INDIAN
FINANCIAL
MARKETS

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1. Motivation for investments and its perks

The money you earn is partly spent and the rest saved for meeting future expenses. Instead of keeping the savings idle, you may like to use savings in order to get a return on them in the future. This is called Investment.

One needs to invest to earn a return on your idle resources and generate a specified sum of money for a specific goal in life to make a provision for an uncertain future One of the important reasons why one needs to invest wisely is to meet the cost of Inflation. Inflation is the rate at which the cost of living increases. The cost of living is simply what it costs to buy the goods and services you need to live. Inflation causes money to lose value because it will not buy the same amount of a good or service in the future as it does now or did in the past.

What are various options available for investment?

One may invest in:

- Physical assets like real estate, gold/jewelry, commodities, etc., and/or
- Financial assets such as fi fixed deposits with banks, small saving instruments with post offices, insurance/provident/pension funds, etc. or securities market-related instruments like shares, bonds, debentures

2. Basics

Budgeting

The first step in your financial planning is budgeting - a process for tracking, planning, and controlling the inflow and outflow of your income. It entails identifying all the sources of income and taking into account all current and future expenses, with an aim to meet your financial goals. The primary aim of budgeting is to ensure reasonable savings after providing for all expenses. Benefits of budgeting

• it puts checks and balances in place in order to prevent overspending at various levels;
• it takes into account the unexpected need for funds;
• it disciplines you in matters of earning and spending; and
• it helps you to maintain, and standard of living even after post-retirement

Inflation effects on Investments

While planning your investment, it is important to take into account the effects of inflation on your investments. Inflation is the rise in the prices of goods and services. As the prices of goods and services increase, the value of the rupee goes down and you will not be able to purchase as much with those rupees as you could have in the last month or last year.

Risk and Return

Risk and return go hand in hand. Risk is loosely defined as the chance of losing all or part of your money invested. The good news is that investment risk comes with the potential for return – which makes the activity worthwhile. The basic thing to remember about risk is that it increases as the potential return increases. Essentially, the higher the risk, the higher the potential return. (Do not forget the two words - “potential return”. There is no guarantee).

Power of Compounding

As you pursue your financial planning, the most powerful tool for creating wealth safely and surely is the magical 'power of compounding'. If you park your money in an investment with a given return and then reinvest those earnings as you receive them, your investment grows exponentially over time.
Hence, it is always advisable to start saving early to enjoy the benefits of the power of compounding

Time Value of Money

Money has a time value. As time passes, the value of money decreases. This means that the value of a thousand rupee note you have today is higher than its value five years hence, even if there is no inflation. This is because we prefer consumption today to consumption in the future which is uncertain.

3. TYPES OF MARKETS

The financial markets have two major components:

Money market

The Money market refers to the market where borrowers and lenders exchange short-term funds to solve their liquidity needs. Money market instruments are generally financial claims that have low default risk, maturities under one year, and high marketability.

Capital market

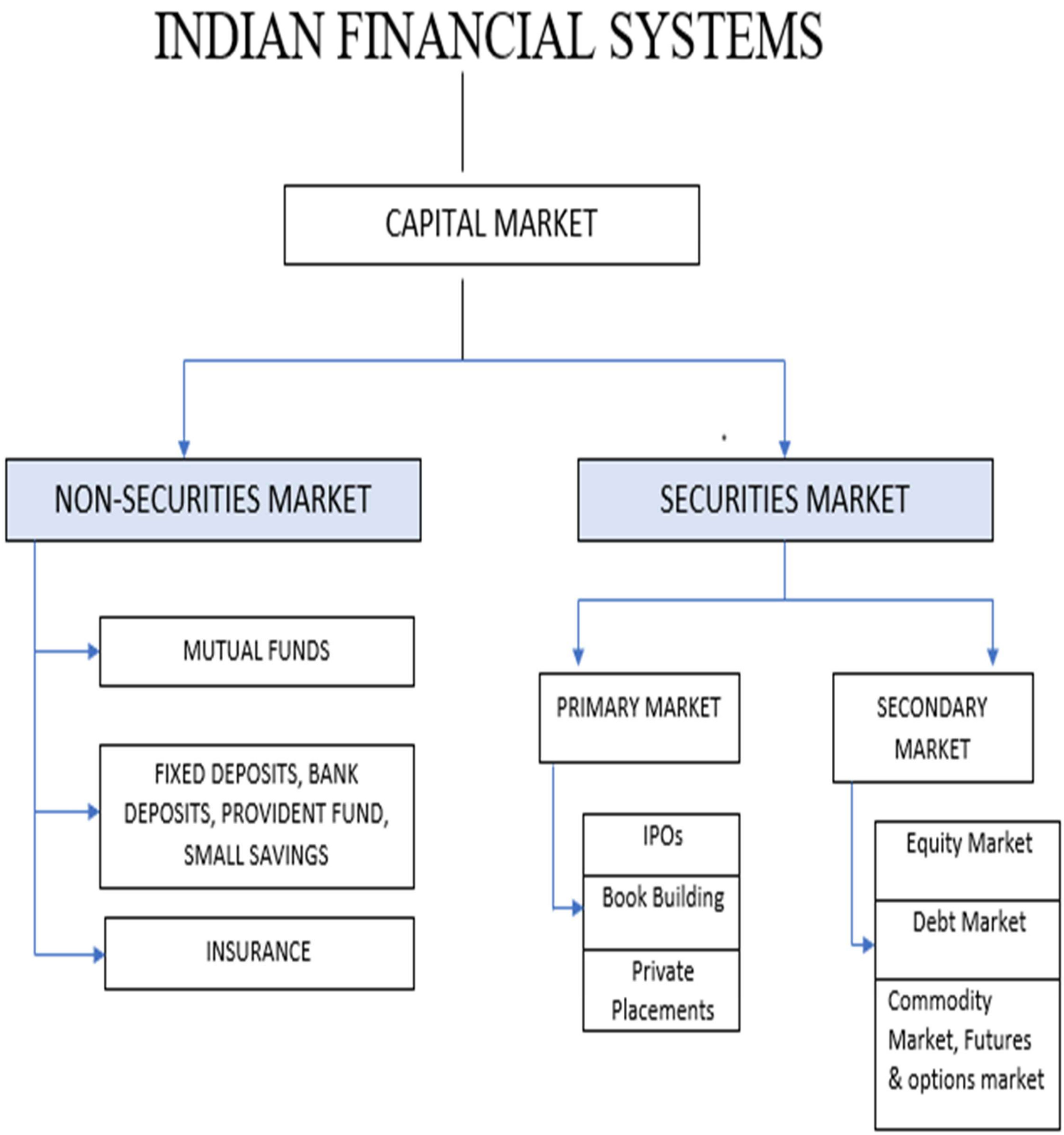
The Capital market is a market for financial investments that are direct or indirect claims to capital. It is wider than the Securities Market and embraces all forms of lending and borrowing, whether or not evidenced by the creation of a negotiable financial instrument. The Capital Market comprises the complex of institutions and mechanisms through which intermediate-term funds and long-term funds are pooled and made available to businesses, government, and individuals. The Capital Market also encompasses the process by which securities already outstanding are transferred.

The Securities Market, however, refers to the markets for those financial instruments/ claims/obligations that are commonly and readily transferable by sale.

The Securities Market has two interdependent and inseparable segments, the **new issues (primary) market** and the **stock (secondary) market**.

The **Primary market** provides the channel for the sale of new securities. The issuer of securities sells the securities in the primary market to raise funds for investment and/or to discharge some obligation. The Secondary market deals in securities previously issued.

The **secondary market** enables those who hold securities to adjust their holdings in response to changes in their assessment of risk and return. They also sell securities for cash to meet their liquidity need


INDIAN FINANCIAL SYSTEMS
CAPITAL MARKET
NON-SECURITIES MARKET
SECURITIES MARKET
MUTUAL FUNDS
FIXED DEPOSITS, BANK DEPOSITS, PROVIDENT FUND, SMALL SAVINGS
INSURANCE
PRIMARY MARKET
SECONDARY MARKET
IPOs
Book Building
Private Placements
Equity Market
Debt Market
Commodity Market, Futures & options market

4. SECURITIES MARKETS

Secondary markets

Equity markets

A market is a location where buyers and sellers come into contact to exchange goods or services. Markets can exist in various forms depending on various factors.

Today India has two national exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). Each has fully electronic trading platforms with around 9400 participating broking outfits. Foreign brokers account for 29 of these. There are some 9600 companies listed on the respective exchanges with a combined market capitalization near Rs.24.7 lakh crore. Any market that has experienced this sort of growth has an equally substantial demand for highly efficient settlement procedures. In India, 99.9% of the trades, according to the National Securities Depository, are settled in dematerialized form in a T+2 rolling settlement The capital market is one environment. In addition, the National Securities Clearing Corporation of India Ltd (NSCCL) and Bank of India Shareholding Ltd (BOISL), Clearing Corporation houses of NSE and BSE, guarantee trades respectively. The main functions of the Clearing Corporation are to work out

(a) what counterparties owe and

(b) what counterparties are due to receive on the settlement date

Furthermore, each exchange has a Settlement Guarantee Fund to meet with any unpredictable situation and a negligible trade failure of 0.003%. The Clearing Corporation of the exchanges assumes the counter-party risk of each member and guarantees settlement through a fine-tuned risk management system and an innovative method of online position monitoring. It also ensures the financial settlement of trades on the appointed day and time irrespective of default by members to deliver the required funds and/or securities with the help of a settlement guarantee fund.

Indian stock markets operated in the age-old conventional style of fact-to-face trading with bids and offers being made by open outcry. At the Bombay Stock Exchange, about 3,000 persons would mill around in the trading ring during the trading period of two hours from 12.00 noon to 2.00 p.m. Indian stock markets basically quote-driven markets with the jobbers standing at specific locations in the trading ring called trading posts and announcing continuously the two-way quotes for the scrips traded at the post. As there is no prohibition on a jobber acting as a broker and vice versa, any member 6 is free to do jobbing on any day. In actual practice, however, a class of jobbers has emerged who generally confine their activities to jobbing only. As there are no serious regulations governing the activities of jobbers, the jobbing system is beset with a number of problems like wide spreads between bid and offer; particularly in thinly traded securities, lack of depth, total absence of jobbers in a large number of securities, etc. In highly volatile scrips, however, the spread is by far the narrowest in the world being just about 0.1 to 0.25 percent as compared to about 1.25 per cent in respect of alpha stocks, i.e. the most highly liquid stocks, at the International Stock Exchange of London. The spreads widen as liquidity decreases, being as much as 25 to 30 per cent or even more while the average touch of gamma stocks, i.e. the least liquid stocks at the International Stock Exchange, London, is just about 6 to 7 per cent. This is basically because of the high velocity of transactions in the active scrips. In fact, shares in the specified group account for over 75 percent of trading in the Indian stock markets while over 25 percent of the securities do not get traded at all in any year. Yet, it is significant to note that out of about 6,000 securities listed on the Bombay Stock Exchange, about 1,200 securities get traded on any given trading day. The question of automating trading has always been under the active consideration of the Bombay Stock Exchange for quite sometime. It has decided to have trading in all the non-specified stocks numbering about 4,100 totally on the computer on a quote driven basis with the jobbers, both registered and roving, continuously keying in their bids and offers into the computer with the market orders getting automatically executed at the touch and the limit orders getting executed at exactly the rate specified. In March 1995, the BSE started the computerized trading system, called BOLT - BSE on-line trading system. Initially only 818 scripts were covered under BOLT. In July 1995, all scripts (more than 5,000) were brought under the computerized trading system. The advantages realized are: (a) improved trading volume; (b) reduced spread between the buy-sell orders; c) better trading in odd lot shares, rights issues etc.

Two major reasons why Indian securities are now increasingly regarded as attractive to international investors are the relatively high returns compared with more developed global markets as well as the low correlation with world markets.

Dept market

The National Stock Exchange started its trading operations in June 1994 by enabling the Wholesale Debt Market (WDM) segment of the Exchange. This segment provides a trading platform for a wide range of fixed income securities that includes central government securities, treasury bills (T-bills), state development loans (SDLs), bonds issued by public sector undertakings (PSUs), floating rate bonds (FRBs), zero coupon bonds (ZCBs), index bonds, commercial papers (CPs), certificates of deposit (CDs), corporate debentures, SLR and non-SLR bonds issued by financial institutions (FIs), bonds issued by foreign institutions and units of mutual funds (MFs).

Debt (loan instruments) a. Corporate debt • Debentures are instrument issued by companies to raise debt capital. As an investor, you lend you money to the company, in return for its promise to pay you interest at a fixed rate (usually payable half yearly on specific dates) and to repay the loan amount on a specified maturity date say after 5/7/10 years (redemption). Normally specific asset(s) of the company are held (secured) in favour of debenture holders. This can be liquidated, if the company is unable to pay the interest or principal amount. Unlike loans, you can buy or sell these instruments in the market. Types of debentures that are offered are as follows: o Non convertible debentures (NCD) – Total amount is redeemed by the issuer o Partially convertible debentures (PCD) – Part of it is redeemed and the remaining is converted to equity shares as per the specified terms o Fully convertible debentures (FCD) – Whole value is converted into equity at a specified price • Bonds are broadly similar to debentures. They are issued by companies, financial institutions, municipalities or government companies and are normally not secured by any assets of the company (unsecured). Types of bonds Regular Income

Bonds provide a stable source of income at regular, pre determined intervals Tax-Saving Bonds offer tax exemption up to a specified amount of investment, depending on the scheme and the Government notification. Examples are: • Infrastructure Bonds under Section 88 of the Income Tax Act, 1961 • NABARD/ NHAI/REC Bonds under Section 54EC of the Income Tax Act, 1961 • RBI Tax Relief Bonds b. Government debt: • Government securities (G-Secs) are instruments issued by Government of India to raise money. G Secs pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years). Since it is sovereign borrowing, it is free from risk of default (credit risk). You can subscribe to these bonds through RBI or buy it in stock exchange. c. Money Market instruments (loan instruments up to one year tenure) • Treasury Bills (T-bills) are short term instruments issued by the Government for its cash management. It is issued at discount to face value and has maturity ranging from 14 to 365 days. Illustratively, a T-bill issued at Rs. 98.50 matures to Rs. 100 in 91 days, offering an yield of 6.25% p.a. • Commercial Papers (CPs) are short term unsecured instruments issued by the companies for their cash management. It is issued at discount to face value and has maturity ranging from 90 to 365 days. • Certificate of Deposits (CDs) are short term unsecured instruments issued by the banks for their cash management. It is issued at discount to face value and has maturity ranging from 90 to 365 days.

Derivative market

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, forex, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the "underlying". In the Indian context the Securities Contracts (Regulation) Act, 1956 (SC(R)A) defines "derivative" to include – • A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security. • A contract, which derives its value from the prices, or index of prices, of underlying securities.

The most commonly used derivatives contracts are forwards, futures and options

• Forwards: A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.

• Futures: A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forwarding contracts in the sense that the former are standardized exchange-traded contracts.

• Options: Options are of two types - calls and puts. Calls give the buyer the right 9 but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date

The derivatives market performs a number of economic functions. First, prices in an organized derivatives market reflect the perception of market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of the derivative contract. Thus derivatives help in discovery of future as well as current prices. Second, the derivatives market helps to transfer risks from those who have them but may not like them to those who have an appetite for them. Third, derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk.

Commodity market

Derivatives as a tool for managing risk first originated in the commodities markets. They were then found useful as a hedging tool in financial markets as well. In India, trading in commodity futures has been in existence from the nineteenth century with organized trading in cotton through the establishment of Cotton Trade Association in 1875. Over a period of time, other commodities were permitted to be traded in futures exchanges. Regulatory constraints in 1960s resulted in virtual dismantling of the commodities future markets. It is only in the last decade that commodity future exchanges have been actively encouraged. However, the markets have been thin with poor liquidity and have not grown to any significant level. Let's look at how commodity derivatives differ from financial derivatives.

Primary market

Companies raise funds to finance their projects through various methods. The promoters can bring their own money of borrow from the financial institutions or mobilize capital by issuing securities. The funds maybe raised through issue of fresh shares at par or premium, preferences shares, debentures or global depository receipts. The main objectives of a capital issue are given below: To promote a new company To expand an existing company To diversify the production To meet the regular working capital requirements To capitalize the reserves Stocks available for the first time are offered through primary market. The issuer may be a new company or an existing company. These issues may be of new type or the security used in the past. In the primary market the issuer can be considered as a manufacturer. The issuing houses, investment bankers and brokers act as the channel of distribution for the new issues. They take the responsibility of selling the stocks to the public.

IPOs

In the sixties and seventies, the company and its personnel managed IPO. But, at present initial public offering involves a number of agencies. The rules and regulations, the changing scenario of the capital market necessitated the company to seek for the support of many agencies to make the public issue a success. As a student of financial market management, one should know the number of agencies involved and their respective role in the public issue. The promoters also should have a clear idea about the agencies to coordinate their activities effectively in the public issue. The manager to the issue, registrars to the issue, underwriters, bankers, advertising agencies, financial institutions and government /statutory agencies.

Initial public offers are floated through Prospectus; Bought out deals/offer for sale; Private Placement; Right Issue and Book Building.

Offer through Prospectus

According to Companies (Amendment) Act 1985, application forms for shares of a company should be accompanied by a Memorandum (abridged prospectus). In simple terms a prospectus document gives details regarding the company and invites offers for subscription or purchase of any shares or debentures from the public. The draft prospectus has 83 to be sent to the Regional Stock Exchange where the shares of the company are to be listed and also to all other stock exchanges where the shares are proposed to be listed. The stock exchange scrutinizes the draft prospectus. After scrutiny if there is any clarification needed, the stock exchange writes to the company and also suggests modification if any. The prospectus should contain details regarding the statutory provisions for the issue, program of public issue - opening, closing and earliest closing date of the issue, issue to be listed at, highlights and risk factors, capital structure, board of directions, registered office of the company, brokers to the issue, brief description of the issue, cost of the project, projected earnings and other such details. The board, lending financial institutions and the stock exchanges in which they are to be listed should approve the prospectus. Prospectus is distributed among the stock exchanges, brokers and underwriters, collecting branches of the bankers and to the lead managers.

Bought out Deals (Offer for Sale)

Here, the promoter places his shares with an investment banker (bought out dealer or sponsor) who offers it to the public at a later date. In other works in a bought out deal, an existing company off-loads a part of the promoters' capital to a wholesaler instead of making a public issue. The wholesaler is invariably a merchant banker or some times just a company with surplus cash. In addition to the main sponsor, there could be individuals and other smaller companies participating in the syndicate. The sponsors hold on to these shares for a period and at an appropriate date they offer the same to the public. The hold on period may be as low as 70 days or more than a year. 86 In a bought out deal, proving is the essential element to be decided. The bought out dealer decides the price after analyzing the viability, the gestation period, promoters' background and future projections. A bough out dealer sheds the shares at a premium to the public. There are many advantages for the issuing company: Firstly, a medium or small sized company, which is already facing working capital shortage, cannot afford to have long lead-time before the funds could be mobilized from the public. Bought out deal helps the promoters to realize the funds without any loss of time. Secondly, the cost of raising funds is reduced in bought out deals. For issuing share to the public the company incurs heavy expenses, which may invariably be as high as 10 percent of the cost of the project, if not more. Thirdly, bought out deal helps the entrepreneurs who are not familiar with the capital market but have sound professional knowledge to raise funds. Sponsors of the deal are mostly concerned with the promoters' background and government policies than about the past track record or financial projections. This helps the new entrepreneur to raise adequate capital from the market. Fourthly, for a company with no track record of projects, public issues at a premium may pose problems, as SEBI guidelines come in the way. The stipulations can be avoided by a bought out deal. Companies sell the shares at a premium to the sponsors and they can off-load the shares to the public at a higher premium. Fifthly, to the investors bought out deals possess low risk since the sponsors have already held the shares for a certain period and the projects might have been completed or may be in the verge of completion, the investors need not wait for returns The major disadvantage of the bought out deals is that the sponsors are able to create a positive image about the shares and sell them at a hefty premium. Single investment banker gives scope for manipulation of the results. Insider trading and price rigging could be carried out, which can be neither detected nor penalized.

Private Placement

In this method the issue is placed with a small number of financial institutions, corporate bodies and high net worth individuals. The financial intermediaries purchase the shares and sell them to investors at a later date at a suitable price. The stock is placed with issue house client with the medium of placing letter and other documents which taken together contribute a prospectus, giving the information regarding the issue. The special feature of the private placement is that the issues are negotiated between the issuing company and the purchasing intermediaries. Listed public limited company as well as closely held private limited company can access the public through the private placement method. Mostly in the private placement securities are sold to financial institutions like Unit Trust of India, mutual funds, insurance companies, and merchant banking subsidiaries of commercial banks and so on. 87 Through private placement equity shares, preference shares, cumulative convertible preference shares, debentures and bonds are sold. In India private placement market is witnessing the introduction of several innovative debt market instruments such as step-down/step-up debentures, liquid debentures, bonds etc. Private placement has several inherent advantages: Cost Effective: Private placement is a cost-effective method of raising funds. In a public issue underwriting, brokerage, printing, mailing and promotion account for 8 to 10 percent of the issue cost. In the case of the private placement several statutory and non-statutory expenses are avoided. Time Effective: In the public issue the time required for completing the legal formalities and other formalities takes usually six months or more. But in the private placement the requirements to be fulfilled are less and hence, the time required to place the issue is less, mostly 2 to 3 months. Structure Effectiveness: It can be structured to meet the needs of the entrepreneurs. It is flexible to suit the entrepreneurs and the financial intermediaries. To make the issue more attractive the corporate can provide discounts to the intermediaries who are buying it. This is not possible with the public issue with stringent rules and regulations. In the case of debentures the interest ceiling cannot be breached in a public issue. Here the terms of the issue can be negotiated with purchasing institutions easily since they are few in number. Access Effective: Through private placement a public limited company listed or unlisted can mobilize capital. Like-wise issue of all size can be accommodated through the private placement either small or big where as in the public issue market, the size of the issue cannot fall below a certain minimum size.

Rights Issue

According to Sec 81 of the Companies Act 1956, if a public company wants to increase its subscribed capital by allotment of further shares after two years from the date of its formation or one year from the date of its first allotment, which ever is earlier should offer share at first to the existing share holders in proportion to the shares held by them at the time of offer. The shareholders have no legal binding to accept the offer and they have the right to renounce the offer in favor of any person. Shares of this type are called right shares. Generally right shares are offered at an advantageous rate compared with the market rate. According to Section 81, the company has to satisfy certain conditions to issue right shares. Right shares must be offered to the equity shareholders in the proportion to the capital paid on those shares. A notice should be issued to specify the number of shares issued. The time given to accept the right offer should not be less than 15 days. 88 The notice also should state the right of the shareholders to renounce the offer in favor of others. After the expiry of the time given in the notice, the Board of Directors has the right to dispose the unsubscribe shares in such a manner, as they think most beneficial to the company.

Book Building

Book building is a mechanism through which the initial public offerings (IPOS) take place in the U.S. and in India it is gaining importance with every issue. Most of the recent new issue offered in the market has been through Book Building process. Similar mechanisms are used in the primary market offerings of GDRs also. In this process the price determination is based on orders placed and investors have an opportunity to place orders at different prices as practiced in international offerings. The recommendations given by Malegam Committee paved way for the introduction of the book building process in the capital market in Oct 1995. Book building involves firm allotment of the instrument to a syndicate created by the lead managers who sell the issue at an acceptable price to the public. Originally the potion of book building process was available to companies issuing more than Rs.100 cr. The restriction on the minimum size was removed and SEBI gave impression to adopt the book building method to issue of any size. In the prospectus, the company has to specify the placement portion under book building process. The securities available to the public are separately known as net offer to the public. Nirma by offering a maximum of 100 lakh equity shares through this process was set to be the first company to adopt the mechanism. Among the lead managers or the syndicate members of the issue or the merchant bankers as member. The issuer company as a book runner nominates this member and his name is mentioned in the draft prospectus. The book runner has to circulate the copy of the draft prospectus to be filed with SEBI among the institutional buyers who are eligible for firm allotment. The draft prospectus should indicate the price band within which the securities are being offered for subscription. The offers are sent to the book runners. He maintains a record of names and number of securities offered and the price offered by the institutional buyer within the placement portion and the price for which the order is received to the book runners. The book runner and the issuer company finalize the price. The issue price for the placement portion and offer to the public should be the same. Underwriting agreement is entered into after the fixation of the price. One day earlier to the opening of the issue to the public, the book runner collects the application forms along with the application money from the institutional buyers and the underwriters. The book runner and other intermediaries involved in the book building process should maintain records of the book building process. The SEBI has the right to inspect the records.

5. Non-securities markets

Mutual funds

Mutual funds collect money from many investors and invest this corpus in equity, debt or a combination of both, in a professional and transparent manner. In return for your investment, you receive units of mutual funds which entitle you to the benefit of the collective return earned by the fund, after reduction of management fees. Mutual funds offer different schemes to cater to the needs of the investor are regulated by securities and Exchange board of India (SEBI) Types of Mutual Funds At the fundamental level, there are three types of mutual funds: o Equity funds (stocks) o Fixed-income funds (bonds) o Money market funds Classification of mutual funds a. By structure • Open-ended Funds An open-ended fund does not have a maturity date. • Closed-end Funds Closed-end funds run for a specific period. b. By investment objective • Growth Funds A mutual fund scheme investing in equity • Bond / Income Funds A mutual fund scheme investing primarily in government and corporate debt to provide income on a steady basis. • Balanced Funds A mutual fund scheme investing in a mix of equity and debt. • Money Market Funds A mutual fund scheme investing in money market instruments. c. Others • Tax savings schemes (Equity Linked Saving Scheme ELSS) Equity funds along with tax benefits to the investors and has a lock in period of three years. • Sector funds They target at the specific sectors of the economy such as financial, technology, health, etc. • Index Funds This type of mutual fund replicates the performance of a broad market index such as the SENSEX or NIFTY.

Fixed deposits

The term “fixed” in fixed deposits denotes the period of maturity or tenor. Fixed Deposits, therefore, pre-supposes a certain length of time for which the depositor decides to 14 keep the money with the bank and the rate of interest payable to the depositor is decided by this tenor. The rate of interest differs from bank to bank and is generally higher for private sector and foreign banks. This, however, does not mean that the depositor loses all his rights over the money for the duration of the tenor decided. The deposits can be withdrawn before the period is over. However, the amount of interest payable to the depositor, in such cases goes down (usually 1% to 2% less than the original rate). Moreover, as per RBI regulations there will be no interest paid for any premature withdrawals for the period 15 days to 29 or 15 to 45 days as the case may be. Other than banks, there are non-banking financial companies and companies who float schemes from time to time for garnering deposits from the public. In the recent past, however, many such schemes have gone bust and it is very essential to look out for danger signals before putting all your eggs in one basket.

Fixed deposits in companies that earn a fixed rate of return over a period of time are called Company Fixed Deposits. Financial institutions and Non-Banking Finance Companies (NBFCs) also accept such deposits. Deposits thus mobilized are governed by the Companies Act under Section 58A. These deposits are unsecured, i.e., if the company defaults, the investor cannot sell the company to recover his capital, thus making them a risky investment option. NBFCs are small organizations, and have modest fixed and manpower costs. Therefore, they can pass on the benefits to the investor in the form of a higher rate of interest. NBFCs suffer from a credibility crisis. So be absolutely sure to check the credit rating. AAA rating is the safest. According to latest RBI guidelines, NBFCs and companies cannot offer more than 14 per cent interest on public deposit

Risk Considerations How Assured Can I be Of Getting My Full Investment Back? Company Fixed Deposits are unsecured instruments, i.e., there are no assets backing them up. Therefore, in case the company/NBFC goes under, chances are that you may not get your principal sum back. It depends on the strength of the company and its ability to pay back your deposit at the time of its maturity. While investing in an NBFC, always remember to first check out its credit rating. Also, beware of NBFCs offering ridiculously high rates of interest. How Assured Is My Income? Not at all secured. Some NBFCs have known to default on their interest and principal payments. You must check out the liquidity position and its revenue plan before investing in an NBFC. Are Their any Risks Unique to Company Fixed Deposits? If the Company/NBFC goes 16 under, there is no assurance of your principal amount. Moreover, there is no guarantee of your receiving the regular-interval income from the company. Inflation and interest rate movements are one of the major factors affecting the decision to invest in a Company/ NBFC Fixed Deposit. Also, you must keep the safety considerations and the company/ NBFC's credit rating and credibility in mind before investing in one. Are Company/NBFC Deposits rated for their credit Quality? Yes, Company/NBFC Fixed Deposits are rated by credit rating agencies like CARE, CRISIL and ICRA. A company rated lower by credit rating agency is likely to offer a higher rate of interest and vice versa. An AAA rating signifies highest safety, and D or FD means the company is in default.

Bank deposits

When you deposit a certain sum in a bank with a fixed rate of interest and a specified time period, it is called a bank Fixed Deposit (FD). At maturity, you are entitled to receive the principal amount as well as the interest earned at the pre-specified rate during that period. The rate of interest for Bank Fixed Deposits varies between 4 and 6 per cent, depending on the maturity period of the FD and the amount invested. The interest can be calculated monthly, quarterly, half-yearly, or annually, and varies from bank to bank. They are one the most common savings avenue, and account for a substantial portion of an average investor's savings. The facilities vary from bank to bank. Some services offered are withdrawal through cheques on maturity; break deposit through premature withdrawal; and overdraft facility etc.

Investment Objectives How Suitable are Fixed Deposits for an Increase in My Investment? While a Bank FD does provide for an increase in your initial investment, it may be at a lower rate than other comparable fixed-return instruments. Since capital appreciation in any investment option depends on the safety of that option, and banks being among the safest avenues, the increase in investment is modest. Are Fixed Deposits Suitable For Regular Income? A Bank FD does not provide regular interest income, but a lump-sum amount on its maturity. Since the lump-sum amount depends on the rate of interest, currently between 4 and 6 per cent, Bank FDs are not suitable for regular income. To What Extent Does a Bank FD Protect Me Against Inflation? With a fixed return, which is lower than other assured return options, banks cannot guard against inflation. In fact, this is the main problem with Bank FDs as any return has to be calculated keeping inflation in mind. Can I Borrow Against Bank FDs? Yes, in some cases, loans up to 90 per cent of the deposit amount can be taken from the bank against fixed deposit receipts

Risk Considerations How assured can I be of getting my Full Investment Back? Almost 100 per cent. Bank Deposits are the safest investment option after post-office schemes since the banks 18 function according to the parameters set by the Reserve Bank of India (RBI), which frames regulations keeping in mind the interest of the investors. How Assured Is My Income? There is no regular income in this option as the payment is made in one lump sum after the expiry of the tenure of the Bank Fixed Deposit. Are There Any Risks Unique To Bank FDs? Not really. Since all the banks operating in the country, irrespective of whether they are nationalized, private, or foreign, are governed by the RBI's rules and regulations, which give due weight age to the interest of the investor, there is little chance of an investment in a bank deposit going under. In fact, till recently, all bank deposits were insured under the Deposit Insurance & Credit Guarantee Scheme of India, which has now been made optional. Nevertheless, bank deposits are still among the safest modes of investment. The thing to consider before investing in a FD is the rate of interest and the inflation rate. A high inflation rate can simply chip away your real returns. So, it is critical to take the inflation rate into consideration to arrive at the real rate of interest. Are Bank FDs rated for their Credit Quality? No, Bank FDs are not commercially rated. Since Bank FDs are extremely secure; the only thing to check out while investing in one is the interest rate being offered and your convenience.

Provident funds

Employees Provident Fund (EPF)

The Employees Provident Fund (EPF) was first established on 1 October 1951 under the EPF Ordinance 1951 which was subsequently known as the EPF Act 1951. The EPF Act 1951 has since then been replaced by the EPF Act 1991 in June 1991. Besides being the world's oldest national provident fund, EPF is also one of the most successful funds of its kind, providing a compulsory savings scheme to ensure security and well being in old age. The first contributions were received in July 1952, totaling Rs.2.6 million. The EPF is under the jurisdiction of a Board, which consists of 20 members who are appointed by the Minister of Finance. The EPF Board is made up of a Chairman, a Deputy Chairman and 18 other members, which comprise of – • 5 Government Representatives • 5 Employer Representatives • 5 Employee Representatives • 3 Professional

Representatives The EPF Board is responsible for formulating EPF policies and to ensure implementation of these policies. Apart from the Board, the EPF also has an Investment Panel, which is responsible to formulate EPF investment policies. The Minister of Finance also appoints the members of the Investment Panel. The Panel is made up of a Chairman, a representative of the Governor of Bank Negara Malaysia, a representative from the Ministry of Finance and three others who are experts in financial, business and investment related matters. The EPF Headquarters is situated in the EPF building in Kuala Lumpur. Apart from the Headquarters, the EPF has 14 State Offices and 33 Local Offices throughout the country. 1.11.1 The Role of EPF As a statutory body and a trustee fund, the main role of the EPF is to provide financial security to its members, especially after retirement, through a compulsory savings scheme.

Under the EPF Act 1991, the employer and employee are required to contribute (remit a percentage of the employee's salary) to EPF based on the rate of contribution set by the EPF Act. Expatriates (other than Singapore citizens), foreign workers and domestic servants and their employers are not required to contribute to EPF, but they can voluntarily do so. This contribution will be invested to accumulate interest or dividend. By the time a member retires, therefore, he has a considerable amount of savings, with compounded dividend, which he can withdraw to provide for his financial needs.

Basic Wages: "Basic Wages" means all emoluments, which are earned by employee while on duty or on leave or holiday with wages in either case in accordance with the terms of the contract of employment and which are paid or payable in cash, but does not include the cash value of any food concession; any dearness allowance (that is to say, all cash payment by whatever name called paid to an employee on account of a rise in the cost of living), house rent allowance, overtime allowance, bonus, commission or any other allowance payable to the employee in respect of employment or of work done in such employment, any present made by the employer. Excluded Employee: "Exclude Employee" as defined under pare 2(f) of the Employees' Provident Fund Scheme means an employee who having been a member of the fund has withdrawn the full amount of accumulation in the fund on retirement from service after attaining the age of 55 years; Or An employee, whose pay exceeds Rs. Five Thousand per month at the time, otherwise entitled to become a member of the fund.

Explanation: ‘Pay’ includes basic wages with dearness allowance, retaining allowance, (if any) and cash value of food concessions admissible there on. How the Employees’ Provident Fund Scheme works: As per amendment – dated 22.9.1997 in the Act, both the employees and employer contribute to the fund at the rate of 12% of the basic wages, dearness allowance and retaining allowance, if any, payable to employees per month. The rate of contribution is 10% in the case of following establishments: 25 • Any covered establishment with less then 20 employees, for establishments covers prior to 22.9.97. • Any sick industrial company as defined in clause (O) of Sub-section (1) of Section 3 of the Sick Industrial Companies (Special Provisions) Act, 1985 and which has been declared as such by the Board for Industrial and Financial Reconstruction. • Any establishment, which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth. • Any establishment engaged in manufacturing of (a) jute (b) breed (c) coir and (d) guar gum Industries/ Factories. 1.11.8 Employees’ Provident Fund Interest Rate The rate of interest is fixed by the Central Government in consultation with the Central Board of trustees, Employees’ Provident Fund every year during March/April. The interest is credited to the members account on monthly running balance with effect from the last day in each year.

1.11.9 Benefits 1. A member of the provident fund can withdraw full amount at the credit in the fund on retirement from service after attaining the age of 55 year. Full amount in provident fund can also be withdraw by the member under the following circumstance: • A member who has not attained the age of 55 year at the time of termination of service. • A member is retired on account of permanent and total disablement due to bodily or mental infirmity. • On migration from India for permanent settlement abroad or for taking employment abroad. • In the case of mass or individual retrenchment. 2. In the case of the following contingencies, the payment of provident fund be made after complementing a continuous period of not less than two months immediately preceding the date on which the application for withdrawal is made by the member: • Where employees of close establishment are transferred to other establishment, which is not covered under the Act. • Where a member is discharged and is given retrenchment compensation under the Industrial Dispute Act, 1947.

Transfer of Provident Fund Account Transfer of Provident Fund account from one region to other, from Exempted Provident Fund Trust to Unexampled Fund in a region and vice-versa can be done as per Scheme. Transfer Application in form 13 may be submitted to the concerned Provident Fund Office. 1.11.13 Nomination The member of Provident Fund shall make a declaration in Form 2, a nomination conferring the right to receive the amount that may stand to the credit in the fund in the event of death. The member may furnish the particulars concerning himself and his family. These particulars furnished by the member of Provident Fund in Form 2 will help the Organization in the building up the data bank for use in event of death of the member. 1.11.14 Annual Statement of Account As soon as possible and after the close of each period of currency of contribution, annual statements of accounts will be sent to each member of the current establishment or other establishment where the member was last employed. The statement of accounts in the fund will show the opening balance at the beginning of the period, amount contribution during the year, the total amount of interest credited at the end of the period or any withdrawal during the period and the closing balance at the end of the period. Member should satisfy themselves as to the correctness of the annual statement of accounts and any error should be brought through employer to the notice of the correctness to the Provident Fund Office within 6 months of the receipt of the statement.

Public Provident Fund (PPF)

A Public Provident Fund (PPF) is a long-term savings plan with powerful tax benefits. Your money grows @ 8 per cent per annum, and this is guaranteed by the Government of India (GOI). You may consider this option if you are not looking for short-term liquidity or regular income. Normal maturity period is 15 years from the close of the financial year in which the initial subscription was made. Maturity values for your PPF account depending on what you invest each year 1.12.1 Investment Objectives How Suitable Is A PPF Account For An Increase In My Investment? A PPF account is not aimed at generating capital appreciation since it has no secondary market. It is mainly suitable for long-term saving and for availing of tax incentives. The lump-sum amount that you receive on maturity (at the end of 15 years) is completely tax-free. Is A Public Provident Fund Account Suitable For Regular Income? PPF does not provide any avenues for regular income. It provides for accumulation of interest income over a 15-year period, and the lump-sum amount (principal + interest) is payable on maturity. To What Extent does a PPF Account Protect Me Against Inflation? A PPF account does not provide protection against high inflation. In certain years when the inflation rate is high, the real rate of return on your PPF may be marginal. This depends on the prevailing rate of interest on your PPF at any given time. These rates are notified by the GOI in the Official Gazette from time to time, and are calculated in such manner as is specified in the scheme. Can I Borrow against my PPF Account? Yes, loans can be availed of from the third to sixth year @ 1 per cent per annum if repaid within 36 months. Else, interest on loan is set at 6 per cent per annum. Amount of such loans will not exceed 25 per cent of the amount that stood to your credit at the end of the second year immediately preceding the year in which the loan is applied for. You will continue to earn interest at the specified rate on your balance in the PPF Account after availing of the loan facility. 1.12.2 Risk Considerations How Assured can I be of getting My Full Investment Back? Your principal is assured. The PPF Scheme has the backing of the GOI, and is considered completely risk-free. How Assured is My Income? Since the PPF Scheme is backed by the GOI, your interest income is assured. Is there any Risks Unique to PPF Scheme? No, you can safely put your money in a PPF Scheme, as it is risk-free. Although factors like inflation and interest rate fluctuations may determine whether you opt for a PPF Account or not, the decision to invest in a PPF Account is based on the twin benefits of long-term savings and tax incentives. Please note that if the government reduces interest rates and you are already operating an account, then the new interest rates will be applicable to your account. Subsequent 28 interest calculations will be on the new rate of interest. Is the PPF Scheme rated for their Credit Quality? No, since the PPF Scheme has the backing of the GOI, it does not require any commercial rating.

Life Insurance

A life insurance policy is a contract between an individual (termed as insured) and an insurance company (insurer) to pay the insured, or his nominated heirs, a specified sum of money on the happening of an event. The event could be the expiry of the insurance policy or the death of the insured before the expiry (date of maturity) of the policy as per the terms of the policy. In a simple example, a person takes an insurance policy and nominates his wife as the beneficiary. On the death of this person, his wife gets the amount for which the life insurance policy was purchased. There are many variants of a life insurance policy: 1. Whole Life Assurance Plans: These are low-cost insurance plans where the sum assured is payable on the death of the insured 2. Endowment Assurance Plans: Under these plans, the sum assured is pay-able on 30 the maturity of the policy or in 14