with business houses. Because the companies are formed by these business houses themselves.

As against open-end investment companies or Mutual Funds/ Unit Trusts , these companies are close-end organization having a fixed amount of share capital. Almost all prominent industrial groups have their own investment companies.

Two categories of Investment companies are :

- (i) Primary Dealers (PDs)
- (ii) Satellite Dealers (SDs)

(i) Primary Dealers are functional since 1996. There were 15 PDs by the end of March, 2000. At present there are 18 PDs. The minimum Net Owned Fund (NOF) is Rs-50 crores, PDS are meant for strengthening the securities market. The RBI prescribed new guidelines in Jan. 2002 to improve the risk management system of PDs. PDs are required to maintain CRAR of 15 per cent. In view of the risks in accepting intercorporate deposits. PDs are advised to restrict acceptance of ICDs to 50 percent of NOF.

(ii) Satellite Dealers (SDs) : As second tier dealers, SDs were introduced in Dec.1996. Nine SDs are registered to perform in government securities market. The response is limited as only 4 SDs are in operation. The SD Scheme has been discontinued from May 31, 2002.

(3) Mutual Fund Companies :

Mutual Fund Companies or Nidhis offer loans to individuals without any complicated procedure. These companies are easily approachable and they customise their loans to the financial needs of their customers.

The sources of funds for Nidhis are share capital, deposits from their members, and deposits from the public.

Nidhis advance loans to their members for several purposes as following :

- (i) House construction
- (ii) Repair of house
- (iii) Marriage

- (iv) Redemption of old debts.
- (v) Medical Expenses etc.

The loans advanced by Nidhis are generally for consumption purposes.

The main characteristics of Nidhis are :

- (a) Local character
- (b) Easy Approachability, and
- (c) Absence of complicated procedure.

Nidhis offer saving schemes and make credit available to those whose credit needs remain unmet by the commercial banks. Nidhis charge interest rates which are reasonable and are comparable to those of commercial banks. Nidhis are exempted from the main provisions of the RBI Act, 1934.

4) Loan companies

Loan companies are generally small partnership concerns which obtain funds in the form of deposits from the public and give loans to wholesale and retail traders, small scale industries and self employed persons. These companies attract deposits from the public by offering higher rates of interest along with various kinds of prizes, gifts etc. These companies give loans at relatively higher rates of interest.

The deposits accepted by these companies are mainly fixed deposits and their funds are partly kept in fixed deposits with banks and the remaining is used to make loans and advances. The borrowers of funds from these companies are those who cannot get adequate credit from commercial banks.

(5) Housing Finance Companies :

Finance is provided for housing as mortgage loans. It is one of the most important finance required by middle class and cover middle class individuals.

Housing finance is supplied by

- (i) Specialised institutions like :
 - (a) Housing Boards in different states and apex co-operative housing finance societies.
 - (b) HUDCO i.e. Housing and Urban Development Corporation, HDFC i.e. Housing Development Finance Corporation.
- (ii) Government at State and Central level
- (iii) Insurance companies like LIC & GIC
- (iv) Commercial banks
- (v) Private housing finance companies and Nidhis

Functions of Housing Finance companies are stated below

- (a) Financing of the acquisition of house.
- (b) Financing of the construction of house .
- (c) Financing of the acquisition of plot of land and I
- (d) Financing of the repair and extension of a house.

There are more than 400 housing finance companies in operation. The RBI has stipulated that the housing finance companies should mobilise household savings in the form of deposit with maturities beyond two years.

Some of the major housing financing Companies are discussed in detail.

(i) Housing and Urban Development Corporation (HUDCO) :

It is the national level institution which gives loans to individuals and societies for building houses and flats. Seventy percent of HUDCO's loans are reserved for economically weaker sections and lower income groups and rural areas. Till March 1993 HUDCO had financed 9,420 projects involving a cost of Rs. 12,490 crores. This has meant the construction of 5.5 million houses out of which 46% are located in rural areas.

(ii) Housing Development Finance Corporation Limited (HDFC) :

This is also a national level housing finance institution. It was set up in 1977 to provide term finance to middle class people and lower income groups for the construction of houses, buying of houses etc.

Till March 1993, HDFC had sanctioned Rs.4,470 crores in housing loans.

(iii) The State Housing Finance Societies :

These societies are established in every State and they advance loans to affiliated primary co-operative housing societies for construction of dwelling housing, purchase of land and repayment mortgage debt.

(iv) Housing Finance subsidiaries :

Like Can Fin. 11011705 Limited, GIC Grih Vitt Limited, State Bank Housing Finance Corporation and LIC Housing Finance Limited Company etc. also provided housing loans.

(6) Equipment Leasing Finance Companies :

It involves a contract whereby the ownership, financing and risk taking of any equipment or asset are separated and shared by two or many parties. In a leasing business, the user of a capital equipment (i.e. an investor) does not buy the product himself but only buys the use of it against payment on a monthly rental fee to a leasing company which owns the product.

The prospect of leasing business are good in India, due to growing needs for investment and scarcity of funds in public financial institutions.

The organisations engaged in lease **finance** business include -

- (i) Nationalised banks,
- (ii) All India financial institutions like ICICI, IDBI, IFCI, SIDBI, HDFC etc.
- (iii) Insurance companies like GIC & LIC.
- (iv) State level SIDCs and SIICs
- (v) Private sector manufacturing companies.
- (vi) NBFCs : Most of these companies are small private limited companies.

The main function of leasing companies is to lease out equipment on rent to industrial companies. Leasing is a form of rental system. A lease is a contractual arrangement whereby the lessor grants the lease the right to use an asset in return for periodical lease-rent payments.

(7) Residuary Non-banking Finance Companies :

These are companies which receive deposits and do not belong to any of the other categories of NBFCs.

There are number of unhealthy features of these companies such as :

- (i) Negative or Negligible NOF.
- (ii) Understatement of their deposit liability.
- (iii) Forfeiture of deposits.
- (iv) Discontinuation of deposit certificates.
- (v) Low rates of return on deposits.
- (vi) Payment of high rates of commission
- (vii) Levy of service charge on the depositors.

The apex has taken up different measures to remove these features, Under the new regulatory framework of the RBI (Amendment) Act, 1997, the RBI has extended prudential norm-3 to these companies, introduced compulsory registration requirement, specified minimum rates of interest payable on their deposits under different schemes. The RBI has stepped up the inspection, and monitoring of the activities of these companies.

Check your progress :

1. Define NBFC.
2. State the sources of hire purchase finance.
3. State the categories of Investment Companies.

4. Explain the functions of Housing Finance Companies.

7.3 Growth of NBFs

The number of NBFCs has gone up from 2,941 in 1970, to 41,000 in 1997. Out of which, many of them are private limited companies (80 to 84%) and remaining are public sector companies.

Following table shows the deposits with NBFC since 1981 to 1996

Table 7. 1

Total deposits with NBFCs	
Year	Total deposits (Rs. In crore)
1981	1,477
1984	3,162
1987	5,942
1990	14,645
1991	17,236
1992	20,450
1993	44,957
1994	56,409
1995	90,097
1996	1,08,437

Source : RBI bulletins and RBI Report

As shown in table 7.1 the total deposits are rising fast. From Rs. 1,477 crores to Rs. 1,08,434 crore in 1996. Over this period the percentage wise contribution to the total deposits by different types of NBFCs in the following range.

Table 7. 2

Name of NBFC	Percentage to the total deposits of NBFC		
	1970	1990	1994
1.HDFC	15.13	8.36	10.37
2.LC	56.30	46.49	47.42
3.IC	11.76	12.72	7.14
4.HFC	0.00	8.05	16.02
5.MFC	11.76	1.32	1.93
6.ELC	4.20	16.52	15.41
7.MNBC	11.68	6.53	1.70

(Source : RBI bulletin and RBI Report 1996-97)

The above table shows the share of different types of NBFCs in the total deposits. During 1970-1994, Leasing Companies (LCs) bare the highest share to the total deposits throughout the period. The Equipment Leasing Companies (ELCs) and Housing Finance Companies (HFC) have earned increasing share in total deposits from 1970 to 1997 of 15.41 % and 16.02 % respectively.

Main Features of Growth of NBFCs

1. High Rate of Growth of NBFCs

From a mere deposit of Rs 119 crore in 1970 the total deposits of NBFCs have reached to Rs. 1,08,434 crores in 1996. The annual compound rate of growth of aggregate deposits of NBFCs has been 29% during 1970-1996

2. Total number of NBFCs has increased

About 745 companies constitute the core companies. About 9% to 21% of NBFCs have accumulated for 94 to 97% of total deposits during the period of 1980-90

3. Exceeded the growth of Commercial Banks

The deposit growth of NBFCs is higher than that of commercial banks during the period of 1980 to 1990.

4. Increase in the mobilization of funds.

The volume of mobilized funds has increased vis-avis commercial banks.

5. An Increase in the resources with NBFCs

In addition to the deposits, the resources of NBFCs consisting of Net owned funds have increased substantially from Rs. 119 crore in 1970 to Rs. 75,079 crore in 1993-94.

Reasons for the growth of NBFCs

1. NBFCs provide ready to use services to the investors.
2. Relatively lower degree of regulation of NBFCs compared to regulation of the banks.
3. Higher degree of customer-oriented approach.
4. Simplicity and Speed of their services.
5. High rates of interest on deposits to small savers.

7.4 Problems of NBFCs

- (a) NBFC *may* not work as per directions of the RBI. Due to this the objectives of monetary policy may not be fulfilled.
- (b) Offering of High rate of interest : NBFCs may offer high rate of interest to its investors but later on, due to some problem, may not be in a position to do so.
- (c) Many Leakages in NBFCs : This is because the entire fund goes through banking system in each turnover period, of which only that portion of saving goes through income turnover period which is allotted to NBFI. In other words the banks provide excess of funds of the people and NBFIs act as a channel to transfer the saving into an investment.

All this create a competition between banks and non-bank financial institutions. Therefore, the RBI controls its operations as follows :

- (1) **Registration of NBFCs** : A NBFC owning funds of Rs.25 lakh has to register itself under the control of the RBI. Similarly, the RBI has a right to cancel the registration of NBFCs.
- (2) **Maintenance of liquidity** : All NBFCs have to maintain 10% to 15% of their assets in liquid form (cash). This is necessary to control credit created by the NBFC. During inflation, credit creating activities are contracted to maintain price stability.
- (3) **Reserve Fund** : All NBFCs have to create a reserve fund and transfer not less than 20% of their net deposits to it every year,
- (4) **RBI Directions and Norms** : As and when required, the RBI can control the activities of the NBFC by the issue of disclosure, prudential norms, directions relating to credit and investment.
- (5) **Nomination facility, to the investors** : NBFCs, as per the RBI guidelines have to provide nomination facility to their investors or depositors.
- (6) **Capital Adequacy norm** : All NBFCs have to achieve a minimum capital adequacy norm of 8%.

- (7) **Credit Rating** : All NBFCs have to obtain credit rating from the credit rating agencies.
- (8) **Ceiling on interest rate** : The RBI has imposed a ceiling c limitation of 15% interest rate on deposits in Mutual Benefit financial Company (MBFC) and 'Nidhis'.

NBFC and Monetary Policy :

NBFCs remained unregulated until 1997. When the RBI Act was amended in 1997, a regulatory framework was made for the functioning of NBFCs. Earlier times, NBFCs were offering high interest rate to their investors. They were regarded as a threat to the functioning of monetary policy of the RBI. Secondly, NBFCs were giving loans to those who were turned down by the banks. As a result the effectiveness of the NBFC had be affected. So, suggestions were made that the monetary controls should be implemented for NBFCs like commercial and cooperative banks.

The RBI, thus, can now issue directives and guidelines to the NBFCs as it is in case of banks. The RBI exercises its power to regulate the activities of the NBFC by various methods of credit control. Since 1997, through the instruments like prudential norms, ceiling on interest rate, Registration of NBFCs, etc. controls the operation of NBFCs for the healthy growth of them.

Check your progress

1. Explain the features and Reasons for the growth of NBFCs.
2. Explain how RBI controls the operations of NBFCs

7.5 The Impact of NBFIs on India's Economic Development

Financial intermediaries are broadly classified into two categories namely

- (a) Banking Intermediaries (Commercial banks, Co-operative banks and private banks)
- (b) Non-banking financial intermediaries (Insurance and investment companies, stock exchanges, mutual funds, development banks and others)

Financial intermediaries play an important role in the economic development of a country. In order to attain highest rate of economic growth, the money market should be a developed one. In India still there is a scope for the development of money market.

Following are main functions of financial intermediaries :

(1) Growth of saving and investment:

Financial intermediaries collect savings from the people and the institutions in return lend money to the borrowers. Due to this, savings is channelized into the process of investment. High saving and investment are necessary for high rate of economic development.

(2) Helps small investors :

An intermediary buys direct securities in denominations preferred by the ultimate borrowers. Often, small investors may not buy securities directly from the issuers. Therefore, financial intermediaries may play a role of link between investors and borrowers.

(3) Flexibility in the maturity of the assets :

Generally, people like to invest in the financial assets which are of short-period, whereas borrowers require money for long-period. Financial intermediaries perform the task of fulfilling the lags in the time-period preference of the two parties (investors and borrowers).

(4) Greater Liquidity :

Financial intermediaries offer the facility of withdrawing the money before the maturity period of the financial assets. Thus, there is greater liquidity of the assets.

(5) Low risk and safety :

Financial intermediaries minimise risks involved in investment. Similarly, money invested with financial intermediaries is highly safe and offer a reasonable rate of interest on the investment.

(6) Wide coverage :

Financial intermediaries have many branches spread over a wide range of area. LIC, UTI, banks are located at different places, convenient for the people.

(7) Information and analysis :

Financial intermediaries provide information about the various investment schemes. They also analyse the securities and their advantages in investment.

(8) Avoidance of malpractices :

Village money lenders adopt malpractices like charging high-rates for loans and other cheating practices. These practices are avoided by

the financial intermediaries. The above discussion shows -that NBFCs play an important role in economic development. In India, NBFIs have contributed their role in attaining high saving and investment rate. High saving and investment are two wheels for economic growth of a country, India has achieved high rate of investment due to development of money market consisted of NBFC.

7.6 Regulation of NBFCs

The NBFCs have been performing an useful role in the economic and financial development of a country. However there have been certain defects in them.

Problems of NBFC:

1. NBFC may not work as per the directions of the RBI. Due to this the objectives of the monetary policy of RBI may not be fulfilled.
2. Offering of High rate of Interest .
3. NBFC may offer high rate of interest to its investors initially, but later on they may not be able to do so.
4. Leakages in NBFCs.

This happens because the entire fund goes through banking system in each turnover period, of which only that portion goes through income turnover period which is allotted to NBFCs. In other words, banks provide excess of funds of the people and the NBFC act as a channel to transfer the saving into an investment.

All this leads to competition between banks and non-banks financial institutions. Therefore the RBI regulates its functioning as per following :

Enactment of Reserve Bank of India (Amendment) Act, 1997 has brought NBFCs under jurisdiction of the RBI. The major regulatory provisions are given below.

1 Registration of NBFCs :

A NBFC owning funds of Rs. 25 lakh has to register itself under the control of the RBI. Similarly, the RBI has the right to cancel the registration of NBFCs.

2. Maintenance of liquidity :

All NBFCs have to maintain 10% to 15% of their assets in liquid form (cash). This is necessary to control credit created by the NBFC. During inflation, creating activities are contracted to maintain price stability.

3. Reserve Fund :

All NBFCs have to create a reserve fund and transfer not less than 20% of their net deposits to it every year .

4. RBI directions and Norms :

As and when the RBI can control the activities of NBFC by the issue of disclosure, prudential norms and directions relating to credit and investment.

5. Nomination facility to the investors :

NBFCs, as per the RBI guidelines have to provide nomination facility to their investors or depositors .

6. Capital adequacy norm :

All NBFCs have to achieve a minimum capital adequacy ratio of 8%

7. Credit Rating :

All NBFCs have to obtain 'credit Rating' from credit rating agencies.

8. Ceiling on interest rates :

The RBI has imposed a ceiling on a limitation of 15% interest on deposits in Mutual Benefit Financial Company (MBFC) and 'Nidhis'

Check your progress :

1. What are the functions of financial intermediaries ?
2. Explain the RBIs regulatory provisions for NBFCs.

7.7 RBI's DIRECTIVE AND GUIDELINES TO REGULATE THE NBFC'S

NBFCs remained unregulated till 1997. But the RBI Act (Amendment) 1997, gave a regulatory framework for the functioning of the NBFCs.

Thus to improve the effectiveness of NBFCs, the RBI has issued the directives and guidelines to regulate the NBFCs.

- 1) Mutual Funds (MF)
- 2) Unit Trust of India
- 3) Insurance Companies

7.7.1 Mutual Funds :

Mutual Funds is an intermediary which buys or sells securities on behalf of its unit holders. Because unit holders may not be able to buy or sell securities economically and profitably. It is an important form of NBFIs which mobilizes savings. The first MF in India was established in 1964. It was called as the Unit Trust of India. MF enables small income earners and middle income earners a high rate of return on their savings.

MFs can be broadly classified into public sector MFs and private sector MFs. All MFs sponsored by the UTI, banks and financial institutions are public sector MFs, whereas, other MFs are called private MFs which were started in 1993.

In MFs business, the UTI plays an important role in India. It was established in 1964 50% of its share capital was owned by IDBI (formerly under the RBI) and rest of the share capital is subscribed by the LIC, the SBI, scheduled commercial banks, the IFCI and the ICICI.

Objectives of MFs (Advantages) :

- (1) To provide an opportunity-of investment to small investors at par with big investors.
- (2) To give high rate of return on investment.
- (3) It enables or provides the benefits of portfolio management of stock market securities to the shareholder.
- (4) It minimizes the risk in investment.

Other advantages of MFs :

- (1) **Economies** (or cost advantages) of scale of operations (i.e. It minimizes the cost of buying the securities.)
- (2) **Spread of risk** : Because the small investor holds large and diversified portfolio of assets, the risk is reduced.
- (3) **Expert and professional management** : MF provide expert guidance, investment consultancy to the investors.
- (4) **Diversification of portfolio**: of assets reduces the risk involved in the investment.
- (5) **Low brokerage and transaction cost** : Generally, brokerage and transaction cost of assets are high. .However, MFs charge low brokerage cost.
- (6) **High rate of return** : MFs assure high rate of return to its investors which increases overall level of investment in an economy.
- (7) **Convenient Administration** : The Administration of MFs regarding assets is convenient as compared to other investments.

- (8) **Liquidity and Flexibility** : The securities held by the investors can be easily transformed into cash. There is also a flexibility in MFs.
- (9) **Tax benefits** : Tax exemptions are issued on securities and assets held by the investors in MFs.

Table 7.3
Cumulative Net Assets of MFs (as on Dec. 31. 01)
 (Rs. Crore)

Sector	Amount	Percent Total
Private	42,582	41.8
Public	8,059	7.9
UTI	51,181	50.3
Total	1,01,822	100.0

(Source : Indian Financial System by Deodhar and Abhyankar, pp.272)

The number of MFs has increased from one in 1964 to 38 in 2003. There are 10 public sector funds and 29 private sector funds. The total investment of MFs in India has increased from Rs.72,435 crore in 1995-96 to Rs.1,00,594 crore in 2002-03.

Policy Measures :

- (1) SEBI controls and regulates the working of MFs.
- (2) SEBI issues the guidelines and norms for disclosure and advertisement of MFs schemes.
- (3) SEBI has made it compulsory to MF to appoint agents and distributors certified by the Association of Mutual Funds of India. (AMFI).

Conclusion :

Thus, MF business in India plays a dominant role in Indian economy. The UTI plays a dominant role. MF is highly concentrated fund-wise and scheme-wise and the small investors are not much benefited from MFs. Similarly, MFs are popular only in urban high and middle, income groups.

7.7.2 Unit Trust of India :

The importance of unit trusts in mobilising savings of small savers was recognised in early 20th century and the need for setting up these trusts was stressed by the Shroff Committee in 1954. However, the Unit Trust of India (UTI) was set up only in 1964 as a public sector financial institution.

Initial Capital :

The initial capital of Unit Trust was statutorily fixed at Rs.5 crores which was to be contributed by the Reserve Bank (Rs.2.5 crore), the LIC (0.75 crore), the SBI and the Associate Banks (Rs.0.75 crores) and other financial institutions and banks (Rs. 1.0 crore).

Since the Trust does not have any share capital, it operates on the principle of “no profit no loss” as all income and gains, net of all costs and development charges, ultimately borne by the investors.

Unit Capital :

The main source of the funds of the UTI is the unit capital raised from the sale of units to the public under various schemes. For example, under the Unit Scheme 1964 (US 64), the Units are sold at the face value of Rs.10/- each but their market price is higher than this value.

Objectives :

Its objectives are as under :

- (i) To encourage saving habit among the people.
- (ii) To pool the savings of the people of different income groups for secured and profitable investment.
- (iii) To provide financial assistance to industrial enterprises through purchase of their securities or through the underwriting of securities.

UTI provides an attractive interest rate of dividend to unit holders which is also exempted from Income Tax under the Income Tax Act.

Financial Resources :

Major sources of funds are from sale of units. The initial capital of the UTI was Rs.5 crore which was raised by the RBI, LIC SBI and other financial institutions.

Total Fund till today :

The total number of unit holders registered with the Trust at present exceed 20 million whose holdings amounted to nearly Rs.34,000/- crores.

Performance of the UTI :

The beginning of US-64 a scheme under the UTI has been a landmark. In principle, the aim of the Unit Trust is appreciable since it started the mobilisation of its resources in trade and industry. The trust being a public sector enterprise, has created confidence among the general public. Besides, it has received a number of tax concessions from the government. The UTI investment fulfills the safety and liquidity conditions with respect to the investment.

Problems faced by UTI:

Following the failure in the UTI's, US-64 Scheme, the government in 2001-02 took effort to resolve the problem and protect the investors. Government introduced many structural improvements. Some of them are stated below.

- (a) **Special Unit Scheme in June 1999** : Under this government bought back from UTI of public sector undertakings shares at a value higher than, the prevailing market-value. This helped considerably to transfer money to investors in the US-64.
- (b) **Limited Repurchase Facility** : Investors were given a facility to sell back the units to the UTI at an administrative determined price through which they could sell upto 3000 units. For each unit repurchased by the UTI at a price above net asset value, the government would make the difference to the UTI.
- (c) **Extended Repurchase Facility** : In December 2001, the limit of 3000 unit was raised to 5000 units. In addition the investors above 5000 units were given the assurance that if they existed in May 2003, they would get the higher of NAV or Rs.10. The Government would make up the difference between repurchase price and NAV experienced by the UTI.

Investment Pattern :

UTI invests its funds in various industrial securities keeping in view three guiding principles namely -

- (i) Security
- (ii) Reasonable return, and
- (iii) Contribution to economic development.

The government and the Securities Exchange Board of India (SEBI) have laid down some norms for the Trust's investment such as -

- (1) The investment by the UTI in any one company should not exceed to 5 percent of its total investible funds or 10 percent of the value of the outstanding securities of that company.
- (2) The UTI can not invest more than 5 percent of its funds in the initial issue of any new company.

The UTI investment in government securities has been in between 10 to 20 percent. It had gone up to 24 percent in 1990 - 91 which came down to 11 percent in 1995 - 96.

Functions of UTI :

- (i) **Share Subscription** : It subscribes the shares and debentures issued by various business companies. It also purchases

securities from secondary market. UTI and LIC are the two largest institutional investors in India.

- (ii) **Collecting funds** : UTI collects funds from the public by way of its various schemes such as
- (a) Units Schemes, 1964.
 - (b) Master Share, 1964.
 - (c) Reinvestment Plan, 1966.
 - (d) Children Gift Plan, 1970.
 - (e) Unit-linked Insurance Plan, 1971,
 - (f) Unit Scheme, 1976.
 - (g) Master Equity Plan, 1991, 1992 and 1993 etc.

7.7.3 Insurance Companies :

An insurance company has both economic and social objectives. The premium charged by the insurance companies is the administrative and marketing cost. In return, they offer protection to their investors. The insurance business consists of the spreading of the risk over time and among the organisation and person. Life insurance is governed by law of mortality.

Insurance Companies are working in following areas :

- (1) Health
- (2) Life
- (3) General.

The life insurance is in existence in India since 1818 (186 years old). The first insurance company namely Oriental Insurance Company was established in Calcutta. The General Insurance is existing since 1850 (154 years old). Following table will explain the size and structure of insurance companies.

Table 7.4

Name of company	Period	No. of Companies
Life Insurance	1818 1956	245 (Private sector)
General Insurance	1850-1972	107 (Private sector) +04 Subsidiaries
LIC (after nationalisation)	1956-2000	01 (Public sector)
GIC (after nationalisation)	1972-2000	01 (Public sector)

After 2000, LIC and GIC allowed the private domestic and foreign companies.

Sources of funds of insurance companies :

The main sources of funds are the premiums collected from the policy holders. Mutual funds also generate funds to insurance companies.

Functions of Insurance Companies :

- (1) To protect the life, health and other assets of the individuals and companies.
- (2) To provide finance to industries by way of subscription to the shares and debentures etc.
- (3) To undertake investment and offer a reasonable return to the investors
- (4) To mobilize saving of the people.
- (5) To finance housing schemes and others.

Investment Pattern:

As per the LIC Act of 1956, the corporation has to invest 50% of the investment in bonds and debentures issued by the Central and State government, 25% in Semi-government and public sector and 10 % in the cooperative sector. It directly invests in shares and debentures of companies (which are financially safe) for the policy holders.

Present state of Insurance companies :

At present, there are 24 insurance companies with two state-owned companies (i.e. LIC and GIC). The total insurance premium of LIC and GIC was Rs.62,477 crore in 2001-02 [LIC (80%) and GIC (20%)]. The share of insurance sector in household financial savings has gone, up from 7.6% in 1980 to 10.1% in 1990 and 12% in 2001. The share of insurance sector has been 0.6% in all these years. However, the insurance penetration (i.e., the share of premium as percentage of GD) has remained low at 2% (March 2000).

Life Insurance Corporation (LIC) :

LIC was established in 1956 after the nationalisation and merger of 250 independent life insurance companies. It has its headquarters in Mumbai. Its primary objective is to provide life insurance cover to the people. It also promotes savings. It also gives income tax concessions to the investors.

The main source of fund is premiums paid by the policyholder.

Objectives of LIC :

- (1) To provide life insurance protection to people at reasonable cost.
- (2) To invest the funds and give good return on it.

- (3) To innovate and adapt to meet the requirements of the community.
- (4) Mobilisation of savings of the people.
- (5) To invest funds in public utility and housing schemes.
- (6) Its mission is “explore and enhance the quality of life of people through financial security”.

LIC has various activities like :

- (i) LIC Housing Finance Ltd. (LICHFL)
- (ii) LIC Mutual Fund (LICMF)
- (iii) Jeevan Bima Sahayog Asset Management (JBSAMC)
- (iv) LIC International E.C.

Various policy schemes of LIC :

- (i) Life insurance policy
- (ii) Endowment policy
- (iii) Pension Plan
- (iv) Children's Plan
- (v) Equity linked Plan
- (vi) Group insurance
- (vii) Non-medical insurance
- (viii) Pension plans.

Thus, through its various schemes, policies and plans, LIC mobilises the savings of the people, financially secures their lives by providing good returns on their investment. People also can withdraw their money which is invested in different policies or schemes. There is also a security, of investment in LIC. Similarly, senior citizens are covered under-different schemes, pension plans. About 18% of its policies are protection policies while 60% are saving policies.

LIC has launched 37 insurance plans. It has 1,774 branches, seven zonal offices, 100 divisional offices, 2,048 branch offices and about 6.28 lakh agents. As of now, total individual life insurance investment was Rs.1,75,491 crore in 2000-01 and total premium income in group insurance was Rs.3,133 crore in the same year. LIC has also played an important role in rural areas by mobilising rural savings.

General Insurance Corporation (GIC) :

GIC is controlled by the government: and it has four subsidiaries namely,

- (1) National Insurance Co. Ltd.,
- (2) New India Assurance Co. Ltd.,
- (3) Oriental Fire and General Insurance Co. Ltd.,

- (4) United India Insurance Company. Ltd. GIC's main business is 'fire insurance', then marine business and miscellaneous. GIC's business is under the provision of Insurance Act, 1938. The sources of funds of GIC are premium incomes, reserves, paid-up capital and profits.

The GIC policies are not like the financial claims of LIC. GIC policies are for a period of one year or more. GIC specialises in areas like fire, automobile, marine, aviation, theft, loss, damage, etc. It had introduced co-op insurance in 1985. GIC meets the requirements of industrial and agricultural sector as well as household sector.

Check your progress

1. What do you understand by Mutual Funds ?
2. Which problems are faced by UTI ?
3. Explain the functions of UTI.
4. What do you mean by LIC & GIC ?

7.8 SUMMARY

The main business activity of NBFCs is to accept the deposits under different schemes and give loans in different ways. There are eight different types of NBFCs. They face a tough competition from the commercial banks. The loan Companies are one of the most important NBFCs. Similarly Equipment Leasing Companies and Housing Finance Companies have emerged as major types of NBFCs.

The RBI Act (Amendment) 1997 provides a comprehensive regulation of NBFCs. According to this Act, NBFC can not carry on its business without obtaining a certificate of Registration from the RBI. They also have to comply with all directions on public deposits, prudential norms and liquid assets. They also required to submit periodic returns to the RBI.

7.9 QUESTIONS

1. Define NBFIs, Discuss the different types of NBFCs
2. Write a note on growth of NBFCs
3. Discuss the impact of NBFCs on India's economic development.
4. Explain the measures undertaken by the RBI to control the operation of NBFCs
5. Write note on following :
 - a) Unit Trust of India
 - b) Mutual Fund
 - c) Insurance Companies



Module 3

FINANCIAL MARKETS

MONEY MARKET

Unit structure

- 8.0 Objectives
- 8.1 Introduction of Money Market
- 8.2 Meaning and Functions of Money Market
- 8.3 Structure of Indian Money Market
- 8.4 Characteristics/features/weaknesses of Indian money market
- 8.5 Reform measures to develop Indian money market
- 8.6 Summary
- 8.7 Questions

8.0 OBJECTIVES

- 1. To acquaint the students with concepts of Money Market.
- 2. To study the Constituents of Money Market.
- 3. To Understand Characteristics of Indian Money Market.
- 4. To study the reforms taken place in the Indian Money market.

8.1 INTRODUCTION OF MONEY MARKET

The **money market** is a component of the financial markets for assets involved in short-term borrowing and lending with original maturities of one year or shorter time frames. Trading in the money markets involves Treasury bills, commercial papers, certificates of deposit, federal funds, and short-lived mortgage and asset-backed securities. It provides liquidity funding for the global financial system.

Money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Participants borrow and lend for short periods of time, typically up to thirteen months. Money market trades in short-term financial instruments commonly called “paper.” This contrasts with the capital market for longer-term funding, which is supplied by bonds and equity.

The core of the money market consists of banks borrowing and lending to each other, using commercial paper, repurchase agreements, and similar instruments.

The India money market is a monetary system that involves the lending and borrowing of short-term funds. India money market has seen exponential growth just after the globalization initiative in 1992. It has been observed that financial institutions do employ money market instruments for financing short-term monetary requirements of various sectors such as agriculture, finance and manufacturing. The performance of the India money market has been outstanding in the past 20 years.

Central bank of the country - the Reserve Bank of India (RBI) has always been playing the major role in regulating and controlling the India money market. The intervention of RBI is varied - curbing crisis situations by reducing the cash reserve ratio (CRR) or infusing more money in the economy.

8.2 MEANING AND FUNCTIONS OF MONEY MARKET

The Money market is a market for lending and borrowing of short-term funds. It deals in funds and financial instruments having a maturity period of one or less than one year. It covers money and financial assets that are close substitutes for money.

It is not a place (like the stock market), but an activity undertaken by telephone. It is not a single market but a collection of markets for seven instruments such as call money market, commercial bill market, and so on. It is a wholesale market for short-term debt instruments.

The main players in the money market are Reserve Bank of India (RBI), Discount and Finance House of India (DFHI), mutual funds, bank corporate investors, non-banking finance companies (NBFCs), state governments, provident funds, primary dealers, Securities Trading Corporation of India (STCI) and Public Sector Undertakings (PSUs).

The Reserve Bank of India is the most important constituent of Indian money market. Money market comes within the direct purview of RBI regulation. The objective of RBI operations in the money market is to ensure that liquidity and short-term interest rates are maintained at levels required for achieving the objectives of monetary policy. The primary objective of monetary policy are to ensure economic growth and price stability.

8.2.1 Functions of Money Market :

The important functions of money market are the following :-

1. It provides a mechanism to achieve equilibrium between demand for and supply of short-term funds.

2. It also provides funds in non-inflationary way to the government to meet its deficits.
3. It provides ample avenues for investment of short-term funds with fair returns.
4. It helps the RBI in effective implementation of monetary policy.

Check your progress:

1. What is Money Market ?
 2. Name the different instruments used in the money market .
 3. What are the functions of the money market ?
 4. Explain the role of RBI in regulating money market.
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8.3 STRUCTURE OF INDIAN MONEY MARKET

The Indian money market consists of two segments, namely organised sector and unorganised sector. The RBI is the most important constituent of Indian money market. The organised sector is within the direct purview of RBI regulation. The unorganised sector comprises of indigenous bankers, money lenders and unregulated non-banking financial institutions.

STRUCTURE OF INDIAN MONEY MARKET

ORGANISED SECTOR	UNORGANISED SECTOR
Call Money Market	Indigenous Bankers
Treasury Bills Market	Money Lenders
Commercial Bills Market	Unregulated Non-bank
Market for Certificates of Deposit (CDs) Intermediaries,	Financial
Market for Commercial Papers (CPs) Loan	(Chit funds, Nidhis, companies)
Repos Market	Finance Brokers
Money Market Mutual Funds (MMMFs)	
Discount & Finance House of India (DFHI)	

8.3.1 ORGANIZED SECTOR OF INDIAN MONEY MARKET :

The organised money market is not a single market. It consists of a number of markets such as call money market, treasury bill market, commercial bill market, and markets for CDs, CPs and repos. Money market deals in many instruments like call money, treasury bills, commercial bills, CDs, CPs and repos. The organised money market is further diversified with the setting up The Discount and Finance House of India (DFHI) and Money Market Mutual Funds.

1. The Call Money Market :

The Call Money Market is centered mainly at Mumbai, Calcutta and Madras. In the Call money market, borrowing and lending of funds are carried out just for one day. The funds can be called back within 24 hours. The Call Money Market is also called the Inter Bank Loan Market. The Scheduled Commercial Banks, Co-operative Banks, and the discount and Finance House of India (DFHI) operate in this market. Institutions like LIC, GIC, UTI, IDBI, & NABARD are allowed to operate in the call money market as lenders. The State Bank of India is invariably on the lenders side of the market. The call money market is highly sensitive and it is the most appropriate indicator of the liquidity position of the money market.

2. The Treasury Bill Market :

This market deals with Treasury Bills. In India, Treasury Bills are short term liabilities of the Central Government which are for 91, 182 and 364 days. The treasury bill market is undeveloped in India. The RBI is just a passive holder of these bills. The RBI holds about 90% of the outstanding Treasury Bills. The RBI is under an obligation to purchase all the Treasury bills which are being offered to it by the Govt. It is also required to rediscount the treasury bills presented to it by banks and others. This has resulted in monetization of public debt which has caused inflationary expansion of money supply.

3. Repo Market :

Repo is a money market which helps in collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. The repo market has now been broadened. It now covers not only Central Govt. bills & securities but also securities of State govt., public sector undertakings and private corporate sector.

During times of foreign exchange volatility, repos have been used to prevent speculative activity as funds flow from money market to foreign exchange market.

4. The Commercial Bill Market :

The Commercial Bill Market is a sub-market in which commercial bills are traded. The commercial bills are the bills drawn by the seller to the buyer. The purpose of a commercial bill is to reimburse the seller while the buyer delays payment.

The RBI has taken efforts to develop bill market in India and popularise the use of bills through its Bill Market Schemes of 1952 and 1970. The Commercial Market is very much underdeveloped in India. The major obstacle of the development of bill finance in our country is the dominant cash credit system of bank lending. In order to encourage 'bills' culture, the RBI advised banks in Oct. 1997, that at least 25% of inland credit purchases of borrowers should be through bills.

5. The Certificate of Deposit (CD) Market :

In 1989, the RBI introduced Certificate of Deposit to widen the range of instruments in the money market and to provide greater flexibility to investors. The CDs can be issued only by the commercial banks in multiples of Rs. 25 lakhs. The minimum size of an issue should be Rs. 1 crore. The maturity of CDs will vary between 3 months and 1 year. The CDs are freely transferable by endorsement. The banks pay high rate of interest on CDs.

In 1992, IDBI, ICICI, IFCI, IRBI were permitted to issue CDs with a maturity period of more than 1 year and up to 3 years. In 1993, two more institutions Small Industries Development Bank of India (SIDBI) and Export-Import Bank of India were permitted to issue CDs. CDs are issued at a discount to face value and the discount rate is freely determined. CDs are freely transferable by endorsement and delivery. Due to easy liquidity conditions in the money market, the interest rates on CDs softened during 1996-97.

6. The Commercial Paper (CP) Market :

This was introduced in 1990. The Commercial Paper (CP) can be issued by a listed company which has a working capital of not less than Rs. 5 Crores. They could be issued in multiples of Rs. 25 lakhs. The minimum size of issue being Rs. 1 crore. The company wanting to issue CP is required to obtain a specified rating from an agency approved by the RBI every six months. CPs are freely transferable by endorsement and delivery. The maturity of CP ranges from 3 months to 6 months. The effective rate of interest has been in the range of 9.35% to 20.9% p.a.

7. Money Market Mutual Funds (MMMFs) :

MMMFs were introduced by the RBI in April 1992. The main objective was to provide an additional short-term avenue to individual investors. The RBI allowed certain relaxations in 1995 to make the

scheme more attractive. The limits imposed on their size and investments have been relaxed. The banks, public financial institutions and private sector institutions are allowed to set up MMMFS. Since 1996, the MMMFS are allowed to issue units to corporate enterprises and others on par with other mutual funds. MMMFS have been brought under the preview of SEBI regulations since March 7, 2000. The organised sector of the Indian money market is fairly organised and integrated but it cannot be compared to London and New York Money markets.

8.3.2 The Unorganised Sector:

The three constituents of the unorganised sector of the Indian Money Market are

1. Indigenous bankers
2. Money lenders
3. Non-banking Financial Companies (NBFC) such as Loan or Finance companies, Chit funds and Nidhis.

1. Indigenous Bankers :

Indigenous bankers are individuals or private firms which receive deposits and give loans and thereby operate as banks. Since their activities are not regulated, they belong to the unorganised segment of the money market. Indigenous bankers are different from money lenders in the sense that in addition to making loans they receive deposits and deal in hundies while the money lenders only make loans and do not receive deposits or deal in hundis.

Indigenous banks do not constitute a homogeneous group. Broadly, they can be classified under 4 main groups - Gujarat shroffs, Multani or Shikarpuri Shroffs, Marwari Kayas and Chettiars. The indigenous banks are unwilling to separate their banking and non-banking activities. This has prevented their integration into the organised money market. The bank rate policy of the RBI has no bearing on the lending rates of the indigenous banks who charge excessively high rate of interest. Over the past two decades with the growth of commercial and co-operative banking, the area of operations of indigenous bankers have declined. But they have still survived due to the following favourable factors:-

1. In urban areas, especially cities, indigenous banks are sought by small manufacturers and small traders because commercial banks do not meet their credit needs adequately.
2. Indigenous banks provide clear advances.
3. They offer personalised informal and prompt services.

4. Their operation costs are lower.
5. Since their borrowers are local parties, the risk of default is less.

2. Money lenders :

Money lenders are of 3 types :-

- a. Professional money lenders
- b. Itinerant money lenders
- c. Non-Professional money lenders.

The methods of operation of money lenders are not uniform. Their activities are localised.

Their main features are :-

1. Money lenders do not receive deposits. Their funds are mostly their own.
2. Their borrowers are generally poor such as agricultural labourers, small and marginal farmers, factory workers etc. whose bargaining position is weak.
3. They charge exorbitant rates of interest and indulge in various mal-practices.
4. Their credit is unregulated and the borrowers exploited.

Several legislative measures have been passed to prevent the exploitation of the borrowers by the money lenders but they have not been enforced due to administrative difficulties.

3. Non-banking financial Companies (NBFC) :

The most prominent non-banking financial intermediaries are:

- a) Loan or Finance Companies
- b) Chit Funds
- c) Nidhis.

a. Loan or Finance Companies :

Loan companies are found in all parts of the country. They raise funds through deposits, borrowings and other receipts apart from their own funds. They give loans to retailers, wholesale traders, artisans and other self employed persons. They charge high rate of interest varying from 36% to 48%.

b. Chit Funds :

Chit funds are savings institutions. A chit fund has regular members who make periodical subscriptions to the fund. The beneficiary may be selected by drawing of lots. Each member is also assured of his turn. The chit fund business is popular in Kerala and Tamilnadu. The RBI has no control over the lending activities of the chit funds.

c. Nidhis :

Nidhis are some sort of mutual benefit funds because their dealings are restricted only to the members. The principal source of their funds is

deposits from the members; The loans are given to members at reasonable rates for purposes like house construction. Nidhis operate particularly in South India.

With the amendment of the RBI act of 1997, it has become obligatory for NBFCs to apply for a certificate of registration. By June 2004, 13,671 NBFCs got registered.

Check your progress :

1. What are the two different sectors of Money Market ?
2. Name the different sub markets of Organised sector of money market.
3. Name the different sub markets of Un-Organised sector of money market.
4. What is Commercial Paper (CP) & Certificate of Deposit (CD)?
5. What are different forms of NBFCs ?

8.4 CHARACTERISTICS / FEATURES / WEAKNESSES OF INDIAN MONEY MARKET

1. Existence of Unorganised Money Market :

The dichotomy nature of the Indian money market into the organised and unorganised sector makes it difficult for the RBI to exercise control over the money market. In the unorganised market, there is no differentiation between short term and long term finance. The indigenous bankers have not accepted the conditions of the RBI. Since these bankers and NBFCs are outside the organised money market, the RBI's control over the money market is limited.

2. Lack of Integration :

There is lack of integration between the various sub- markets as well as between the various institutions and agencies constituting the money market. There is less co-ordination between Co-operative banks, Commercial banks, State Bank and Foreign banks. The Commercial banks and Co-operative banks compete with each other. The indigenous banks have their own way of doing business.

3. Multiplicity of Interest rates :

The existence of too many rates of interest is another defect of the Indian money market. In the unorganised money market interest rates differ widely from one area to other even for the same type of loans. The borrowing rates of the Government, the deposit and lending rates of the Commercial and Co-operative banks etc. differ.

The diversity in interest rates is due to lack of integration among the various components of the money market. The immobility of funds from one section of the money market to another is an important cause of the multiplicity of rates of interest. The RBI must effectively rationalise and administer the interest rate structure.

4. Absence of organised bill market:

Though both inland and foreign bills are being purchased as well as discounted by the commercial banks, yet an organised bill market does not exist in the country. Only a limited bill market has been created by RBI under its schemes of 1952 and 1970. These schemes failed to develop a bill market in the country. There is a severe shortage of commercial bills. The popularity of cash credit and lack of uniformity in commercial bills proved to be a serious obstacle to the development of bill market. The bill finance has fallen from 20.3% in 1971 to 9.1% in 1997-98.

5. Shortage of funds:

The Indian money market is characterised by shortage of funds. The demand for loanable funds exceeds its supply. Small savings due to low per capita income, lack of banking habits, inadequate banking facilities and emergence of a parallel economy are also responsible for the shortage of financial resources.

6. Seasonal stringency of money:

Seasonality factor in the availability of funds is another drawback of the money market. This has caused wide seasonal fluctuations in the interest rates.

During the busy season additional finance is required. A monetary stringency is created in the market and interest rates are high. But in slack season, the interest rates drop considerably. Despite the efforts by RBI to moderate the fluctuations in the call money rates, the call money market continued to be highly volatile.

7. Inadequate banking facilities :

Though the commercial banks, have been opened on a large scale, yet banking facilities are inadequate in our country. The rural areas are not covered. In the US, there is a branch of a commercial bank for every

1200 persons while in India, there is a branch for every 15,000 persons. Due to poverty, the savings are small and mobilisation of small savings is difficult.

Indian money market is undeveloped and it lacks a number of sub-markets. It does not attract foreign funds. It cannot be compared with the advanced London and New York money market.

8.5 REFORM MEASURES TO DEVELOP THE INDIAN MONEY MARKET

The RBI initiated a number of policy measures to develop the money market. The Indian money market is now closely knit together, at least in the organised sector.

On the recommendations of the Sukhmoy Chakravorty Committee and Narsimhan Committee, the RBI has initiated a series of reforms.

1. Relaxation of Interest rate regulations:

Banks have been advised to ensure that the interest rates changed remained within reasonable limits. Following the recommendations of the Narasimhan Committee in November 1991, interest rates have been further deregulated and banking and financial institutions have been told to determine and adopt market related rates of interest. In order to stimulate the economy & liquidity position, RBI continued to reduce the bank rate from 10% in 1990-91 to 6% in 2003-04.

2. Reforms in Call and Term Money Markets:

During the 1990s the RBI liberalised entry into call money market to provide more liquidity. At present Banks and Primary dealers (P05) are operating as both lenders and borrowers while a number of non-banking financial institutions and mutual funds are operating only as lenders. The constraints in the term money market has also been removed by the RBI.

3. Introduction of new instruments in the money market:

a. Four major instruments have been introduced in the money market viz. 182 days Treasury bills, 364 days Treasury Bills, Certificate of Deposits (CDs & Commercial Paper (CP). The volume of CDs issued by the Commercial Banks have rose sharply. The primary market for CPs made significant progress since 1992. The Govt. has decided to sell dated Government Securities on auction basis to develop dated securities as a monetary instrument.

b. The heavy stamp duty on usance bill was considered a major disincentive in the bill market. In August 1989, the Government, remitted the stamp duty on usance bill.

c. From 1st May 1989, the RBI deregulated the money market interest rates. This is a major step towards activation of the money market.

4. Refinance from RBI:

The RBI used refinance facilities to various sectors to meet liquidity shortages and control the credit conditions. At present there are two refinance schemes in operation, export credit finance and general refinance. The RBI has kept the refinance rate linked to the bank rate.

5. Money Market Mutual Funds (MMMFs):

In April 1992, Govt. announced the setting up of Money Market Mutual Funds (MMMFs) with the purpose of bringing money market instruments within the reach of individuals. So far, three MMMFs have been set up one each by the IDBI, UTI and one in the private sector.

6. The Discount & Finance House of India(DFHI):

The Discount & Finance House of India(DFHI) was set up on April 25th 1988. Its major function is to bring into the hold of the Indian Money market the entire financial system comprising of scheduled commercial banks, foreign banks, co-operative banks, and all India financial institutions in the public and private sectors. The DFHI has been very active in the short term money market and has effectively contributed to the over-all stability of the money market.

7. Introduction of Repos:

Repo was introduced in December 1992. It is an instrument of repurchase agreement between the RBI and Commercial banks. It has now become popular among banks and financial institutions as it enables short term liquidity management. The repo rates are market determined and the period of repo has stabilised at 14 days since 1993. The RBI introduced regulatory safeguards to further widen Repos in April 1999. Since Nov. 1996, RBI introduced Reserve Repos i.e. to see dated Govt. securities through auction at fixed cut-off rate interest. This policy of using Repos and Reserve Repos is called Liquidity Adjustment Facility(LAF). Since 2000-01, LAF emerged as major instrument of monetary policy.

Check your progress:

1. What are the new instruments in the Money Market ?
2. What is Money Market Mutual Fund (MMMFs)?
3. What is the main function of DFHI.?
4. What is Repo?

5. What Liquidity Adjustment Facility (LAF)?

8.6 SUMMARY

1. The money market is a component of the financial markets for assets involved in short-term borrowing and lending with original maturities of one year or shorter time frames. It involves Treasury bills, commercial papers, certificates of deposit, federal funds, and short-lived mortgage and asset-backed securities. It provides liquidity funding for the global financial system.
2. Money market comes within the direct purview of RBI regulation. The objective of RBI operations in the money market is to ensure that liquidity and short-term interest rates are maintained at levels required for achieving the objectives of monetary policy.
3. The Indian money market consists of two segments, namely organised sector and unorganised sector.
4. Organised money market consists of a number of markets such as call money market, treasury bill market, commercial bill market, and markets for CDs, CPs and repos. It is further diversified with the setting up The Discount and Finance House of India (DFHI) and Money Market Mutual Funds.
5. The three constituents of the unorganised sector of the Indian Money Market are
 - a. Indigenous bankers
 - b. Money lenders
 - c. Non-banking Financial Companies (NBFC) such as Loan or Finance companies, Chit funds and Nidhis.
6. Indian money market is undeveloped and it lacks a number of sub-markets. It does not attract foreign funds.
7. On the recommendations of the Sukhmoy Chakravorty Committee and Narsimhan Committee, the RBI has initiated a series of policy reforms to develop the Indian money market.

8.7 QUESTIONS

1. Define the following:
 - a. Money market
 - b. Call money market
 - c. Repo market.
 - d. indigenous bankers
2. What are the principal constituents of the Indian money market ?
3. Explain the chief characteristics of Indian money market.
4. Discuss the measures to strengthen the Indian Money Market.
5. Distinguish Between
 - a. Organised and unorganised sector of Indian money market.
 - b. Commercial Papers and Certificate of Deposit.
6. Explain the organised and unorganised sectors of Indian money market
7. Money Market in India is characterised by its dichotomy” - Discuss.
8. Explain the structure of Indian Money Market.
9. Explain the principal constituents of the organised segment of the Indian money market.
10. Critically evaluate the role of the unorganised sector in the Indian Money market.
11. What are the weaknesses/drawbacks of the Indian money market?
12. Explain the various measures taken by RBI to strengthen money market.
13. Write notes on:
 - a. Money Market in India.
 - b. Main features of money market in India
 - c. Deficiencies in the Indian Money Market.



CAPITAL MARKET

Unit structure

- 9.0 Objectives
- 9.1 Introduction of Capital market
- 9.2 Role and significance of capital market in India's economic development
- 9.3 Structure / Constituents of capital market in India
- 9.4 Functions of capital market
- 9.5 Overview of History of Indian capital market
- 9.6 Free pricing regime in primary market
- 9.7 Book – building a New Issue mechanism in India
- 9.8 Summary
- 9.9 Questions

9.0 OBJECTIVES

- 1. To acquaint the students with concepts of Capital market Market.
- 2. To study the Constituents of Capital Market.
- 3. To Understand the Role of Indian Capital Market.
- 4. To study the Overview of History of Indian Capital market.
- 5. To familiar with the book building process in primary market
- 6. To understand Green shoe option in new issue market.
- 7. To learn importance of On-line IPO.

9.1 INTRODUCTION OF CAPITAL MARKET

Capital market is the market for long term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (medium-term and long-term funds). The demand for long-term funds comes mainly from industry, trade, agriculture and government. The central and state governments invest not only on economic overheads such as transport, irrigation, and power supply but also on basic and consumer goods industries and hence require large sums

from capital market. The supply of funds comes largely from individual savers, corporate savings, banks, insurance companies, specialized financial institutions and government.

9.2 ROLE AND SIGNIFICANCE OF CAPITAL MARKET IN INDIA'S ECONOMIC DEVELOPMENT

Capital market has a crucial significance to capital formation. Adequate capital formation is indispensable for a speedy economic development. The main function of capital market is the collection of savings and their distribution for industrial development. This stimulates capital formation and hence, accelerates the process of economic development.

1. Mobilisation of savings and acceleration of capital formation :-

The various types of securities in the capital market help to mobilise savings from various sectors of the population. Reasonable return and liquidity are two important features which urge investors to invest in securities. This accelerates capital formation which promotes economic development.

2. Long-term capital:- The stock-exchange market enables the companies to raise long-term capital. Companies require permanent capital but investors cannot commit their funds for a permanent period. The capital market provides an opportunity for investors to buy and sell securities while the permanent capital remains unaffected.

3. Industrial growth : The stock exchange market encourages people to invest in productive activities rather than unproductive sectors like gold, real estate etc. The stock exchange market transfers funds to the industrial sector and stimulates industrial growth and economic development.

4. Proper channelisation of funds : An efficient capital market creates liquidity and allocates resources to the most efficient industries. The market price of the security and its yield guide the people to channelise their funds in a particular company. This enables effective utilisation of funds.

5. Ready and continuous market :- The investment in securities is more liquid because of easy marketability. Buyers and sellers can easily purchase and sell securities.

6. Provision of a variety of services :- The financial institutions in the capital market provide a variety of services such as:

- i. Provision of medium and long- term loans to entrepreneurs to establish, expand or modernize business.

- ii. Participation in equity capital.
- iii. Under-writing facilities.
- iv. Assistance in promotion of companies.
- v. Expert advice on management of investment in industrial securities.

In the last two decades the volume of capital market transactions has increased rapidly. The capital market functions have been diversified. There has been a phenomenal increase in investments, keeping pace with the accelerated tempo of economic development.

9.3 STRUCTURE / CONSTITUENTS OF CAPITAL MARKET IN INDIA

Capital Market is the market for long-term funds just as money market is the market for short-term funds. It refers to all facilities and institutional arrangements for borrowing and lending long-term funds. The demand for long-term money capital comes from private business corporations, public corporations and the government. The supply of funds for capital market comes from individual and institutional investors, banks and special industrial financial institutions.

CLASSIFICATION OF CAPITAL MARKET

Capital Market in India

Gilt-edged Market Financial (Govt. securities Intermediaries Market) Merchant banks, Mutual Lease	Industrial Securities Market i) New Issues Market ii) Old Issues Market (StockCompanies, Exchange) Capital	Dev. Financial Institutions IFCI, ICICI, IDBI, SFCs, IRBI, UTI etc. Funds, Venture Co.
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The capital market includes the following institutions.

1) Commercial banks 2) Insurance Companies (LIC, GIC) 3) Special institutions like IFCI, IDBI, UTI etc. 4] Merchant Banking agencies 5] Mutual Funds.

Thus the capital market is composed of those who demand funds (borrowers) and those who supply funds (lenders). The Capital market can be divided into 2 constituents.

- 1) The Financial Institutions like IFCI, IDBI, LIC, UTF etc. which provide medium and long term loans.
- 2) The Securities market where the securities can be bought and sold freely.

The Indian Capital Market is divided into gilt-edged market and the industrial securities market.

Gilt-edged Market : This refers to the market for government and semi-government securities backed by RBI .

Industrial Securities Market: This refers to the market for shares and debentures of old and new companies. This market is divided into the New Issue Market and the Old Capital Market meaning the stock exchange.

a) The New issue market refers to the raising of new capital in the form of shares and debentures. This market is more important from the point of view of economic growth.

b) The Old capital Market deals with securities already issued by companies.

The capital market is also classified into Primary capital market and Secondary capital market.

Primary market : This refers to the new issue market which relates to the issue of shares, preference shares and debentures of non-government public limited companies and the issue of public sector bonds.

Secondary Market: This refers to the market for old or already issued securities. The secondary market is composed of Industrial security market or stock- exchange market in which industrial securities are bought and sold and the gilt-edged market in which government and semi-government securities are traded.

9.4 FUNCTIONS OF CAPITAL MARKET

The functions of an efficient capital market are as follows.:-

- Mobilise long-term savings to finance long-term investments.
- Provide risk capital in the form of equity or quasi-equity to entrepreneurs.
- Encourage broader ownership of productive assets. -
- Provide liquidity with a mechanism enabling the investor to sell financial assets.
- Lower the costs of transactions and information.

- Improve the efficiency of capital allocation through a competitive pricing mechanism.
- Disseminate - information efficiently for enabling participants to develop an formed opinion about investment, disinvestment, reinvestment, or holding a particular financial asset.
- Enable quick valuation of financial instruments—both equity and debt.
- Provide insurance against market risk or price risk through derivative trading and default risk through investment protection fund.
- Enable wider participation by enhancing the width of the market by encouraging participation through networking institutions and associating individuals.
- Provide operational efficiency through
 - simplified transaction procedures;
 - lowering settlement timings; and
 - lowering transaction costs.
- Develop integration among :-
 - Real and financial sectors;
 - Equity and debt instruments;
 - Long-term and short-term funds;
 - Long-term and short-term interest costs;
 - Private and government sectors; and
 - Domestic and external funds.
- Direct the flow of funds into efficient channels through investment, disinvestment, and reinvestment.

Check your progress:

1. What is Capital Market ?
2. Name the different Constituents of the Capital market .
3. What are the functions of the Capital market ?
4. Explain the role of Capital market in regulating Economic development of a country .
5. What is meant by Primary and Secondary market ?
6. Give examples of Development Financial Institutions.

9.5 OVERVIEW OF HISTORY OF INDIAN CAPITAL MARKET

The history of the capital market in India dates back to the eighteenth century when the East India Company securities were traded in the country. Until the end of the nineteenth century, securities trading was unorganised and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata). Of the two, Bombay was the chief trading centre wherein bank shares were the major trading stock. During the American Civil War (1860—61), Bombay was an important source of supply for cotton. Hence, trading activities flourished during the period, resulting in a boom in share prices. This boom, the first in the history of the Indian capital market, lasted for nearly half a decade. The bubble burst on July 1, 1865, when there was a tremendous slump in share prices.

Trading was at that time limited to a dozen brokers; their trading place was under a banyan tree in front of the Town Hall in Bombay. These stock brokers organised an informal -association in 1875—the Native Shares and Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmedabad, also industrial and trading centres materialised later. The Bombay Stock Exchange was recognised in May 1927 under the Bombay Securities Contracts Control Act, 1925.

The capital market was not well-organised and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

In the post-independence era also, the size of the capital market remained small. During the first and second five year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. Public sector undertakings were healthier than private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades.

In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scrips of speculators. As speculation became rampant, the stock market came to be known as the **satta bazaar**. Despite speculation, non-payment or defaults were

not very frequent. The government enacted the Securities Contracts (Regulation) Act in 1956 to regulate stock markets. The Companies Act, 1956 was also enacted. The decade of the 1950s was also characterised by the establishment of a network for the development of financial institutions and state financial corporations. -

The 1960s was characterised by wars and droughts in the country which led to bearish trends. These trends were aggravated by the ban in 1969 on forward trading and *badla*, technically called 'contracts for clearing'. **Badla** provided a mechanism for carrying forward positions as well as for borrowing funds. Financial institutions such as LIC and GIC helped revive the sentiment by emerging as the most important group of investors. The first mutual fund of India, the Unit Trust of India (UTI) came into existence in 1964.

In the 1970s, *badla* trading was resumed under the guise of 'hand-delivery contracts—a group.' This revived the market. However, the capital market received another severe setback on July 6, 1974, when the government promulgated the Dividend Restriction Ordinance, restricting the payment of dividend by companies to 12 per cent of the face value or one-third of the profits of the companies that can be distributed as computed under Section 369 of the Companies Act, whichever was lower. This led to a slump in market capitalisation at the BSE by about 20 per cent overnight and the stock market did not open for nearly a fortnight. Later came a buoyancy in the stock markets when the multinational companies (MNCs) were forced to dilute their majority stocks in their Indian ventures in favour of the Indian public under FERA in 1973. Several MNCs opted out of India. One hundred and twenty-three MNCs offered shares worth Rs 150 crore, creating 1.8 million shareholders within four years. The offer prices of FERA shares were lower than their intrinsic worth. Hence, for the first time, FERA dilution created an equity cult in India. It was the spate of FERA issues that gave a real fillip to the Indian stock market. For the first time, many investors got an opportunity to invest in the stocks of such MNCs as Colgate, and Hindustan Lever Limited. Then, in 1977, a little-known entrepreneur, Dhirubhai Ambani, tapped the capital market. The scrip, Reliance Textiles, is still a hot favourite and dominates trading at all stock exchanges.

The 1980s witnessed an explosive growth of the securities market in India, with millions of investors suddenly discovering lucrative opportunities. Many investors jumped into the stock markets for the first time. The government's liberalisation process initiated during the mid-1980s, spurred this growth. Participation by small investors, speculation, defaults, ban on **badla**, and resumption of **badla** continued. Convertible

debentures emerged as a popular instrument of resource mobilisation in the primary market. The introduction of public sector bonds and the successful mega issues of Reliance Petrochemicals and Larsen and Toubro gave a new lease of life to the primary market. This, in turn, enlarged volumes in the secondary market. The decade of the 1980s was characterised by an increase in the number of stock exchanges, listed companies, paid-up capital, and market capitalisation.

The 1990s will go down as the most important decade in the history of the capital market of India. Liberalisation and globalisation were the new terms coined and marketed during this decade. The Capital Issues (Control) Act, 1947 was repealed in May 1992. The decade was characterised by a new industrial policy, emergence of the SEBI as a regulator of the capital market, advent of foreign institutional investors, euro-issues, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.

Major capital market scams took place in the 1990s. These shook the capital market and drove away small investors from the market. The securities scam of March 1992 involving brokers as well as bankers was one of the biggest scams in the history of the capital market. In the subsequent years owing to free pricing, many unscrupulous promoters, who raised money from the capital market, proved to be fly-by-night operators. This led to an erosion in the investors' confidence. The M S Shoes case, one such scam which took place in March 1995, put a break on new issue activity.

The 1991—92 securities scam revealed the inadequacies of and inefficiencies in the financial system. It was the scam which prompted a reform of the equity market. The Indian stock market witnessed a sea change in terms of technology and market prices. Technology brought radical changes in the trading mechanism. The Bombay Stock Exchange was subject to nationwide competition by two new stock exchanges—the National Stock Exchange, set up in 1994, and the Over the Counter Exchange of India, set up in 1992. The National Securities Clearing Corporation (NSCC) and the National Securities Depository Limited (NSDL) were set up in April 1995 and November 1996 respectively for improved clearing and settlement and dematerialised trading. The Securities Contracts (Regulation) Act, 1956 was amended in 1995—96 for introduction of options trading. Moreover, rolling settlement was introduced in January 1998 for the dematerialised segment of all companies. With automation and geographical spread, stock market participation increased.

In the late 1990s, Information Technology (IT) scrips dominated the Indian bourses. These scrips included Infosys, Wipro, and Satyam. They were a part of the favourite scrips of the period, also known as 'new economy' scrips, along with telecommunications and media scrips. The new economy companies were knowledge intensive unlike the old economy companies that were asset intensive.

The Indian capital market entered the twenty-first century with the Ketan Parekh scam. As a result of this scam, *badla* was discontinued from July 2001 and rolling settlement was introduced in all scrips. Trading of futures commenced from June 2000, and Internet trading was permitted in February 2000. On July 2, 2001, the Unit Trust of India announced suspension of the sale and repurchase of its flagship US-64 scheme due to heavy redemption leading to a panic on the bourses. The government's decision to privatise oil PSUs in 2003 fuelled stock prices. One big divestment of international telephony major VSNL took place in early February 2002. Foreign institutional investors have emerged as major players on the Indian bourses. NSE has an upper hand over its rival BSE in terms of volumes not only in the equity markets but also in the derivatives market.

It has been a long journey for the Indian capital market. Now the capital market is organised, fairly integrated mature, more global and modernised. The Indian equity market is one of the best in the world in terms of technology. Advances in computer and communications technology, coming together on Internet are shattering geographic boundaries and enlarging the investor class. Internet trading has become a global phenomenon. Indian stock markets are now getting integrated with global markets.

9.6 FREE PRICING REGIME IN PRIMARY MARKET

Before 1992, the Controller of Capital Issues (CCI) used to regulate the new issues market under the Capital Issues (Control) Act, 1947. Companies had to obtain approval from the CCI for raising funds in the primary market. The timing, quantum, and pricing of the issue were decided by the controller. New companies could issue shares only at par, while the existing companies with substantial reserves could issue shares at a premium. This premium was based on a prescribed formula set by the CCI. The formula is based on balancing the two criteria, viz., the net assets value and price earnings value. The issue price was set far below the market price of the company's share. This fixed price mechanism resulted in under pricing of many issues.

In 1992, the Capital Issues (Control) Act, 1947 was repealed and all controls relating to raising of resources from the market were removed. Hence, now the promoters (issuers of securities) do not require the consent of any authority either for making the issue or for pricing it. The promoter and his merchant banker together decide the price of the issue. Both new and established companies are free to decide the price of their issue.

There emerged under free pricing, an alliance of dishonest promoters and greedy merchant bankers. They brought out issues with rosy but unreal projections and sold shares at very high premiums. These projections never materialised, leading to a crash in prices. Moreover, companies with a negative bottom line came back with repeated rights issues at a premium. Issues of all kinds and premiums unheard of in corporate history were made in the early days of free pricing. These issues killed the primary market. Most of these issues were quoted below their offer price on the day they were listed at the stock exchange. Of the 4,000 issues that hit the market in 1992—96, more than 3,000 quoted below their offer price on the very day they were listed. For example, Saurashtra Cements hit the market in September 1993 at Rs 250 per share. It stood at Rs 85 when it was listed on the stock exchange; today it fetches only Rs.8. The free market became a free falling market in numerous cases.

The regulator brought in strict regulations for merchant bankers, brokers, and others, and laid guidelines for full disclosures for investor protection. Unfortunately, this was done only when the small investors had fled the market. Today promoters are required to justify the issue price in the prospectus and make material disclosures about the risk factors in the offer document.

9.7 BOOK-BUILDING—A NEW ISSUE MECHANISM IN INDIA

Before 1992, the Controller of Capital Issues (CCI) used to regulate the new issue

The mechanics of determining the offer price during the CCI regime was to offer the share at a fixed price. Here, the firm and the merchant banker decided an offer price without taking into account the investor's feedback. Fixed price offerings were made to uniform investors. Moreover, there was a long time lag from the date of pricing to the date the issue open, and to the date trading commenced. This raised the possibility of price fluctuations in the intervening period. Empirical evidence supports the view that fixed price offering results in high cost

of capital for firms due to under-pricing of shares for attracting subscription.

The pricing pattern changed in the free pricing era. This era was characterised by unrealistic and abrupt pricing structure, which stripped the radiance of the capital market. Investors shied away from the market after burning their fingers in those premium issues that are now being quoted not only below their issue price but even below their par value.

Following the inefficient functioning of the capital market system, an alternative method, book building method, is slowly becoming popular in India. Book building is a mechanism through which an offer price for IPOs based on the investors' demand is determined. In the fixed price method, the investors' demand is not taken into account; the book building method explicitly uses investor's demand for shares at various prices as an important input to arrive at an offer price. Globally, book building is a recognised mechanism for capital raising. It was book building which built the US market almost entirely in the 1940s and 1950s.

The SEBI guidelines define book building as a process undertaken by which a demand for the securities proposed to be issued by a corporate body is elicited and built-up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means a notice, circular, advertisement, document or information, memoranda or offer document.

9.7.1 The Book Building Process

The book building is basically an auction of shares. Book building essentially means that the 'book is being built.' During the process on both the NSE and the BSE, investors can watch the book being built a chart shown indicates the bid price and the number of shares being bid for. This helps the investor to know the market price. It offers investors the opportunity to bid collectively, It then uses the bid to arrive at a consensus price.

- The Company (issuer) first of all appoints a book runner, i.e. a merchant banker.
- The book runner prepares and submits the draft documents to the SEBI and obtains an acknowledgement card.
- The issuer and the book runner decide to offer shares at a price within a specified price band (range).
- Offers regarding the demand for securities at different price levels are invited from syndicate members consisting of eligible brokers, merchant bankers, underwriters, financial institutions, mutual funds, and others. The advertisement should mention the opening and closing

dates for the bids. A bid is usually open for a minimum of five working days.

- Based on the bids received, the issuer arrives at a final cut-off rate and the final allocation in consultation with the book runner and lead manager.
- The issuer and the book runner may impose restrictions on the number of shares that can be allotted to each client so as to avoid any future takeover threats.
- The final prospectus is filed with the Registrar of Companies (ROC) along with the procurement agreement.
- The placement portion opens for subscription only after the prospectus is filed with the ROC.
- The placement portion closes a day before the opening of the public issue portion.
- The public portion opens and the allotment and listing of this portion is done. The price determined in the book building process is applicable to the public portion as well. If the public portion stands oversubscribed, then the allotment is made on a proportionate basis. In case, the public portions remains undersubscribed, the shortfall is distributed amongst those who have opted for placement. If the placement portion is undersubscribed, the size of the public issue is enhanced.

In the Book building issues, a red herring prospectus which does not have details of either price or number of shares being offered or the amount of issue is filed with the ROC.

The underwriter collects information from potential buyer and attempts to build interest. Part of the process of collecting this information is a road show, so named because the underwriter goes from city to city making presentations about the company and the offering. The road show is conducted in the form of press release, a broker—analyst meet and investor meet.

The SEBI reintroduced the moving price band concept in book built IPOs. Book building was first introduced in 1999 with the concept of a moving price band. However, in April 2000, the SEBI moved to the concept of fixed floor price, which led to underpricing as maximum bids were received at or just above the floor price. In a moving price band, the range can be moved, upwards or downwards, depending upon the demand and the direction in which the book is being built. The band can be moved by 50 percent either way.

In the Book building, books can be two types, **Open book and Closed book**. In the open book system of building, there is an online display of the demand and bids during the bidding period. This facility is available on the terminals of both the NSE and the BSE. This enables the investor to know the movement and quantum of the bids during the period in which the bid is kept open.

Under closed book building, the book is not made public and hence investors bid without having any information on the bids submitted by other bidders.

Thus, Book building is a process by which demand for the proposed issue is elicited and built-up and the price at which the securities will be issued is determined on the basis of the bids received

9.7.2 Benefits of Book Building Method

Book building enables issuers to reap benefits arising from price and demand discovery. The aim of the process is to have the issue presold and preclude chances of under-subscription/devolvement. The cost and time for making public issues is lowered; the procedures are also simplified.

The public issue benefits investors as they can trust the price at which the syndicate members have purchased the shares. Due to this, the possibility of price falling below par after listing is remote.

9.7.3 Limitations of the Book Building Method

The book building method is still at a nascent stage and not without limitations.

- The book building process adopted in India is quite different from that of the USA, wherein road shows are held and the issue price is arrived at a few hours before the issue opens. The lead manager makes a market in the paper by offering two-way quotes on the secondary market, till trading picks up. There are no such provisions in the Indian book building process.
- In India, unlike in the developed markets, the book building process is still dependent on good faith. The numbers of investors invited to apply are limited and it is the peer pressure and reputation that ensures that there are no defaults. Book building relies on much interaction among firms, merchant bankers, and investors, which is absent in India.
- There is a lack of transparency at critical steps of the book building process and the absence of strong regulation.
- Since the price fixed for the public portion as well as for the placement portion is the same, issues may not succeed in inviting the desired public response.

- Advertisements about book built issues to retail investors are not necessary. This increases the chances of negotiated deals.
- It has not proved to be a good price discovery mechanism. Many issues have been listed below their issue price. The lag time of more than 60 days between issue pricing and listing is the building block to price discovery mechanism.
- Issuers may have to sell cheap due to the collective bargaining power of institutions.
- High institutionalised holding may affect the stock's liquidity and make it volatile as well in case of bulk offloading.
- The role of retail investors in determining the pricing decreases. Moreover, retail investors may not have the information to judge the issue and thus, may not be able to arrive at the correct pricing.

9.7.4 GREEN SHOE OPTION

The SEBI permitted the green-shoe option in book building issues when it amended the guidelines in August 2003.

A Green-shoe option means an option of allocating shares in excess of the shares included in the public issue and operating a post-listing price stabilising mechanism for a period not exceeding 30 days in accordance with the provisions of Chapter VIIIA of the DIP guidelines follows :-

1. A company desirous of availing the option should seek authorisation in the general meeting for allotment of the additional shares to the stabilising agent (SA) at the end of the stabilisation period.
2. The company should appoint one of the merchant bankers or book runners as the SA who will be responsible for the price stabilisation process, if required. The SA should enter into an agreement with the issuer company, prior to filing of offer document with the SEBI, clearly stating all the terms and conditions relating to this option including fees charged/expenses to be incurred by the SA for this purpose.
3. The SA should also enter into an agreement with the promoter(s) who will lend their shares. The agreement should specify the maximum number of shares that may be borrowed from the promoters or the shareholders which should not be in excess of 15 per cent of the total issue size. The details of the agreements shall be disclosed in the draft prospectus, the draft Red Herring Prospectus, the Red Herring Prospectus and the final prospectus.

4. The promoters and pre-issue shareholders, of both unlisted and listed company, holding more than 5 percent shares should lend the shares for the purpose of green-shoe option.
5. The allocation of these shares should be on pro-rata basis to all the applicants. The stabilisation mechanism should be made available for not more than 30 days from the date when trading is permitted on the exchange(s).

A Stabilising agent (SA) steps in and buys the shares from the market when the share price falls below the offer price. He has the discretion to decide the timing, the quantity and the price at which to buy shares for stabilising the post-listing price. To ensure the post-listing price, the SA may either buy the issuer's equity shares from institutional shareholders or purchase them from the market but not in excess of 15 per cent of the issue size. The issuer may set up a separate stabilising fund account to keep the funds as well as the shares for purpose of stabilisation. The stabilising measure serves as a cushion against temporary volatility in stock. The SA is also responsible for meeting the excess demand after the commencement of the trading activity. On expiry of the stabilisation period, in case the SA does not buy shares to the extent of shares over-allotted by the company from the market, the issuer company shall allot shares to the extent of the shortfall in dematerialised form.

The first ever exercise of a green-shoe option in the course of a public issue was carried out by the ICICI Bank. The Life Insurance Corporation became the first institution to lend shares in the primary market. It provided 16 million shares to the DSP Merrill Lynch to ensure the post-listing price.

The green-shoe option is an investor protection measure—especially for protection of small investors during the post-listing period. This option benefits the underwriters in both bullish and bearish conditions. In a bull market, underwriters will opt for additional allotment of 15 per cent due to index riding high. In such a scenario, the post-listing price will be automatically maintained and sometimes even higher than the offer price, enabling underwriters to make larger profits. However, in a bearish market, the underwriting option may not be exercised or the underwriters may buy up to 15 per cent at Lower than the issue price from the market.

Earlier, the green-shoe option could be exercised only in book built IPOs. Now it can be exercised IPOs. This measure is expected to mitigate volatility and enhance investor confidence.

Green-shoe option is also referred to as an over- allotment option. It is a mechanism to provide post-Listing price stability to an initial public

offering. The Green-shoe company was the first to issue this type of option, hence the name green-shoe option

Red Herring Prospectus is a prospectus which does not have details of either price or number of shares being offered or the amount of issue

9.7.5 ON-LINE IPOs

The on-line issue of shares is carried out via the electronic network of the stock exchanges. The guidelines for online issue of shares are incorporated in a new chapter in the SEBI (Disclosure Investor Protection) Guidelines, 2000. The guidelines clearly state that public issue can be made either through the on-line system or through the existing banking channels. The company proposing to make a public issue through the on-line system of stock exchange has to comply with sections 55-68A of the Companies Act, 1956 and Disclosure and Investor Protection (DIP) guidelines. The issuer company is required to enter into an agreement with stock exchanges which have the requisite system for an on-line, offer and has to appoint brokers and registrars to the issue having electronic connectivity with stock exchanges.

This system reduces the time taken for the issue process and securities get listed within 15 days from the closure of the issue, thereby enabling faster access to funds. The new norms prescribe that the allotment of securities should be made not later than 15 days from the closure of the issue, failing which interest at the rate of 15 per cent should be paid to investors. Corporates planning an IPO can reduce their stationery, printing, and other expenses. The investor also benefits as the system eliminates refunds except in case of direct application.

The SEBI, in its Endeavour to bring the Indian stock market on par with its global counterparts, has issued guidelines for the on-line issue of shares by corporates. The salient features of the guidelines are as follows. :-

1. The company will have to first enter into an agreement with a stock exchange for the on-line offer of securities.
2. The company will have to appoint a registrar to the issue having electronic connectivity with the stock exchange.
3. The stock exchange, in turn, will appoint the SEBI-registered brokers for accepting applications and placing orders for shares.
4. The broker will collect the money from clients. In case the client fails to pay for the shares collected, the broker will have to pay the amount.
5. The broker shall accept orders from clients to send the application with payment to the registrar to the issue or place the order to subscribe through a broker under the on-line system.

6. In case a client fails to pay the application money, the broker, through whom the client placed the order, will have to bring in the money. If the broker fails to pay, he will be declared a defaulter.
7. During the period the issue is given to the public for subscription, applicants may approach brokers of the stock exchange through which the securities are offered under the on-line system to place an order for subscribing to the shares.
8. In the case of public issues of Rs 10 crore or more, the registrar to the issue shall open centres for collection of applications in New Delhi, Chennai, Kolkata and Mumbai.
9. The broker shall open a separate bank account (escrow account) with the clearing house for primary market issues and the amount collected by the broker from his clients as margin money shall be deposited in this account.
10. The prospectus should list the names of all the brokers appointed for the issue along with the names of other intermediaries like lead managers and registrars to the issue.
11. The company shall have the option of listing its securities on any other exchange(s) other than the exchange through which it offers its securities to the public through the on-line system.

PRIMARY ISSUES

Public Issue	Rights Issue	Private Placement
1. Initial Public Offering : (IPO) A first time offer of sale of securities by an unlisted company.	1. An offer of sale of securities to existing shareholders	1. Private placement (Unlisted Cos.) Direct sale of securities to some selected people or to financial institutions
2. Follow-on Public Offering (FPO) An offer of sale of securities by a listed company		2. Preferential Issue allotment of shares to some selected group of persons u/s 81 of the Companies Act 1956.
		3. Qualified Institutions Placement (For listed Cos.)

9.7.6 Initial Public Offering (IPO)

It is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time to the public.

In the case of an IPO, the availability of information regarding the past performance of the company & its track record is generally inadequate and may lack credibility. This information asymmetry may lead to the problems of moral hazard and adverse selection. To enable investors to take informed decisions and protect their interests, the SEBI has laid down stringent entry norms.

A follow-on public offering (FPO) is an offering of either a fresh issue of securities or an offer for sale to the public by an already listed company through an offer document. Investors participating in these offerings take informed decisions based on its track record and performance.

The SEBI has laid down eligibility norms for entities raising funds through an IPO and an FPO. The entry norms are as follows :-

Entry Norm I:

The company desiring to tap the primary market shall meet the following requirements.

1. Net tangible assets of at least Rs 3 crores for three full years, of which not more than 50 per cent is held in monetary assets.
2. Distributable profits in at least three out of the preceding five years.
3. Net worth of at least Rs 1 crore in three years.
4. If there is a change in the company's name, at least 50 per cent revenue for preceding one year should be earned from the new activity.
5. The issue size should not exceed 5 times the pre-issue net worth.

To provide sufficient flexibility and also to ensure that genuine companies are not deprived an access to the primary market on account of rigidity of the parameters, the SEBI has provided two other alternative routes to a company not meeting any of the above mentioned requirements. They are as follows :-

Entry Norm II:

1. Issue shall be through a book building route, with at least 50 percent of the issue to be mandatorily allotted to the qualified institutional buyers (QIBs), failing which the money shall be refunded.
2. The minimum post-issue face value capital shall be Rs 10 crore or there shall be compulsory market making for at least 2 years.

OR

Entry Norm III :

1. The 'project' is appraised and participated to the extent of 15 per cent by FIs/scheduled commercial banks of which at Least 10 per cent comes from the appraiser(s).
2. The minimum post-issue face value capital shall be Rs 10 crore or there shall be a compulsory market making for at least 2 years.

In addition to satisfying the aforesaid eligibility norms, the company shall also satisfy the criteria of having at least 1000 prospective allottees in its issue.

The SEBI has exempted the following entities from entry norms.

1. Private sector banks.
2. Public sector banks.
3. An infrastructure company whose project has been appraised by a PFI or IDFC or IL&FS or a bank which was earlier a PFI and not less than 5 per cent of the project cost is financed by any these institutions.
4. Rights issue by a listed company.

Thus, Initial Public Offering is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time to the public. IPO enables Listing and trading of the issuer's securities.

'Offer document' means prospectus in case of a public issue or offer for sale and letter of offer in case of a rights issue.

Listed company means a company which has any of its securities offered through an offer document listed on a recognised stock exchange and also includes public sector undertakings whose securities are listed on a recognised stock exchange.

Offer for sale means offer of securities by existing shareholder(s) of a company to the public for subscription, through an offer document.

Public issue means an invitation by a company to the public to subscribe to the securities offered through a prospectus.

Issuer company means a company which has filed offer documents with the SEBI for making issue of securities.

Check your progress:

1. What is the importance of Free Price Regime in primary market ?
2. Define :- Book building Process.
3. What is meant by Green Shoe Option ?

4. Name the benefits of Book building method.
 5. List the limitations of Book building Method.
 6. Define : IPO
 7. What are the three types of Primary Issues ?
 8. What is Offer document.?
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9.8 summary

The main business activity of NBFCs is to

1. Capital market is the market for long term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (medium-term and long-term funds).
2. The main function of capital market is the collection of savings and their distribution for industrial development. This stimulates capital formation and hence, accelerates the process of economic development.
3. The Indian Capital Market is divided into gilt-edged market and the industrial securities market.

Gilt-edged Market refers to the market for government and semi-government securities backed by RBI .

Industrial Securities Market refers to the market for shares and debentures of old and new companies.

4. The capital market is also classified into Primary capital market and Secondary capital market.

Primary market refers to the new issue market which relates to the issue of shares, preference shares and debentures of non-government public limited companies and the issue of public sector bonds.

Secondary Market refers to the market for old or already issued securities. The secondary market is composed of Industrial security market or stock- exchange market in which industrial securities are bought and sold and the gilt-edged market in which government and semi-government securities are traded.

5. The history of the capital market in India dates back to the eighteenth century when the East India Company securities were traded in

the country. Until the end of the nineteenth century, securities trading was unorganised and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata).

6. The decade of 1990s is the most important decade in the history of the capital market of India. Liberalisation and globalisation were the new terms coined and marketed during this decade. The decade was characterised by a new industrial policy, emergence of the SEBI as a regulator of the capital market, advent of foreign institutional investors, euro-issues, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.
7. In 1992, the Capital Issues (Control) Act, 1947 was repealed and all controls relating to raising of resources from the market were removed. Hence, now the promoters (issuers of securities) do not require the consent of any authority either for making the issue or for pricing it.
8. Book building is a mechanism through which an offer price for IPOs based on the investors' demand is determined. The book building method explicitly uses investor's demand for shares at various prices as an important input to arrive at an offer price.
9. The SEBI guidelines define book building as a process undertaken by which a demand for the securities proposed to be issued by a corporate body is elicited and built-up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means a notice, circular, advertisement, document or information, memoranda or offer document.

9.9 QUESTIONS

1. What is Capital market ? How does it aid to economic development?
2. Elaborate the different functions of the capital market.
3. Discuss in detail the history of Indian Capital market.
4. Explain the Process of Book Building.
6. Explain the benefits & limitations of Book Building Method.
7. What is the meaning of Green Shoe Option? Enlist the guidelines of SEBI for undertaking Green shoe option.
8. What is the importance of the On-line IPO? What conditions to be fulfilled by a company going for an On-line IPO ?
9. Explain in detail three kinds of Norms laid down by SEBI for IPO.



SECONDARY MARKET AND FOREIGN EXCHANGE MARKET

Unit Structure

- 10.0 Objectives
- 10.1 Introduction of secondary market
- 10.2 Post reform Stock market scenario
- 10.3 Regulation of stock exchanges
- 10.4 Organisation, management and membership of stock exchanges
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- 10.6 Listing of securities
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- 10.10 Debt market in India
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- 10.17 Relationship between Money market and Capital market
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- 10.20 RBI intervention and exchange rate management
- 10.21 Liberalisation measures in Foreign Exchange Market since 1991-92
- 10.22 Rate of exchange and its influence on financial flows
- 10.23 Summary
- 10.24 Questions

10.0 OBJECTIVES

The main business activity of NBFCs

1. To understand the concept & functions of Secondary Market
2. To study the Organisation, Management & Membership of stock Exchanges
3. To be familiar with Listing, Trading & Settlement Systems
4. To acquaint with Overviews of Debt Market in India
5. To know the Interlink between Money Market & Capital market
6. To understand the concept of Foreign Exchange Market
7. To know the Participants in Foreign Exchange Market
8. To study the Growth of Foreign Exchange Market since 1991.
9. To be familiar with the concept of Rate of Exchange & its influence on Financial flows.

10.1 INTRODUCTION OF SECONDARY MARKET

The secondary market is a market in which existing securities are resold or traded. This market is also known as the stock market. In India the secondary market consists of recognised stock exchanges operating under rules, by-laws and regulations duly approved by the government. These stock exchanges constitute an organised market where securities issued by the central and state governments, public bodies, and joint stock companies are traded. A stock exchange is defined under Section 2(3) of Securities Contracts (Regulation) Act, 1956, 'as any body of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities'.

It deals in securities already issued or existing or outstanding. The primary market mobilises savings and supplies fresh or additional capital to business units. Even though secondary market does not contribute directly to the supply of additional capital, does so indirectly by rendering securities issued on the primary market liquid. This takes place through stock exchanges.

10.1.1 Functions of the Secondary Market

1. To facilitate liquidity and marketability of the outstanding equity and debt instruments.
2. To contribute to economic growth through allocation of funds to the most efficient channel through the process of disinvestment to reinvestment.

3. To provide instant valuation of securities caused by changes in the internal environment (company-wide and industry-wide factors). Such valuation facilitates the measurement of the cost of capital and the rate of return of the economic entities at the micro level.
4. To ensure a measure of safety and fair dealing to protect investors' interests.
5. To induce companies to improve performance since the market price at the stock exchanges reflects the performance and this market price is readily available to investors.

10.2 POST-REFORM STOCK MARKET SCENARIO

After the initiations of reforms in 1991, the Indian Secondary market now has a three-tier form :-

1. Regional Stock Exchanges.
2. The National Stock Exchange (NSE).
3. The Over Counter Exchange of India (OTCEI)

The NSE was set up in 1994. It was the first modern stock exchange to bring in new technology, new trading practices, new institutions, and new products. The OTCEI was set up in 1992 as a stock exchange providing small- and medium-sized companies the means to generate capital.

In all, there are, at present, 23 stock exchanges in India—19 regional stock exchanges, the BSE, the NSE, the OTCEI, and the Interconnected Stock Exchange of India (ICSE). The ICSE is a stock exchange of stock exchanges. The 19 regional stock exchanges are located at Ahmedabad, Bangalore, Bhubaneswar, Kolkata, Cochin, Coimbatore, Delhi, Guwahati, Hyderabad, Indore, Jaipur, Kanpur, Ludhiana, Chennai, Mangalore, Pune, Patna, Rajkot, and Vadodara. They operate under the rules, by laws and regulations approved by the government and the SEBI.

10.3 REGULATION OF STOCK EXCHANGES

The stock markets in India are regulated by the central government under the Securities Contracts (Regulation) Act, 1956 which provides for the recognition of stock exchanges, supervision and control of recognised stock exchanges, regulation of contracts in securities, listing of securities, transfer of securities and many other related functions. The Securities and Exchange Board of India Act, 1992 provides for the establishment of the Securities and Exchange Board of India (SEBI) to protect investor's interest in securities and promote and regulate the securities market.

10.3.1 ORGANISATION, MANAGEMENT, AND MEMBERSHIP OF STOCK EXCHANGES

The organisational forms of the various recognised stock exchanges in India are as follows :-

1. Bombay, Ahmedabad, Patna, Indore	Voluntary non-profit making association
2. Kolkata, Delhi, Bangalore, Cochin, Kanpur, Guwahati, Ludhiana, Mangalore, Chennai	Public limited company
3. Hyderabad, Pune, Rajkot, Magadha.	Company limited by guarantee.
4. The National Stock Exchange	A tax-paying company incorporated under the Companies Act and promoted by leading financial institutions and banks.
5. The Over the Counter Exchange	A company under Section 25 of India the Companies Act, 1956.

The regional stock exchanges are managed by a governing body consisting of elected and nominal members. The trading members, who provide broking services, own, control, and manage the exchanges. The governing body is vested with wide ranging powers to elect office bearers committees, admit and expel members, manage properties and finances of the exchange disputes, and conduct day-to-day affairs of the exchange.

The OTCEI and the NSE are demutualised exchanges wherein the ownership and management of the exchange are separated from the right to trade on exchange. Brokers are members of the stock exchange. They enter trades either on their own account or on behalf of clients. They are given a certificate of registration by the SEBI and they have to comply with the prescribed code of conduct. Over a period of time, many brokers with proprietary and partnership firms have converted themselves into corporate entities. Both the NSE and the OTCEI have laid down strict standards for the admission of members, which relate to capital adequacy, track record, education experience, and so on to ensure quality broking services.

Brokers are important intermediaries in the stock markets as they bring buyers and Sellers together, and aid in price discovery. There are three classes of brokers namely proprietary, partnership & corporate. In the old exchanges, most of the brokers are proprietary in nature, whereas in the exchanges they are corporate members. Several structural changes have taken place in the Indian broking industry over the past few years. Consolidation and

Recon-structuring have assumed considerable importance in this segment. As on 31 March 2005, there were 9,129 brokers registered with the SEBI. The CSE has the highest number of brokers followed by the NSE, the OTCEI and the BSE.

A stock broker is required to pay an annual registration fee of Rs 5,000 if his turnover per year does not exceed Rs one crore. If it does, he has to pay Rs. 5000 plus one-hundredth of one percent of the turnover in excess of Rs. One Crore. Five years from the date of initial registration he has to pay Rs 5,000 for a block of five financial years. The exchange also levies transaction charges.

The brokerage on transactions vary from broker to broker. The maximum brokerage that can be levied is 2.5 per cent of the contract price exclusive of statutory levies such as the SEBI turnover fee, service tax, and stamp duty. Consolidation is taking place in the broking industry. Small brokerages are shutting shop as the big broking entities have cornered a big chunk of the broking business.

10.4 DEMUTUALISATION OF STOCK EXCHANGES

All the stock exchanges in India except the NSE and the OTCEI are broker-owned and broker-controlled. In other words, it is the brokers who trade, collectively own and run these exchanges. The ownership and managerial rights of the brokers often led to a conflict of interests wherein the interest of brokers was preserved over those of the investors. Instances of price rigging, recurring payment crisis on stock exchanges, and misuse of official position by office bearers have been unearthed in the last few years. As a result, both rolling settlement and demutualisation of stock exchanges was announced to preserve their integrity.

Demutualisation is the process by which any member-owned organisation can become a shareholder-owned company. Such a company could either be listed on a stock exchange or be closely held by its shareholders. Stock exchanges in India are either Section 25 companies under the Companies Act or an association of persons. Hence, stock exchanges are exempt from all taxes. Through demutualisation, a stock exchange becomes a corporate entity, changing

from a non-profit making company to a profit-making & tax-paying company.

The Securities Contracts (Regulation) Act was amended on 12 October 2004 through an ordinance, making it compulsory for the exchanges to convert into corporate entities and delink their broker-members from the management. The ordinance restricts brokers' representation in the governing body board of stock exchanges to 25 percent. It also reduces their shareholding in the exchange to 49 per cent from the existing 100 percent. Moreover, 51 per cent of the stake of an exchange should be held by the public, other than shareholders having trading rights. Brokers' trading rights will be distinct from their ownership and management right in all exchanges. The segregation is expected to safeguard the interest of investors and bring about greater transparency and efficiency of stock exchanges. The ordinance also allows inter-exchange trading among brokers which would promote a trading platform for small and mid-cap companies.

The SEBI has made it mandatory for stock exchanges to dilute 51 per cent ownership in favour of public. The Bombay Stock Exchange (BSE) completed the process of demutualisation in June 2007. The Government has permitted 49 per cent (26 per cent by FDI and 23 per cent by FIIs) foreign investment in stock exchanges. Strategic investments in stock exchanges are required for the revival and growth of stock exchanges so that they can compete globally. The compulsory corporatisation and demutualisation of stock exchanges is expected to strengthen their governance, avoid conflict of interest, and protect investors.

10.5 LISTING OF SECURITIES

A Company has to list its securities on the exchange so that they are available for trading. A company can seek listing on more than one stock exchange but it is compulsory to list on the regional stock exchange nearest to its registered office. A security listed on one exchange is permitted for trading on the other. Provisions in the listing agreement attempt to ensure liquidity and investor protection in the stock market. There were 6000 securities listed on exchanges at the end of March 2007.

A Company can seek listing if at least 10 per cent of the securities, subject to a minimum of 20 lakh securities, have been offered to the public for subscription. In addition, the size of the net offer to the public (i.e. the offer price multiplied by the number of securities offered to the public, excluding reservations, firm allotment, and promoters'

contribution) is not less than Rs 100 crore and the issue is made only through book building method with 60 per cent of the issue size allocated to the Qualified Institutional Buyers (QIBs). Alternatively, a company has to offer at least 25 per cent of the securities to the general public.

The basic norms for listing of securities are uniform for all exchanges. They are specified in the listing agreement entered into between the company and the concerned exchange and their compliance is monitored by the exchanges. The stock exchanges levy annual listing fees from the listed companies; this constitutes their major source of income.

After a security is issued to the public and listed on a stock exchange, the issuing company has to make continuous disclosures relating to financial results, material information which would have a bearing on the performance of the company, and information in the form of a statement on the actual utilisation of funds and actual profitability as against the projected utilisation of funds and projected profitability on a quarterly basis to the stock exchanges. To improve transparency, the SEBI made it mandatory for listed companies to provide their half-yearly results on the basis of a limited review by its auditors or chartered accountants to the stock exchanges.

10.5.1 Central Listing Authority

The listing fees constitutes the major source of income of stock exchanges. The greater the number of companies listed on an exchange, the higher their listing fees. To attract companies to get listed, exchanges are tempted to ease listing standards. Moreover, listing requirements vary from exchange to another. This results in issuers wasting resources to comply with listing requirements of a number of exchanges simultaneously. Hence, a conflict of interest arises when stock exchanges regulate the companies that contribute to their revenues through listing fees. This conflict may become more serious in the near future as the process of demutualisation of stock exchanges is underway. With demutualisation, the core objective of stock exchanges would be profit maximisation; this would lead to further dilution in listing requirements to maintain or increase listing fees.

To resolve these issues, a central listing authority is needed in the country who would not only frame listing regulations but also take on the task of ensuring compliance of listing requirements. In the UK, the London Stock Exchange (LSE) takes care of trading while a listing authority takes care of the activity. The government has proposed the introduction of a Central Listing Authority (CLA). The would regulate prelisting procedures including clearing of prospectus.

To make corporates more accountable for their actions and to prevent any further scandals, the SEBI has set up the Central Listing Authority with strict norms.

The SEBI provides operational and functional support to the CLA in matters relating to appointment of the CEO and providing infrastructure and manpower to the CLA as and when required. The CLA is headed by Shri M. N. Venkatachalaiah, former Chief Justice of India. The aim of the CLA is to ensure uniform and standard practices for listing the securities on stock exchanges.

10.6 TRADING ARRANGEMENTS

The Open outcry system, prevalent a few years ago on regional stock exchanges, has been replaced by an on-line screen-based electronic trading system. The NSE and the OTCEI had adopted screen-based trading right from inception. With almost all the exchanges going electronic, trading has shifted from the floor to the broker's office where trades are executed through a computer terminal. All stock exchanges together have 8000 terminals spread across the country. In a screen-based trading system, a member can feed into the computer the number of securities and the prices at which he would like to transact and the transaction is executed as soon as it finds a matching order from a counter party. The electronic trading system is superior to the open outcry system of the past. It ensures transparency, as it enables participants to see the full market during real time. It increases information efficiency by allowing faster incorporation of price sensitive information into prevailing prices and thereby helps in efficient price discovery. This also results in operational efficiency as there is a reduction in time, cost, risk of error, and fraud and elimination of a chain of brokers and jobbers, which result in low transaction costs. This system has enabled a large number of participants, in every part of the country, to trade in full anonymity with one another simultaneously, thereby improving the depth and liquidity of the market. This has led to the integration of different trading centres spread all over the country into a single trading platform.

The SEBI has permitted the setting up of trading terminals abroad as well as Internet trading. Now investors in any part of the world can route the order through the Internet for trading in Indian scrips. Internet trading is more cost effective than using trading terminals.

There are two types of trading systems—order driven trading system and quote driven trading system. In the Order driven system, orders from all over the country are entered into an electronic system and matched directly and continuously without the involvement of a jobber

or a market maker. In the Quote driven system, there are market makers who continuously offer two-way quotes—buy and sell quotes and are willing to buy and sell any quantity. The BSE provides both these systems while the NSE provides only the order driven system.

10.6.1 TRADING RULES & REGULATIONS

Strict rules and regulations have been framed to prevent unfair trading practices and insider trading. The trading rules relate to the margin system, intra-day trading limit, and exposure limit. Brokers are levied various types of margins such as daily margins, mark to market margins, ad hoc margins, and volatility its so on to check price volatility.

Stock exchanges impose different types of margins on brokers for individual stocks depending on the exposures taken by these brokers in these stocks, both on a proprietary basis and on behalf of clients, vis-a-vis the overall market exposure in the scrips. Several of these margins are paid upfront by brokers. These margins are collected to prevent operators from taking market positions in excess of their buying capacities and are used to settle dues to the exchange/clearing corporation/traders in the event of any fund shortage faced by the broker. The margins vary from operator to operator depending on the size of the positions taken in the market.

The SEBI has shifted the margining system from net basis to gross basis (sale and purchase) with effect from 3 September 2001, and introduced a 99 per cent value-at-risk (VaR) based margin for all scrips in the compulsory rolling system with effect from 2 July 2001. VaR measures the worst expected potential loss from an unlikely adverse event in a normal everyday market environment. Prior to VaR, trade positions were reported at book value only and no considerations were made for market changes. This margin is kept in a manner that covers price movements for more than 99 per cent of the time. Usually sigma (standard deviation) is used for the measurement.

The intra-day trading limits, i.e., limit to volume is specified and no broker's trading volume can exceed this limit. If a broker wishes to exceed the limit he has to deposit additional capital with the exchange. The upper limit for the gross exposure of a broker is fixed at 20 times his capital to ensure market safety. Besides these, there are capital adequacy norms for members, indemnity insurance, and online position monitoring by exchanges.

To ensure fair trading practices, the SEBI has formulated Insider Trading Regulations prohibiting insider trading making it a criminal offence. To enhance transparency of the takeover process and to protect

the interests of minority shareholders, there are now separate regulations relating acquisitions and takeovers.

10.6.2 CIRCUIT BREAKERS

To contain excessive volatility in prices, the SEBI introduced, in 1995, scripwise daily circuit breakers price bands. The circuit breakers bring about a halt/suspension in trading automatically for a specified period if the market prices vary unusually on either side, i.e., move out of a pre-specified band. Circuit breakers do not halt trading but no order is permitted if it falls out of the specified price range.

Circuit breakers allow participants to gather new information and assess the situation. This helps in controlling panic. It helps exchange clearing houses to monitor their members. However, the introduction of circuit breakers precipitates matters during volatile moves and leads to chaos as participants rush to execute their orders before an anticipated trading halt.

10.7 TRADING AND SETTLEMENT SYSTEM

After the reforms, the trading and settlement cycle was trimmed from 14 days to 7 days. Later on, securities were traded and settled under a uniform weekly settlement cycle. In a trading cycle, trades accumulated till the end of a specified period and the positions were settled in the form of payment of cash and delivery of securities. The carry forward system prevailed for a long period at stock exchanges as it increased the volume of trading and thereby added to the liquidity of the system. However, it also increased speculation which increased volatility in prices and defaults by brokers, thereby impeding the price discovery process. Hence, an alternative system called **Rolling settlement** was introduced in a phased manner.

Under the T + 5 basis rolling settlement system, the trading cycle comprises one day and transactions in these securities are settled 5 days after the trade date. The rolling settlement on a T+5 basis was introduced in 10 scrips in January 2000, then extended to another 153 scrips in May 2000, then to 414 securities in July 2001, and thereafter all scrips were covered under this system. The rolling settlement system is on a T+3 basis since April 2002 and T+2 basis from April 2003. Effective implementation and success of the rolling settlement requires electronic fund transfer facility and dematerialisation.

10.7.1 Dematerialisation of Securities

To eliminate various problems such as theft, fake/forged transfers, transfer delays, and the paperwork associated with physical certificates, an electronic book entry form of holding and transferring securities has

been introduced. Investors have the option to hold securities in either physical or dematerialised form. In order to expedite the process of dematerialisation, the SEBI has mandated the compulsory settlement of trade in demat form in certain select scrips. Securities issued through initial public offering can be settled only in dematerialised form. Henceforth, all IPOs will be issued in dematerialised form. Two depositories—the National Securities Depository Limited (NSDL) and the Central Depository Service Limited (CDSL)—offer trading facility in dematerialised form. The dematerialisation process is almost complete and more than 99 per cent of the turnover settled by delivery is in a dematerialised form.

10.7.2 Risk Management

On the instructions of the SEBI, the stock exchanges have developed a comprehensive risk management system to promote a safe and efficient market. Stock exchanges have laid down trading rules and regulations for broker-members, set up market surveillance systems to curb excess volatility, created trade/settlement guarantee fund to ensure timely settlements even if a member defaults to deliver securities or pay cash, and set up a clearing corporation to guarantee financial settlement of all trades and thereby reduce credit risk in the settlement system. The Clearing Corporation matches the transactions, reconciles sales and purchases and daily settlements. It is also responsible for the risk management of its members and conducts inspection and surveillance. It also collects margins, and capital from members and monitors their net worth requirement. Its major role is to ensure the fulfillment of every contract either by becoming a counter-party itself to every trade or by guaranteeing performance of all trades. This risk management system was absent in the pre-reforms period and the setting up of the system is one of the landmark achievements of financial market reforms.

10.7.3 INTERNET TRADING

Internet trading in India made its debut in April 2000. Through this means of trading, investors can buy and sell shares online through the Internet. To start Internet trading, an investor has to register himself with a broker offering online services. He has to open a bank account as well as a demat account with the broker. The broker is responsible for the risk management of his clients. The orders get logged directly on the trading platforms within the assigned limits designated by the broker to the clients. Even if the client order exceeds the assigned limits, the order gets re-routed to the broker's server for authorisation or rejection. The broker can change the parameters on-line. His software allows real

time market information display, client information display, bank account management, and a transaction history display

Around 14.43 lakh investors had registered to trade online as on March 31, 2006. There has been a sharp increase in volumes after the rolling settlement was introduced. The online trading volumes rose from Rs 7288 crore in 2000-01 on the National Stock Exchange to Rs 1,83,428 crore in 2005-06. Around 11.68 percent of the total trading volume was routed and executed through internet during 2005-06. On-line trading has driven down the transaction costs substantially and increased the liquidity options available to an investor to enter or exit from the stock at his own wish. The Internet has provided a wide range of information to the investor which has enabled him to take calculated risks.

10.7.4 Advantages of Rolling Settlement

1. The basic advantage of rolling system over the *badla system* is its simplicity. The *badla* system was non-transparent and unregulated and the investors' exposure to risk and fraud was very high. The investor had to keep track of different stocks as they had different settlement systems. With rolling settlement, the investor has to merely keep track of the day of purchase/sale of scrips as all the scrips are settled in the same format on all trading screens.
2. This system eliminates arbitrage opportunities in scrips.
3. It improves the price discovery process as the settlement process is standardised and the participants can focus more on market outcomes.
4. This improvement in price discovery would lead to a single, well-defined price that can be used for information processing by different economic agents.
5. It reduces settlement risk and narrows the bid—ask spreads (difference between the bid and offer prices) due to its transparent nature.
6. It encourages wider participation as institutional investors forbidden from doing *badla* or netting trades within a settlement can now take advantage of this system as it shortens delay in settlement of transactions.
7. It eliminates fluctuations of prices which take place around settlement dates. With the setting up of clearing corporations, rolling settlement reduces the working capital requirements of brokerage firms.
8. As it reduces price manipulation and arbitrage, it helps in reducing volatility and turbulence in the markets.

9. Finally, retail investors benefits as it shortens the delays for converting securities into cash and vice versa.

10.8 NATIONAL STOCK EXCHANGE (NSE)

The establishment of the National Stock Exchange of India limited (NSE) has been a step towards professionalisation of the capital market as also to provide nation-wide securities trading facilities to investors. The setting up of the NSE was to ensure better trading facilities for investors and bringing Indian financial markets in line with international markets.

10.8.1 Incorporation

The National Stock Exchange of India was incorporated in November 1992 with an equity capital of Rs. 25 crore and promoted among others by IDBI, ICICI, LIC, GIC and its subsidiaries, commercial banks including State Bank of India and other institutions including SW Capital Markets Limited.

The main agenda of NSE has been to strengthen the move towards professionalisation of the capital market as also to provide nation-wide securities trading facilities to investors.

10.8.2 Objectives

The main objectives of the NSE are:

1. To establish a nation-wide trading facility for equities, debt instruments and hybrids.
2. To ensure equal access to investors all over the country through an appropriate communication network.
3. To provide a fair, efficient and transparent securities market to investors using electronic trading systems.
4. To enable shorter settlement cycles and book entry settlement system.
5. To meet the current international standards of securities markets.

The establishment of the NSE is an important step in upgrading trading facilities for investors and bringing Indian financial markets in line with international markets. The NSE market is a fully automated screen-based trading system.

The emphasis of secondary markets in India has been primarily on equity trading. Trading in corporate debt and government securities has not picked up as in the case of the equity markets. The NSE is expected to play an effective role in providing infrastructure and trading facilities for developing an efficient secondary market for both debt and equity instruments.

The NSE is thus a stock exchange with a difference — besides the traditional retail market for equities, debentures, etc., traded under the capital market, the NSE, following its inception is operating, for the first time in the country, the screen-based trading facility for the Wholesale Debt Market (WDM).

NSE is a new generation exchange whose style of functioning is vastly that of other exchanges. The major differences are described here:

1. Trading is computer-based at NSE whereas other exchanges have floor-based trading.
2. Trades at NSE are automatically matched, automatically matched with a sale order from and quantity agree.
3. At NSE, system programming allows choice of counter-party and specification of transaction size to be made. However such choice can be made only negatively. e.g., black listed parties can be fed in and transaction size can be specified to ensure that the purchase is not executed in too many small lots or vice versa. Further, the duration of an order can be specified as either “good till day” or “good till cancelled. Once specified, the computer will automatically execute the order when the prescribed price is reached.
4. The name of buying/selling party is kept secret from its counterpart. The anonymity makes sure that speculative variations are avoided due to entry of large players.
5. NSE is a truly national system due to absence of a trading floor.
6. NSE ensures total transparency since the computer screen indicates the price at which the deal is executed.

10.8.3 Benefits of NSE

A. Benefits to Trading Members

1. They can provide efficient service to their clients.
2. Their back office load is reduced considerably as the system generates details of trade undertaken.
3. There will be no need to occupy office premises near the Exchange unlike at present, and thus can lead to reduced establishment costs.
4. The system will assure ‘best price’ to participants in the market.
5. Settlement will be quick and efficient.

B. Benefits to Investors:-

1. The investor is assured of the best price in the market.
2. Price and brokerage are separately shown on contract notes.
3. Date and time of trade are indicated. -
4. The system is better monitored and regulated ensuring a fair deal to investors.

5. Safety of securities is enhanced in a depository and there will be no problem of bad delivery, loss, theft or forgery.

C. Benefits to Issuers :-

1. By a single listing, they can provide nation-wide access to their investors.
2. As a result their listing costs are reduced considerably.
3. Issuers will have high visibility.

10.8.4 Trading System

The Exchange provides a facility for screen based trading with automated order matching. The system is order driven and conceals the identity of parties to an order or a trade. This helps orders whether large or small to be placed without the members being disadvantaged by disclosure of their identity. The trading system operates on price time priority. All orders received on the system are sorted with the best priced order getting the first priority for matching i.e. the best buy order matches the best sell order. Within similar priced orders, they are sorted on time i.e., the one that came in early gets priority over the later one. Orders are matched automatically by the computers keeping the system transparent, objective and fair. Where an order does not find a match it remains in the system and is displayed to the whole market, till a fresh order comes in or the earlier order is cancelled or modified.

The trading system provides tremendous flexibility to the users in terms of the kinds of orders that can be placed on the system. Several time related, price related or volume related conditions can easily be placed on an order. The trading system also provides complete market information on-line through various inquiry facilities. The market screens at any point of time give the member complete information on the total order depth in a security, the best buys and sells available in the market, the quantity traded in that security, the high price, the low, last traded price etc. This information is updated on-line real time enabling the member to make better decisions. It is thus possible for investors to know the actual position of the market before placing orders. Investors can also know the fate of the orders almost as soon as they are placed with the Trading Members.

NSE practices order-driven trading as compared to quote driven trading prevalent at other exchanges. Thus trades at NSE are executed on the basis of actual orders received from clients. In contrast, under a quote-driven system, brokers offer a 'buy quote' and a 'sell quote' without being aware of the size of a particular order or the price which a client is willing to accept. Though the speed of execution of transactions could be slower when volumes are low in this system (because a transaction

will be completed only if and when an order is matched with another order), yet the order-driven system leads to a lower speed between buying and selling price.

At NSE, at the end of the trading day, each trader receives a print-out of all trades, orders and cancellations, as well as obligation reports telling him his position regarding both securities and funds.

Check your progress:

1. Define :- Secondary Market.
2. Explain the functions of Secondary market.
3. Give Full form of – i) NSE ii) BSE iii) OTCEI
4. What is Listing of Securities ?
5. What is T+5 & T+2 settlement ?
6. What is Dematerialisation of Securities ?
7. Discuss the functions of NSE.
8. How does Internet trading is useful to small investors?

10.9 DEBT MARKET IN INDIA

The debt market is one of the most critical components of the financial system of any economy and acts as the fulcrum of a modern financial system. The debt market in most developed countries is many times bigger than the other financial markets, including the equity market. The US bond market is more than USD 13.5 trillion in size with a turnover exceeding USD 500 billion daily, representing the largest securities market in the world. The size of the world bonds market is close to USD 31.4 trillion which is nearly equivalent to the total GDP of all the countries in the world.

The total size of the Indian debt market is currently estimated to be in the range of USD 92 billion to USD 100 billion. India's debt market accounts for approximately 30 per cent of its GDP. The Indian bond market, measured by the estimated value of the bonds outstanding, is next only to the Japanese and Korean bond markets in Asia. The Indian debt market, in terms of volume, is larger than the equity market. In terms of the daily settled deals, the debt and the forex markets currently (2001—02) command a volume of Rs 25,000 crore against a meagre Rs. 1,200 crore in the equity markets (including equity derivatives).

In the post-reforms era, a fairly well-segmented debt market has emerged comprising the following:

1. Private corporate debt market.
2. Public sector undertaking bond market.
3. Government securities market.

The government securities market accounts for more than 90 per cent of the turnover in the debt market. It constitutes the principal segment of the debt market.

10.9.1 History of the Indian Debt Market

The Indian debt market has traditionally been a wholesale market with participation restricted to a few institutional players—mainly banks. Banks were the major participants in the government securities market due to statutory requirements. The turnover in the debt market too was quite low at a few hundred crores till the early 1990s. The debt market was fairly underdeveloped due to the administered interest rate regime and the availability of investment avenues which gave a higher rate of return to investors.

In the early 1990s, the government needed a large amount of money for investment in development and infrastructure projects. The government realised the need of a vibrant, efficient, and healthy debt market and undertook reform measures. The Reserve Bank put in substantial efforts to develop the government securities market but its two segment, the private corporate debt market and public sector undertaking bond market, have not fully developed in terms of volume and liquidity.

The debt market plays a key role in the efficient mobilisation and allocation of resources in the economy, financing the development activities of the government, transmitting signals for implementation of the monetary policy, facilitating liquidity management in tune with both short-term and long-term objectives and pricing of non-government securities financial markets.

It is the debt market which can provide returns commensurate to the risk, a variety of instruments to match the risk and liquidity preferences of investors, greater safety, and lower volatility. Hence, the debt market has a lot of potential for growth in the future. The debt market is critical to the development of a developing country like India which requires a large amount of capital for achieving industrial and infrastructure growth.

10.9.2 REGULATION OF DEBT MARKET

The RBI regulates the government securities market and money market while the corporate debt market comes the purview of the SEBI.

In order to promote an orderly development of the market, the government issued a notification on March 2, 2000 delineating the areas of responsibility between the Reserve Bank and the SEBI. The sale and purchase of government securities, gold related securities, money market securities and securities derived from these securities, and ready forward contracts in debt securities shall be regulated by the RBI. Such contracts, if executed on the stock exchanges shall, however, be regulated by SEBI in a manner that is consistent with the guidelines issued by the RBI.

10.10 CHARACTERISTICS OF DEBT MARKET

The Characteristics of an efficient debt market are as follows :-

1. It has a competitive market structure.
2. In this market, transaction costs are low.
3. It has a safe market infrastructure and a high level of heterogeneity among market participants.
4. An efficient debt market helps in reducing the borrowing cost of the government.
5. It helps in reducing the pressure on institutional financing by providing greater funding avenues.
6. It enhances mobilisation of resources by unlocking unproductive investment like gold and developing a stable yield curve.

10.11 PARTICIPANTS IN THE DEBT MARKET

The participants in the debt market are a small number of large players which has resulted in the debt market evolving into a wholesale market. Most primary debt issues are privately placed or auctioned to the participants while secondary market dealings are negotiated over the telephone. The NSE Wholesale Debt Market Segment (WDM) has emerged as an active platform for trading in debt instruments. Recently, the BSE also started trading in debt instruments. The primary dealers act as market makers in the government securities market. The debt market has become more diversified with the entry of new participants such as high net worth individuals, cooperative banks, large corporates, mutual funds and insurance companies.

The Major Participants in the debt market are as follows :-

- 1. Central and state governments:** The central government raises money through the issue of dated securities and treasury bills to finance the budget deficit and other short-term and long-term financial requirements. The Reserve Bank is the investment banker, which

performs the task of raising money and issuing securities on behalf of the government.

The state government, municipalities, and local bodies also issue securities to finance their budgetary deficits and developmental projects,

- 2. Primary Dealers :** They are market makers appointed by the Reserve Bank and have emerged as active intermediaries in the government securities market and money market,
- 3. Public Sector Undertakings (PSUs):** They issue tax-free and taxable bonds to meet their long term and working capital needs. They also invest in debt securities to park their surplus funds
- 4. Corporates:** They are both issuers and investors in the debt market.
- 5. Banks:** They are the captive investors in the government securities market. They participate both as lenders and borrowers in the call money market and as arrangers and investors in the commercial paper market. They issue certificates of deposits (CDs) to finance their short term requirements and bonds to finance their long-term requirements.
- 6. Mutual Funds:** Mutual funds are the predominant investors, in the debt market. They have specialised debt funds such as money market mutual funds, gilt funds, and so on. They have also emerged as active participants and traders in the debt market.
- 7. Foreign Institutional Investors (FIIs):** They have been permitted to invest in government securities and corporate bonds. The limits of their investment have been specified.
- 8. Provident Funds (PFs):** PFs are large investors in government securities and PSU bonds. They are not active traders in their portfolios.
- 9. Charitable Institutions and Trusts:** They are large investors in government securities and bonds specified in the bye-laws governing them. They are also not active traders in their portfolios. Satellite dealers (SDs) were also one of the participants in the debt market but the Reserve Bank discontinued their participation from May 2002.

In the government securities market, the Negotiated Dealing System (NDS) has replaced the system negotiations through telephones. The Clearing Corporation of India Limited (CCIL) has revolutionised the clearing and settlement system in the government securities market. Both the NDS and the CCIL have brought about a radical transformation in the debt market similar to that brought about by NSE in the equity market.

10.12 RISKS ASSOCIATED WITH DEBT SECURITIES AND TRADING IN DEBT SECURITIES

(A) Risk associated with debt securities

1. **Default / Credit Risk** : The issuer of a debt security may be unable to make timely payment of interest or principal amount or comply with the provision of a bond indenture.
2. **Interest Rate Risk** : Risk arising from an adverse change in the interest rate which affects the yield on the existing instruments.
3. **Reinvestment Rate Risk** : The probability of a fall in the interest rate resulting in lack of options to invest the interest received at regular intervals at higher rates or at comparable rates in the market.

(B) Risk associated with trading in debt securities

1. **Counter-Party Risk** : Risk arising due to the inability of the opposite party to the contract to deliver either the promised security or the sale value at the time of settlement.
2. **Price Risk** : Risk arising on account of the inability to receive the expected price due to an adverse movement in the prices.

10.13 TYPES OF INSTRUMENTS IN THE DEBT MARKET

The different types of instruments traded in the debt market can be classified into following :-

Market Segment	Issuer	Instruments
Government securities.	Central government State governments.	Zero coupon bonds, coupon bearing bonds, tre-asury bills, floating rate bonds, STRIPS.
	State Government	Coupon bearing bonds, floating rate bonds.
Public sector bonds	Government agencies /statutory bodies	Government guaranteed bonds, debentures.
	Public sector units	PSU bonds-taxable and tax-free, debentures, commercial

		paper, deep discount bonds.
Private sector bonds	Corporates	Debentures, bonds, CPs, floating rate bonds, secured premium notes, zero coupon bonds, inter-corporate deposits.
	Banks.	CDs, debentures, bonds
	Financial Institutions	CDs, bonds

Source: BSE.

10.14 PROBLEMS OF THE DEBT MARKET

Amongst the numerous problems hounding the debt market the major problem is the lack of depth. The biggest holders of debt are banks. And internationally also banks are the biggest and most active players in debt. However, in India banks are allowed to invest only a very small amount in corporate debt (maximum of 5 percent of incremental liabilities) and are prohibited from trading in the secondary market. Further, most banks hold government debt “ad nauseam” and due to erosion in its value are able to neither divest nor invest further. Besides, no conscious efforts has been made to develop a secondary market for debt instruments, hence it is very difficult for individuals or corporates to buy or sell debt in the secondary market. The absence of a central depository further compounds the problem with title and transfer becoming hazardous issues.

The absence of the retail investor in the debt market has contributed substantially to its development. If the equity market can capture the imagination of the small investors, there is no reason why attempts to develop a retail debt market will not bear fruit. Unfortunately, no such concerted effort has been-made.

Accepting that the above are important problems, the single-most important lacuna in the debt market is the absence of forward trading. As in the equity market, this would not only encourage position-taking and development of sophisticated instruments (viz., interest-rate swaps, options, etc.) but also give rise to that breed so essential for imparting depth to any market-the speculation.

The debt market in India has been victim of over regulation, under policing and abuse at the hands of market players. These and other various reasons have contributed to its present state. The scam has set back the market by about five years and it may take some more time before the emergence of a vibrant debt market is seen in India. However, given that, reforms are progressing in the right direction, we cannot afford to ignore the tremendous advantages which a well-developed debt market offers.

10.15 IMPORTANCE OF DEBT MARKET

“Debt Market is the life line of the entire commercial activity any country.”

The debt market is the life line of the entire commercial activity of any country, and hence it is a major indicator of the level of development of an economy. A well functioning debt market is one which has adequate, breath to accommodate a variety of instruments to meet the needs of different kinds of investors and sufficient depth to absorb large trading volumes without much price variations

Debt securities include treasury bills, promissory notes, bonds, debentures, mortgages, commercial paper, and certificates of deposits and UTI units. They can be short-term as well as long- term with maturities ranging from twelve hours to twenty years. Government securities are high quality debt securities of all lengths of maturity and can be considered as risk free or zero risk instruments. The debt market in India consists of three segments:-

1. Government securities.
2. PSU bonds
3. Corporate bonds and debentures

The debt market may be divided into primary and secondary markets. Most banks invest in government, securities in order to meet their Statutory Liquidity Ratio (SLR) requirement rather than investment purposes. Some banks also invest in government securities in excess of their SLR requirements contain the proportion of performing assets in their portfolio. The secondary markets in debt instruments have been outmoded mainly due to the lack of any organised exchange till recently. The lack of depth and liquidity in most debt instruments, be it government or corporate, are the principle lacunas in the secondary markets.

Although the Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI) were set up in 1988 and 1993 respectively, they have not become active market makers. The National Stock Exchange of India Ltd. (NSE) started a screen based

wholesale debt market (WDM) segment in order to create an active secondary debt market. But even this has not performed well and volumes in the WDM although steadily increasing, have been low, at around Rs. 1000 crore, a month for the past few months.

There have been two fundamental reforms in the government securities market. The government is moving from a system of low administered rates to a system of market determined rates on government securities. This would also help evolve a benchmark and determine the true term structure of interest rates.

A phased reduction in the reserve requirement of banks is also proposed. The government in consensus with the RBI, also plans to control the magnetisation of the budget deficit. The RBI and the GOI have resorted to converting T-bills to dated securities. Several measures have been taken by the RBI, in recent times to develop an active market in government securities. The setting up of the STCI is one of the steps in this direction currently, only the RBI, DFHI and STCI can be considered as market makers. However, the RBI has appointed six primary dealers in government securities. This would boost the liquidity in secondary debt markets.

In order to provide greater transparency to the dealing in government securities, the transactions are to be dematerialised through the subsidiary general ledger (SGL). Also the system of Delivery versus Payment (DVP) will ensure greater security in transactions. The CRR and the SLR rates have not been changed in the two credit policy announcements. The central government budgeted Rs. 19,000 crore through roll-overs of maturing securities and zero coupon bonds during 1995-96.

10.16 RELATIONSHIP BETWEEN MONEY MARKET AND CAPITAL MARKET

The relationship between the money market and capital market helps explain the basic framework of the financial system. Under this framework, businesses and government agencies access sources of short-term and long-term funds to generate immediate cash flow or finance long-term projects. Both markets have a particular role in how money flows from savers to businesses and government to finance operations and investment. As a result, both markets provide investors with opportunities to generate earnings and premiums from risky ventures.

Capital Market :

Broadly, the capital market is a marketplace for trading investments with maturities of more than a year. Capital market investments are typically debt, equity or derivative securities used to raise money for

long-term purposes. For example, large corporations issue equity securities called stocks to raise money. This money is invested back into the company in the form of machinery, real estate or equipment to improve and build long-term profitability, and increase the value of the company.

Money Market :

The money market is the marketplace used to trade short-term securities which have maturity dates of less than one year. Money market securities are commonly short-term bonds issued by corporations or governments to fund immediate needs. For instance, the federal government finances its budget deficits by issuing Treasury bills to investors in the U.S. and around the world. Similarly, large corporations issue commercial paper to raise money from investors which is then used to fund ongoing operations.

Capital Market Purpose :

Capital markets provide a source of funds from which corporations and governments borrow based on potential future cash flows. For example, a large manufacturing company borrows money by selling bonds to investors to finance an upgrade in machinery. The upgrade is calculated to increase production and profits beyond current levels. The increase in profit makes it possible to pay back bond holders and increase the value of the company for stock holders. Therefore, the company bet that the increase in future income from the upgrade financed with bonds would be sufficient to cover the bond issue and make money for the company.

Money Market Applications :

Alternately, the money market is used to finance current operations and is not necessarily used to fund investment spending. For instance, a large company that does not have enough money to cover payroll might issue commercial paper to raise money to pay employees. In turn, investors use the money market as a safe holding place where money still earns even a minimal return but more than in a traditional savings or checking account.

Risk :

Short-term securities correlate with lower levels of risk while long-term securities are exposed to greater amounts of risk. This occurs from long-term securities being exposed to the volatility in the securities market for a much longer period of time. Generally, short-term securities are less risky because there is less market volatility in the short term. This difference in risk also corresponds to returns. Returns are generally higher with riskier investments and than in safer investments.

Check your progress:

1. Explain the concept of Debt market.
 2. Who are the participants of Debt Market?
 3. Elaborate the features of Debt Market.
 4. What are the different types of risks associated with debt securities?
 5. Explain the relationship between Money market & Capital market .
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10.17 FOREIGN EXCHANGE MARKET

10.17.1 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 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.

Policies in respect of management of the exchange rate, foreign exchange reserves and external debt have received increasing emphasis in emerging market economies. The scope for exchange rate flexibility has generated considerable debate, particularly in view of the recent build-up of reserves and appreciation of rupee. Furthermore, the need for careful assessment of the external debt situation has assumed an added significance on a day-to-day basis, it is capital flows that influence the exchange rate and interest rate arithmetic of the financial markets, rather than real factors underlying trade competitiveness.

10.17.2 CONCEPTS OF FOREIGN EXCHANGE :

Foreign exchange refers to foreign currencies possessed by a country making payments to other countries. It refers to all those credit instruments gives the residents of a country a claim upon foreign currencies.

Foreign exchange mechanism refers to the international payments mechanism through which payments are made between two countries having different currency systems. It is the mechanism through which a country's domestic currency is converted into foreign currency.

In order to effect international payments and transactions, it is necessary to connect the values of different currencies of different countries. Hence the concepts of foreign exchange and foreign exchange mechanism came into existence.

10.17.3 Foreign exchange Market :

Foreign exchange market refers to the buying and selling of one national currency for another i.e. buying foreign currencies with domestic currencies and selling foreign currencies for domestic currencies. Import-Export traders convert their foreign earnings into home currencies or home currencies into foreign currencies to meet their obligations abroad. Institutions like the Treasury, Central Bank, Foreign exchange banks etc, involved in the purchase and sale of foreign exchange currencies constitute the foreign exchange market.

10.17.4 RATE OF EXCHANGE - CONCEPTS

The rate of exchange refers to the rate at which the currencies of two countries are exchanged for each other. Rate of exchange is the value or price of a country's currency in terms of foreign currency. For e.g. if 1 US dollar is exchanged for Rs.40, then the foreign exchange rate is \$1 Rs.40.

In the Foreign exchange market, there is a variety of exchange rates according to the credit instruments employed in the transfer function. For e.g.

- (a) Spot rate or cable rate.
- (b) Sight rate in case of foreign currency bills.
- (c) Usance rate or long rate which may be one month's rate or 3 month's rate.
- (d) Forward exchange rate for future contracts.

The foreign exchange market mainly deals with two types of exchange transaction as follows:

- 1. Spot rate:** Spot rate of exchange refers to the price of foreign currency in terms of domestic currency payable for the immediate delivery of the foreign currency. The seller has to deliver the foreign exchange on the Spot & the buyer will receive payments of foreign exchange without much delay.
- 2. Forward Rate:** Forward rate refers to a contract to buy or sell foreign currency at a fixed date in future at a price agreed at present. This predetermined rate at which the currency is to be bought & sold at a future date is called as the forward rate.
- 3. Arbitrage :** Arbitrage is act of simultaneously buying a currency in one market and selling it in another market to make a profit by taking

advantage of the differences in the exchange rate in the two markets. If the arbitrage is confined only to two markets, it is known two-point arbitrage. If they extend to three or more markets, they are known as three-point or multi-point arbitrage.

10.18 STRUCTURE OF THE FOREIGN EXCHANGE MARKET

The foreign exchange market in India is a three-tier structure comprising (a) the Reserve bank at the apex, (b) Authorized Dealers (ADs) licensed by the Reserve Bank, and customers such as exporters and importers, corporates and other foreign exchange earners. Apart from these main market players, there are foreign exchange money changers 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 (FEDAI). Dealings in the foreign exchange market include transactions 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.

At present, there are 92 banks authorized to deal in foreign exchange, referred to as Authorised dealers (ADs). Of these, most foreign banks and bigger Indian banks actively quote two-way prices. The banks deal among themselves directly or through the foreign exchange brokers presently numbering 47. Besides banks, term lending institutions have been given restricted dealing licenses. 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. Wider spreads are an indication of an illiquid or a one-way market. In India, the normal spot market quote has a spread of 0.25 to 0.50 paise, while swap quotes are available at 1 to 2 paise spread. The total turnover in the foreign exchange market has been showing an increasing trend over the years.

10.18.1 Foreign Exchange Dealers Association of India (FEDAI):

With the rapid growth of foreign trade, RBI permitted several scheduled commercial banks undertake foreign exchange transactions. The Foreign Exchange Dealers Association of India (FEDAI) was formed with the approval of RBI in 1958. Each member bank has to give an undertaking to RBI that it will abide by the exchange rates and other

rules and regulations of FEDAI for transacting Foreign Exchange business.

FEDAI has become a registered company since 1st April 1990 and has a managing committee of 20 members and a chief executive. It has a registered office in Mumbai and Local committees at Delhi, Kolkata, Chennai and Cochin represented by local bankers. FEDAI formulates various guidelines for authorised dealers for carrying out Forex transactions. Its primary objective is to ensure the implementation of RBI rules by authorised dealers.

10.18.2 Participants Or Players of the foreign exchange market:

The different categories of participants who take part in the foreign exchange market are

- 1) **Central Bank** : The Central Bank buys and sells country's foreign exchange reserves. When the Central Bank deliberately attempts to alter the exchange rate between two currencies by buying one and selling the other currency, it is called **intervention**.
- 2) **Authorised Dealers** : Banks and non-bank institutions are authorised dealers in foreign exchange market who buy and sell foreign currencies to get profit. There is stiff competition among these dealers which makes the market efficient.
- 3) **Individual & Firms** : Exporters, Importers, International investors, Multi national Corporations, Tourists and other individuals use foreign exchange market for commercial and investment transactions.
- 4) **Brokers** : Brokers bring together buyers and sellers of foreign currency. They are specialised in currencies like dollar and sterling and give information about rates of exchange.
- 5) **Speculators & Arbitragers** : Speculators and Arbitragers trade in foreign exchange market to make profit through normal and speculative transactions. They act on behalf of major banks. Arbitragers are those who buy foreign currency in one market at a lower rate and sell it in another market at a higher rate.

10.18.3 Instruments of Credit Traded in Foreign Exchange Market:

In addition to conversion of foreign currency notes and cash, a number of instruments of credit are used for effecting conversion in the foreign exchange market. These instruments are:

1. Telegraphic Transfers (TT)
2. Mail Transfers (MT)
3. Drafts and Cheques
4. Bills of Exchange.

10.19 RBI INTERVENTION AND EXCHANGE RATE MANAGEMENT

The Exchange Control Department of the RBI was set up in 1939. In order to conserve the scarce foreign exchange reserves and use them judiciously, the Foreign Exchange Regulation Act (FERA) was passed in 1947.

The act empowered the Central Government and the RBI to control and regulate all dealings involving foreign exchange transactions. The main objective of RBI in Indian foreign exchange market are:

- 1) To maintain stability in exchange rates.
- 2) To conserve scarce foreign exchange reserves for essential purposes.
- 3) To develop domestic industry.
- 4) To promote economic development by restricting imports and encouraging exports.

The FERA Act of 1947 was amended and enlarged in 1973. This act came in force on 1st Jan .1974 and it gave wide ranging powers to RBI to administer exchange control mechanism properly.

10.19.1 ROLE OF RBI IN THE FOREIGN EXCHANGE MARKET

The role of RBI in the foreign exchange market is revealed by the provisions of FERA (1973).

- 1) **Administrative Authority** : The RBI is the administrative authority for exchange control in India under the supervision of the Central Government. The RBI has been authorised to issue licenses to those who are involved in foreign exchange transactions.
- 2) **Appointment of authorised dealers**: The RBI does not directly deal with the public. It has appointed a number of authorised dealers. It has issued licenses to many commercial banks and 'money exchangers' to act as authorised dealers in foreign exchange. Only they are permitted to carry out all transactions involving foreign exchange. Section 3 of FERA lays down the above provision.
- 3) **Issue of Directions** : The RBI issues directions from time to time to authorised dealers, relating to imports and exports, foreign travel remittances, capital transfers, transfer of investment incomes etc. The 'Exchange Control Manual' contains all directions and procedures given by RBI from time to time.
- 4) **Fixation of Exchange rates** : The RBI has the responsibility of fixing the exchange value of the home currency (i. e. rupee) in terms

of other currencies - basket of unspecified currencies. This rate is known as the official rate of exchange and all authorised dealers and money lenders are required to follow this rate strictly in all their foreign exchange transactions. According to the Foreign Exchange Regulation (Amendment) Ordinance 1993, the RBI is permitted to express exchange rates in terms of rupees per \$ US instead of \$ US per Rs. 100)

- 5) **Controlling Import Trade** : Imports are permitted only against proper licenses and the necessary foreign exchange is released by the RBI. The foreign exchange must be used only for the purpose for which it is obtained. The items of imports that can be imported freely are specified under (Open General License) According to the provisions of FERA, all payments for imports have to be made only through authorised dealers. Thus the RBI regulates import trade.
- 6) **Controlling Export Trade** :The RBI controls export trade in collaboration with customs authorities and authorised dealers. Export of gold and jewellery are allowed only with special permission from RBI. Payments for exports must be received only by the approved method recognised by the RBI.
- 7) **Controlling Foreign Travel**: Foreign Travel comes under invisible items. Indian residents can get foreign exchange released from RBI up to a specified amount for travel abroad through proper application. The foreign currencies brought in must be declared at entry point and they must be sold only to authorised dealers in foreign exchange.
- 8) **Controlling Foreign Investments** : Non-residents can make investments in India only after obtaining the necessary permission from the Central Government or the RBI. This is governed by the Industrial Policy of the Government of India. Investments with and without repatriation facilities are permitted very liberally by the RBI, in the recent years. Great Investment opportunities are provided to nonresident Indians. Permission is also granted to foreign countries and nationals to invest in Indian Companies on more liberal terms. FERA has been considerably relaxed to encourage exports' and foreign investments. The recent amendments also permit the outflow of Indian capital through joint ventures abroad.
- 9) **Import & Export of gold, silver, currency notes etc**: The limits fixed for bringing gold, silver currency notes etc has been relaxed considerably by the RBI in the recent years. All imports must be declared to the controlling authorities.

- 10) Rupee Accounts of Non-Residents :** Accounts opened and maintained with authorised dealers in the names of persons residing outside India are called Non-resident External Accounts (NRE Accounts). Many benefits like exemption from income tax, gift tax, wealth tax etc. are available under NRE accounts.
- 11) Submission of Returns :** All foreign exchange transactions made by authorised dealers must be reported to the RBI. This enables the RBI to have a closed watch on foreign exchange dealings in India.

Thus the RBI is the apex bank that intervenes, supervises controls the foreign exchange markets in order to create an active and stable exchange market.

10.20 LIBERALISATION MEASURES IN FOREIGN EXCHANGE MARKET SINCE 1991-92

In the post 1991 period, the system exchange controls was relaxed and the intervention by RBI in foreign exchange market is limited only to maintaining the exchange rate stability of rupee.

1) Dual Exchange rate system :

The Govt. of India introduced a dual exchange rate system in 1992-93 known as Liberalised Exchange Rate Management Systems (LERMS).

a) The Govt. of India accepted the existence of two exchange rates in the country — the official exchange rate which was controlled and the market rate which fluctuate according to market conditions.

b) All foreign exchange remittances into India were allowed to be converted in the following manner

- i) 60 % of earnings could be converted at free market determined rate.
- ii) The balance 40 % of the earnings should be sold through RBI authorised dealers at official rate of exchange.

The Govt. hoped that this would be an incentive to promote exports. The foreign exchange reserves increased from \$5.8bn in 1990-91 to \$25.2bn in 1994-95.

2) Full convertibility of rupee on Current Account:

Convertibility means the freedom to convert domestic currency into foreign currency without any limit or for any purpose. The Indians abroad and exporters were unhappy to surrender 40% of their earnings at official exchange rate. Hence the Govt. abolished the dual exchange rate system and adopted a unified exchange rate system since March 1993.

The Govt. allowed full convertibility of rupee on trade account – i.e. Indians abroad and exporters can convert 100% of the foreign exchange earnings at market rates. Dr. Man Mohan Singh, the then Finance Minister introduced convertibility of rupee on the current account. This liberalised access to foreign exchange for all current business transactions including travel, education, medical expenses etc. This led to an increase in forex reserves and improvements in balance of payments position.

3) Tarapore Committee on Capital Account Convertibility:

Capital convertibility is the freedom to convert domestic financial assets into foreign financial assets. Full Capital Convertibility is the ability of the Indian resident to hold his money in dollars or buy shares in New York Stock exchange or own property abroad.

The RBI appointed a Committee on Capital Account Convertibility (CAC) headed by S.S. Tarapore (Former Deputy Governor of RBI).

The advantages of CAC as put forward by the Committee are:

- 1) Availability of foreign capital to supplement domestic resources and promote economic growth.
- 2) Better access to International Financial markets and reduction in the cost of capital.
- 3) Incentives for Indians to hold international securities and assets.
- 4) Improvement in the financial system to face global competition.
- 5) Integration of domestic markets with overseas markets.

The CAC would be effective only if the following conditions are met.

- 1) Substantial Foreign exchange reserves and strong balance of payments position.
- 2) Efficient Financial system.
- 3) Appropriate exchange rate policy.
- 4) Fiscal deficit should be reduced to 3.5%.
- 5) Interest rates should be fully deregulated.
- 6) Inflation should be under control.

Full convertibility of rupee both on current account and capital account is necessary for the close integration for the Indian economy with the global economy. As per the latest indications, the RBI is not keen to propose full convertibility as our financial sector is not matured enough and the RBI is still worried about the sudden outflow of capital.

10.20.1 FOREIGN EXCHANGE MANAGEMENT ACT (FEMA):

The relaxation of FERA encouraged the inflow of foreign capital and the growth of Multi National Corporations (MNCs) in India. FERA was replaced by FEMA in 1999. The emphasis under FERA was on

exchange regulation or exchange control, while under FEMA, the emphasis was on exchange management. The purpose of FEMA is to facilitate external trade and payments and promote orderly development and maintenance of foreign exchange market in India. Under FERA it was necessary to obtain RBI's permission in respect of most of the regulations under the Act. Under FEMA, except for section 3 which relates to dealing in foreign exchange, no other provision of FEMA stipulates obtaining RBI's permission.

Under FERA (1973) all transactions in foreign exchange and all transactions with non-residents were absolutely prohibited except where specific relaxations were made. Non-residents also not permitted to have any dealings in India.

Under FEMA (1998), the major focus is on transactions involving foreign exchange and foreign securities. Restrictions over dealings with non-residents have been substantially diluted though not eliminated.

If any person contravenes any provision of FEMA 1998, he shall be liable to a penalty up to twice the sum involved in such contravention. There would be no punishment in way of imprisonment unlike FERA.

FEMA 1998 has simplified the provisions of FERA 1973. The two key aspects of FEMA are the relaxation of foreign exchange controls and move towards capital account convertibility. FEMA regulates both import and export trade and methods of payment. The restrictions on draws of foreign exchange for the purpose of current and capital account transactions have been removed to facilitate foreign trade.

10.21 RATE OF EXCHANGE AND ITS INFLUENCE ON FINANCIAL FLOWS

With the gradual opening of current and capital account transactions in the 1990s, the increasing volume of capital flows had a direct bearing on the stability of the exchange rate. There were intermittent periods of excessive capital inflows followed by episodes of ebbing of capital flows and subsequent recovery in capital inflows. From the viewpoint of examining the impact of external transactions on the exchange rate impact of external transaction on the exchange rate stability, the 10-years period starting from March 1993 (when the exchange rate became market determined) could be divided into three sub periods as detailed below.:

March 1993-August 1995: Reflecting the positive investor confidence, the Indian economy experienced surges in capital inflows during 1993-94, 1994-95 and the first half of 1995-96, which, coupled with robust export growth, exerted upward pressures on the exchange

rate. In the face of these inflows, the Reserve Bank absorbed the excess supplies of foreign exchange. In the process, the nominal exchange rate of the rupee vis-à-vis the US dollar remained virtually unchanged at around Rs 31.37 per US dollar over the extended period from March 1993 to August 1995.

September 1995-December 1996: The Period from September 1995 to February 1996 witnessed large capital inflows. The real appreciation of the Rupee resulting from surges in capital inflows triggered off market expectations and led to a depreciation of the Rupee in the second half of 1995-96, i.e., between September 1995-mid-January 1996. In response to the upheavals, the Reserve Bank intervened in the market to signal that the fundamentals were in place and to ensure that market correction of the overvalued exchange rate was orderly and calibrated. The interventions in the forex market were supported by monetary tightening to prevent speculative attacks. These decisive and timely measures brought stability to the market lasting till mid-January 1996. In the first week of February 1996, another bout of uncertainty led the Rupee to overshoot to Rs. 37.95 per US dollar. The monetary and other measures succeeded in restoring orderly conditions and the Rupee traded in a range of Rs. 34-35 per US dollar over the period March-June 1996. The Rupee remained range bound during the second half of 1996.

1997 onwards: The foreign exchange market since 1997 had to cope with a number of adverse internal as well as external developments. The important internal developments include the economic sanctions in the aftermath of nuclear tests during May 1998 and the border conflict during May-June 1999. The external developments included, *inter alia*, the contagion due to the Asian financial crisis and the Russian crisis during 1997-98 and the sharp increase in international crude prices in the period since 1999, especially from May 2000 onwards. Movements in interest rates in the industrialized countries as well as the cross-currency movements of the US dollar vis-à-vis other major international currencies were some of the other external developments impacting the foreign exchange market. These developments created a large degree of uncertainty in the foreign exchange market leading to excess demand, which was reflected in the spot market gap in the merchant segment, increasing from US \$ 3.2 billion in 1997-98 to US \$ 4.4 billion in 1998-99. The Reserve Bank responded through timely monetary and other measures like variations in the Bank Rate, the repo rate, cash reserve requirements, refinance to banks, surcharge on import finance and minimum interest rates on overdue export bills to curb destabilizing speculative activities during these episodes of volatility while allowing

an orderly effective measures were initiated and orderly conditions in the market were restored quickly.

Check your progress:

1. Define :a) Foreign Exchange b) Foreign Exchange Market.
2. What is Spot Exchange rate & Forward Exchange rate ?
3. What is Arbitrage?
4. Who are the participants in Forex Market ?
5. What is the purpose of FEMA 1998 ?

10.22 SUMMARY

1. The secondary market is a market in which existing securities are resold or traded. This market is also known as the stock market.
2. After the initiations of reforms in 1991, the Indian Secondary market now has a three-tier form :- Regional Stock Exchanges, The National Stock Exchange (NSE), The Over Counter Exchange of India (OTCEI).
3. The stock markets in India are regulated by the central government under the Securities Contracts (Regulation) Act, 1956 which provides for the recognition of stock exchanges, supervision and control of recognised stock exchanges, regulation of contracts in securities, listing of securities, transfer of securities and many other related functions.
4. Demutualisation is the process by which any member-owned organisation can become a shareholder-owned company. Through demutualisation, a stock exchange becomes a corporate entity, changing from a non-profit making company to a profit-making & tax-paying company.
5. A Company has to list its securities on the exchange so that they are available for trading. To improve transparency, the SEBI made it mandatory for listed companies to provide their half-yearly results on the basis of a limited review by its auditors or chartered accountants to the stock exchanges.
6. The SEBI has permitted the setting up of trading terminals abroad as well as Internet trading. Now investors in any part of the world can route the order through the Internet for trading in Indian scrips.

7. After the reforms, the trading and settlement cycle was trimmed from 14 days to 7 days. To eliminate various problems such as theft, fake/forged transfers, transfer delays, and the paperwork associated with physical certificates, an electronic book entry form of holding and transferring securities has been introduced. Investors have the option to hold securities in either physical or dematerialised form.
8. The National Stock Exchange of India was incorporated in November 1992 with an equity capital of Rs. 25 crore and promoted among others by IDBI, ICICI, LIC, GIC and its subsidiaries, commercial banks including State Bank of India and other institutions including SW Capital Markets Limited. The main agenda of NSE has been to strengthen the move towards professionalisation of the capital market.
9. The corporate debt market comes within the purview of the SEBI. The participants in the debt market are a small number of large players which has resulted in the debt market evolving into a wholesale market.
10. The debt market is the life line of the entire commercial activity of any country, and hence it is a major indicator of the level of development of an economy. Debt securities include treasury bills, promissory notes, bonds, debentures, mortgages, commercial paper, and certificates of deposits and UTI units. They can be short-term as well as long-term with maturities ranging from twelve hours to twenty years.
11. Foreign exchange mechanism refers to the international payments mechanism through which payments are made between two countries having different currency systems. It is the mechanism through which a country's domestic currency is converted into foreign currency.
12. Foreign exchange market refers to the buying and selling of one national currency for another, i.e. buying foreign currencies for domestic currencies and selling foreign currencies for domestic currencies.
13. The rate of exchange refers to the rate at which the currencies of two countries are exchanged for each other. Rate of exchange is the value or price of a country's currency in terms of foreign currency.
14. The foreign exchange market in India is a three-tier structure comprising (a) the Reserve bank at the apex, (b) Authorized Dealers (ADs) licensed by the Reserve Bank, and customers such as exporters and importers, corporates and other foreign exchange earners.

- 15 In order to conserve the scarce foreign exchange reserves and use them judiciously, the Foreign Exchange Regulation Act (FERA) was passed in 1947. It was amended and enlarged in 1973. This act came in force on 1st Jan .1974 and it gave wide ranging powers to RBI to administer exchange control mechanism properly.
16. FERA was replaced by FEMA in 1999 i.e. in post reform period. The two key aspects of FEMA are the relaxation of foreign exchange controls and move towards capital account convertibility.

10.23 QUESTIONS

1. Define Secondary market and explain its functions.
2. Write a note on NSE.
3. What do you understand by Listing of Securities?
4. What is Dematerialisation of Securities ?
5. How does Internet trading is useful to small investors?
6. Explain in detail the concept of Debt market.
7. What are the different types of risks associated with debt securities?
8. Explain the relationship between Money market & Capital market.
9. Explain the various concepts of rate of exchange.
10. Who are the authorised dealers in the Indian foreign exchange market?
11. Explain the role of RBI in the foreign exchange market.
12. How does the RBI intervene in the foreign exchange market?
13. Explain the exchange controls administered by the RBI under FERA.
14. Examine the liberalisation measures introduced by the Govt. of India in the foreign exchange market since 1991.

