MODULE 1: OVER VIEW OF THE INDIAN FINANCIAL SYSTEM

- Over view of the Financial System,
- Financial Institutions, Financial Markets, Financial Instruments and Services,
- Financial Intermediation Process: Role of Intermediaries- Source of Funds, Application of Funds.
- Financial sector reforms,
- Financial Regulatory and Promotional Institutions- RBI, SEBI, IRDA, PFRDA,
- Board of Financial Supervision,
- Financial stability-Assessment, Ethics and Principles in Financial Markets.

INTRODUCTION

 Like any other country, the **financial system of India** comprises of financial markets, financial intermediaries, and financial instruments.

 In simple words, finance is a term equivalent to money. However, this is only partially correct. Finance refers to the source which provides funds for any particular activity.

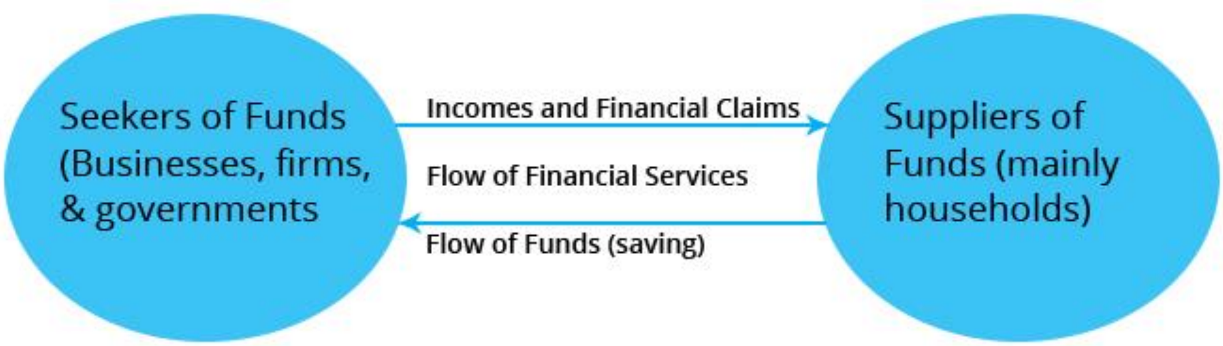
 The economic development of India or any other nation is reflected by the progress of its various economic units; government, corporate, and household and their surplus, deficit, or balanced budget situations.

Working

 Financial System thus acts as an intermediary that shall facilitate the flow of funds from the areas of surplus to that of deficits.

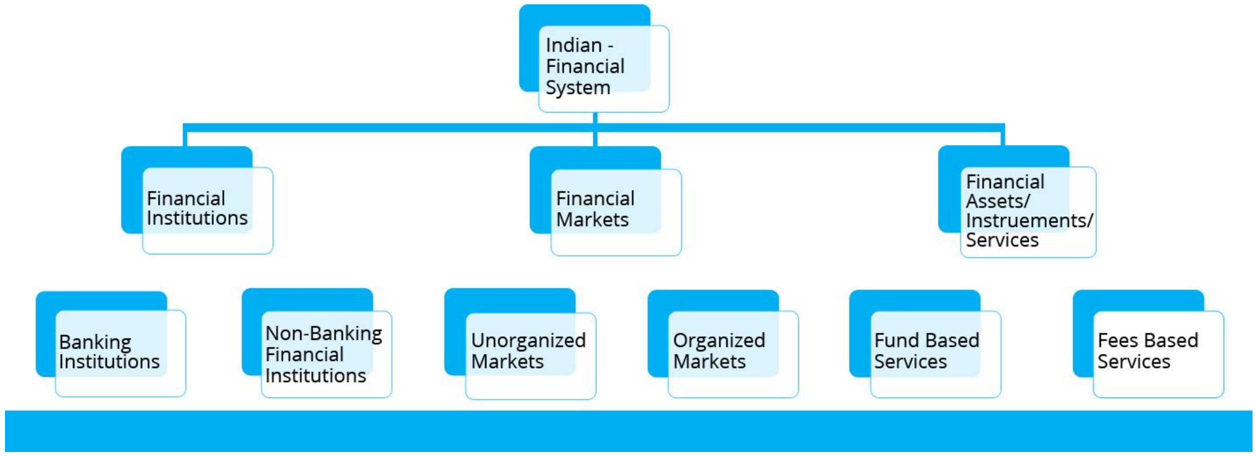
 Therefore, an **Indian financial system** is a mixed composition of institutions, markets, regulations, law, practices, money managers, analysts, transactions, claims, and liabilities that exist within the economy.

The diagram below will give a clear idea of what the **Indian financial system** refers to:



STRUCTURE

The structure of **Indian Financial System** comprises of:



1. Financial Institutions: These institutions act as intermediaries of financial markets that will facilitate financial transactions occurring between individuals and financial customers. There are two types of financial institutions:

- Banking or depository institutions: These institutions are banks and credit unions that collect money from the public. In return, the public receives interest on money deposits. These can further be categorised as:
  - Regulatory institutions like **SEBI**, **RBI**, **IRDA**
  - Intermediaries that include commercial banks who provide short-term loans and other financial services.
  - Non-intermediaries that provide long-term loans to corporate customers like **NABARD**, **IDBI**.
- Non-Banking or Non-depository institutions: These are firms and companies that deal in brokerage, insurance, and mutual funds to collect money deposits. They can also sell financial products.

2. Financial markets: These marketplaces are used by buyers and sellers to trade assets like shares, bonds, currencies, and other financial instruments. They are of two types:
Capital Markets: These markets deal in long terms securities, i.e. securities that have a maturity period of more than one year.

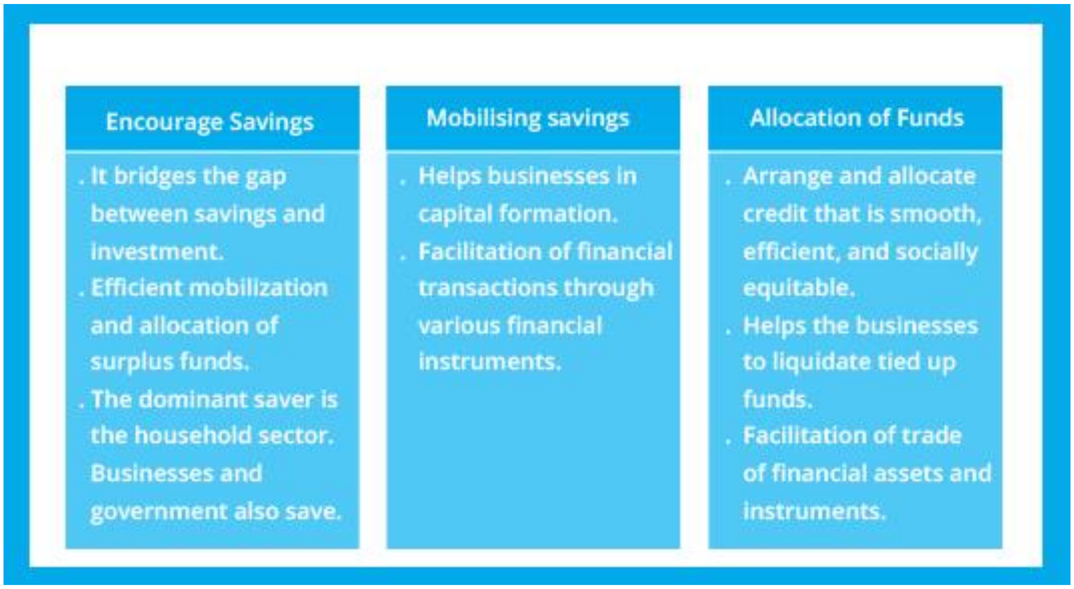
- Money Market: These markets deal with short-term debt instruments that have a maturity period of less than one year.

3. Financial assets, instruments, and services: Financial assets include cash deposits, checks, loans, bank notes, letter of credit, and all other financial instruments that either specify a certain amount on a pecific future date or pay a principal amount. Financial services are services that are concerned with the design and delivery of these financial instruments.

Functions

Each of the function performed by the **Indian Financial System** is unique and important. Conversely, the efficiency of the same is dependent on how well these functions are being performed.

The primary functions of the Indian Financial System are:



Importance

- Provision of various financial instruments allows the mobilisation of savings in the **Indian financial system**. This helps to accelerate the rate and volume of savings.

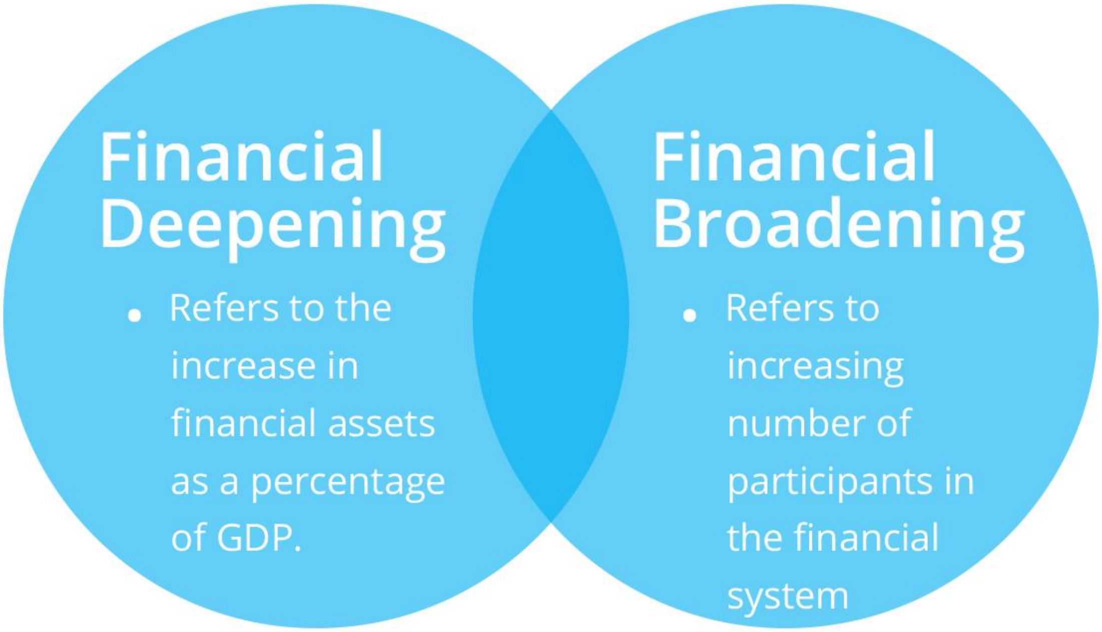
- Funds are provided to corporate customers so that they can expand their respective businesses. Further, this aids the increasing the national output of India.

- The regulatory bodies like **RBI**, **SEBI** help to protect the interests of the investors. Thus, ensuring the smooth flow of financial transactions.

- The financial system works in favour of economic development of the country. This will, in turn, raise the standard of living of Indians.

- The rural development banks and the co-operative societies work to help to promote the development of a weaker section of society in India.
- Adequate financial and advisory services provided by the **Indian financial system** helps the corporate customers to make better financial decisions.

Overall, the financial system has been formulated with the idea of financial deepening and broadening.



Intermediary

Intermediaries Involved:

- The **Indian financial system** is equipped with proper channels to ensure that adequate information of the issue, issuer, and the security is passed on. These channels are referred to as financial intermediaries.
- **These financial intermediaries ensure that the financial assets reach the ultimate investor to garner their requisite amount**.
- Along with the development in the financial system, in India, financial intermediaries have also widened. It has now been conducted by various institutions but under the surveillance of the Reserve bank of India (RBI).

However, the services offered by various institutions may differ. The table below will give a detail:

Intermediaries	Type of Market	Example of institutions	Role Performed
Stock Exchanges	Capital Market	NSE, BSE, Calcutta Stock Exchange, Cochin stock exchange etc.	Secondary markets to securities
nvestment Bankers	Capital larket, Credit Market	Commercial banks, cooperative banks	Corporate advisory ervices, Issue of services

Underwriters	Capital Market, loney Market	Development banks, NBFC	Subscribe to ınsubscribed portion of securities
Registrars, Depositories, Custodians	Capital Market	Insurance companies, mutual fund companies, and so on.	Issuance of securities to ne investors on behalf of the company. Handle share transfer activity.
Primary Dealers Satellite Dealers	Money Market	Registered entities, commercial banks and heir subsidiaries which have the license to ırchase and sell government securities like SBI.	The market making in government securities.
Forex Dealers	Foreign Exchange Market	Western Union	Ensure exchange link currencies

FINANCIAL INTERMEDIARIES (FIS): MEANING AND ROLE

Financial Intermediaries – Meaning, Functions And Importance

A financial intermediary is an entity that facilitates a financial transaction between two parties. Such an intermediary or a middleman could be a firm or an institution. Some examples of financial intermediaries are banks, insurance companies, pension funds, investment banks and more.

One can also say that the primary objective of the financial intermediaries is to channel savings into investments. These intermediaries charge a fee for their services.

Financial intermediaries have emerged as a useful tool for the efficient market system as they help channelize savings into investment. However, they can also be a cause of concern, as the sub-prime crisis shows. Often, there is a need to regulate the activities of these intermediaries.

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EXAMPLES OF FINANCIAL INTERMEDIARIES

Bank: These intermediaries are licensed to accept deposits, give loans and offer many other financial services to the public. They play a major role in the economic stability of a country, and thus, face heavy regulations.

Mutual Funds: They help pool savings of individual investors into financial markets. A fund manager oversees a mutual fund and allocates the funds to different investment products.

Financial advisors: Such intermediaries may or not offer a financial product, but advises investors to help them achieve their financial objectives. These advisors usually undergo special training.

Credit Union: It is also a type of bank, but works to serve its members and not public. They may or may not operate for profit purposes.

Other financial intermediaries are pension funds, insurance companies, investment banks and more.

FUNCTIONS OF FINANCIAL INTERMEDIARIES

A financial intermediary performs the following functions:

- As said before, the biggest function of these intermediaries is to convert savings into investments.
- Intermediaries like commercial banks provide storage facilities for cash and other liquid assets, like precious metals.
- Giving short and long term loans is a primary function of the financial intermediaries. These intermediaries accept deposits from the entities with surplus cash and then loan them to entities in need of funds. Intermediaries give the loan at interest, part of which is given to the depositors, while the balance is retained as profits.
- Another major function of these intermediaries is to assist clients to grow their money via investment. Intermediaries like mutual funds and investment banks use their experience to offer investment products to help their clients maximize returns and reduce risks.

ADVANTAGES OF FINANCIAL INTERMEDIARIES

- They help in lowering the risk of an individual with surplus cash by spreading the risk via lending to several people. Also, they thoroughly screen the borrower, thus, lowering the default risk.
- They help in saving time and cost. Since these intermediaries deal with a large number of customers, they enjoy economies of scale.
- Since they offer a large number of services, it helps them customize services for their client. For instance, banks can customize the loans for small and long term borrowers or as per their specific needs. Similarly, insurance companies customize plans for all age groups.
- They accumulate and process information, thus lowering the problem of asymmetric information.

Let us consider a simple example that will help us understand these advantages better. Suppose you need some loan, but you don't know who has enough money to give you. So, you contact a middleman, who in turn is in contact with those with surplus money.

A POTENTIAL ISSUE WITH INTERMEDIARIES

It is possible that a financial intermediary may not spread risk. They may channel depositor's funds to schemes that earn them (intermediaries) more profits. Or, due to poor management, they may invest money in schemes, which may not be so attractive now.

Such issue (or issues) with the intermediaries, however, are avoidable. Moreover, after the 2008 crisis, financial intermediaries are facing increased regulations to ensure that they don't overreach their limits.

CONCLUSION

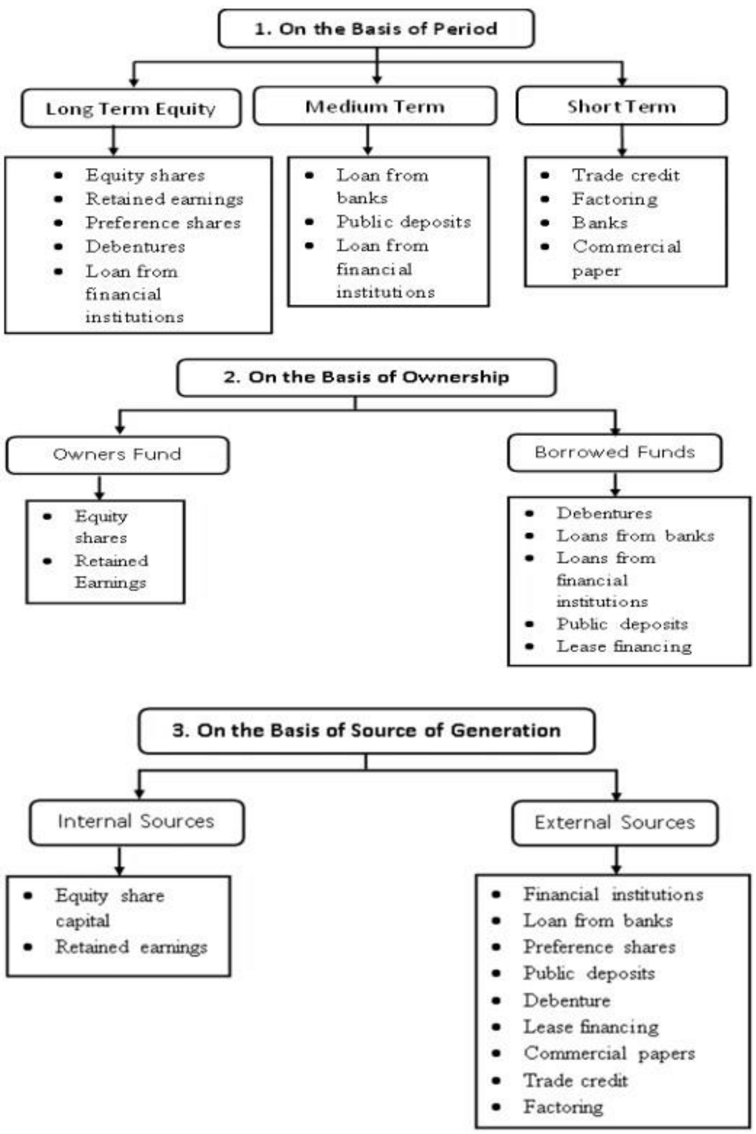
Reading the above points, it is clear that financial intermediaries play a very important role in the economic development of the country. They play even bigger role in the developing countries, including helping the government to eliminate poverty and implement other social programs.

CLASSIFICATION OF SOURCES OF FUNDS

Have you ever been in a situation where you have to buy a gift for someone? The important aspects you consider are the budget of the gift and sources of fund required to fulfil that budget. Similarly, with managing a business, funds are extremely important for any business to sustain. Let us learn the sources of funds.

Sources of Funds

Business simply cannot function without money, and the money required to make a business function is known as business funds. Throughout the life of business, money is required continuously. Sources of funds are used in activities of the business. They are classified based on time period, ownership and control, and their source of generation.



On the basis of the period, the different sources of funds can be classified into three parts. Which are:

- ***Long-term source*s** fulfil the financial requirements of a business for *a period more than 5 years.* It includes various other sources such as shares and debentures, long-term borrowings and loans from financial institutions. Such financing is generally required for the procurement of fixed assets such as plant, equipment, machinery etc.
- ***Medium-term sources*** are the sources where the funds are required for *a period of more than one year but less than five years.* The sources of the medium term include borrowings from commercial banks, public deposits, lease financing and loans from financial institutions.
- ***Short-term sources:*** Funds which are required for *a period not exceeding one year* are called short-term sources. Trade credit, loans from commercial banks and commercial papers are the examples of the sources that provide funds for short duration.

Short-term financing is very common for the financing of present assets such as inventories and account receivables. Seasonal businesses that must build inventories in terms of future prospects of selling requirements often need short-term financing for the interim period between seasons. Wholesalers and manufacturers with a major portion of their assets used in inventories or receivables also require a large number of funds for a short period.

Ownership Basis Sources

On the basis of ownership, the sources can be classified into Owner's funds and Borrowed funds. ***Owner's funds*** mean funds which are procured by the owners of a business, which may be a sole entrepreneur or partners or shareholders of a business. It also includes profits which are reinvested in the business. The owner's capital remains invested in the business for a longer duration and is not required to be refunded during the life period of the business.

This capital forms the base on which owners gain their right of control of management in the business. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk. Equity shares and retained earnings are the two important sources from where owner's funds can be obtained.

Borrowed funds refer to the funds raised with the help of loans or borrowings. This is the most common type of source of funds and is used the majority of the time. The sources for raising borrowed funds include loans from commercial banks, loans from financial institutions, issue of debentures, public deposits and trade credit.

These sources provide funds for a specific period, on certain terms and conditions and have to repay the loan after the expiry of that period with interest. A fixed rate of interest is paid by the borrowers on such loans. Often it does put a lot of burden on the business as payment of interest is to be made even when the earnings are low or when the loss is incurred. These institutions don't take into consideration the activities of business after the loan is given. Generally, borrowed funds are provided on the security of some assets of the borrower.

Generation Basis Sources

The way of classifying the sources of funds is whether the funds are generated from within the organization or from external sources of the organization. ***Internal sources*** of funds are those that are generated inside the business. A business, for example, can generate funds internally by speeding collection of receivables, disposing of surplus inventories and increasing its profit. The internal sources of funds can fulfil only limited needs of the business.

Whereas, ***External sources*** of funds are the sources that lie outside an organization, such as suppliers, lenders, and investors. When a large amount of money is needed to be raised, it is generally done through the external sources. External funds may be costly as compared to those raised through internal sources.

In some cases, business is required to mortgage its assets as security while obtaining funds from external sources. The issue of debentures, borrowing from commercial banks and financial institutions and accepting public deposits are some of the examples of external sources of funds commonly used by business organizations.

FINANCIAL SECTOR REFORM

Major Regulatory Changes Since 1992

Year	Regulatory Change
1992	The SEBI Act was passed, with the objective of protecting the interests of investors in securities and to promote the development of and regulate the securities market.
1993	Mutual funds sponsored by private sector entities were allowed to enter the Indian market, introducing competition within the mutual fund industry and resulting in the introduction of new products and improvement of services.
2000	Exchange traded financial derivatives were introduced in India at the two major stock exchanges, NSE and BSE. There are various contracts currently traded on these exchanges.
2003	The National Commodity & Derivatives Exchange Limited (NCDEX) and MCX (Multi Commodity Exchange) started operations, to provide a platform for commodities trading.
2007	First Gold Exchange Traded Fund started.
2009	Exchange traded interest rate derivatives introduced.
2010	Options in currency derivatives launched.

Source: Cognizant Business Consulting

Financial sector refers to the part of the economy which consists of firms and institutions that have the responsibility to provide financial services to the customers of the commercial and retail segment. The financial sector can include commercial banks, non banking financial companies, investment funds, money market, insurance and pension companies, and real estate etc. The financial sector is considered as the base of the economy which is essential for the mobilization and distribution of financial resources.

The financial sector reforms refer to steps taken to reform the banking system, capital market, government debt market, foreign exchange market etc. An efficient financial sector is necessary for the mobilization of households savings and to ensure their proper utilisation in productive sectors. Before 1991, the Indian financial sector was suffering from several lacunae and deficiencies which had reduced their quality and efficiency of operations. Therefore, financial sector reforms had become essential at that time.

Reasons for financial sector reforms in India

- After independence, India inherited various deprivations and problems due to colonial legacy. The country was lagging behind in social as well as economic affairs. To attain the goal of rapid economic development, India adopted the system of planned economy based on the Mahalanobis model. This model had started showing its limitations in the mid-80s and early nineties.
- The government adopted the strategy of fiscal activism for economic growth and large doses of public expenditure were financed by heavy borrowings at concessional rates. This was responsible for comparatively weak and underdeveloped financial markets in India.
- Due to the policy of Fiscal activism, the fiscal deficit increased year after year. The policy of automatic monetization of Fiscal deficit had inflationary tendencies and other negative impacts on the economy.
- The nationalisation of Banks had given complete control over these banks to the government, which resulted in the limited role of market forces in the financial sector.
- The growth rate was hovering around 3.5 % per annum before 1980, and it reached around 5% in the mid-1980s. This growth rate was proving insufficient to solve the economic and financial problems of the country.
- Lack of transparency and professionalism in the banking sector and issues of red-tapism had been responsible for the increase of non performing assets.
- There were issues of inadequate level of proper Regulation in the financial sector. The technologies used in the financial system and their institutional structures were outdated.
- By 1991, India was facing several economic problems. The war in the Middle East and the fall of USSR had put pressure on the Foreign Exchange Reserves of India. India was facing the balance of payment crisis and reforms were now inevitable.

The strategy adopted by India for Financial Sector Reforms

- To initiate financial reforms, India adopted the path of gradual reforms instead of Shock Therapy. This was necessary to ensure continuity and stability of the financial sector in India.
- India incorporated International best practices at the same time adjusted it as per the local requirements.

- The first generation reforms aimed to create an efficient and profitable financial sector by ensuring flexibility to operate with functional autonomy.
- The second generation reforms were incorporated to strengthen the financial system through structural improvements.
- India adopted the policy of consensus driven approach for liberalisation as this was necessary for a democracy.

Financial sector reforms in India

Narasimham Committee report, 1991

The Narasimham committee was established in August 1991 to give comprehensive recommendations on the financial sector of India including the capital market and banking sector. The major recommendations made by the committee are

- **To reduce the cash reserve ratio CRR and the statutory liquidity ratio SLR-** The committee recommended reducing CRR to 10% and SLR to 25% over the period of time.

- **Recommendations on priority sector lending-** the committee recommended to include marginal farmers, small businesses cottage industries etc in the definition of priority sector. The committee recommended for fixing at least 10% of the credit for priority sector lending.

- **Deregulation of interest rates-** the committee recommended deregulating the interest rates charged by the banks. This was necessary to provide independence to the banks for setting the interest rates themselves for the customers.

- The committee recommended to set up tribunals for recovering loans of non-performing assets etc. It gave recommendations on asset quality classifications.
- The committee recommended for entry of new private banks in the banking system.

Banking sector reforms

- **Changes in CRR and SLR:** One of the most important reforms includes the reduction in cash reserve ratio (CRR) and statutory liquidity ratio (SLR). The SLR has been reduced from 39% to the current value of 19.5%. The cash reserve ratio has been reduced from 15 % to 4%. This reduction in the SLR and CRR has given banks more financial resources for lending to the agriculture, industry and other sectors of the economy.
- **Changes in administered interest rates:** Earlier, the system of administered interest rate structure was prevalent in which RBI decided the interest rate charged by the banks. The main purpose was to provide credit to the government and certain priority sectors at concessional rates of interest. The system has been done away and RBI no longer decides interest rates on deposits paid by the banks. However, RBI regulates interest on smaller loans up to Rs 2 lakhs on which the interest rate should not be more than the prime lending rates.

- **Capital Adequacy Ratio:** The capital adequacy ratio is the ratio of paid-up capital and the reserves to the deposits of banks. The capital adequacy ratio of Indian banks had not been as per the international standards. The capital adequacy of 8% on the risk-weighted asset ratio system was introduced in India. The Indian banks had to achieve this target by March 31, 1994, while the foreign Bank had to achieve this norm by 31st March 1993. Now, Basel 3 norms are introduced in India.
- **Allowing private sector banks:** after the financial reforms, private banks we are given life and HDFC Bank, ICICI Bank, IDBI Bank, Corporation Bank etc. were established in India. This has brought much needed competition in the Indian money market which was essential for the improvement of its efficiency. Foreign banks have also been allowed to open branches in India and banks like Bank of America, Citibank, American Express opened many new branches in India. **Foreign banks were allowed to operate in India using the following three channels:**
    - As foreign bank branches,
    - As a subsidiary of a foreign bank which is wholly owned by the foreign Bank,
    - A subsidiary of a foreign bank within maximum foreign investment of 74%
- **Reforms related to non performing assets (NPA):** non performing assets are those loans on which the loan installments have not been paid up for 90 days. RBI introduced the recognition income recognition norm. According to this norm, if the income on the assets of the bank is not received in two quarters after the last date, the income is not recognised. Recovery of bad debt was ensured through Lok adalats, civil courts, Tribunals etc. The Securitisation And Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was brought to handle the problem of bad debts.
- **Elimination of direct or selective credit controls:** earlier, under the system of selective or direct credit control, RBI controlled the credit supply using the system of changes in the margin for providing a loan to traders against the stocks of sensitive commodities and to the stockbrokers against the shares. This system of direct credit control was abolished and now the banks have greater freedom in providing credit to their customers.
- **Promotion of microfinance for financial inclusion:** for the promotion of financial inclusion, microfinance scheme was introduced by the government, and RBI the gave guidelines for it. The most important model for microfinance has been the Self Help Group Bank linkage programme. It is being implemented by the regional rural banks, cooperative banks, and Scheduled commercial banks.

Reforms in the government debt market

- The policy of automatic monetization of the fiscal deficit of government was phased out in 1997 through an agreement between the government and RBI. Now the government borrows money from the market through the auction of government securities.

- The government borrows the money at market determined interest rates which have made the government cautious about its fiscal deficits.
- The government introduced treasury bills for 91 days for ensuring liquidity and meeting short-term financial needs and for benchmarking.
- Foreign institutional investors were now allowed to invest their funds in the government securities.
- The government introduced the system of delivery versus payment settlement for ensuring transparency in the system.
- The system of repo was introduced for dealing with short term liquidity adjustments.

Role of regulators

- Importance of the role of the regulator was recognised and RBI became more independent to take decisions. More operational autonomy was granted to RBI to fulfill its duties.
- The Securities and Exchange Board of India (SEBI) became an important institution in managing the securities market of India.
- The insurance regulatory and Development Authority was an important institution for initiating reforms in the Insurance sector. Its responsibilities include the Regulation and supervision of the Insurance sector in India.

Reforms in the foreign exchange market

Since 1950s, India had a highly controlled foreign exchange market and foreign exchange was made available to the Reserve Bank of India in a very complex manner. The steps taken for the reform of the foreign exchange market were:

- In 1993, India moved towards market based exchange rates, and the current account convertibility was now allowed. The commercial banks were allowed to undertake operations in foreign exchange.
- The Rupee foreign currency swap market has been developed. New players are now allowed to enter this market and undertake currency swap transactions subject to certain limitations.
- The authorised dealers of foreign exchange were now given the permission for activities such as initiating trading positions, borrowing and investing in foreign markets etc. subject to certain limitations and regulations.
- The foreign exchange Regulation Act, 1973 was replaced by the foreign exchange management Act, 1999 for providing greater freedom to the exchange markets.
- The foreign institutional investors and non-resident Indians were allowed to trade in the exchange-traded derivatives contracts subject to certain regulations and limitations.

Other important financial sector reforms

- Some important steps were taken for the non-banking financial companies for the improvement of their productivity, efficiency, and competitiveness. Many of the non-banking financial companies have been brought under the regulation of Reserve Bank of India. Many of the other intermediaries were brought under the supervision of the Board of Financial Supervision.
- In 1992, the Monopoly of UTI was ended and mutual funds were opened for the private sector. The mutual fund industry is now controlled by the SEBI Mutual Funds regulations, 1996 and its amendments.
- In 1992, the Indian capital market was opened for the foreign institutional investors in all the securities.
- Electronic trading was introduced in the National Stock Exchange (NSE) established in 1994, and later on in the Bombay Stock Exchange (BSE) in 1995.

Assessment of financial sector reforms

- After the financial sector reforms, the resilience and stability of Indian economy have increased. The growth rate up the economy has increased from around 3.5 % to more than 6% per annum.
- The country has been able to deal with the Asian economic crisis of 1977-98 and the recent Global subprime crisis which affected the banking system of the world but did not have much impact on the economy of India.
- The banking sector and Insurance sector have grown considerably. The entry of private sector banks and foreign banks brought much-needed competition in the banking sector which has improved its efficiency and capability.
- The Insurance sector has also transformed over the period of time. All these have benefited the customer with diversified options.
- The stock exchanges of the country have seen growth and stability, and it has adopted the international best practices.
- RBI has effectively regulated and managed the growth and operations of the non-banking financial companies of India.
- The budget management, fiscal deficit, and public debt condition have improved after the financial sector reforms. The country is moving with more such future reforms in different sectors of the economy.
- However, all the issues of Indian economy have not been resolved. The social sector indicators such as the provision of health facilities, quality of education, empowerment of women etc have not been at par with the economic growth.
- Further, the new issues like the recent rise in non-performing assets of banks, slow growth of investments in the economy, the issues of jobless growth, high poverty rate, a much lower growth rate in the agriculture sector etc need to be resolved with more concrete efforts.

Way forward

The overall impact of the financial sector reforms has been positive. However consistent reforms are needed to maintain the economic growth and make it inclusive of all the sections of society. The recent measures taken by government includes the bankruptcy and insolvency code for resolution of non performing assets, the indradhanush strategy for strengthening the banking sector, the goods and services tax for making India a unified market, single window clearance to remove red tapism and bring transparency, startup India scheme and standup India scheme to boost economic growth in the country etc. India has reached among the top 100 in the ease of doing business of World Bank. But continued efforts are required to sustain and improve the economic growth rate.

RBI-RESERVE BANK OF INDIA

Introduction

The **Reserve Bank of India** was established on April 1, 1935 in accordance with the provisions of the **Reserve Bank of India Act, 1934** (recommendations of John Hilton Young Commission 1926 – called Royal Commission on Indian Currency & Finance)

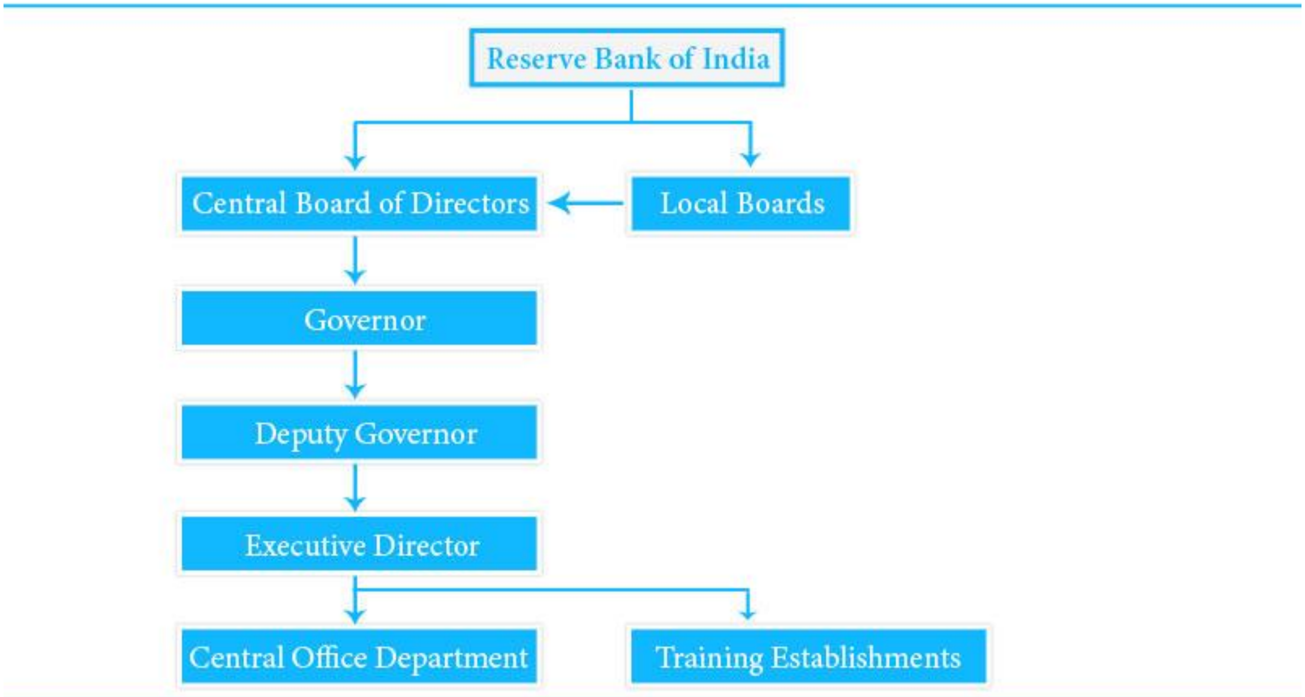
- The **Central Office** of the Reserve Bank was initially established in Calcutta but was permanently moved to Mumbai in 1937.

- The Central Office is where the **Governor sits and where policies** are formulated. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.
- RBI is not expected to perform the function of accepting deposits from the general public.
- RBI has its **headquarters at Mumbai**
- RBI decides the following rates namely; Bank rate, repo rate, reverse repo rate & cash reserve ratio.

Organization

As per the Reserve Bank of India Act, **the organizational structure** of the Reserve Bank comprises of:

A. Central Board
B. Local Boards



A. Central Board –

The Central Board of Directors is the leading governing body of the bank. It is entrusted with the responsibility of general superintendence and direction of the affairs and business of the Reserve Bank.

The Central Board of Directors consists of 20 members as follows:-

One Governor and four Deputy Governors:

They are appointed by the Government of India for a period of five years.Their salaries, allowances and other perquisites are determined by the Central Board of Directors in consultation with the Government of India.

Four Directors Nominated from the Local Boards:

There are four local Boards of Directors in addition to the Central Board of Directors. They are located at Mumbai, Kolkata, Chennai and New Delhi. The Government of India nominates one member each from these local Boards. The tenure of these directors is also for a period of five years.

Ten other Directors:

The ten other directors of the Central Board of Directors are also nominated by the Government of India. Their tenure is four years.

One Government Official:

The Government of India also appoints one Government Official to attend the meetings of the Central Board of Directors. This official can continue for any number of years with the consent of the Government, but he does not enjoy the right to vote in the meetings of the Central Board.

B. Local Boards-

The Reserve Bank of India is divided into four regions :

- The Western, the Eastern, the Northern and the Southern regions. For each of these regions, there is a Local Board, with headquarters in Mumbai, Kolkata, New Delhi and Chennai.
- Each Local Board consists of five members appointed by the Central Government for four years.

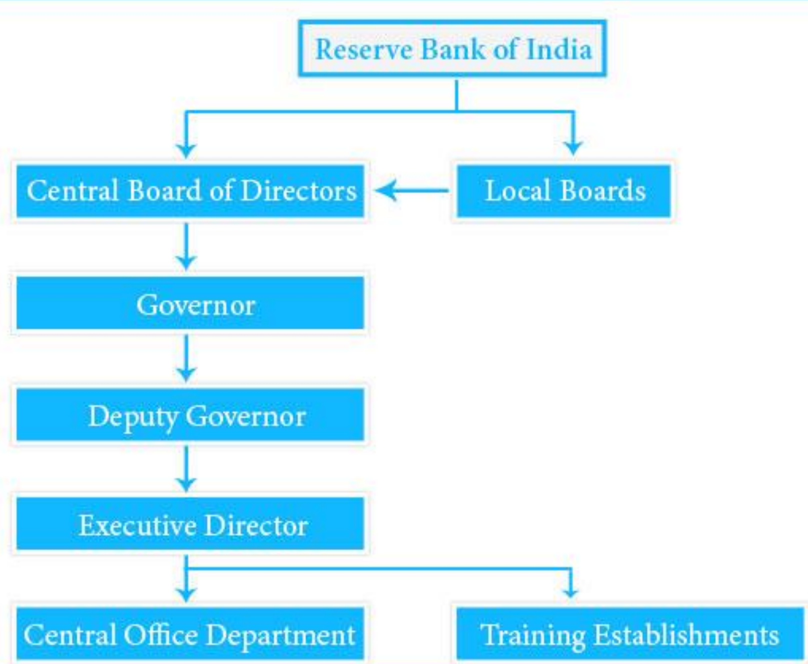
- They represent territorial and economic interests and the interests of co-operative and indigenous banks in their respective areas.
- In each Local Board, a chairman is elected from amongst their members. Managers incharge of the Reserve Bank's offices in Mumbai, Kolkata, Chennai and New Delhi are ex-officio Secretaries of the respective Local Boards at these places.

Functions

Functions of RBI

According to the preamble of the Reserve Bank of India Act, the main functions of the bank is "***to regulate the issue of bank notes and the 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***." The various functions performed by the RBI can be conveniently classified in three parts as follows:

A. Central banking function
B. Promotional functions
C. Supervisory functions



A. Central Banking Functions

"Issue of Currency :

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denomination. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes.

Note: The One Rupees notes and coins are issued by the Central Govt., The Ministry of Finance.

Banker to the Government :

The Reserve Bank of India serves as a banker to the Central Government and the State Governments. It is its obligatory function as a central bank. It provides a full range of banking services to these Governments, such as:-

a. Maintaining and operating of deposit accounts of the Central and State Government.

b. Receipts and collection of payments to the Central and State Government.

c. Making payments on behalf of the Central and State Government.

d. Transfer of funds and remittance facilities of the Central and State Governments.

e. Managing the public debt and issue of new loans and Treasury Bills of the Central Government.

f. It acts as adviser to the Government on all monetary and banking matters.

g. It accepts money, makes payment and also carries out their exchange and remittances for the Govt.

h. Providing ways and means advances to the Central and State governments to bridge the interval between expenditure and flow of receipts of revenue. Such advances are to be repaid by the government within three months from the date of borrowable.

Banker's Bank :

The RBI has extensive power to control and supervise commercial banking system under the RBI Act, 1934 and the Banking Regulation Act, 149.

(i) The Banks are required to maintain a minimum of Cash Reserve Ratio (CRR) with RBI.

(ii) The RBI provides financial assistance to scheduled banks and state cooperative banks.

(iii) Enables banks to maintain their accounts with RBI for statutory reserve requirements and maintenance of transaction balances.

Lender of the Last Resort:

Lender of the last resort means "Central Bank (RBI) helps all the commercial and other banks in time of financial crises.

(i) It can come to the rescue of a bank that is solvent but faces temporary liquidity problems by supplying it with much needed liquidity when no one else is willing to extend credit to that bank.

(ii) The Reserve Bank extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of the bank, which in turn may also affect other banks and institutions and can have an adverse impact on financial stability and thus on the economy.

National Clearing House :

The Reserve Bank acts as the national clearing house and helps the member banks to settle their mutual indebtedness without physically transferring cash from place to place. The Reserve Bank is managing many clearing houses in the country with the help of which cheques worth crores of rupees are cleared every year. The ultimate balances are settled by the banks through cheques on the Reserve Bank.

Controller of credit:

Credit control is generally considered to be the principal function of Central Bank. By making frequent changes in monetary policy, it ensures that the monetary system in the economy functions according to

the nation’s need and goals.
(i) It can do so through changing the Bank rate or through open market operations.
(ii) It controls the credit operations of banks through quantitative and qualitative controls.
(iii) It controls the banking system through the system of licensing, inspection and calling for information.

Custodian of foreign exchange reserves :

The RBI functions as the custodian and manager of forex reserves, and operates within the overall policy framework agreed upon with Government of India.
(i) The ‘ reserves ’ refer to both foreign reserves in the form of gold assets in the Banking Department and foreign securities held by the Issue Department, and domestic reserves in the form of ‘bank reserves’.
(ii) Foreign exchange reserves are important indicators of ability to repay foreign debt and for currency defense, and are used to determine credit ratings of nations.
(iii) Its commonly includes foreign exchange and gold, special drawing rights,(SDRs) and International Monetary Fund(IMF) reserve positions.

B. Promotional Functions:

Reserve Bank of India and Agricultural Credit:

- The bank’s responsibility in this field has been occasioned by the predominantly agricultural basis of the Indian economy and the urgent need to expand and coordinate the credit facilities available to the rural sector.
- The RBI has set up a separate agricultural department to maintain an expert staff to study all questions of agricultural credit and coordinate the operation of the bank with other agencies providing agricultural finance.

The RBI does not provide finance directly to the agriculturists, but through agencies like cooperative banks, land development banks, commercial bank etc.

- After the establishment of the National Bank for Agriculture and Rural Development (NABARD) on July 12, 1982, all the functions of the RBI relating to rural credit have been transferred to this new agency.

Reserve Bank of India and Industrial Finance:

- The Reserve Bank of India has taken initiative in setting up statutory corporations at the all-India and regional levels to function as specialised institutions for term lending.

- The first of these institutions was the Industrial Finance Corporation of India set up in 1948. Followed by the State Finance Corporations in each of the state from 1953 onwards.

- The RBI has also helped in the establishment of other financial institutions such as the Industrial Development Bank of India, the Industrial Reconstruction Bank of India, Small Industries Development Bank of India, Unit Trust of India, etc.

- For the promotion of foreign trade the Reserve Bank has established the Export and Import Bank of India. Similarly, for the development of the housing industry the RBI has established the National Housing Bank.

C. Supervisory Functions

The various aspects of the supervisory/regulatory functions exercised by the Reserve Bank may be briefly mentioned as under:-

Licensing of Banks:

There is a statutory provision that a company starting banking business in India has first to obtain a license from the Reserve Bank. If the Reserve Bank is dissatisfied on account of the defective features of the proposed company, it can refuse to grant the license. The bank is also empowered to cancel the license of a bank when it will cease to carry on banking business in India.

Approval of Capital, Reserves and Liquid Assets of Bank:

The Reserve Bank examines whether the minimum requirements of capital, reserve and liquid assets are fulfilled by the banks and approves them.

Branch Licensing Policy:

The Reserve Bank exercises its control over expansion of branches by the banks through its branch licensing policy.

Inspection of Banks:

The Reserve Bank is empowered to conduct inspection of banks. The inspection may relate to various aspects such as the bank's organizational structure, branch expansion, mobilization of deposits, investments, credit portfolio management, credit appraisal profit planning, manpower planning, as well as assessment of the performance of banks in developmental areas such as deployment of credit to the priority sectors, etc. The bank may conduct investigation whenever there are complain about major irregularities or frauds by certain banks. The inspections are basically meant to improve the working of the banks and safeguard the interests of depositors and thereby develop a sound banking system in the country.

Control Over Management:

The Reserve Bank also looks into the management side of the banks. The appointments, re-appointment or termination of appointment of the chairman and chief executive officer of a private sector bank is to be approved by the Reserve Bank. The bank's approval is also required for the remuneration, perquisites and post-retirement benefits given by a bank to its chairman and chief executive officer.

Control Over Methods:

The Reserve Bank exercises strict control over the methods of operation of the banks to ensure that no improver investment and injudicious advances made by them.

Audit:

Banks are required to get their balance sheets and profits and loss accounts duly audited by the auditors approved by the Reserve Bank. In the case of the SBI, the auditors are appointed by the Reserve Bank.

Credit Information Service:

The Reserve Bank is empowered to collect information about credit facilities granted by individual bank and supply the relevant information in a consolidated manner to the bank and other financial institutions seeking such information.

Control Over Amalgamation and Liquidation:

The banks have to obtain the sanction of the Reserve Bank for any voluntary amalgamation. The Reserve Bank in consultation with the central government can also suggest compulsory reconstruction or amalgamation of a bank. It also supervises banks in liquidation. The liquidation have to submit to the Reserve Bank returns showing their positions. The Reserve Bank keeps a watch on the progress of liquidation proceedings and the expenses of liquidation.

Training and Banking Education:

The RBI has played an active role in making institutional arrangement for providing training and banking education to the bank personnel, with a view to improve their efficiency.

ROLE OF SEBI AS A REGULATOR

Securities and Exchange Board of India [SEBI] is made for protecting the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto.

The **Securities and Exchange Board of India Act, 1992' [SEBI ACT 1992]**, an Act of the Parliament of India enacted for regulation and development of securities market in India, was enacted on April 4th, 1992 by Parliament of India. **SEBI ACT 1992** was amended in the years **1995, 1999 and 2002** to meet the requirements of changing needs of the securities market.

Introduction

Securities Appellate Tribunal is a statutory body established under the provisions of Section 15K of the **Securities and Exchange Board of India Act, 1992** to hear and dispose of appeals against orders passed by the Securities and Exchange Board of India or by an adjudicating officer under the Act; and to exercise jurisdiction, powers and authority conferred on the Tribunal by or under this Act or any other law for the time being in force.

Consequent to **Government Notification No.DL-33004/99 dated 27th May 2014**, SAT hears and disposes of appeals against orders passed by the **Pension Fund Regulatory and Development Authority (PFRDA)** under the PFRDA Act, 2013.

Further, in terms of **Government Notification No.DL- (N)/04/0007/2003-15 dated 23rd March 2015**, SAT hears and disposes of appeals against orders passed by the Insurance Regulatory Development Authority of India (IRDAI) under the Insurance Act, 1938, the General Insurance Business (Nationalization) Act, 1972 and the **Insurance Regulatory and Development Authority Act, 1999** and the Rules and Regulations framed thereunder.

SAT

COMPOSITION OF SAT

CASES

NOTABLE CASES

Sahara-SEBI case:

In early February this year, SAT disposed off an appeal by the Sahara group saying that the matter was already pending before the Supreme Court. Two Sahara Group firms have been accused of raising money without regulatory approvals by the SEBI. The appeal related to the case involving two Sahara group firms raising money without regulatory approvals. The legal battle with market regulator SEBI is continuing in the Supreme Court over the refund of over Rs 20,000 crore to investors.

Reliance Industries-SEBI

An insider trading case is being heard by the SAT for the past seven years.

The Spice Telecom IPO case:

The Tribunal barred one Dipti Kirit Parekh from accessing the capital market for two years for cornering shares issued in the initial public offer (IPO) of Spice Communications back in 2007.

ROLE OF SEBI AS MARKET REGULATOR

ROLE OF COURTS IN ENFORCING SECURITY REGULATIONS:

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an adjudicating officer appointed under this Act or a Securities Appellate Tribunal constituted under this Act is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under the SEBI Act

APPEAL TO SUPREME COURT:

Any person aggrieved by any decision or order of the Securities Appellate Tribunal may file an appeal to the
Supreme Court within sixty days from the date of communication of the decision or order of the Securities Appellate Tribunal to him on any question of law arising out of such order:

- Provided that the Supreme Court may if it is satisfied that the applicant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.

BAR OF JURISDICTION

No order passed by the Board [or the Adjudicating Officer] under SEBI Act shall be appealable and no civil court shall have jurisdiction in respect of any matter which the Board [or the Adjudicating Officer] is empowered by, or under, this Act to pass any order and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any order passed by the Board [or the Adjudicating Officer] by, or under, SEBI Act.

ESTABLISHMENT OF SPECIAL COURTS

1. The Central Government may, for the purpose of providing a speedy trial of offenses under this Act, by notification, establish or designate as many Special Courts as may be necessary.

2. A Special Court shall consist of a single judge who shall be appointed by the Central Government with the concurrence of the Chief Justice of the High Court within whose jurisdiction the judge to be appointed is working.

3. A person shall not be qualified for appointment as a judge of a Special Court unless he is, immediately before such appointment, holding the office of a Sessions Judge or an Additional Sessions Judge, as the case may be.

OFFENCES TRIABLE BY SPECIAL COURTS

Not withstanding anything contained in the Code of Criminal Procedure, 1973, all offenses under SEBI Act committed prior to the date of commencement of the Securities Laws (Amendment) Act, 2014 or on or after the date of such commencement, shall be taken cognizance of and tried by the Special Court established for the area in which the offense is committed or where there are more Special Courts than one for such area, by such one of them as may be specified in this behalf by the High Court concerned.

APPEAL AND REVISION

1. Save as otherwise provided in this Act, the provisions of the Code of Criminal Procedure, 1973 shall apply to the proceedings before a Special Court and for the purposes of the said provisions, the Special Court shall

be deemed to be a Court of Session and the person conducting prosecution before a Special Court shall be deemed to be a Public Prosecutor within the meaning of clause (u) of section 2 of the Code of Criminal Procedure, 1973.

2. The person conducting prosecution referred to in sub-section (1) should have been in practice as an advocate for not less than seven years or should have held a post, for a period of not less than seven years, under the Union or a State, requiring special knowledge of the law.

TRANSITIONAL PROVISIONS.

Any offense committed under SEBI Act, which is triable by a Special Court shall, until a Special Court is established, be taken cognizance of and tried by a Court of Session exercising jurisdiction over the area, notwithstanding anything contained in the Code of Criminal Procedure, 1973:

Provided that nothing contained in this section shall affect the powers of the High Court under section 407 of the Code of Criminal Procedure, 1973 to transfer any case or class of cases taken cognizance by a Court of Session under this section.

IRDA – INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY

Introduction

- **Insurance Regulatory and Development Authority (IRDA)** of India was founded in 2000 as an autonomous statutory body.
- Incorporation of **IRDA** was done following the privatization of the insurance sector.
- Headquartered in Hyderabad, this authority is tasked to regulate and promote the insurance and reinsurance sector in India.
- IRDA acts as a regulator to resolve problems and supervise the issues that arise in the insurance sector. Further, it also fulfills its roles, duties, and powers to develop the sector.
- The IRDA must control, promote, and safeguard the growth of the Indian insurance industry and reinsurance business.
- For all further information, refer website: **www.irdai.gov.in**.

Structure

Organization Structure:

- IRDA consists of a Chairman, whole time members, and part-time members.
- **Mr. Subhash Chandra Khuntia** is the current Chairman of IRDA.

- All the members and the Chairman shall act as a group of members and work jointly as the Controller of Insurance rather than working individually.
- This shall mean that the authority continues to work consistently irrespective of resignation or death of a member.
- The authority holds a common seal that is bestowed with the power to enter into a contract by fixing a stamp on the document.
- The authority holds the right to sue any person or organization and can also be sued.

Members

Designation	Name	Brief Profile
Chairman	Mr. Subhash Chandra Khuntia	• The assumed charge on May 2018. • An Economics scholar and a law graduate, Dr. Khuntia was appointed in Indian Administrative Service in 1981
Member (Finance & Investment)	Mr. Pravin Kutumbe	• The assumed charge on 12th March 2018. • Mr. Kutumbe used to work as an Executive Director (Finance & Accounts) in LIC. • His 33 years of prior work experience at LIC involve working as CEO of LIC's overseas Fiji operations, visiting faculty in various management institutions.
Member (Distribution)	Mr. Sujay Banarji	• The assumed charge on March 1, 2018. • Mr. Banarji has previously worked with Oriental Insurance Company, Head of the Reinsurance Department, New India's Sydney office.
Member (Life)	Mr. Nilesh Sathe	• The assumed charge on July 1, 2015. • Mr. Sathe has been privileged to head the Northern Zone of LIC and after that, many positions in LIC India. • Mr. Sathe has pursued post graduation in CommerceMr.. and has worked with Bank of India and Canara Bank before joining LIC.
Member (Actuary)	Ms. Pournima Gupta	• The assumed charge on January 2015. • Ms. Gupta has worked for 30 years in the Indian insurance industry in various capacities.

		• Ms. Gupta is a Fellow of Institute of Actuaries of India and holds a degree in Statistics from Mumbai University.

Functions

- Protection of interest of policyholders and secure them through fair treatment.
- Provision of benefits to the common man by bringing in speedy and orderly growth in the industry.
- Provision of long term funds for accelerating economic growth.
- Establishment of high standards of integrity is done by IRDA such that these are enforced to bring in financial soundness, competencies among various players, and fair dealing.
- Ensure quick settlement of claims that are genuine through effective grievance redressal mechanisms.
- IRDA undertakes steps for prevention of insurance frauds and other malpractices.
- Take actions if the standards enforced are found to be inadequate and ineffective.
- Efforts are made by IRDA for the promotion of fairness, orderly conduct, and transparency in the Indian financial markets that deal with insurance.
- IRDA works to build a reliable management information system for the enforcement of high standards of financial soundness among market players.
- Maintain optimum amount of self-regulation in day to day working such that the industry works consistently with the requirements of the prudential regulation.

Products

Segment	Examples of Insurance Companies
Life Product	TATA AIA Life Insurance Co. Ltd., Shriram Life Insurance Co. Ltd., DHFL Pramerica Life Insurance Co. Ltd., Exide Life Insurance Co. Ltd., Max Life Insurance Co. Ltd., Aditya Birla Life Insurance Co. Ltd..
General Insurance	Acko General Insurance Limited, Baja Allianz General Insurance Co. Ltd., Bharti AXA General Insurance Co. Ltd., Cholamandalam General Insurance Co. Ltd., DHFL General Insurance Co. Ltd.
Health Insurance	Aditya Birla Health Ins co., Apollo Munich Health Insurance Co Ltd., Bharti AXA General Insurance Co. Ltd., Cigna TTK Health Insurance Company.

Impact

Impact of IRDA:

IA

International Affairs:

- IRDA also has extended support to the less developed or developing countries. The support is in the form of providing technical inputs based on the requirements of the same.
- International assistance is provided with an objective to improve strategies and enhance knowledge of various aspects of insurance worldwide.

PFRDA - PENSION FUND REGULATORY & DEVELOPMENT AUTHORITY

Pension Fund Regulatory and Development Authority was instated in the year 2003. The body was set up with an aim to promote, regulate and develop the pension sector in the country. The National Pension Scheme (NPS) was launched by PFRDA in the year 2003 and thereby extended to all sections of citizens in the year 2009. Pension fund regulatory and development authority comes under the jurisdiction of the Ministry of Finance.

Functions of PFRDA

The preamble of PFRDA states that the aims of the authority is – “to promote old age income security by establishing, developing and regulating pension funds, to protect the interests of subscribers to schemes of pension funds and for matters connected therewith or incidental thereto.”

- PFRDA is head-quartered at New Delhi with various regional offices spread across the country.
- Promote pension scheme in the country by fostering mandatory as well as voluntary pension schemes in order to serve the old age income needs of retired personnel
- National Pension System, both tier 1 and tier 2 are under the purview of PFRDA and are dictated by the same
- PFRDA performs the function of appointing various intermediate agencies like Pension Fund Managers, Central Record Keeping Agency (CRA) etc.
- Educating the general public and stakeholders about the importance of pension.
- Training of intermediaries that perform the task of popularizing and educating people about the importance of pension.
- Addressing grievances related to various pension schemes in the country.
- Addressing and resolving disputes between various intermediaries like banks and between customers and intermediaries.

Intermediaries of PFRDA

The Pension Fund Regulatory and Development Authority is divided into three sub-divisions, each of which performs a task to add on

Central Record Keeping Agency (CRA)

Central Record Keeping Agency performs the following functions –

- Administration and record-keeping of all information of customers who are registered under the National Pension System
- Issuing of PRAN or Permanent Retirement Account Number for customers who have availed savings plan under the National Pension Scheme
- Acting as an operational intermediary between PFRDA and other entities like Pension Funds, Trustee Bank etc.
- Monitoring contributions of NPS subscribers and updating various intermediaries about the same
- Furnishing periodic and updated PRAN statements to all subscribers on a regular basis
- Overseeing the settlement of funds that have been invested and the subsequent units allotted to subscribers

Pension Fund Managers (PFMs)

Listed below are some of the most important functions of the PFMs.

- Pension Fund Manager essentially are mandated to invest and manage funds of subscribers enrolled in the National Pension System
- Investment of contribution of subscriber as per rules and guidelines of the PFRDA
- Maintain books and records of the investment and flow of funds
- Construction of portfolio of customers who choose auto-allocation of funds
- Reporting to PFRDA on a regular basis
- Public disclosure of financial information from time to time as per guidelines issued by PFRDA

Point of Presence Agencies (PoPs)

The third and the most public-facing entity of the PFRDA is the Point of Presence Agencies. Following are the functions that it performs.

- Receive and analyse the duly filled application form along with KYC documentation, furnished by customers who register for the NPS scheme
- To verify KYC documents as and when required
- To collect and verify NPS contributions made by subscribers via various channels like cash, Demand Draft, cheques and so on
- To deduct and collect NPS application fee and to furnish receipt of the same to the subscribers
- To upload contribution files of subscribers on to the Central Record-Keeping Agency system
- To maintain records of all transactions that happen for various NPS accounts of customers
- Carry out changes in subscriber details as per requests made by subscriber
- Handle requests and complaints with regards to contributions made towards NPS and other such request

Trustee Bank

This is also one of the intermediaries of PFRDA. Following are the tasks that this agency performs

- Receives funds for NPS from all over the country via zonal and regional offices
- Verifies amounts paid by the zonal offices
- Fund transfers with discrepancy are returned to zonal office or bank involved and correct transfers are sought
- Prepares Fund Receipt Information by consolidating all funds received to NPS
- Transfer funds according to instructions by CRA for settlement of funds for various entities
- Reconcile daily balances in accordance with CRA
- Maintain records of contributions by nodal offices and other documents pertaining to the same

Custodian

- Does the job of maintaining accounts of securities and assets held by customers
- Collecting accrued benefits on securities and assets
- Acting as a Domestic Depository and performing functions related to the same
- Informing about the actions that are to be taken or have been taken by issuer of securities
- Maintains and reconciles records of services

Nodal offices

Nodal offices are an important link in the spread and reach of NPS schemes. These are the numerous links that join up to make the robust PFRDA.

- Central Government nodal offices perform the task pf interacting with CRA on behalf of customers for the purposes of NPS
- State Government Nodal Offices too, perform the same task but under a smaller node

Aggregators

Aggregator can be understood as the most prominent and first point of contact between subscriber and the NPS – Swavalamban scheme.

- Responsible for carrying out changes in any of the KYC information as requested by subscriber. This includes change in name, address, contact information etc.
- Grievance handling in cases where subscriber raises a complaint or grievance against any of the intermediaries of the PFRDA.

Apart from the above listed intermediaries, banks that is both public and private ones are also responsible to a certain extent for popularizing and opening of NPS Accounts of subscribers in the country. The main aim of the government behind running the Pension fund regulatory and development authority and subsequent NPS schemes is to make sure that citizens have a certain pension fund to fall back on when they retire from their jobs (government or private).

BOARD OF FINANCIAL SUPERVISION (BFS)

Financial regulation and supervision are the two important functions of the RBI. Though the RBI is known for its function of monetary policy implementation, financial regulation and supervision are more effort taking as well as sophisticated functions. Supervision helps the RBI to continuously check to assess the health and stability of the financial system. Without effective supervision, the financial system may face crisis.

Regulation is just stipulating rules in accordance with the laws framed by the government for the effective control over the financial system. There is the Banking Regulation Act to regulate banks.

Supervision is different from regulation. Here, the RBI goes to the headquarter of the bank to check whether the bank's balance sheet is good. Objective of supervision is to ensure that banks remains healthy and stable.

Several norms are there for effective supervision. Supervision requires onsite surveillance of banks. Since the RBI is the regulator for most of the money market institutions including banks and Non-Banking Financial Institutions, there need a separate entity. The RBI has constituted a separate unit for supervision and it is called Board for Financial Supervision (BFS). The convention in central banking is that regulation and supervision should not be done by the same entity.

Board for Financial Supervision

The Board for Financial Supervision (BFS) was constituted in November 1994 to supervise the money market institutions in the country. The BFS has been constituted as an autonomous body under the RBI.

Board is drawn from the members of the Central Board of the Reserve Bank with the Governor as Chairman and one of the Deputy Governors as full time Vice-Chairman. The Board exercises the powers of supervision and inspection under the RBI Act, 1934 and the Banking Regulation Act, 1949 in relation to the different sectors of the financial system.

The BFS was initially given the mandate for supervision of commercial banks, Financial Institutions and NBFCs. Later, urban cooperative banks and primary dealers were also brought under the purview of the BFS. Since its formation, the BFS which meets every month, conducting on-site supervision of banks and off-site monitoring, based on quarterly reporting system.

Banking Supervision procedure

The main instrument of supervision in India is the periodical on-site inspection of banks that is supplemented by off-site monitoring and surveillance. Since 1995, on-site inspections are based on CAMELS (Capital adequacy, asset quality, management, earning, liquidity and systems and controls) model and aim at achieving the set objectives.

The domestic banks are rated on CAMELS model while foreign banks are rated on CALCS model (capital adequacy, assets quality, liquidity, compliance and systems). The frequency of inspections is generally annual, which can be increased / reduced depending on the financial position, methods of operation and compliance record of the bank.

FINANCIAL STABILITY

Financial stability can be defined as “a condition in which the financial system is not unstable". It can also mean a condition in which the three components of the financial system -- financial institutions, financial markets and financial infrastructure -- are stable.

Financial stability is defined in terms of its ability to facilitate and enhance economic processes,

manage risks, and absorb shocks.

- ‘Stability of financial institutions’ refers to a condition in which individual financial institutions are sound enough to carry out their financial intermediation function adequately, without assistance from external institutions including the government.
- ‘Stability of financial markets’ means a condition in which there is no major disruption of market transactions, with no significant deviation of financial asset prices from economic fundamentals, thereby enabling economic agents to raise and operate funds with confidence.

- 'Stability of financial infrastructure' refers to a condition in which the financial system is well structured to ensure smooth operation of market discipline, and both the financial safety net and the payment and settlement system are running effectively.

Financial stability can be more broadly defined as "a condition in which the financial system can facilitate real economic activities smoothly and is capable of unravelling financial imbalances arising from shocks."

Why is Financial Stability Important?

Financial stability is an essential requirement not only for price stability, the policy goal of the central bank, but also for healthy development of the economy. This is because financial instability entails heavy costs for an economy, since the volatility of price variables in the financial markets increases and financial institutions or corporations may go bankrupt. In addition, economic development can be limited at such a time, since economic agents find it difficult to make rational decisions and the efficiency of resource allocation is reduced.

Since the 1980s, many countries around the world have achieved the positive effects of rapid financial industry growth owing to the progress of financial liberalization. At the same time, however, they have also experienced periods of dramatic slowdown in economic growth, due to heavy economic expenses arising from financial instability or financial crises.

Against this backdrop, many countries have started to place great emphasis on financial stability when implementing their policies. Attention paid to financial stability is growing, as new factors with the potential to generate financial instability, including the strengthening of financial sector links among countries and the rampant development of complex financial instruments, have recently emerged.

<u>ETHICS & PRINCIPLES IN FINANCIAL MARKET</u>

PRINCIPLES

- Principle 1: Legal basis
- Principle 2: Governance
- Principle 3: Framework for the comprehensive management of risks Credit and liquidity risk management
- Principle 4: Credit risk
- Principle 5: Collateral
- Principle 6: Margin
- Principle 7: Liquidity risk Settlement
- Principle 8: Settlement finality
- Principle 9: Money settlements
- Principle 10: Physical deliveries Central securities depositories and exchange-of-value settlement systems
- Principle 11: Central securities depositories CPSS-IOSCO – Principles for financial market infrastructures – April 2012 i ii CPSS-IOSCO – Principles for financial market infrastructures – April 2012
- Principle 12: Exchange-of-value settlement systems Default management
- Principle 13: Participant-default rules and procedures
- Principle 14: Segregation and portability General business and operational risk management
- Principle 15: General business risk
- Principle 16: Custody and investment risks
- Principle 17: Operational risk Access
- Principle 18: Access and participation requirements
- Principle 19: Tiered participation arrangements
- Principle 20: FMI links Efficiency
- Principle 21: Efficiency and effectiveness
- Principle 22: Communication procedures and standards Transparency
- Principle 23: Disclosure of rules, key procedures, and market data
- Principle 24: Disclosure of market data by trade repositories.

FINANCIAL MARKET-I

- **Monetary Policy Committee-**
- **formation*Monetary policy-Tools, Goals and Targets,**
- **Theories of interest rates***
- **structure of interest rates – Nominal and real interest rate, inflation relationship and computation. Money Market- instruments, utility, eligibility: Call, Notice & Term Money Market, Commercial Bills, Commercial Paper- cost computation, Certificate of Deposits, T-Bills issue & yieldcomputation,**
- **Competitive bidding, Non-Competitive bidding,**
- **Repo,**
- **market for financial Guarantees, Discount market, Government (Gilt-edged) Securities Market & design, Commercial Banks, Cooperative banks, Insurance companies**

MONETARY POLICY COMMITTEE

Monetary Policy Committee (MPC) constituted by the Central Government as per the Section 45ZB of the amended RBI Act, 1934. The first meeting of the MPC was held on October 3 and 4, 2016. This committee decides various policy rates like Repo rate, Reverse repo rate, MSF and Liquidity Adjustment Facility etc. On 4th October, 2019 the RBI Monetary Policy committee has cut the repo rate by 25 bps to 5.15%. Now the repo rate stands at 5.15%, the lowest since March 2010.

Monetary Policy Committee (MPC) is a 6 member committee formed after the amendment in the RBI Act, 1934 through the Finance Act, 2016. The basic objective of MPC is to maintain price stability and accelerate the growth rate of the economy.

What is Monetary Policy

Monetary policy refers to the policy of the Reserve Bank of India with regard to the use of monetary instruments under its control to achieve the goals of GDP growth and lower inflation rate. **The RBI is authorised to made monetary policy under the Reserve Bank of India Act, 1934.** Hence monetary policy refers to the credit control measures adopted by the Central Bank of a country.

Objectives of the Monetary Policy:

The Chakravarty committee has emphasized that price stability, economic growth, equity, social justice, promoting and nurturing the new monetary and financial institutions have been important objectives of the monetary policy in India.

RBI tries always tries to reduce rate of inflation or keep it within a sustainable limit while on the other hand government of India focus to accelerate the GDP growth of the country.

Structure of Banking Sector in India

What is Monetary Policy Committee?

The Monetary Policy Committee (MPC) constituted by the Central Government under Section 45ZB. The MPC determines the policy interest rate required to achieve the inflation target.

The Reserve Bank's Monetary Policy Department (MPD) assists the Monetary Policy Committee (MPC) in forming the monetary policy. The Monetary Policy Committee determines the policy rates required to achieve the inflation target.

Composition of Monetary Policy Committee

The 6 member Monetary Policy Committee (MPC) **constituted by the Central Government as per the Section 45ZB of the amended RBI Act, 1934**. The first meeting of the **Monetary Policy Committee (MPC) was held on in Mumbai on October 3, 2016.**

The composition of the MPC as on April 2019 is as follows;

1. Governor of the Reserve Bank of India – **Chairperson, ex officio; (Shri Shaktikanta Das)**

2. Deputy Governor of the Reserve Bank of India, in charge of Monetary Policy – BP Kanungo (Member, ex officio)

3. One officer of the Reserve Bank of India to be nominated by the Central Board – Member, ex officio; (Dr. Michael Debabrata Patra)

4. Dr. Ravindra H. Dholakia, Professor, Indian Institute of Management, Ahmedabad – Member

5. Professor Pami Dua, Director, Delhi School of Economics – Member

6. Shri Chetan Ghate, Professor, Indian Statistical Institute (ISI) – Member

Except ex-officio members all members will hold the office for a period of 4 years or until further orders, whichever is earlier.

Instruments of Monetary Policy;

The instruments of monetary policy are of two types:

1. Quantitative Instruments: General or indirect (Cash Reserve Ratio, Statutory Liquidity Ratio, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate, Marginal standing facility and Liquidity Adjustment Facility (LAF))

2. Qualitative Instruments: Selective or direct (change in the margin money, direct action, moral suasion)

It is worth to mention that all of the above mentioned instruments of the monetary policy are managed as per the requirement of the economy. These instruments maintain the flow of money supply in the economy so that the rate of inflation can be stabilised for ensuring the growth of the Economy.

MONETARY POLICY-TOOLS, GOALS AND TARGETS

Meaning of Monetary Policy:

Monetary policy is concerned with the changes in the supply of money and credit. It refers to the policy measures undertaken by the government or the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives. Monetary policy aims at influencing the economic activity in the economy mainly through two major variables, i.e., (a) money or credit supply, and (b) the rate of interest.

The techniques of monetary policy are the same as the techniques of credit control at the disposal of the central bank. Various techniques of monetary policy, thus, include bank rate, open market operations, variable cash reserve requirements, selective credit controls. R.P. Kent defines monetary policy as the management of the expansion and contraction of the volume of money in circulation for the explicit purpose of attaining a specific objective such as full employment.

According to A. J. Shapiro, "Monetary Policy is the exercise of the central bank's control over the money supply as an instrument for achieving the objectives of economic policy." In the words of D.C. Rowan,

"The monetary policy is defined as discretionary action undertaken by the authorities designed to influence (a) the supply of money, (b) cost of money or rate of interest and (c) the availability of money."

Monetary policy is not an end in itself, but a means to an end. It involves the management of money and credit for the furtherance of the general economic policy of the government to achieve the predetermined objectives. There have been varying objectives of monetary policy in different countries in different times and in different economic conditions.

Different objectives clash with each other and there is a problem of selecting a right objective for the monetary policy of a country. The proper objective of the monetary policy is to be selected by the monetary authority keeping in view the specific conditions and requirements of the economy.

Objectives of Monetary Policy:

The goals of monetary policy refer to its objectives such as reasonable price stability, high employment and faster rate of economic growth. The targets of monetary policy refer to such variables as the supply of bank credit, interest rate and the supply of money.

These are to be changed by using the instruments of monetary policy for attaining the objectives (goals). The instruments of monetary policy are variation in the bank rate, the repo rate and other interest rates, open market operations (OMOs), selective credit controls and variations in reserve ratio (VRR). [The targets are to be changed by using the instruments to achieve the objectives.]

Four most important objectives of monetary policy are the following:

1. Stabilising the Business Cycle:

Monetary policy has an important effect on both actual GDP and potential GDP. Industrially advanced countries rely on monetary policy to stabilise the economy by controlling business. But it becomes impotent in deep recessions.

Keynes pointed out that monetary policy loses its effectiveness during economic downturn for two reasons:

(i) The existence of liquidity trap situation (i.e., infinite elasticity of demand for money) and

(ii) Low interest elasticity of (autonomous) investment.

2. Reasonable Price Stability:

Price stability is perhaps the most important goal which can be pursued most effectively by using monetary policy. In a developing country like India the acceleration of investment activity in the face of a fall in agricultural output creates excessive pressure on prices. The food inflation in India is a proof of this. In such a situation, monetary policy has much to contribute to short-run price stability.

Due to various changes in the structure of the economy in a developing country like India some degree of inflation is inevitable. And mild inflation or a functional rise in prices is desirable to give necessary incentive to producers and investors. As P. A. Samuelson put it, mild inflation at the rate of 3% to 4% per annum lubricates the wheels of trade and industry and promotes faster economic growth.

Price stability is also important for improving a country's balance of payments. In the opinion of C. Rangarajan, **"The increasing openness of the economy, the need to service external debt and the necessity to improve the share of our exports in a highly competitive external environment require that the domestic price level is not allowed to rise unduly".** This is more so in view of the fact that India's major trading partners have achieved notable success in recent years in achieving price stability.

3. Faster Economic Growth:

Monetary policy can promote faster economic growth by making credit cheaper and more readily available. Industry and agriculture require two types of credit—short-term credit to meet working capital needs and long-term credit to meet fixed capital needs.

The need for these two types of credit can be met through commercial banks and development banks. Easy availability of credit at low rates of interest stimulates investment or expansion of society's production capacity. This in its turn, enables the economy to grow faster than before.

4. Exchange Rate Stability:

In an 'open economy'—that is, one whose borders are open to goods, services, and financial flows— the exchange-rate system is also a central part of monetary policy. In order to prevent large depreciation or appreciation of the rupee in terms of the US dollar and other foreign currencies under the present system of floating exchange rate the central bank has to adopt suitable monetary measures. India by the Reserve

Conflicts among Objectives:

In the long run there is no conflict between the first two objectives, viz., price stability and economic growth. In fact, price stability is a means to achieve faster economic growth. In the context of the Indian economy C. Rangarajan writes, **"It is price stability which provides the appropriate environment under which growth can occur and social justice can be ensured."** However, in the short run there is a trade-off between price stability and economic growth. Faster economic growth is achieved by increasing-the availability of credit at a lower rate of interest. This amounts to an increase in the money supply.

But an increase in the money supply and the consequent rise in consumer demand tends to generate a high rate of inflation. This raises the question of what is the minimum acceptable rate of inflation which does not act as a growth-retarding factor. The question still remains unanswered.

There is also a conflict between exchange rate stability and economic growth. If the rupee depreciates in terms of the dollar, then RBI has to tighten its monetary screws, i.e., it has to raise the interest rate and reduce excess liquidity of banks (from which loans are made).

On the other hand in order to promote faster economic growth the RBI has to lower interest rate and make more credit available for encouraging private investment. Thus the RBI often faces a dilemma situation.

Ultimate Versus Intermediate Targets:

The ultimate target over which the central bank of a country wants to exercise control are three major macroeconomic variables such as the rate (level) of employment, the general price level (or the rate of inflation) and the rate of growth of the economy which is measured by the annual rate of increase of real GDP.

Now the question is how effectively does the RBI act on such targets? The truth is that RBI is not in a position to act on them directly. The main reason for this is its imperfect monitoring of the operation of the economy. This is attributable to lack of adequate, necessary and timely information about the key variables.

So what does the RBI do then? It has no other option but to control intermediate targets exert indirect influence on the ultimate targets and, of course, in a predictable manner. Important intermediate targets are the three money supply concepts (aggregates), viz., M_1, M_2 or M_3 and, of course, the interest rate.

While the RBI seeks to control the rate of inflation by controlling the money supply, it exerts influence on economic growth by altering the interest rate structures which alter the incentives to invest in physical capital as opposed to that in financial (liquid) assets.

Mode of Operation:

The RBI's mode of operation as far as intermediate targeting on monetary aggregate is concerned is simple. At the start of each quarter, the Bank fixes the rate of growth of the money supply which, it thinks, is quite consistent with its ultimate target, viz., reasonable price level stability and faster economic growth.

The RBI takes decision on the basis of data on past performance as also forecast about the next quarter or over a full financial year. The RBI makes an appropriate choice of its policy action with a view to meeting this fixed target. At the start of the next quarter, the RBI makes a review of its money supply target and adjust it appropriately on the basis of actual experience of the past.

In 1998, the RBI made a sudden switch from a money supply targeting to a list of certain broad policy indicators. In spite of this broad monetary aggregate (mainly M,) is now perhaps*the most important of its policy stance.

There are two reasons for this:

(i) Correct Prediction of Inflation:

In India the rate of inflation is measured by the wholesale price index (WPI). And in the intermediate run (covering a period of 3 to 5 years), M_3 is fairly accurate predictor of inflation.

(ii) Transparency:

Most people in India have a fairly good idea of money supply targeting. With money supply targeting, the policy stance of the RBI is quite transparent and performs a signaling function. It gives a clear signal to the public and policymakers. The control of inflation depends much on the RBI's credibility reputation is a big factor here.

If the RBI does exactly what it announces people will believe in the RBI's commitment to achieve price stability by keeping the growth of the money supply within a target range? This is perhaps the best way to achieve anti-inflationary credibility by keeping people's inflationary expectations at a low level. Interest rate targeting is not that effective as an anti-inflationary measure.

Limited Scope of Monetary Policy in Developing Countries:

Monetary policy influences economic activity in two ways:

1. Directly through Money Supply:

Money supply is directly related to the level of economic activity. An increase in money supply increases economic activity by enabling people to purchase more goods and services, and vice versa.

2. Indirectly through Rate of Interest:

A change in money supply influences economic activity through its impact on rate of interest and investment. Increase in money supply reduces the rate of interest, which in turn, increases investment, and hence promotes economic activity, and vice versa.

The monetary policy in an economy works through two main economic variables, i.e., money supply and the rate of interest. The efficient working of the monetary policy, however, requires the fulfillment of three basic conditions- (a) The country must have highly organised, economically independent and efficiently functioning money and capital markets which enable the monetary authority to make changes in money supply and the rate of interest as and when needed, (b) Interest rates can be regulated both by administrative controls and by market forces so that consistency and uniformity exists in interest rates of different sectors of the economy, (c) There exists a direct link between interest rates, investment and output so that a reduction in the interest rate (for example) leads to an increase in investment and an expansion in output without any restriction.

The developed countries largely satisfy all the necessary prerequisites for the efficient functioning of the monetary policy, whereas the developing or underdeveloped economies normally lack these requirements.

The monetary policy has the limited scope in the underdeveloped countries because of the following reasons:

(i) There exists a large non-monetised sector in most of the underdeveloped countries which act as a great hurdle in the successful working of the monetary policy.

(ii) Small-sized and unorganised money market and limited array of financial assets in underdeveloped countries also hinder the effectiveness of monetary policy.

(iii) In most of the underdeveloped countries, total money supply mainly consists of currency in circulation and bank money forms a very small portion of it. This limits the operation of central bank's monetary policy which basically works through its impact on bank money.

(iv) The growth of nonbank financial institutions also restricts the effective implementation of monetary policy because these institutions fall outside the direct control of the central bank.

(v) In the underdeveloped countries (e.g., in Libya), many commercial banks possess high level of liquidity (i.e, funds in cash form). In these cases, the changes in monetary policy cannot significantly influence the credit policies of such banks.

(vi) Foreign-based commercial banks can easily neutralise the restrictive effects of tight monetary policy because these banks can replenish their resources by selling foreign assets and can also receive help from international capital market.

(vii) The scope of monetary policy is also limited by the structural and institutional realities of the underdeveloped countries, weak linkage between interest rate, investment and output, particularly due to structural supply rigidities.

When investment is increased as a result of a fall in the rate of interest, increased investment may not expand output due to the structural supply constraints, such as inadequate management, lack of essential intermediate products, bureaucratic rigidities, licensing restrictions, lack of interdependence within the industrial sector. Thus, higher investment, instead of increasing output, may generate inflationary pressures by raising prices.

Role of Monetary Policy in Developing Countries:

The monetary policy in a developing economy will have to be quite different from that of a developed economy mainly due to different economic conditions and requirements of the two types of economies. A developed country may adopt full employment or price stabilisation or exchange stability as a goal of the monetary policy.

But in a developing or underdeveloped country, economic growth is the primary and basic necessity. Thus, in a developing economy the monetary policy should aim at promoting economic growth. The monetary authority of a developing economy can play a vital role by adopting such a monetary policy which creates conditions necessary for rapid economic growth.

Monetary policy can serve the following developmental requirements of developing economies:

1. Developmental Role:

In a developing economy, the monetary policy can play a significant role in accelerating economic development by influencing the supply and uses of credit, controlling inflation, and maintaining balance of payment.

Once development gains momentum, effective monetary policy can help in meeting the requirements of expanding trade and population by providing elastic supply of credit.

2. Creation and Expansion of Financial Institutions:

The primary aim of the monetary policy in a developing economy must be to improve its currency and credit system. More banks and financial institutions should be set up, particularly in those areas which lack these facilities.

The extension of commercial banks and setting up of other financial institutions like saving banks, cooperative saving societies, mutual societies, etc. will help in increasing credit facilities, mobilising voluntary savings of the people, and channelising them into productive uses.

It is also the responsibility of the monetary authority to ensure that the funds of the institutions are diverted into priority sectors or industries as per requirements of be development plan of the country.

3. Effective Central Banking:

To meet the developmental needs the central bank of an underdeveloped country must function effectively to control and regulate the volume of credit through various monetary instruments, like bank rate, open market operations, cash-reserve ratio etc. Greater and more effective credit controls will influence the allocation of resources by diverting savings from speculative and unproductive activities to productive uses.

4. Integration of Organised and Unorganised Money Market:

Most underdeveloped countries are characterized by dual monetary system in which a small but highly organised money market on the one hand and large but unorganised money market on the other hand operate simultaneously.

The unorganised money market remains outside the control of the central bank. By adopting effective measures, the monetary authority should integrate the unorganised and organised sectors of the money market.

5. Developing Banking Habits:

The monetary authority of a less developed country should take appropriate measures to increase the proportion of bank money in the total money supply of the country. This requires increase in the bank deposits by developing the banking habits of the people and popularising the use of credit instruments (e.g, cheques, drafts, etc.).

6. Monetisation of Economy:

An underdeveloped country is also marked by the existence of large non-monetised sector. In this sector, all transactions are made through barter system and changes in money supply and the rate of interest do not influence the economic activity at all. The monetary authority should take measures to monetise this non-monetised sector and bring it under its control.

7. Integrated Interest Rate Structure:

In an underdeveloped economy, there is absence of an integrated interest rate structure. There is wide disparity of interest rates prevailing in the different sectors of the economy and these rates do not respond to the changes in the bank rate, thus making the monetary policy ineffective.

The monetary authority should take effective steps to integrate the interest rate structure of the economy. Moreover, a suitable interest rate structure should be developed which not only encourages savings and investment in the country but also discourages speculative and unproductive loans.

8. Debt Management:

Debt management is another function of monetary policy in a developing country. Debt management aims at- (a) deciding proper timing and issuing of government bonds, (b) stabilising their prices, and (c) minimising the cost of servicing public debt.

The monetary authority should conduct the debt management in such a manner that conditions are created "in which public borrowing can increase from year to year and on a big scale without giving any jolt to the system. And this must be on cheap rates to keep the burden of the debt low."

However, the success of debt management requires the existence of a well- developed money and capital market along with a variety of short- term and long-term securities.

9. Maintaining Equilibrium in Balance of Payments:

The monetary policy in a developing economy should also solve the problem of adverse balance of payments. Such a problem generally arises in the initial stages of economic development when the import of machinery, raw material, etc., increase considerably, but the export may not increase to the same extent.

The monetary authority should adopt direct foreign exchange controls and other measures to correct the adverse balance of payments.

10. Controlling Inflationary Pressures:

Developing economies are highly sensitive to inflationary pressures. Large expenditures on developmental schemes increase aggregate demand. But, output of consumer's goods does not increase in the same proportion. This leads to inflationary rise in prices.

Thus, the monetary policy in a developing economy should serve to control inflationary tendencies by increasing savings by the people, checking expansion of credit by the banking system, and discouraging deficit financing by the government.

11. Long-Term Loans for Industrial Development:

Monetary policy can promote industrial development in the underdeveloped countries by promoting facilities of medium-term and long-term loans to tire manufacturing units. The monetary authority should induce these banks to grant long-term loans to the industrial units by providing rediscounting facilities. Other development financial institutions also provide long-term productive loans.

12. Reforming Rural Credit System:

Rural credit system is defective and rural credit facilities are deficient in the under-developed countries. Small cultivators are poor, have no finance of their own, and are largely dependent on loans from village money lenders and traders who generally exploit the helplessness, ignorance and necessity of these poor borrowers.

The monetary authority can play an important role in providing both short-term and long term credit to the small arrangements, such as the establishment of cooperative credit societies, agricultural banks etc.

Conclusion:

It is true that monetary policy in a developing economy can play a positive role in facilitating the process of economic development by influencing the supply and use of credit through well-developed credit institutions, checking inflation, maintaining balance of payments equilibrium, providing loan facilities to industrial and agricultural sectors, and so on.

But it must be clearly borne in mind that the role of monetary policy in economic development is secondary and indirect, and not primary and direct. The fundamental problem of underdeveloped countries is that of inadequate saving which cannot be solved merely by creating financial institutions. The growth of saving basically depends upon the increase in productive capacity and income of the country.

Financial institutions only provide facilities to encourage savings and smoothen the process of economic development; they are not the primary movers of economic development. A.S. Meier and Baldwin put it, “The currency and credit system must be responsive to the stimuli of development, but monetary and financial institutions in themselves cannot be expected to be the primary and active movers of development in a direct sense.”

The Role of Monetary Policy in Promoting Faster Economic Growth:

Economic growth refers to a sustainable or a continuous increase in national and per capita incomes. This occurs when there is an increase in an economy's capital stock through an increased investment. As a result there is expansion of the economy's production capacity. This enables the economy to produce more goods and services every year.

In truth, faster economic growth can be attained by an economy largely if not entirely, by increasing the rate of saving and investment.

How this can be achieved by using monetary policy may now be discussed:

1. Increasing the Rate of Saving:

If monetary policy is to promote economic growth, it has to raise the rate of saving. In a developing country like India, the central bank should raise the rate of interest to a reasonable level to induce people to save more. So larger and larger volume of resources will be available for investment (particularly in fixed assets).

In times of inflation the nominal rate of interest has to be raised so that the real rate of interest remains constant. In fact in order to mobilise more and more saving through the banking system for investment purposes, it is absolutely essential to maintain reasonable price stability so that people have less incentive to buy gold, real estate or goods for hoarding and speculation. If due to excessive rise in price the real rate of interest becomes negative, people will have less incentive to save.

However, the rate of interest affects only people's desire to save. But their capacity to save depends, apart from income, on the existence of banks and other financial institutions. So the governments of developing countries should build a strong financial infrastructure by setting up banks, post offices, insurance companies, stock exchanges, mutual funds, and pension funds mainly in rural areas where the majority of the people live.

2. Monetary Policy and Investment:

Even if the rate of interest is very low, private enterprises may not be willing to make new investment in time of depression due to lack of profitable business opportunities.

This, of course, is Keynes's view. But in normal times an increase in the supply of money due to an increase in bank credit leads to an increased investment. In addition in a developing country public (government) investment plays an important role in economic development. So monetary policy should also make adequate funds available for public investment.

(a) Monetary Policy and Public Investment:

The monetary policy of a developing country like India has to be such as to ensure that a large portion of deposits mobilised by banks is invested in government and other approved securities so as to enable the government to finance its planned investment. Infrastructure building is so important for economic development.

So public investment has to be made to set up power plants, build roads, highways and ports. Such investment promotes industrial development directly and indirectly (by establishing backward and forward linkages). As a result there is a tremendous increase in demand for industrial products.

Each industry purchases inputs from other industries and sells its products to both households and other businesses. The operation of multiplier stimulates private investment further. Thus public investment on social overhead capital will crowd in, rather than crowd out, private investment. Moreover, construction of irrigation dams promotes agricultural growth by raising both production and productivity.

In India, a new tool of monetary control has been introduced for taking out large resources from the banking sector for financing public investment, viz., statutory liquidity ratio (SLR). Now in addition to keeping cash reserves commercial banks are to keep a minimum portion of their total demand and time deposits in some specified liquid assets, mainly in government and other approved securities'.

(b) Monetary Policy and Private Investment:

Since both large-scale and medium-size industries require funds for investment in fixed capital, working capital as also for holding inventories (of both finished goods and raw materials) monetary policy has also to ensure that the need for bank credit for investment and production in the private sector is fully satisfied.

Adequate bank credit is necessary for two purposes:

(i) To utilise the existing production capacities in the private sector and

(ii) To create additional capacity.

Banks must also provide adequate credit to meet the minimum working capital needs of agriculture and industry.

(c) Allocation of Investment Funds:

The mobilisation of savings is not enough. Savings are to be utilised for productive investment. So monetary policy should be discriminatory in nature. It should restrict the flow of credit in unproductive sectors and wasteful activities which are inimical to economic growth. At the same time it should direct the flow of credit in productive channels.

So there is need for much stricter application of selecting credit control (SCC) mainly with a view to influencing the pattern of investment. SCC also helps the process of development indirectly by checking price rise and thus avoiding the distortion created by double digit inflation. However, it has to be supported by proper credit rationing.

In addition, measures such as lengthening the periods of repayment of loans, lowering of margin requirements, provision of rediscounting facilities at rates below the market rates, interest and provision of special loans to entrepreneurs setting up labour-intensive industries in backward areas are to be adopted for promoting faster industrial growth.

Monetary policy should provide the necessary incentives to channelise saving in the desired direction. This is supposed to widen the horizons of development in accordance with the pre-determined goals of planning.

Targets for Monetary Policy:

Conditions of a Good Target:

In order to become a good target for monetary policy a variable should satisfy the following conditions:

1. Measurability:

The target variable should be easily measurable with little or no time lag. To meet this condition, accurate and reliable data must be available. The data should also conform to the theoretical definitions of the target variables.

2. Attainability:

The monetary authority should be able to attain its targeted goals, otherwise, setting the targets will be an exercise in futility. The targets which are unattainable are not practical. A target will be attainable when- (a) it is rapidly affected by policy instruments; and (b) there are no or very little non-policy influences on it.

3. Relatedness to Goal Variables:

The target variable should be closely related to the higher level goal variables and this relation should be well understood and reliably estimable. For example, even if the monetary authority is able to attain the interest rates target, all is in vain if the interest rates do not affect the ultimate goals of employment. The price level, the rate of economic growth, and the balance of payments.

Superiority of Target Variables:

There are three main variables used as monetary targets. They are- money supply, bank credit and interest rates. Which of these variables is superior and chosen as target variable depends upon how far it satisfies the three criteria of measurability, attainability and relatedness to ultimate goals.

In spite of certain conceptual and practical difficulties in the measurement of target variables, all the three variables satisfy equally well the criterion of measurability and can be estimated with reasonable accuracy. As regard the condition of attainability, both money supply and bank credit meet equally well this condition, whereas interest rates do not fulfill it satisfactorily.

All the interest rates in the market do not change together and equi-proportionately. Interest rates are also not affected by the policy instruments as rapidly as other target variables are. Moreover, non-policy factors greatly influence the interest rates.

As regards the fulfillment of the criterion of relatedness to goal variables, the economists differ sharply. The Keynesians recommend interest rate as appropriate target variable, while the monetarists prescribe money supply. Practical central bankers, on the other side, consider bank credit as a better target variable.

THEORIES OF INTEREST RATES

The five theories of interest are as follows: 1. Productivity Theory 2. Abstinence or Waiting Theory 3. Austrian or Agio Theory 4. Classical or Real Theory 5. Loanable Fund Theory.

1. Productivity Theory:

According to productivity theory, interest can be defined as a reward for availing the services of capital for the production purpose.

Labor that is having good amount of capital produces more as compared to the labor who is not assisted by good amount of capital.

For example, farmer having tractor to plough the field produces more as compared to the farmer who does not have it. Thus, interest is the payment for the productivity of capital.

However, the productivity theory is criticized on the following grounds:

i. Focuses only on the causes for what the interest is paid, not on the determination of interest rates.

ii. Assumes that interest is paid due to the productivity of capital. In such a case, pure interest should vary as per the productivity of the capital. However, pure interest is the same in money market during the same period of time.

iii. Lays emphasis on the demand of interest, but ignores the supply side of capital.

iv. Fails to explain how the interest is paid for the loan borrowed for consumption purposes.

2. Abstinence or Waiting Theory:

The abstinence theory was propounded by Senior. According to him, interest is a reward for abstinence. When an individual saves money out of his/her income and lends it to other individual, he/she makes sacrifice. The term sacrifice implies that the individual refrains from consuming his/her whole income that he/she could spent easily. Senior advocated that abstaining from consumption is unpleasant. Therefore, the lender must be rewarded for this. Thus, as per Senior, interest can be regarded as the reward for refraining from the use of capital.

Abstinence theory was also criticized by a number of economists. According to the theory, an individual feels unpleasant when they save as it reduces his/her consumption. However, rich people do not feel unpleasant while saving because they are able to meet their requirements.

Therefore, Marshall has replaced the term abstinence with waiting and described saving in terms of waiting. He states that saving is done by transferring the present requirement to the future and the person needs to wait for meeting those requirements. However, people do not want to wait rather they are motivated to save money by providing a certain amount of interest.

3. Austrian or Agio Theory:

Austrian theory is also termed as psychological theory of interest. This theory was advocated by John Rae and Bohm Bawerk in an Austrian school. According to Austrian theory, interest came into existence because present goods are preferred over future goods. Therefore, the present goods have premium with them in the form of interest. In other words, present satisfaction is of greater concern as compared to future satisfaction.

Therefore, future satisfaction has certain type of discount if compared with present satisfaction. The interest is the discounted amount that is required to be paid for motivating people to invest or transfer their present requirements to future. For example, an individual has to make a choice between two options.

He/she can either have Rs. 500 now or the same amount after a year. In such a case, he/she would prefer to have Rs. 500 in present. However, in case, the individual has a choice of getting Rs. 500 in present and Rs. 600 after one year.

In such a case, he/she would be more inclined toward getting Rs. 600 after a year. Thus, the extra payment of Rs. 100 would compensate the sacrifice involved in delaying his/her present satisfaction. The extra payment of Rs. 100 in the given case is considered as interest.

Agio theory' has been criticized by various economists on the following grounds:
i. Lays too much emphasis on the supply aspect and ignores the demand aspect

ii. Does not focus on the determination of rate of interest

4. Classical or Real Theory:
Classical theory helps in the determination of rate of interest with the help of demand and supply forces. Demand refers to the demand of investment and supply refers to the supply of savings. According to this theory, rate of interest refers to the amount paid for saving

Therefore, the rate of interest can be determined with the help of demand for saving money to be invested in the capital goods and the supply of savings. Let us understand the concept of demand of investment. Capital goods are used for the production of consumer goods and provide returns continuously for many years.

However, a certain degree of uncertainty is associated with capital goods due to their future use. In addition, operation and maintenance costs are involved in using capital goods. This makes organizations to calculate the net expected return on the marginal cost that is represented as the percentage of cost of capital good.

In case, an organization has similar type of capital goods, then the increase in one more capital good would not yield them high revenue. The increase in the rate of interest would result in the fall of demand of capital goods.

STRUCTURE OF INTEREST RATE

The **term structure of interest rates** is the variation of the yield of bonds with similar risk profiles with the terms of those bonds. The **yield curve** is the relationship of the yield to maturity (YTM) of bonds to the time to maturity, or more accurately, to duration, which is sometimes referred to as the effective maturity. In most cases, bonds with longer maturities have higher yields. However, sometimes the yield curve becomes inverted, with short-term notes and bonds having higher yields than long-term bonds. Sometimes, the yield curve may even be flat, where the yield is the same regardless of the maturity. The actual shape of the yield curve depends on the supply and demand for specific bond terms, which, in turn, depends on economic conditions, fiscal policies, expected forward rates, inflation, foreign exchange rates, foreign capital inflows and outflows, credit ratings of the bonds, tax policies, and the current state of the economy. The yield curve changes because a component of the supply and demand for short-term, medium-term, and long-term bonds varies, to some extent, independently. For instance, when interest rates rise, the demand for short-term bonds increases faster than the demand for long-term bonds, which causes a flattening of the yield curve. Such was the case in 2006, when T-bills were paying the same high rate as 30-year Treasury bonds.

The term structure of interest rates has 3 characteristics:

1. The change in yields of different term bonds tends to move in the same direction.
2. The yields on short-term bonds are more volatile than long-term bonds.
3. The yields on long-term bonds tend to be higher than short-term bonds.

NOMINAL AND REAL INTEREST RATE- INFLATION RELATIONSHIP AND COMPUTATION.

The real interest rate is found by adjusting a standard interest rate so that the effects of inflation are not present. This allows you to understand the interest rate better by revealing the true yield of lenders and investors as well as the true cost of funds for borrowers.

In other words, it shows the true rate of loans and bonds. Calculating the real interest rate involves subtracting the rate of inflation (whether expected or actual) from the more straightforward nominal interest rate (described in more detail below). When the actual rate of inflation is not known, real interest rates are predictive.

The World Bank has a page containing the real interest rates for most countries.

Time-Preference Theory of Interest

The real interest rate is a representation of how much individuals favor current goods rather than goods in the future. If a borrower is choosing to use funds now they are prioritizing current goods above future goods, or showing a greater time-preference for current goods; they are thus prepared to take out a loan with a higher interest rate. Meanwhile, lenders who wait to spend funds until the future are demonstrating a lower time-preference and can loan at a lower rate of interest.

Real Interest Rate Formula

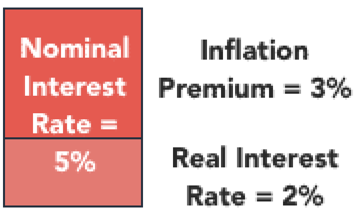
The basic formula is as follows:

Real Interest Rate (R) = Nominal Interest Rate (r) – Rate of Inflation (i)

The more precise and mathematical formula is:

$(1+ (R)) = (1+ (r)) / (1+ (i))$

This means that when the rate of inflation is zero, the real interest rate is equal to the nominal interest rate. With positive inflation, the nominal interest rate is higher than the real interest rate. Effectively, the real interest rate is the nominal interest adjusted for the rate of inflation. It allows consumers and investors to make better decisions about their loans and investments.



Example: If the rate of inflation is at 3%, and the real interest rate is 2%, then the nominal interest rate would be 5%.

Rate of Inflation

Since calculating the real interest rate requires you to know the rate of inflation, it's important to understand this as well. The rate of inflation describes how much the cost of goods/services will increase in a particular year.

Here is the formula for calculating the rate of inflation:

$$\text{Rate of Inflation} = \frac{\left(CPI_{x+1} - CPI_x\right)}{CPI_x}$$

Source: https://www.wallstreetmojo.com/rate-of-inflation-formula/

CPIX refers to the "initial consumer price index," meaning the previous year's consumer price index.

Difference Between the Real & the Nominal Interest Rate

The difference between the real and nominal interest rate is that the real interest rate is approximately equal to the nominal interest rate minus the expected rate of inflation. The nominal interest rate in the interest rate before inflation has been accounted for and removed from the number. Investors and lenders are typically concerned with real interest rates.

Nominal Interest Rate

The [nominal interest rate] is the simplest type of interest rate. It is the stated interest rate of a given bond or loan. The nominal interest rate is in the actual monetary price that borrowers pay to lenders to use their money. For instance, if the nominal rate on a loan is 5%, then borrowers can expect to pay $5 of interest for every $100 loaned to them. But the nominal interest rate doesn't take inflation into account.

Real Interest Rate

To continue the example, now imagine that the inflation rate was 5%. A 5% inflation rate means that an average basket of goods you purchased this year is 5% more expensive when compared to last year. Continuing with our previous example, the lender would make nothing if he loaned it out at 5% when the rate of inflation was 5%.

MONEY MARKET- INSTRUMENTS, UTILITY, ELIGIBILITY: CALL, NOTICE & TERM MONEY MARKET, COMMERCIAL BILLS, COMMERCIAL PAPER- COST COMPUTATION, CERTIFICATE OF DEPOSITS, T-BILLS ISSUE & YIELDCOMPUTATION

What is a Money Market?

The term 'Money Market', according to the Reserve Bank of India, is used to define a market where short-term financial assets are traded. These assets are a near substitute for money and they aid in the money exchange carried out in the primary and secondary market. So, essentially, the money market is an apparatus which facilitates the lending and borrowing of short-term funds, which are usually for a duration of under a year. Short maturity period and high liquidity are two characteristic features of the instruments which are traded in the money market. Institutions like commercial banks, non-banking finance corporations (NBFCs) and acceptance houses are the components which make up the money market.

The money market is a part of the larger financial market and consists of numerous smaller sub-markets like bill market, acceptance market, call money market, etc. Money market deals are not carried out in money / cash, but other instruments like trade bills, government papers, promissory notes, etc. Also, money market transactions cannot be done via brokers but have to be carried out via mediums like formal documentation, oral or written communication.

Some Important Objectives Served By a Money Market

The money market serves several objectives in the overall economy. Listed below are some important objectives:

- The money market doesn't only help in the storage of short-term surplus funds but also helps in lowering short term deficits.
- They help the central bank in regulating liquidity in the economy.
- Money markets help short-term fund users to fulfill their needs at reasonable costs.
- The money market helps in the development of the capital market, trade and industry.
- To help design effective monetary policies.
- To facilitate streamlined functioning of commercial banks.

What Are Money Market Instruments?

As the name suggests, Money Market Instruments are simply the instruments or tools which can help one operate in the money market. These instruments serve a dual purpose of not only allowing borrowers meet their short-term requirements but also provide easy liquidity to lenders. Some of the common money market instruments include Banker's Acceptance, Treasury Bills, Repurchase Agreements, Certificate of Deposits and Commercial Papers.

Characteristics of Money Market Instruments

Money market instruments allow governments, financial organizations and businesses to finance their short-term cash requirements. Some of the notable characteristics of money market instruments are as follows.

- **Liquidity** – Money market instruments are highly liquid because they are fixed-income securities which carry short maturity periods of a year or less.
- **Safety** – Issuers of money market instruments have strong credit ratings, which automatically means that the money instruments issued by them will also be safe.
- **Discount Pricing** – Another important characteristic feature of money market instruments is that they are issued at a discount on their face value.

Financial Market # 1. Treasury Bills Market:

A Treasury bill is promissory note or a finance bill arising without any genuine transaction in goods. It is a claim against the government and does not require any ‘grading’, ‘endorsement’ or ‘acceptance’. It is highly liquid because it is guaranteed for repayment by the government.

The Treasury bill rate is fixed from time-to-time by the Reserve Bank of India (RBI). The rate of discount of the treasury bills sold by the RBI is the lowest in the country. It is deliberately kept at a low rate, and even when determined by market forces, its level is very low. The reason for this is ‘high safety’ ‘low risk’ and ‘short-term maturity’.

In India, treasury bills are of two types — ‘ordinary’ and ‘ad-hoc’. The ordinary treasury bills are issued to the public and the RBI to enable the government to meet its requirement for short-term finance. Ad hoc treasury bills, popularly known as ‘ad-hocs’ are created in favour of the Reserve Bank of India. Both types of treasury bills have a maturity of 91 days.

The ad-hoc bills serve the government in two ways. They replenish government cash balances. The finance raised through these bills is used by the Central Government as an advance by the RBI to State Governments.

Secondly, this helps the government by providing a medium for investing temporary surpluses of state governments, semi- government departments and foreign central banks. To some extent, this is able to eliminate undesirable fluctuation in this document rate which might occur if state governments competed with regular investors in treasury bills issued to the public.

The Treasury bill market is limited in India. Although its participants are the Reserve Bank of India, Commercial Banks, State Governments and the financial institutions like Life Insurance Corporation and Unit Trust of India, the market is not as active as in the UK. In the UK, banks actively engage in treasury market and sell bills to discount houses for settling inter-bank indebtedness and government payments and receipts.

Discount houses hold treasury bills because they can offer security for obtaining call loans from banks. They also conduct business dealings in treasury bills with foreign banks overseas and with clients who hold treasury bills.

In London, the treasury bills are treated as liquid. The banks have the facility to buy treasury bills from discount houses when a part of the maturity has elapsed, i.e., after the discount houses have held the bills for four to five weeks. In India, the bills do not have as much liquidity or facility. The banks have to buy treasury bills on their account and once they buy them, they have to hold it up to the maturity period.

Also, the low rate of return on investment in treasury bills dissuades banks to operate in them. The effect of non-liquidity and low interest rate is seen in the undeveloped state of the Treasury bill market. In India, an additional facility has been made available.

The banks have been offered rediscounting facilities with the Central Bank but the market has not picked up because the banks do not enjoy dealing with a formal government agency and would prefer a non-official financial agency like a discount house in London to look after their requirements. This market continues to be small and underdeveloped in India.

Chakravarty and Vaghul committee recommendations have brought about changes in the market. Yields have become more attractive and new the ad-hoc Treasury bills have been discontinued and the RBI continues to play an important role in the Treasury bill market. There are at present 14 days, 91 days, 182 days and 364 days Treasury bills.

The new Treasury bills introduced in 1997 were of 14 days duration. With the introduction of the auction system, the interest rates of Treasury bills are determined by the market. With all its limitations, the Treasury bill market is attractive because of the absence of the risk of default and high liquidity.

Financial Market # 2. Call Money Market:

The Call Money Market deals in loans which have very short maturity and are highly liquid. The loans are payable on demand, at the option of either the tender or the borrower and the maturity period varies from one day to fourteen days.

Call money markets are located in India in major industrial towns where important stock exchanges are located. They are located in Mumbai, Kolkata, Chennai, Delhi and Ahmedabad. The markets in Mumbai and Kolkata are most significant. While in UK and USA there are separate call money markets, in India they are associated with the pressure of the stock exchange.

The call loans in India are given:

1. To the bill market;

2. For inter-bank uses;

3. For dealing in stock exchanges and bullion markets; and

4. Individuals for trade purposes to save interest on cash credits and overdrafts.

Out of the four uses mentioned here, the inter-bank uses have been most significant for call money market. Call loans in India are unsecured and extremely useful because of inter-bank uses, banks borrow from other banks in order to meet a sudden demand for funds, large payments, large remittances and to maintain cash or liquidity with the Reserve Bank of India.

In India, commercial banks, both scheduled and unscheduled, foreign banks, state, district, urban and co-operative banks use the facility offered by the call market. The financial institutions such as LIC, GIC, and UTI also participate in the call market by giving loans to banks. The Development Banks such as IDBI, ICICI, IFC also indirectly participate in the call market.

Since 1970, brokerage has been prohibited by the RBI on operations in the call market. The call market has a special feature regarding interest on short-term loan. This loan varies from day-to-day and sometimes from hour to hour and centre to centre. It is very sensitive to changes in demand and supply of call loans. It has been lowest in Mumbai and highest in Kolkata in the past years.

The entry of term lending institutions in the call market has also changes the complexion of the system. It has to some extent regulated the working of the short-term market. It has also made available a huge reservoir of funds hitherto invested in long-term funds only. This has helped the call money market to grow.

The Call Money Market in India is, to a great extent, controlled through the Reserve Bank operations. When the RBI follows a restrictive monetary policy, the call market becomes very active and there is a scramble for funds.

If the RBI follows a liberal policy, the banks stop borrowing from the call market. In this way, the call money market functions in India and reflects variations in its requirements through 'dull' and 'active' borrowing scenario.

The call money market where money was borrowed for a very short period had a ceiling rate of 10% rate of interest. From May 1, 1989, the Reserve Bank of India has withdrawn ceiling rates on inter-bank money, participation certificates and on rediscounting of commercial bills.

The commercial banks were also given the option of getting short- term funds through the new instruments called Certificate of Deposits (CD). Another instrument called the inter- participation was introduced for improving short-term liquidity with the banking system.

The Reserve Bank further decided to set up an Apex body for improvement in the monetary system. This organization was to be called the Discount and Finance House of India. The RBI would set this up jointly with public sector bankers and financial institutions.

Another important dimension in this direction was the liberalization of the credit policy of banks. Banks were to rename credit authorization scheme and to call it 'credit monitoring arrangements'. All proposals exceeding 5 crores could be sanctioned by the banks and the RBI's sanction to such working capital requirements should be only a post sanction security.

From November, 1988, RBI has permitted the transfer of customer's account from one bank to another without any questions. Transfer of accounts was made possible without any objections from the existing bank. The transferee bank had to take over both the liabilities as well as responsibilities existing in the present bank.

The call and short money market was liberalized to the extent of allowing the private sector companies to issue commercial paper with competitive interest rates for a period of three to six months. Companies would be allowed to issue commercial paper if it got a rating from Credit Rating and Information Services of India Limited. The bank finance could not exceed 250 million rupees.

There have been many developments in the money market since 1991. Existing money market instruments have been changed. New instruments have been adopted and the money market has increased liquidity.

In 1997, the Narsimham committee recommended the reforms in the call money market for its development. The call money market became an inter-bank market with primary dealers and the repo market was developed.

Primary and satellite dealers have been appointed within prudential norms to improve the lending and borrowing situation in the market. The banks and primary dealers were permitted to lend and borrow whereas other participants could only be lenders in the market. From 2002, primary dealers can lend in the call money market up to 25% of their net owned assets.

This reform was made in a phased manner between 1999 and 2005.

Financial Market # 3. Commercial Bills Market:

In India, there are many kinds of bills in the Commercial Bills Market. A bill of exchange, according to the Indian Negotiable Instruments Act, 1881, is a 'self-liquidating' paper and negotiable. It can change hands during its currency and has legal safeguards. The bills of exchange are generally for short-term accommodation and vary in maturity from three to six months.

Bills may be classified as:

i. Demand and Usance bills:

A bill in which no time of payments is specified in the demand bill, it is payable immediately at sight. Usance or time bill refers to the time period recognized by custom or usage for payments of bills.

ii. D/A and DIP Bills:

A D/A bill becomes a clean bill after delivery of the documents. In a D/P (documents against payments) bill, documents of title will be held by the banker, once the bill has been accepted by the drawee, till the maturity of the bill of exchange.

iii. Inland and foreign bills:

Inland bills are drawn and payable in India upon a person resident in India. Foreign bills are drawn outside India; they may be payable in India or outside India or drawn upon a person resident in India.

iv. Hundis:

'Hundis' are the purely Indian method of trade bills used to raise or remit money or finance inland trade by indigenous bankers in the country. The 'hundis' are known by various names such as 'Shahjog', 'Namjog', 'Dekharnarjog', 'Fermainjog', 'Jokhani', 'Dhanijog', and 'Darshani'.

v. Accommodation Bills:

In India, there are other bills of exchange in evidence which are not genuine bills. These are called accommodation and supply bills. Such a bill is also called 'kite' or 'wind-mill'. In this bill, there is no genuine transaction but a person accepts the bill to help the other person to meet his financial obligations.

Such a bill is prepared because government payments are low and the supplier needs funds. Government does not accept a bill which is not accompanied by the documents of title to goods but bank advances can be easily received through accommodation bills.

The concept of bill of exchange has been the availability of funds as soon as a sale has been executed. The buyer accepts a bill and promises to pay at a later date, but the seller can ensure payment immediately by discounting the bill or, in other words, getting the release of the payment by paying a small amount of money to the bank called the 'Discount Rate'.

On the maturity date, the banker claims the amount on the bill from the person accepting the bill.

In India, the bill market is under-developed. It is neither established nor widespread. The banks usually accept bills for the conversion of cash credits of overdrafts of their customers. These are, therefore, bills which are not genuine.

Sometimes banks give loans on the security of bills. Unfortunately, there is no practice of re-discounting of bills between banks who need funds and those who have excess funds. In 1974, the Reserve Bank of India took the step of involving financial institutions like LIC, UTI, GIC and ICICI for re-discounting genuine bills of commercial banks. Yet, Bill Financing has not been a significant source of short-term finance in India.

The Bill Market rates in India are the same as those prevailing in the short-term market. However, there are two type of rates — 'prevailing in the organized and unorganized sector'. The RBI publishes the discount rate prevailing with the State Bank of India. The 'Bazar' Bill rate differs from location to location depending on the requirement of finance.

In India, apart from the short-term bills market, there is a long-term bills market also. This was introduced in 1965 by the IDBI under the bills Re-discounting Scheme. These bills have their creation through the sale of machinery on deferred payment basis.

This bill enables the manufactures of machinery to get the value of machinery sold immediately. Banks and other eligible financial institutions discount these bills or re-discount them from banks and other institutions. The maturity of these bills is up to 5 years. Sometimes they are extended to 7 years.

The IDBI fixes rates of discounting according to period of maturity. IDBI has been able to organize the long-term bill finance better than the prevailing short-term bill finance in India.

Also, the long-term bill finance made available by IDBI is cheaper than short-term bill finance. Government has tried to enlarge the bill market since 1991. There have been additions in the form of foreign bills but not Indian bills. Hence, the market continues to be small.

Financial Market # 4. Market for Financial Guarantees:

Guarantee is a contract to discharge the liability of a third party in case of default. Creditors secure their advance against various types of tangible securities. In addition, they also ask guarantees from borrowers. It can be called a security demanded by the creditor.

Usually, the borrower finds a person himself to guarantee his acts. The purpose of seeking guarantee is to minimize the risk of default. The guarantor should undoubtedly be known to both parties to be a person of repute and a person who has the means to discharge his liability. Guarantee can both written or oral and single or joint.

Guarantees may be:

(a) ‘Specific’ or ‘continuing’. Specific guarantee covers only one particular transaction. Continuing guarantee covers a series of transactions,

(b) Guarantees may also be ‘unsecured’ or ‘secured’ with tangible asset.

(c) Explicit or Implicit. An implicit guarantee arises out of the special nature of the guarantee and explicit guarantees are properly spelled out.

(d) Another category of guarantees are ‘performance’ and ‘financial’ guarantees.

Performance guarantees cover payment of earnest money, retention money, penalty charges, advance payments and non-completion of contracts. Financial guarantees consist of financial contracts only.

In India, guarantee contracts consists of:

(i) Deferred payments for imported and indigenous capital goods,

(ii) Medium and long-term loans raised abroad,

(iii) Credit advanced by banks and other institutions. In India, there are generally financial guarantees of varying maturity periods.

The market for financial guarantees is well organized in India. There are various suppliers of guarantee. Personal Guarantee is the oldest form of guarantee service but the institutional market for financial guarantees is also well developed in India.

There are specialized guarantee institutions who guarantee payments but the maximum period for guarantee is 15 years. Central and State Government also provide guarantees. Commercial Banks guarantee funds and they are accepted in contracts.

Insurance Companies and other statutory companies also undertake to make guarantees but there is no specialized private institution providing guarantee service in the credit market in India. A large number of guarantees issued by insurance companies is given to banks or financial institutions like IDBI, ICICI, IFC who give guarantees to creditors, suppliers or contractors.

The IDBI guarantees deferred payments due from industrial public market or from scheduled banks.

The ICICI guarantees loans from other private investment sources. The SFC's guarantee loans raised by industrial concerns and are repayable up to 20 years. They issue secured guarantees.

State Industrial Corporation extends guarantees for loans and deferred payments for industrial concerns. National Small Industries Corporation guarantees loans from banks to Small Industrial Units. Government has also set up certain specialized agencies with the central objectives of providing guarantees.

These are:

(a) Credit Guarantee Organization (CGO) which is a part of RBI and guarantees loans from lending institutions to the small-scale industrial units,

(b) The Export Credit Guarantee Corporation (ECGC) was set up in 1964 to offer financial protection to the exporters, especially in their relationship with bankers. ECGC provides packing credit, post- shipment export credit guarantee, export production and export finance guarantee,

(c) Deposit Insurance and Credit Guarantee Corporation (DICGC). This was started in 1971 as a public limited company.

It operated three schemes:

(i) Small Loans Guarantee Scheme,

(ii) Financial Corporation Guarantee Scheme, and

(iii) Service Co-operative Societies Guarantee Scheme.

In 1981 government integrated Credit Guarantee Organization and Deposit Insurance and Credit Guarantee Corporation under one organization, namely the Deposit Insurance and Credit Guarantee Corporation for greater flexibility. Thus, the guarantee market is well organized in India.

The DICGC provides loans to traders in the retail sector, professionals, farmers, Joint Hindu families and association of persons. The loans are guaranteed for a maturity period of 15 years. It charges a guarantee fee of 1.5% per annum. Thus, the guarantee market is well organized in India.

Financial Market # 5. Mortgages Market:

A mortgage loan is a loan against the security of immovable property like land and buildings. Mortgages are well secured and have low credit risk but the degree of security depends on whether it is the first charge or second charge on mortgage.

In the first charge, the mortgage transfers his interest in a given piece of property to the mortgage concerned and no one else. When the property has already been mortgaged once to another creditor, it is known as second mortgage. When the mortgagee transfers his interest by way of mortgage, it is called sub-mortgage. Mortgage loans maturity period varies from 15 years to 25 years.

The market for mortgages can be arbitrarily divided into:

(a) Primary Market,

(b) Secondary Market.

Primary market consists of original extension of credit and secondary markets have sales and re-sales of existing mortgages at prevailing. In India, market for residential mortgages is significant. The two major institutions providing mortgage loans for purchase of houses are Housing and Urban Development Corporation (HUDCO), and Life Insurance Corporation (LIC).

HUDCO finances residential projects located near commercial or industrial sites. It provided loans for co-operative housing societies also. The market for residential mortgages is quite inadequate although supported by institution in its present position in India.

The second form of mortgages is land mortgages both in rural and urban areas. The land development banks provide cheap mortgage loans for development of land including purchasing of equipment like tractors, machinery and pump-sets.

Land development banks obtain resources at concession rates from RBI and other institutions and also get subsidies from government but land development banks also face inadequate resources and cannot always help in conditions of shortages.

As a part of the mortgage market it may be mentioned that the land development banks issue debentures which are secured by mortgages of land by borrowers and are often guaranteed by State Governments in respect of payment of interest and principal.

These debentures are treated as trustee securities and are on par with government securities for making advances. They are transferable and can be used as security against borrowings.

The agriculture debenture market is fully dependent on institutional investors like LIC and commercial banks to purchase these debentures so that individual savings can be channelled through this market. Funds in this market are also derived through direct and indirect budgeting support.

Rural debentures are being floated since 1957. Special Development Debentures have become the major source of development loans during 1970. This discussion now brings forth some aspects of the Foreign Exchange Market.

Financial Market # 6. Foreign Exchange Market:

The Foreign Exchange Market is not a place where people 'meet' each other for transacting business. People who wish to indulge in foreign exchange dealings have to get an informal acceptance in the code evolved for the working of the market. In India, the foreign exchange business is controlled and regulated by the Reserve Bank of India.

It has a three- tier structure consisting of foreign business:

(a) Trading between banks and their commercial customers,

(b) Between banks through brokers, and

(c) Business with banks abroad.

Banks, individuals and institutions wanting to deal in foreign exchange have to receive formal authority from the RBI. Those engaged in foreign exchange business are also bound by Foreign Exchange Regulations Act (FERA).

Under this Act, those banks dealing in these securities get their formal authorisation through licences. Only banks in the Second Schedule of Reserve Bank of India Act, 1934, were eligible to apply for these licences.

Banks receiving these licences are called Authorised Dealers or (Ads). They are allowed to run foreign exchange business under FERA and are supposed to help in the smooth flow of foreign currency and try to stop any misuse of foreign currency.

(a) Inter-bank dealings go on between Ads, exchange brokers and central bank. Inter-bank dealings in India take place in Kolkata, Mumbai and Chennai.

(b) Brokers play a significant role in the foreign exchange market of India. They are licensed brokers under the (FEBAI) or Foreign Exchange Brokers Association of India. Brokers serve as a link between the banks. All Ads dealings except those with RBI take place through the brokers. The brokers get a small percentage of brokerage fees,

(c) Business with banks abroad is also a part of Foreign Exchange Market. Ads open branches in the overseas market to carry out business abroad.

Apart from ADs, the RBI also licences hotels and other individuals as AMCs or Authorized Money Changers.

The money changers are categorized as:
(i) Full-fledged money changers, and

(ii) Restricted money changers.

The restricted money changers can purchase only foreign currency notes, coins and travellers' cheques whereas the former category has a right to both purchase and sale to the public. Foreign capital in India has acquired an enlarged role since 1991.

The new areas of foreign capital flow are direct foreign investment, non-resident Indian investments, Foreign Institutional investments, Euro Issues and off-shore Mutual funds. A foreign investment promotion board has been set up for automatic approvals to proposals.

RBI has relaxed its rules for approval. It gives automatic approvals to trading houses for foreign investment if the company is registered as an export house. Major incentives are given to foreign collaborations in the area of power generation and promotion of agriculture. Non-Resident Indians (NRIs) have been given many relaxation facilities for promotion of business in India.

Foreign Institutional Investment has an important role to play in India. In 1994, there were 165 foreign investment institutions in India. These are pension funds, investment trusts, asset management companies and portfolio managers.

Indian companies also raised funds through further relaxations by government. They floated bonds and equities in the Euro capital markets. The new instruments floated in the stock market to raise equity are the American depository receipts, Global depository receipts and European depository receipts.

The Sadhani committee report was made on foreign exchange market reforms in India in 1995. In 1997, the Tarapore committee report was made on ‘capital account convertibility’ and the Rangarajan committee report was prepared on ‘balance or payments’ to make reforms and changes in the foreign exchange market for a liberal foreign exchange market.

These reforms were expected to make trading simple and to increase the volume of transactions.

In 2005, the RBI constituted an internal technical group for further flexibility in foreign exchange transactions and freedom for carrying on business transactions.

Reforms were instituted for commercial banks for increasing trading volumes. The reforms towards commercial banks were to provide them with more freedom in foreign exchange dealings. Banks were permitted to extend their closing time in the foreign exchange market from 4 P.M. to 5 P.M.

They are permitted to provide capital on actual overnight open exchange positions which was maintained by them rather than on their open position limits. The technical group also recommended that besides the popular US dollar, Pound sterling, Euro and Japanese yen foreign exchange non-resident deposits should also be accepted in Canadian dollars, Australian dollars and New-Zealand dollars.

The non-resident entities were allowed re-booking and cancellations of forward contracts booked by residents. They were permitted to hedge in international exchanges. Another reform was to raise the ceiling on investments made by Indians abroad. The Authorized Dealers were permitted to have foreign currency account of offices setup by foreign companies in India with any approval from the RBI.

Foreign capital has also come into India through trust companies which raise funds for investments in Indian securities. The first off-shore fund was floated by the UTI in collaboration with Merrill Lynch International better known as India Fund; Morgan Stanley floated Indian Magnum Fund and India Investment Fund.

CanBank floated the Himalayan fund in collaboration with Indo-Suez Investment Management Asia. SBI Mutual Fund floated Asian convertibles. Jardinal Flemming floated the India Pacific Fund. Many more funds were also floated. These are Bombay Fund, India Opportunities Fund, India Liberalization Fund, Lloyd George India Fund. Let us now view the government gilt-edged secure these market.

Financial Market # 7. Government (Gilt-Edged) Securities Market:

The Government Securities Market in India is an integral part of the Stock Exchange. Apart from the government securities, the stock exchange also deals in industrial securities for which it is better known. In India, there are many kinds of government securities.

These are issued by the Central Government, State Government and Semi-Government authorities including City Corporation Municipalities, Port Trusts, Improvement Trusts, State Electricity Boards, Metropolitan Authorities and Public Sector Corporations.

The development banks and agencies are also engaged in the issue of these securities. Included in this category are the IDBI, IFCI, SFCs, SIDCs, ARC, LDBs and Housing Boards.

The Government Securities Market consists of various kinds of participating institutions. Apart from the major contributions of the government agencies who are issuing securities, there are other participants also. They support the issuing institutions.

These are:

(a) The banking sector. They include RBI, SBI, commercial banks and co-operative banks,

(b) LIC,

(c) Provident Funds,

(d) Other special financial institutions,

(e) Joint stock companies,

(f) Local authorities,

(g) Trusts, and

(h) Individuals, resident and non-resident.

The most active participation in the government securities market is of the banking and corporate sector. They purchase and sell large quantities of government securities. Apart from these two sectors, government selling is extremely limited.

LIC, UTI and other special financial institutions are rarely active in this market. The reason for this is the special kind of policy formation of these organizations. They prefer to hold securities till maturity rather than sell them at an earlier date to make profit. For these reasons, the government securities secondary market is quite dull. Whatever limited dealings are held is confined to Mumbai Stock Exchange.

The role of brokers in marketing government securities is also limited. In fact, there is no individual dealer especially for the purpose of government securities. Broker's firms dealing in other securities also include government selling as a part of their function in the stock market.

The brokers receive 'over the counter' orders from their customers locally. They have to negotiate each purchase and sale separately. Anyone who purchases government securities from brokers holds it till maturity. The broker thus acts like a mere jobber. He, however, keeps in contact with RBI, LIC and other institutional investors.

Government securities are issued in denominations of Rs. 100. Interest is payable half-yearly and it is exempted from income tax up to Rs. 3,000 and wealth tax up to Rs. 1, 50,000. Financial institutions and commercial banks maintain their secondary reserve requirements in the form of these securities.

Against collateral of these securities, commercial banks obtain accommodation from the Reserve Bank of India. Since it is the most secure financial instrument guaranteed by government, it is called a 'Gift-edged Security' or 'near gold', or 'ultimate liquidity'.

The government securities are in many forms.

These are:

(a) Stock Certificates (SC) or inscribed stock,

(b) Promissory notes,

(c) Bearer Bonds which are now discounted. Promissory Notes of any loan can be converted into stock certificates of any other loan or vice versa.

These are, therefore, most popular. Government issues are sold through the RBI's Public Debt Office (PDO) while Treasury Bills are sold through auctions. The method of selling government securities is through notification before the date of subscription.

Subscription is kept open for two or three days. RBI makes an announcement after which it suspends the sale of existing loans till the closure of subscriptions to new loans. Government can retain up to 10% in excess of notified amounts.

Applications are received by the RBI and in States by the State Bank Over-subscription to loans of one State are transferable to another State Government whose loan is still open subscription at the option of the subscriber.

Government securities obtained through subscription, help the exchequer to obtain inexpensive finance. The RBI being the Central Bank of the country is able to fix interest rates on government borrowing and selling and able to influence the behaviour of prices and yields in the gilt-edged market.

Thus, RBI can execute its interest rate policy through changes in the bank rate and control the advances policy and liquidity of commercial banks. The government gilt-edged securities market is, therefore, considered important from the point of view of monetary management. There are many reforms in the government securities market.

The Fiscal Responsibility and Budget Management Act 2003 was passed. This Act proposed to separate debt management and monetary operations within the RBI. The open market operation of the RBI would become its focus and it would withdraw its participation from the primary issues of the government securities.

In 2005, a technical group on securities market made several recommendations.

These were:

(a) Primary dealers would be allowed to underwrite hundred per cent of each government auction both in the whole-sale and retail segment

(b) RBI would be permitted to participate in the secondary market for improving liquidity in government securities.

(c)There would be an effective transparency through monitoring and surveillance through the negotiated dealing system.

As a part of the reform process, the government securities would be on a negotiated dealing system which is an electronic order matching trading module for government securities. All orders would be matched on price and time priority and trade would be settled through the Clearing Corporation of India.

The Securities Trading Corporation of India was set up with all India financial institutions and RBI for developing and supporting the secondary market for government securities.

Two way quotes were introduced through Primary Dealers. Retail trading of government securities was started in select stock markets. Private sector mutual funds, finance companies and individuals were permitted to participate in the government securities market.

Financial Market # 8. Industrial Securities Market:

The Industrial Securities Market consists of two complementary parts, i.e., the New Issue Market (NIM) and the Stock Exchange. The New Issue Market deals with those securities which are issued to the public for the first time.

The stock exchange is a place for secondary sale of securities. These are securities which have already passed through the NIM and are quoted in the stock exchange, thus providing continuous and regular market for buying and selling of securities in India.

Industrial Securities:

The most important component of the Industrial Securities Market comprising the New Issue and Stock Exchange market are the 'Industrial Securities' themselves. This is the physical or tangible asset through which the market functions.

The three types of securities through which the corporate sector raises their capital are

(a) Equity Shares or Ordinary Shares or Common Stock,

(b) Preference Shares, and

(c) Debenture or Bonds.

Equity Shares or Ordinary Shares:

These are also called variable securities. From the point of view of the company, it is advantageous to issue these securities as payment of dividend is not mandatory. The investors' view is that this is the best type of investment as the shareholdings can be converted into cash. Further, the investor also participates in the earnings and wealth of the company.

Preference Shares:

These are called fixed interest bearing securities of several types. The preference shareholders are entitled to claims before ordinary shareholders but after fulfilment of creditors' shares.

The operating preference shares are:

(a) Cumulative and non-cumulative. Most Indian preference shares have a fixed dividend with cumulative rights,

(b) Redeemable and irredeemable. Redeemable preference shares with varying maturity periods are the usual form of shares issued in India.

(c) Participating and non-participating. Participating shares are not issued in India. In India, preference shares are not very popular.

Debentures or Bonds:

In India, debentures derived importance only since 1970. There are various kinds of debentures in the market.

These are:

(a) Registered,

(b) Bearer,

(c) Redeemable,

(d) Perpetual,

(e) Convertible, and

(f) Right.

In India, the pattern of debentures quoted in the stock exchange show that the prevalent ones are redeemable and convertible debentures. Normally, the face value of a debenture is Rs. 100. In India, the convertible debentures have become significant.

These debentures can be converted into ordinary shares at the option of the shareholders after a certain number of years. Right debentures are also being issued but generally financial institutions and trusts purchase these debentures.

The bond market in India is not well developed but the bonds issued by public sector financial institutions were quite popular with the public. Since 1985, public sector institutions have been encouraged to borrow directly from the public. This had led to the issue of bonds by mutual funds and financial institutions.

In recent years, the Bonds issued by IDBI have received overwhelming support of the public and have been oversubscribed. Banks issue infrastructure bonds for giving tax relief to people. These have a great response in the month of March every year.

New Issue Market:

The New Issue Market according to Henderson has three important functions. These are: Origination, Underwriting and Distribution.* The NIM facilitates the capital market to raise long-term funds for industry. New issues are further classified as 'initial' issues and 'further' issues.

Initial issues are capital issues offered for the first time by a new company. Initial capital can be raised only through equity or preference shares. When existing companies raise issues, it is called 'further' capital. Such organizations can raise debentures.

There are various methods of issuing fresh capital. They are issue through prospectus, offer for sale, private placement, stock market placing, and rights issues. In India, almost 80% of the issues are through prospectus.

SEBI has introduced many reforms for regulating pre issue and post issue activities in the New Issue Market. It has also tried to bring in reforms to protect the interest of the investors.

It has tried to regulate the dealings on the stock exchange. Some of the reforms consist of free pricing and book building method of floating shares, Code of conduct and regulations for merchant bankers, underwriting made non-compulsory, allotment of shares within 30 days of subscription.

The Stock Market:

In India, there are 24 recognized Stock Exchanges but the National Stock Exchange and Mumbai Stock Exchange are the two active stock markets. The regional stock markets found it difficult to survive with the entry of NSE in 1994.

Most of them have become the institutional members of the NSE and BSE by setting up subsidiaries of their own. Members of such stock markets can do business both in NSE and BSE as well as their regional stock market. Some of the large stock markets in India are discussed below:

The main objectives of the stock market are to provide ready marketability, liquidity, negotiability, control of dealings and protection of interest to investors. In the Stock Exchanges, only listed securities are allowed to be traded. Listed securities are 'cleared' and 'non-cleared'. To get listing, arrangements have to be made by observing certain rules.

These are:

(a) Memorandum of association should be filed with SEBI,

(b) Public subscription should be offered through prospectus,

(c) Prospectus should conform to the rules,

(d) Allotment of shares must be fair and unconditional, and

(e) Listing agreement must be executed.

Securities after listing can be branded as cleared securities only if they comply with certain requirements. They will be put on the clearing list if they are fully paid up equity shares, of non-banking companies, being traded in the stock exchange for at least three years and should not be on the cleared list of any other stock exchange. The shares have to be registered with SEBI and listing has to be approved by it.

The Securities Exchange Board of India (SEBI) has been established as a statutory autonomous body protects the interest of the investors and develop and regulate the securities market. Trading in the stock market can be by ready delivery or through a future date.

Derivatives have been introduced This implies buying or selling of certain goods at some future date on which date the transaction is to be settled. Derivatives in India are through shares, commodities and foreign exchange.

Financial Market # 9. Commodity Markets:

In India, there are three national level commodity exchange markets. These are National Commodity and Derivatives Exchange of India Ltd. (NCDEX), Multi Commodity Exchange of India (MCX), and National Multi Commodity Exchange of India Ltd. (NMCEIL). These exchanges deal with commodity derivative trading like gold, silver, mettles, wheat and rice. In India, only futures trading is performed.

Commodity futures are used by agricultural producers and industrial raw material users to hedge price risks. The participants who purchase commodity futures try to lock a future fixed price to hedge against future price rise. The sellers of commodity futures try to lock a price which can be realized against delivery and the future date.

India was known for its commodity derivatives in agricultural products, raw materials and precious metals up to 1960. However, government banned commodity futures trading in mid-sixties and it only got established in India after liberalization.

In 2003, national level commodity exchanges were instituted to offer trade in commodity futures. 78 commodities were allowed to trade in futures. The potential of the commodity market in India is approximately three times higher than the equity markets. It is expected that commodity trade would help in contributing to India's GDP.

Future settlements can be either through cash settlement or a physical delivery. They are used for hedging to reduce a particular risk. The classic hedging example is of the price of wheat by a farmer when his produce is ready for harvesting.

When he sells his crop for a future date, he locks his price at a predetermined price. A short hedge requires a short position in a futures market. This is possible when a hedger owns an asset or is likely to own it and expects to sell it at some time in the near future.

A cotton grower is a good example when he sells his cotton crop even before it is ready for sale, on the expectation that it will be ready in the next two months. Another example is of people who receive foreign currency in payments after four months.

If he makes a futures deal and the value of the foreign currency increases, he will gain. If the value of the currency declines, he will make a loss. A long position taken in a future markets is called a long hedge. Many companies take a long hedge when they expect to purchase a certain assets in future and are interested in locking the price at present.

A commodity futures market is often considered to be speculative. Commodities are bulky products and the costs and procedures of handling them are expensive. Therefore, it is difficult to stock them but they can speculate on the price of underlying commodities.

In a competitive market, it is possible to indulge in the arbitrage activity by simultaneously buying and selling the same commodity in two different markets for advantage of different prices and thus hedging favorably.

In India, there has been a high rate of inflation since January 2008. The Abhijit Sen Committee was appointed to study the commodities market to find out if it had any relationship with inflation. Although the committee did not find a correlation, futures in soya have been suspended.

The RBI has tried to control traders who have taken speculative positions in overseas markets. Trade has also been suspended in chana (Gram), potato and rubber. Investors and trader have to square of their positions in May 2008 in India.

COMPETITIVE BIDDING, NON-COMPETITIVE BIDDING

T- bills are issued through bidding wherein the competitive bidders are primary dealers, financial institutions, mutual funds, and banks. Besides these, individuals, corporate bodies, institutions, and trusts have been allowed to bid in government securities. Bids can also be routed through both banks and primary dealers. Non Competitive bids are conducted to encourage participants who do not have sufficient expertise in bidding. The non-competitive bidders are state governments, municipalities, non-government provident funds, and other central banks. Non competitive bids are kept outside the notified amount so that the non competitive bidders do not face any uncertainty in purchasing the desired amount. Non competitive bidders are issued T- bills at the weighted average price determined in auction.

The uniform price auction method is in use for selling T- bills. In such an auction, all successful bidders pay a uniform price, which is usually the cut off price.

There exists a fixed calendar for auctions of all types of treasury bills and the auction is announced in advance through a public notification.

Government dated Securities:

The Government of India securities are medium to long term obligations by the Reserve bank on behalf of the government to finance the latter's deficit and public sector development program.

Government securities are predominantly coupon bearing and the coupon is paid semi annually on a 30 / 360 days basis. However, there are floating rate or zero coupon securities also. No TDS is applicable. All government securities are SLR eligible. The central government securities are eligible for ready forward (Repo) facility, whereas state loans are not eligible for repos. These securities are highly liquid.

Primary Market Issuance of Government Securities:
Government securities are issued either (a) auction (b) sale, or (c) private placement with the Reserve Bank.

Auction: Auction is a form of allocative mechanism where by commodities and financial assets are allocated to individuals and forms, particularly in a market oriented economy. The government's preference for the auction system for selling securities stems from the ability of auctions to reveal more information about price determination and improve the allocation process. Auctions are designed to generate higher volumes for meeting the target market requirement without recourse to underwriting and / or devolvement, broaden participation to ensure that bids are not concentrated or skewed and ensure efficiency through lowering the cost of borrowing for the government.

In June 1992, the government switched from the fixed price tender offer to the auction system for sale of government securities. The government, as a part of its annual budget exercise, announces the borrowing program for the financial year. The Reserve bank, acting in the capacity of merchant banker for the government's borrowing program raises money on behalf of the government by auctioning securities from time to time depending on the government's need for money, interest rates, and liquidity in the banking system.

The primary market for government securities starts wit an auction. A brief outline of the auction process is given below:

1) The Reserve bank announces the quantum, maturity and date of the auction
2) On the day of the auction, all the participants submit their bid to the Reserve bank. The bid includes the quantum and the yield at which they are biding.
3) The Reserves bank decides the cut off yield on the basis of the competitive bids it has received and its own view of the interest rates.
4) Once the cut off yield is decided, bids below the cut off yield are accepted and bids above the cut off yield are rejected.
5) If the amount for which the bids are received falls short of the total quantum for which the auction is conducted, the Reserve bank devolves the shortfall on itself or on the primary dealers (to the extent of their underwriting commitments).
6) The cut off yield becomes the coupon rate of that particular security.
7) Lately, in order to promote liquidity in a particular security and to reduce the number of different government securities, the Reserve bank has started issuing further tranches of existing securities in price based auction. Since the coupon rate and the maturity of the security are decided earlier, the bids are for the price. The auction procedure remains the same except that the bids higher than the cut-off price are accepted. Successful bidders are those that bid at a higher price, exhausting the accepted amount at the cut off price. This multiple price auctions are predominantly used in selling government securities. Since 1999-2000, most of the current primary issues of dated securities are through reissues and price based auctions, instead of yield based auctions to enable the consolidation of securities. Such consolidation is necessary is necessary for ensuring sufficient volumes and liquidity in any one issue, to facilitate emergence of benchmarks, and development of Separately Traded Registered Interest and Principal of Securities. The uniform price auction format for auctions, which was confined to the auction of 91 day treasury bills, was extended to the auction of dated securities in November 2001. The government securities auction held on April 4, 2002, was also based on uniform price auction.

The government auctioned for the first time on July 17, 2002, a bond with call and put features. The notified amount was Rs 3,000 core and the bond had a maturity of 10 years. On any coupon date on or after five years, the government can call the bond with two months notice. The investor also has the right to put the bond on the same terms

REPO

Definition: Repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds. Repo rate is used by monetary authorities to control inflation.

Description: In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. This ultimately reduces the money supply in the economy and thus helps in arresting inflation.

The central bank takes the contrary position in the event of a fall in inflationary pressures. Repo and reverse repo rates form a part of the liquidity adjustment facility

MODULE 3-FINANCIAL MARKET-II

- Equities Market-
- Primary Markets –
- SEBI Norms (ICDR Regulations),
- Angel / VC Investing Stages, Growth Of Companies, Next Stage Of Funding (Expansion & Flourishing Stage Thru PE Investing),
- Exit Routes,
- Intro For Public Issues, Types Of Issues,
- Appointing Merchant Bankers & Other Intermediaries, Their Role & Responsibilities,
- Filing DRHP & Types Of Prospectus, Book Building Mechanism,
- Types Of Investors, ASBA. –
- Secondary Markets- Purpose & Procedures For Listing (Post-IPO);
- SEBI Framework;
- Role Of Stock Exchanges-NSE,BSE*,
- Role Of Secondary Market Intermediaries, Depositories.
- Overview Of Bond Market And Recent Developments.

EQUITIES MARKET

Every market is a meeting point of **buyers and sellers.** Markets are all about transactions. Somebody buys, somebody sells. In the **equity market**, trading keeps on happening at an incredible speed. Investors are able to deal in shares in a fraction of a second. Every day, thousands of crores worth of equities are transacted in the equity market in India. If you are new to markets, you should gain some knowledge before you venture into the equity market. Plus, there are different types of equity market and so you know about them as well. In the following sections, you will know about 12 important things related to Indian equity market. Read on.

What Is Equity Market ?

Equity market is a place where stocks and shares of companies are traded. The equities that are traded in an equity market are either over the counter or at stock exchanges. Often called as stock market or share market, an equity market allows sellers and buyers to deal in equity or shares in the same platform.

First things first, it is important to begin with a good understanding of what is equity market in the Indian context. Equity market, often called as **stock market** or **share market**, is a place where shares of companies or entities are traded. The market allows **sellers and buyers** to deal in equity or shares in the same platform.

In the global context, equities are traded either over the counter or at stock exchanges. There are multiple buyers and sellers of the same equity/share. Hence, you stand a good chance to strike a nice deal at the **equity market**. If you want to begin online equity trading in India, you have to get a demat account. **Open a demat account in simple steps**.

How Is Equity Market In India ?

Equities are mostly traded on the stock exchanges in India. In the Indian stock market, equities are available for trading at the **National Stock Exchange (NSE)** , the **Bombay Stock Exchange (BSE)** and the latest entrant, Metropolitan Stock Exchange of India (MSE). Shares of stock market listed companies are bought/sold.

Equity share trading is roughly in two forms - **spot/cash market** and **futures market**. These are the different types of equity market in India. The spot market or cash market is a public financial market in which stocks are traded for immediate delivery. The futures market is a place where the shares' delivery is due at a later date. With the help of an equity trading account, a **trustworthy broker like Nirmal Bang and online equity trading systems**, investors can utilize the **indian equity market..**

What is 'Growth' in Equity Market ?

Shares/stocks traded in the equity market belong to companies that show growth. Investors typically invest in 'growth' stocks, which belong to small companies showing potential for high growth rates. The **growth stocks** are those where investors are ready to make big bids in the **live equity market**, be it in India or global equity market. With the help of online equity trading, investors aim to accumulate growth stocks today so that they can them off after incredibly low prices.

[How Do Equity Markets Work ?]

The concept behind how the stock market works is simple. Think of an auction house where buyers and sellers negotiate prices and make trades. Now, substitute the auction house and items with **equity market** and shares. **Companies list their shares on an exchange.** Investors can buy shares in the primary market i.e. **IPOs, and secondary market.**

The stock market is regulated by a financial watchdog. The equity market is maintained by stock exchanges, and various stakeholders like brokers, dealers, clearing corporations etc. It is an extended family of institutions and this is the true equity market meaning.

What Are the Timings of Equity Market ?

There is no 24 hour stock trading system yet. The normal trading time for equity market is between 9:15 am to 03:30 pm, Monday to Friday. On Saturday and Sunday, trading does not happen unless there are special circumstances.

What Are Equity Trading Holidays ?

Apart from weekends and non-business days, trading does not stop. You can check equity **trading holidays 2019** on NSE or BSE website.

What Is Difference Between Stock And Equity ?

There is virtually no difference between stock and equity. These two words are commonly used to mean shares. Stock and equity are just synonyms. **Equity share trading** is done via **online equity trading systems**.

What Is Equity in NSE ?

Equity in NSE refers to **stock market.** The securities market has two segments, the new issues (primary) market and the stock (secondary) market. Currently more than 1300 securities or stocks are available for trading on the NSE.

The stock exchange's automated screen based trading allows investors across the length and breadth of India to trade and invest. The NSE trading system is called 'National Exchange for

Automated Trading' (NEAT). The equity space in NSE comprises of cash/spot trading and also trading in equity derivatives.

How Can I Trade In Equity ?

To trade in equity share market, you will need to have the proper tools - **open a demat and trading account**, have funds to buy stocks and a good broker platform to execute the trades. Thanks to technological advancements, you can do online equity trading, at your home, office or even while on the move.

To begin trading, you need to select the right stocks. Follow the **live equity market** to some worthy stock ideas and do some **research**. This will help you fine-tune equity market growth & **investment strategies**.

How To Do Online Equity Trading ?

Today, carrying out online equity trading in India is an easy process. Every user with an online account has a user/customer ID and password. These credentials will help you do equity share trading on the equity market live.

Do always remember that brokers take professional-grade IT security, thus ensuring high quality online equity trading that is completely safe. Here is a step by step process. Don't forget to open a **free demat account** to begin investing.

- Login to the **online broker platform.**
- Enter the ID and password to access your account.
- Your customized page opens and thus the opportunity to trade is open. Ensure you access the online platform during market/trading hours.
- Select the stock to trade and buy/sell them on the stock exchange at your preferred rate. Once the order goes through, your trade is completed.
- In the evening, you will get an SMS notification of the trade order specifics, along with confirmation of the ledger balance.

What Are The Things To Know Before You Trade In Equity ?

The equity share market, be it the equity market in india or asian equity market, is full of traders and investors wanting to make a profitable deal. It can sometimes be a lot of information to process. Also, there are different types of equity market. Hence, it is always good to have some ground rules before you trade in equity.

- Never go against the sentiment of the equity market today - The trend is your friend. Unless you are 100% sure, do not try to take totally contrarian bets. When you go against the tide, the risk factor increases.
- Buy low, sell high - You should try to buy stocks that are trading at historically low prices and cheap valuations. When you buy such stocks, you can gain when the equity makes the next up move.
- Think long term - In the short term, nobody can predict what the equity market live will see next. So, it's important to have a long term view on trades that you do.
- **Know-how about intraday trading** - Before you jump into the stock market bandwagon by listening to random tips, it would be better to know how to do intraday trading for better results with your trades and investments.
- A Rs 1000 stock is not expensive and a Rs 5 stock is not cheap - Some investors approach equity investing in the same way they buy clothes or vegetables. They seem to think if a stock is priced at Rs 1000 is it costly than a stock that is Rs 100. Use valuations to understand exactly what is cheap and what is expensive.

What Are the Pros & Cons of Trading In Equity Market?

There are advantages and disadvantages to trading equity market. The outcome of any situation is dependent on the way we behave. Let us look at the benefits first.

Pros of Equity Market	
Great wealth	The biggest benefit of the equity market is the opportunity to make huge profit. Many investors have experienced big returns that can never be given by any other financial

Pros of Equity Market	
creation	investment.
Enter and exit easily	In case of equity market, you can easily enter and exit a stock. This should be compared to when you want to sell a house, where you cannot sell it on your own will always.
Lower taxes	When an equity is sold for profit after holding for more than 1 year, the profit attracts 10% tax. In case of fixed deposits, the tax rate is as per the individual's tax rate i.e up to 30%.

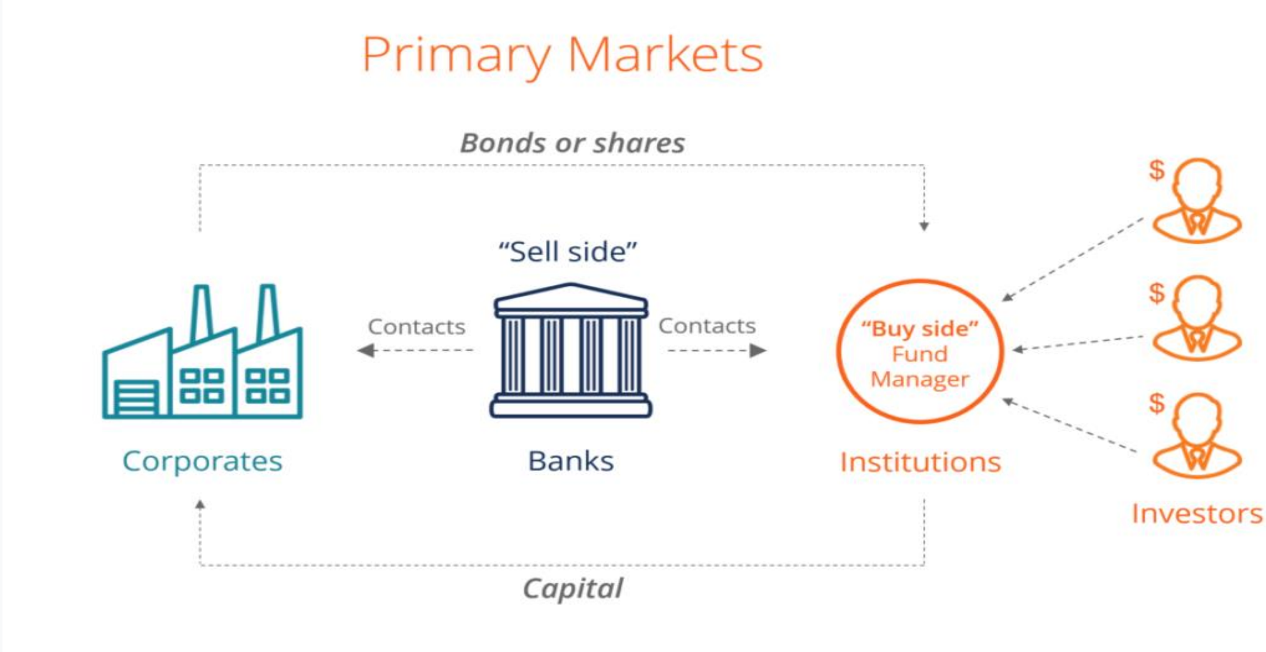
There are some downsides in equity trading too.

Cons of Equity Market	
Lack of understanding can be costly	If you do not properly do research or invest in bad stocks, your chances of making losses are high in a equity market live type situation. So, be careful.
Equity market can be volatile	Equity investment return does not move in a straight line. There are upswings and downswings in the live equity market.
There is risk of capital erosion	Equity share trading involves a chance of capital erosion.

PRIMARY MARKET & SECONDARY MARKET

What is the Primary Market?

The primary market is the financial market where new securities are issued and become available for trading by individuals and institutions. The trading activities of the capital markets are separated into the primary market and secondary market.



The primary market is where companies issue a new security, not previously traded on any exchange. A company offers securities to the general public to raise funds to finance its long-term goals. The primary market may also be called the **New Issue Market (NIM).** In the primary market, securities are directly issued by companies to investors. Securities are issued either by an Initial Public Offer (IPO) or a Further Public Offer (FPO).

An IPO is the process through which a company offers equity to investors and becomes a publicly-traded company. Through an IPO, the company is able to raise funds and investors are able to invest in a company for the first time. Similarly, an FPO is a process by which already listed companies offer fresh equity in the company. Companies use FPOs to raise additional funds from the general public.

Raising Funds from the Primary Market

Below are some of the ways in which companies raise funds from the primary market:

1. Public Issue

This is the most common way to issue securities to the general public. Through an IPO, the company is able to raise funds. The securities are listed on a stock exchange for trading purposes.

2. Rights Issue

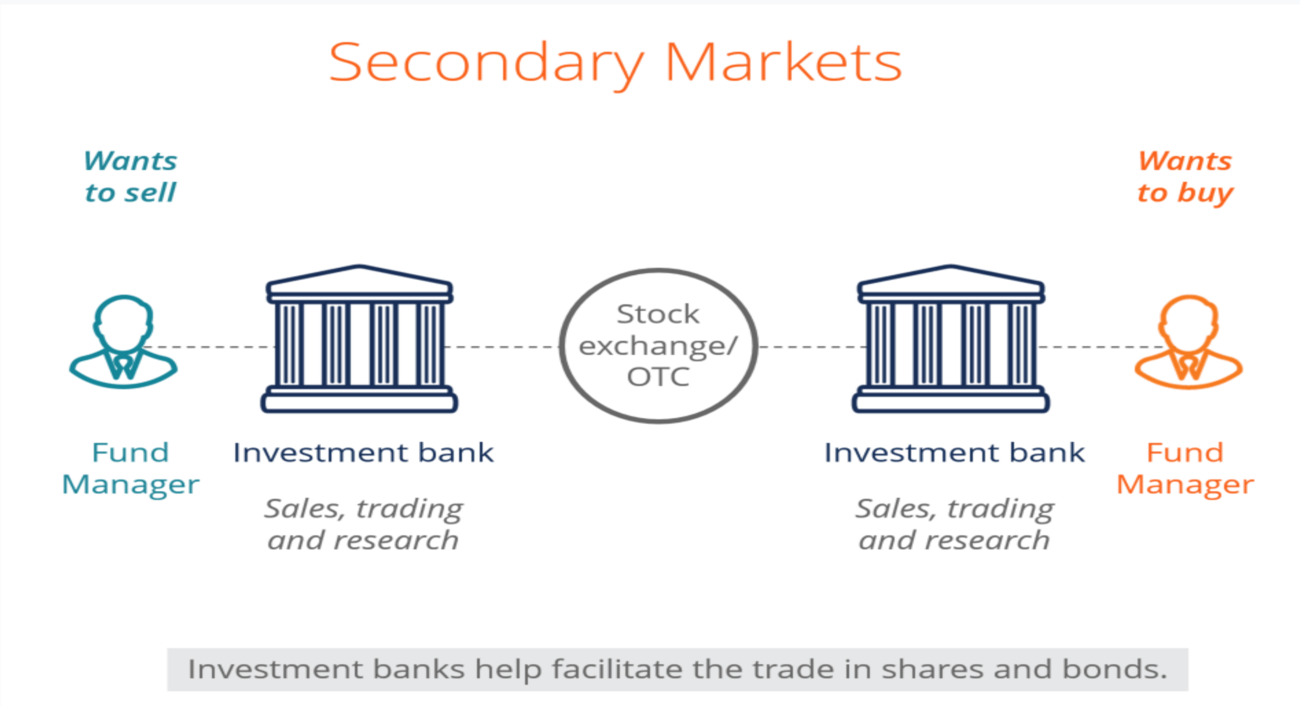
When a company wants to raise more capital from existing shareholders, it may offer the shareholders more shares at a price discounted from the prevailing market price. The number of shares offered is on a pro-rata basis. This process is known as a Rights Issue.

3. Preferential Allotment

When a listed company issues shares to a few individuals at a price that may or may not be related to the market price, it is termed a preferential allotment. The company decides the basis of allotment and it is not dependent on any mechanism such as pro-rata or anything else.

Secondary Market

The secondary market is where existing shares, debentures, bonds, etc. are traded among investors. Securities that are offered first in the primary market are thereafter traded on the secondary market. The trade is carried out between a buyer and a seller, with the stock exchange facilitating the transaction. In this process, the issuing company is not involved in the sale of their securities.



Primary Market vs. Secondary Market

Primary Market	Secondary Market
It is a way of issuing fresh shares in the market. It is also called New Issue Market. A major component of the primary market is the IPO.	It is a place where already issued or existing shares are traded. It is called After Issue Market.

Primary Market	Secondary Market
The amount received from the issue of shares goes to the company for their business expansion purposes.	The amount invested by the buyer of shares goes to the seller, and hence the company doesn't receive anything.
Securities are issued by the companies to the investors.	Securities are exchanged between buyers and sellers, and stock exchanges facilitates the trade.
The securities are all issued at one price for all investors participating in the offering.	Securities are exchanged at the market price.
The primary market doesn't provide liquidity for the stock.	The secondary market provides liquidity to the stock.
Underwriters act as intermediaries.	Brokers act as intermediaries.
On the primary market, security can be sold just once.	On the secondary market, securities can be sold innumerable times.

SEBI NORMS-ICDR(Issue Of Capital & Disclosere Requirement) REGULATION

SEBI Guidelines | Fresh capital Share | Primary & secondary markets

SEBI advises certain guidelines in issue of fresh share capital, first issue by new companies in Primary Market and functioning of secondary markets in order to maintain quality standards. A few such guidelines and objectives of the Securities and Exchange Board of India (SEBI) are discussed here.

SEBI Guidelines for issue of fresh share capital

1. All applications should be submitted to SEBI in the prescribed form.

2. Applications should be accompanied by true copies of industrial license.

3. Cost of the project should be furnished with scheme of finance.

4. Company should have the shares issued to the public and listed in one or more recognized stock exchanges.

5. Where the issue of equity share capital involves offer for subscription by the public for the first time, the value of equity capital, subscribed capital privately held by promoters, and their friends shall be not less than 15% of the total issued equity capital.

6. An equity-preference ratio of 3:1 is allowed.

7. Capital cost of the projects should be as per the standard set with a reasonable debt-equity ratio.
8. New company cannot issue shares at a premium. The dividend on preference shares should be within the prescribed list.

9. All the details of the underwriting agreement.
10. Allotment of shares to NRIs is not allowed without the approval of RBI.

11. Details of any firm allotment in favor of any financial institutions.

12. Declaration by secretary or director of the company.

SEBI Guidelines for first issue by new companies in Primary Market:

1. A new company which has not completed 12 months of commercial operations will not be allowed to issue shares at a premium.

2. If an existing company with a 5-year track record of consistent profitability, is promoting a new company, then it is allowed to price its issue.

3. A draft of the prospectus has to be given to the SEBI before public issue.

4. The shares of the new companies have to be listed either with OTCEI or any other stock exchange.

SEBI guidelines for Secondary market

1. All the companies entering the capital market should give a statement regarding fund utilization of previous issue.

2. Brokers are to satisfy capital adequacy norms so that the member firms maintain adequate capital in relation to outstanding positions.

3. The stock exchange authorities have to alter their bye-laws with regard to capital adequacy norms.

4. All the brokers should submit with SEBI their audited accounts.

5. The brokers must also disclose clearly the transaction price of securities and the commission earned by them. This will bring transparency and accountability for the brokers.

6. The brokers should issue within 24 hours of the transaction contract notes to the clients.

7. The brokers must clearly mention their accounts details of funds belonging to clients and that of their own.

8. Margin money on certain securities has to be paid by claims so that speculative investments are prevented.
9. Market makers are introduced for certain scrips by which brokers become responsible for the supply and demand of the securities and the price of the securities is maintained.

10. A broker cannot underwrite more than 5% of the public issue.

11. All transactions in the market must be reported within 24 hours to SEBI.

12. The brokers of Bombay and Calcutta must have a capital adequacy of Rs. 5 lakhs and for Delhi and Ahmadabad it is Rs. 2 lakhs.

13. Members who are brokers have to pay security deposit and this is fixed by SEBI.

ANGEL/VC INVESTING STAGES

- Angel Investors could be an individual or a group of individuals with similar objectives who invest small amounts (in lakhs) and start mentoring/incubating process over a period of time (may be 2 to 3 years) ready the business for the next big round of funding.
- E.g. Your parents, Your uncle, Your Education Institute

VENTURE CAPITAL INVESTOR

- VC companies are professional institutions that support the innovative projects and promising business ideas through raising funds from risk taking investors. They are the lifeline for entrepreneurs and start-up companies that struggle for funds.
- E.g. Google, Facebook, Ola cabs, Zoomin cabs, Android App, Café Caffee Day are examples of innovative businesses.
- E.g. ICICI Venture fund, UTI Venture funds management, Can bank Venture fund.
- E.g. SKS Micro finance, Just Dial, Bigbasket.com, Redbus.in, Flipkart.com funded by VC.

VC companies invest in risky businesses or projects which may be innovative where traditional banks or FI would have rejected

Angel Investing

- Typical wealthy individuals
- Invest their personal money
- Small amount (in lakhs)
- Will not be on the board of company
- Takes mentoring role
- working hard in initial stages

VC Investing

- VCs invest other investors' money
- Raise funds from risky investors
- Invest high amount (in crores)
- Involve in business by becoming board members
- Guide through taking decision
- Drives business for revenue & profit exits

A startup demands much more than just a great idea. It demands a lot of time, discipline, dedication, and most importantly, funding. A 2016 British Business Bank Survey highlights the fact that more than 60% of startups require external funding rounds in order to establish their ground firmly. Hence, without further ado, let's discuss the various startup funding stages that every entrepreneur should know.

Startup Funding Stages You Should Know About

1. Pre-Seed Funding: The bootstrapping stage
2. Seed Funding: Product development stage
3. Series A Funding: First round of VC
4. Series B Funding: Second round of VC
5. Series C Funding: Third round of VC
6. Series D Funding: Special round of funding
7. IPO: Stock market launch

The startup funding rounds have transformed the business landscape completely, over the past few years. Not long ago, the available startup fundraising options were few, but lately, we've experienced a surge for startup funding at different stages. As a budding startup owner, you must evaluate where your startup stands and how much funding can you raise from external sources.

Before we discuss ins and outs of each funding stage, here's an overview of major startup funding stages.

Now let's delve deeper into different stages of fundraising in a startup lifecycle.

1. The Pre-seed Funding Stage

This prime stage of seed funding falls so early that it's not even considered as a startup funding. The pre-seed funding stage generally refers to the time period in which a startup is getting their operations off the ground.

It's likely that investors won't make an investment in exchange for equity in the startup during the pre-series stage. This stage can last for a long time or you can get pre-series funding in quick time. It depends on the nature of your startup and the initial costs that you must consider while developing the business model.

The pre-seed funding stage is commonly known as bootstrapping. In simple terms, it means using your own existing resources in order to scale your startup. Startup owners invest from their own pocket and try to grow themselves in the most resourceful manner.

During the development stage of the startup, entrepreneurs may have to work overtime or get a second job so that they can invest their additional income into their new startup.

Let's learn about pre-seed funding from **Jonathan Mills Patrick** of Funding Simplified:

Adding to what Jonathan said, the pre-seed funding stage allows a budding startup to build and distribute their product(s) or service(s) effectively. In the research or development phase, the entrepreneurs tend to assess the viability of their idea. They might have a working prototype of their product and are in search of appropriate funding that allows them to scale their startup full-time.

During this stage, many entrepreneurs also seek guidance from founders who have been there and have gone through a similar experience as them. It allows them to determine the incurring costs of their idea or project, develop a winning business model, and garner ideas on how to grow their plan into an operating business.

Entrepreneurs should also work out any necessary partnership agreements, copyrights, or other legal issues during the pre-series stage as similar issues are best resolved during this stage. Later on, they might become expensive and even insurmountable. Also, no investor will provide funds to a startup having legal issues prior to their launch.

Potential Investors of Pre-Seed Stage

The most common pre-series investors are:

- Startup Owners
- Friends and Family
- Early Stage Venture Funds (Micro VCs)

"Ask people who know you already. Friends, past co-workers, family, etc. That is your best and almost only chance. Failing that ask people who are from the industry and have a lot of money. They might be able to recognize something at the pre-seed stage." said **Kamal Hassan**, Partner at Loyal VC.

Startup Valuation in Pre-Seed Stage

During the pre-seed funding stage, startups value anywhere between **$10,000** to **$100,000**.

Active Pre-Seed Stage Funds

- Seedcamp
- K9 Ventures
- First Round

2. Seed Funding Stage

After the pre-seeding stage, it's time to actually plant the seed. The first in the startup funding stages is "Seed funding". Almost 29 percent of startups fail because they run out of capital while bootstrapping, which makes seed capital critical to get a business up and running.

Entrepreneur turned investor, Mark Suster says: "The single biggest mistake founders make is waiting until they have too little cash in the bank before fund raising"

You can consider the seed funding stage as an analogy of planting a tree. Ideally, the initial funding is the "seed" which allows any startup to flourish. When you provide appropriate water i.e. a successful business strategy, alongside the dedication of the entrepreneur, the startup will eventually grow into a "tree".

Because the investors are taking a huge risk by investing in the business, startups must provide them equity against seed fundings. The stakes are even higher because, at this stage, startups cannot guarantee a successful business model.

Seed funding allows a startup to fund costs of product launch, get early traction through marketing, initiate important hiring and further market research for developing product-market-fit.

Many startups consider the seed funding round is all that is necessary to successfully get their startup off the ground.

Potential Investors of Seed Stage

The common types of investors who participate in seed funding are:

- Friends and Family
- Angel Investors
- Early Stage Venture Funds (Micro VCs)
- Crowdfunding

Startup Valuation & Fundraising in Seed Stage

Startups that are eligible for seed funding have a business that values anywhere between **$3 million** to **$6 million**. The seed funding stage will facilitate funding from **$50,000** up to **$3 million** for a promising startup.

Active Seed Stage Funds

- 500 Startups
- Y Combinator
- AngelPad
- Techstars
- Speedinvest

3. Series A Funding Stage

Series A stage is the first round of venture capital financing.

By now, the startup must have a developed product and a customer base with consistent revenue flow. Now it's time for them to opt for series A funding and optimize their value offerings. This is an ideal opportunity that allows startups to scale themselves across different markets.

In the Series A funding round, it's significant to have a plan that will generate long-term profits. Many times, startups come up with great ideas that can generate a substantial amount of enthusiastic users, however, they do not know how to monetize it in the long run.

This is the stage where you must start learning how fundraising works and start making early connections with angel investors and VCs. Following the 30-10-2 rule, you must identify investors who would want to invest in your startup. According to this rule, you must find **30 investors** who are willing to invest in your business. **10 out of those 30** investors might show interest in your proposal, **2 of which** will really pass on funds to you.

Mark Suster said, *"Meet your potential investors early. Tell them you're not raising money yet but that you will be in the next 6 months or so. Tell them you really like them so you want them to have an early view (which is what all investors want)."*

Series A funding mostly comes from angel investors and traditional venture capital firms. They are not looking for "great ideas", instead, they are looking for startups with a solid business strategy that can turn their great idea into a successful, money-making organization, allowing the investors to reap the benefits of their investment.

A single investor may serve as an "anchor" but once a startup has secured its first investor, it's easier to attract additional investors. Although angel investors prefer to invest during this stage, they tend to have much less influence than VC firms in this stage.

Potential Investors for Series A

- Accelerators
- Super Angel Investors
- Venture Capitalists

Company Valuation & Fundraising in Series A

Startups with a good business plan valuing up to **$10 million** to **$30 million** are able to raise approximately **$15 million** during the Series A funding stage.

Active Series A Investors

- IDG Capital
- New Enterprise Associates
- Plug and Play
- SOSV

4. Series B Funding Stage

Startups that go through the previous startup funding stages (seed funding and Series A) have already developed a substantial user base alongside a steady stream of revenue. They have proven themselves in front of their investors that they are can achieve success at a larger scale.

Investors assist startups to expand their horizons by funding their market reach activities, increasing their market share, form operational teams such as marketing, business development, and customer success. The series B funding stage allows startups to grow so that they can meet the various demands of their customers and also compete in tight markets in terms of competition.

Series B funding stage may appear to be similar to the former funding stage in terms of processes and key players, however, series B funding is often led by same characters, including a key anchor investor that helps you to attract other investors. The major difference is the addition of a new wave of VCs that specialize in investing in well-established startups so that they can further exceed expectations.

"The dilemma is that while your Series A investors were extremely important to you during that round, they may not be the investors you need going forward. If you are in a position where going public is a real possibility, then you need the crossover investors who will be there for you today and when you go public," suggests Praveen Tipirneni, MD & CEO of Morphic Therapeutic Inc.

Potential Investors for Series B

- Venture Capitalists
- Late stage VCs

Company Valuation & Fundraising in Series B

Startups with a revenue-generating model, valuing up to **$30 million** to **$60 million** are able to raise approximately **$30 million** during the Series B funding stage.

Active Series B Investors

- Khosla Ventures
- GV
- StartX (Stanford-StartX Fund)

5. Series C Funding Stage

Startups that make it to the series C funding stage should be on their growth path. These startups search for more funding that could help them build new products, reach new markets, even acquire other under-performing startups of the similar industry.

In the series C funding stage, investors happily fund successful startups. They are hopeful to receive a profit that is more than the money they invest. The Series C funding stage focuses on scaling the startup as rapidly as possible.

To scale your startup significantly, you can acquire different startups with the Series C funding. By now, your startup operations have become less risky whereas more investors are coming in to play. Many hedge funds, investment banks, private equity firms etc. will happily invest in your startup during the Series C stage.

The reason behind this is that the startup has already proven itself to be an operating success. New investors join the game by investing a significant amount of money into thriving startups to secure their own position as leading investors.

Do remember that startups that engage in Series C Funding are well-established, hold a strong customer base, have procured stable revenue streams alongside proven histories of their growth, and want to expand their operations on a global scale. If you haven't accomplished any of the above, then you're not ready for the Series C funding yet.

"Now is a better time than ever for emerging businesses to apply for the funding they need to accelerate their growth," said Marz Ayyad, EMEA Lead at NetSuite PE & VC Practice.

Potential Investors for Series C

- Late stage VCs
- Private Equity Firms
- Hedge Funds
- Banks

Company Valuation & Fundraising in Series C

Startups with a good business growth valuing up to **$100 million** to **$120 million** are able to raise approximately **$50 million** during the Series C funding stage.

6. Series D Funding Stage and Beyond

Not many startups find a need to go to this stage. The Series D funding stage allows entrepreneurs to raise funds for a special situation. For instance, a merger and also if it has not yet hit its growth goal.

A startup may consider series D funding if it hasn't gone public yet, but is contemplating a merger with a competitor on agreeable terms. The Series D funding offers startups the most viable solutions allowing them to negotiate issues head-on by acquiring another startup as a merger.

Also, If a startup was unable to achieve its growth landmark with series C funds, then it will find a need to get more funds through series D funding to keep afloat.

Potential Investors for Series D

- Late stage VCs
- Private Equity Firms
- Hedge Funds
- Banks

Company Valuation & Fundraising in Series D

Startups in this stage may value around **$150 million** to **$300 million** are able to raise approximately **$100 million** during this startup funding stage.

Active Series C & D Investors

- Accel
- Sequoia Capital
- Founders Fund
- Lightspeed Venture Partners

7. Initial Public Offering (IPO)

IPO is the process of offering corporate shares to the general public for the first time.

Growing startups that need funding often use this process to generate funds, whereas established organizations use it to allow startup owners to exit some or all of their ownership by selling the shares to the general public.

When a startup decides to go public, a specific set of events occur during the IPO process. They include:

- Formation of an external public offering team comprising of underwriters, lawyers, certified public accountants, and SEC experts.
- Compilation of the startup's Information including its financial performance as well as its expected future operations.
- Audit of the startup's financial statements takes place which generates an opinion about its public offering.
- The startup files its prospectus with the SEC and determines a specific date for going public.

Benefits of IPO

Raising funds for the startup is not the only benefit that entrepreneurs enjoy in case of a public offering. Some other advantages are:

- A public organization is able to generate additional funds through secondary offerings as it already has access to public markets.
- Many public organizations compensate executives through stock. The stocks of a public organization are more attractive to employees as the stocks can be sold easily. Also, being public allows an organization to recruit better talent as well.
- Mergers are easier for a public organization as it can utilize its public shares to acquire another startup.

In a nutshell

The various startup funding stages allow entrepreneurs to scale their startup at any stage of their entrepreneurial journey. This scaling practice allows them to identify where their startup stands and which potential investors would invest in them in order to help them grow.

Do remember that in order to gain funding, startups must be mature enough to qualify for a specific funding round. You can identify where your startup stands by its net worth.

Many startup owners retire once after they've gone public. Many amongst them also prefer becoming an angel investor themselves and invest their hard earned money into other startups. After all, they've certainly earned the right to relax and advise other entrepreneurs on how to grow their startup and make it profitable.

What Do Private Equity Investors Actually Do?

- PE investors invest into a business at the later stages/matured stage of a business.
- They invest in existing companies with existing products and proven cash-flows.
- They try to restructure the existing business by trying to optimize the performance.

- They even would be largely instrumental in transforming companies on the brink of bankruptcy into profitable enterprises.

There are four basic things private equity investors do to earn money.

1. **Raise money** from Limited Partners (LPs) like pension and retirement funds, endowments, insurance companies, and wealthy individuals
2. **Source, diligence, and close** deals to acquire companies
3. **Improve** operations, cut costs, and tighten management in their portfolio companies
4. **Sell** portfolio companies (i.e., exit them) at a profit

Raising Money

Private equity firms raise funds by getting **capital commitments** from external financial institutions (LPs). They also put up some of the their own capital to contribute into the fund (commonly 1-5% but it can be higher). The partners of the firm (the GP) might go on a **roadshow** themselves to raise the money (as did the partners at the firm I worked at) or they might use a **placement agent** (an outside fundraising team) to help them do a lot of the legwork.

LPs are usually required to **commit a significant amount** of capital in order to be allowed to participate in the fund, since the last thing the partners want is to be fielding “support” calls and communications to a “long tail” of many little investors who only commit a small amount but require a lot of hand-holding to service. The ideal fund to a PE firm would be comprised of a handful of LPs that each commit tens or hundreds of millions of dollars, or even billions of dollars, each. Huntsman Gay, the Bain Capital spinout that I worked at, had less than 10 LPs that each committed more than $100M.

If you’re a **high net worth individual**, the commitment thresholds might be a little lower than a normal LP, but they will likely still be in the millions in order to comply with federal securities laws that basically say you can only sell PE investments to rich people because they are the ones who actually probably know what they are doing.

But even though LPs make a capital commitment, they don’t give all the money to the GP all upfront. Instead, the GP begins to source and close deals, and as those deals need to be funded, they “**call capital**” from the LPs. LPs then have a very limited window (e.g., 2 weeks) to write a check to the GP so that the GP can fund and close the deal. So committed funds are called “**committed capital**” while disbursed funds are called “**contributed capital**.”

Many PE funds have something called “first close” vs. “final close.” **First close** basically means that when a certain threshold of money has been raised, the PE firm can begin making investments and actually closing deals and new LPs can still join in by committing capital for a limited time (e.g., 1 year from first close). **Final close** means that when a second threshold has been reach, new LPs can no longer join in on that particular fund.

Sourcing, diligencing, and closing deals

When PE firms analyze companies for potential acquisition, they will consider things like **what the company does** (their product or service and their strategy for it), the senior **management team** of the company, the **industry** the company is in, the company's **financial performance** in recent years, and the **valuation** and likely **exit scenarios** of the company.

Prospective deals come in to the firm through a combination of the **partners' reputation** (in which case companies themselves may reach out to the firm), investment professionals who proactively reach out to potential investment targets through their own networks or through **cold calls**, or through **investment banks** that may be representing a company and pitching it to investors through the issuance of bank books or confidential investment memorandums. When investment banks run a process, they often do it through an **auction** where several private equity firms bid for the company, and firms drop out along the way as their bids are either rejected or accepted to each successive "round" of bidding.

The best way to get deals is through **proprietary** means because that means the PE firm has an edge against other firms in acquiring the company, either through **personal relationships** or special knowledge or simply a head start. At Huntsman Gay, there were a few proprietary deals we looked at and closed, and those were definitely the ones we tried to move more quickly on, that didn't tend to get dragged out in a process, and that were more pleasant to close. To get good proprietary deal flow, the partners of the fund have to build and maintain strong relationships with key people in industry, advisers, and even bankers.

Once a potential deal has been sourced, then the investment team will conduct **heavy due diligence** to assess the company's strategy, business model, management team, the industry and market, the financials, the risk factors, and the exit potential. Diligence is typically conducted in stages that correspond to phases of the **bidding process**, where financial and operational information is progressively revealed to PE firms based on bidders that are still in the running at each phase. If the deal looks promising and no dealbreaker red flags are found, then the investment professionals will **present to the investment committee** (comprised of partners) for funding approval.

Final terms of the deal with be negotiated with lawyers on both sides, and the deal will transact, with funds being released and equity being traded.

Improving operations, cutting costs, and tightening management

One thing to be very clear on is that the GP does NOT run the portfolio companies on a **day to day basis**. They are not installing themselves as CEOs and COOs. Instead, they take **board seats**, they may or may not reshuffle **senior management** of the company, and they provide **advice, support, introductions**, etc, relating to operations, strategy, and financial management.

How involved the GP is really depends on how big their stake in the company is. If they only own a small minority stake, then they won't be very involved; rather, the lead investor owning the biggest stake will be most involved. However, if they own either a sizeable percentage of the equity or a significant portion of the entire fund is invested in the company, then they will be much more highly engaged in streamlining and improving the company for a profitable exit down the line.

The GP must also produce **official reports** for LPs, generally each quarter, on the progress and value of their portfolio companies, along with general financial updates, and LPs may use that information to mark their own portfolios to market when they report their results to their own investors.

Exiting portfolio companies

The end goal for PE firms is to **exit their portfolio companies** at a substantial profit. Typically, the exit occurs between **3-7 years after the original investment**, but it could be shorter or take longer depending on the strategic circumstances. The **main sources of value capture** at exit include: growing revenue (and therefore EBITDA) substantially during the holding period, cutting costs and optimizing working capital (and therefore increasing EBITDA), selling the company at a higher multiple than the original acquisition multiple, and paying down debt that was initially used to fund the transaction.

Most exits happen as the result of an IPO or acquisition by another firm, with acquisitions being the more common method. Returns are then measured by the "**internal rate of return**" (IRR) (which is the discount rate that makes the net present value from the entry date of all cash flows between entry and exit equal zero), or its quicker proxy the "**multiple of money**" (MoM) which is simply the amount of money returned divided by the amount invested for that particular investment.

Note that the IRR depends on the duration of the holding period while the MoM technically does not (although you will be judged by your investors how long it took to generate that MoM). So, for instance, if a $100M investment is sold for $200M just one year later, the MoM is 2x but the IRR is 100%; if it's sold after 3 years, the MoM is still 2x but the IRR has fallen to 26%; and it's sold 5 years later, the MoM is still 2x, but the IRR is 15%.

While partners do a lot of the coordination to sell the firm's portfolio companies, they may also retain investment banks to handle the execution, especially when the transactions are large or complex. That's how investment banks earn their fees — on selling the portfolio companies into PE firms and then again on selling them out to downstream acquirers.

- Companies eventual IPO (offer for sale) or
- offering their stake to the promoters through buy-back arrangement
- Strategic stake sale to another investors e.g. Private Equity Investors.
- Note: Today, VC invests not just in start-ups but they also invest in already existing companies those may or may not be listed on stock exchanges.

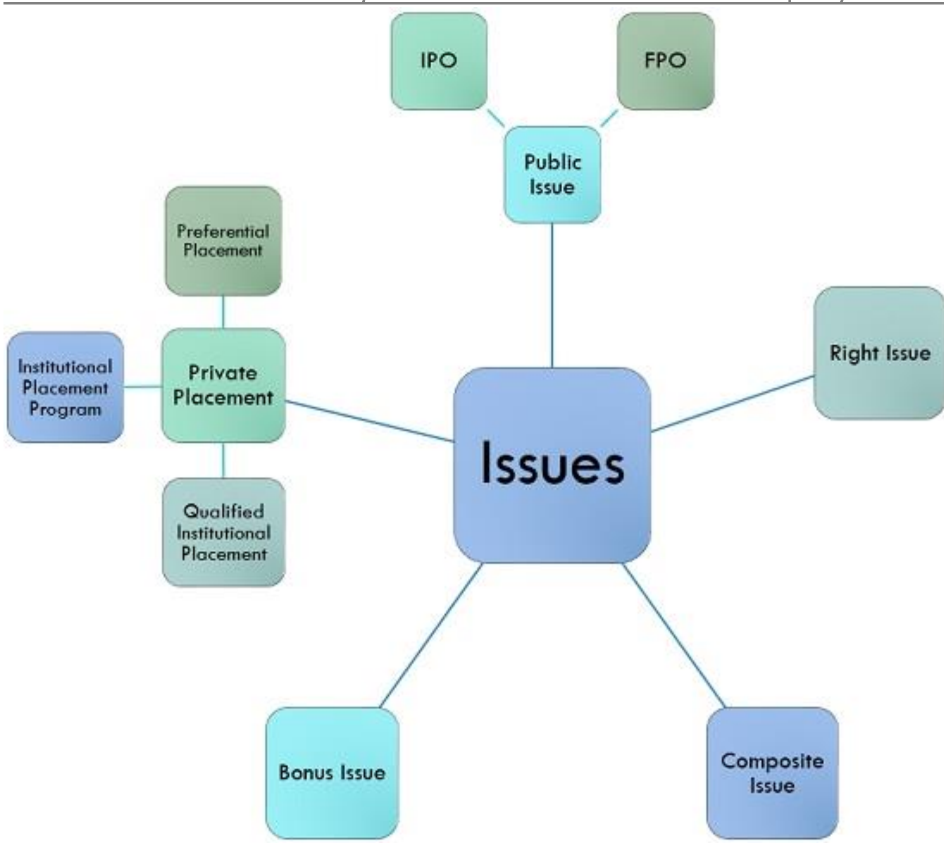
INTRO FOR PUBLIC ISSUES, TYPES OF ISSUES,

Types of Issue of Shares

Definition: A share is that smallest part, into which the overall capital of the company is divided. Issue of shares is a process through which the company allocates fresh shares to the new or existing shareholders. The issue of shares is made to both individuals, institutions or body corporates.

Types of Issue of Shares

There are a number of ways in which the shares of a company can be issued, as discussed below:



1. **Public Issue**: Public issue or public offering refers to the issue of shares or convertible securities in the primary market by the company's promoters, so as to attract new investors for a subscription.

In a public issue, the shares are offered for sale in order to raise capital from the general public, for which the company issues a prospectus. The investors who want to subscribe for the shares make an application to the company, which then allots shares to them. The entity which makes an issue is called an **Issuer**.

- **Initial Public Offer**: Otherwise called an IPO, as its name suggests it is the sale of company's shares to the public at large for the very first time. It is an offer in which an unlisted or privately held company makes a fresh issue of shares or convertible securities, or an already listed company makes an issue of existing shares or convertible securities, for the first time to the public at large.

  In this way the unlisted or budding company lists its shares in the recognized stock exchange and goes public, to raise funds for running the business. On the other hand, established entities make IPO facilitate owners to sell some or all of their ownership to the public.

- **Further Public Offer**: If an already listed company, which has gone through an IPO offers new or in better words, additional shares to the public for sale, so as to expand their equity base or pay off debts, it is known as Follow-on Public Offer or Further Public Offer (FPO)

2. **Right Issue**: In a right issue, shares or convertible securities are offered to the existing shareholders at a concessional rate, on a stipulated date, fixed by the company itself. The main aim of issuing right shares is to raise additional funds by offering shares to the existing equity shareholders, in the proportion of their holdings, rather than making a fresh issue.
3. **Composite Issue**: A composite issue is one in which an already listed company offers shares on the public-cum-rights basis and makes concurrent allotment of the shares.
4. **Bonus Issue**: As the name itself suggests, it is the free additional shares distributed to the current shareholders in the proportion of the fully paid-up equity shares held by them on a particular date. The issue of these shares is made out of the company's free reserves or securities premium account.
5. **Private Placement**: If a company offers shares to a selected group of investors which can be mutual funds, banks, insurance companies, pension funds and so forth, to raise capital, is called private placement.

- **Preferential Issue**: Preferential allotment is one in which a publicly listed enterprise allots shares to a selected group of investors such as individuals, venture capitalists, companies on preferential basis.
- **Qualified Institutional Placement (QIP)**: If a listed organization offers equity shares or non-convertible securities to a qualified institutional buyer for sale to raise capital. Here qualified institutional buyer includes mutual funds, venture capital fund, public financial institutions, insurance funds, scheduled commercial bank, pension funds, etc.
- **Institutional Placement Programme (IPP)**: If a publicly listed company makes a follow-on offer of equity shares or the promoters offers shares for sale, wherein the shares are allotted to the QIB's only, with the aim of achieving minimum public shareholding.

The company issues share in order to raise funds from the general public, so as to apply these funds in business operations. However, they can also be issued to serve other purposes also, as the money can be utilized in repaying debts, funding a new project, acquiring another company.

APPOINTING MERCHANT BANKERS & OTHER INTERMEDIARIES, THEIR ROLE & RESPONSIBILITIES

(1) The issuer shall appoint one or more merchant bankers, at least one of whom shall be a lead merchant banker and shall also appoint other intermediaries, in consultation with the lead merchant banker, to carry out the obligations relating to the issue.

(2) The issuer shall, in consultation with the lead merchant banker, appoint only those intermediaries which are registered with the Board.

(3) Where the issue is managed by more than one merchant banker, the rights, obligations and responsibilities, relating inter alia to disclosures, allotment, refund and underwriting obligations, if any, of each merchant banker shall be predetermined and disclosed in the offer document as specified in **Schedule I** :

Provided that where any of the merchant bankers is an associate of the issuer, it shall declare itself as a marketing lead manager and its role shall be limited to marketing of the issue.

(4) The lead merchant banker shall, only after independently assessing the capability of other intermediaries to carry out their obligations, advise the issuer on their appointment.

(5) The issuer shall enter into an agreement with the lead merchant banker in the format specified in **Schedule II** and with other intermediaries as required under the respective regulations applicable to the intermediary concerned:

Provided that such agreements may include such other clauses as the issuer and the intermediary may deem fit without diminishing or limiting in any way the liabilities and obligations of the merchant bankers, other intermediaries and the issuer under the Act, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1996 and the rules and regulations made thereunder or any statutory modification or statutory enactment thereof:

Provided further that in case of ASBA process, the issuer shall take cognisance of the deemed agreement of the issuer with Self Certified Syndicate Banks.

(6) An issuer shall, in case of an issue made through the book building process, appoint syndicate members and in the case of any other issue, appoint bankers to issue, at all mandatory collection centres as specified in **Schedule III** and such other collection centres as it may deem fit.

(7) The issuer shall appoint a registrar which has connectivity with all the depositories:
Provided that if issuer itself is a registrar to an issue registered with the Board, then another registrar to an issue shall be appointed as registrar to the issue:

Provided further that the lead merchant banker shall not act as a registrar to the issue in which it is also handling the post issue responsibilities.

Explanation: For the purpose of this regulation, in case of a book built issue, the lead merchant banker appointed by the issuer shall act as the lead book runner.

FILING DRHP & TYPES OF PROSPECTUS

Meaning of Prospectus of Company

"**prospectus of company**" means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate. A prospectus of company may issued by or behalf of a public company. It can issue either with reference to its formation or subsequently, or on behalf of any person who has engaged or interested in the formation of a public company.

Types of Prospectus

Advertisement of Prospectus

Where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein the contents of its memorandum as regards the objects, the liability of members and the amount of share capital of the company, and the names of the signatories to the memorandum and the number of shares subscribed for by them, and its capital structure.

Shelf Prospectus

(1) Any class or classes of companies, as the Securities and Exchange Board may provide by regulations in this behalf, may file a shelf prospectus with the Registrar at the stage of the first offer of securities included therein which shall indicate a period not exceeding one year as the period of validity of such prospectus which shall commence from the date of opening of the first offer of securities under that prospectus, and in respect of a second or subsequent offer of such securities issued during the period of validity of that prospectus, no further prospectus is required.

(2) A company filing a shelf prospectus shall be required to file an information memorandum containing all material facts relating to new charges created, changes in the financial position of the company as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer of securities and such other changes as may be prescribed, with the Registrar within the prescribed time, prior to the issue of a second or subsequent offer of securities under the shelf prospectus:

Provided that where a company or any other person has received applications for the allotment of securities along with advance payments of subscription before the making of any such change, the company or other person shall intimate the changes to such applicants and if they express a desire to withdraw their application, the company or other person shall refund all the monies received as subscription within fifteen days thereof.

(3) Where an information memorandum then filed, every time an offer of securities thus made under sub-section (2), such memorandum together with the shelf prospectus shall deemed as prospectus.

Explanation.—For the purposes of this section, the expression “shelf prospectus” means a prospectus in respect of which the securities or class of securities included therein hence issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

Red Herring Prospectus(Draft -RHP)

(1) A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.

(2) A company proposing to issue a red herring prospectus under sub-section (1) shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer.

(3) A red herring prospectus shall carry the same obligations as are applicable to a prospectus and any variation between the red herring prospectus and a prospectus shall thus highlighted as variations in the prospectus.

(4) Upon the closing of the offer of securities under this section, the prospectus stating therein the total capital raised, whether by way of debt or share capital, and the closing price of the securities and any other details as not included in the red herring prospectus shall then filed with the Registrar and the Securities and Exchange Board.

Explanation.—For the purposes of this section, the expression “red herring prospectus” means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

BOOK BINDING MECHANISM

Companies all over the world use either fixed pricing or book building as a mechanism to price their shares. Over the period of time, the fixed price mechanism has become obsolete and book building has become the de-facto mechanism used in pricing shares while conducting an initial public offer (IPO). In this article, we will study how book building process works i.e. how are shares priced in an IPO:

What is Book Building ?

Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time. When shares are being offered for sale in an IPO, it can either be done at a fixed price. However, if the company is not sure about the exact price at which to market its shares, it can decide a price range instead of an exact figure. This process of discovering the price by providing the investors with a price range and then asking them to bid on it is called the book building process. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market. This is the preferred method which is recommended by all major stock exchanges and as a result is followed in all major developed countries in the world.

Book Building Process

The detailed process of book building is as follows:

1. **Appointment of Investment Banker:** The first step starts with appointing the lead investment banker. The lead investment banker conducts due diligence. They propose the size of the capital issue that must be conducted by the company. Then they also propose a price band for the shares to be sold. If the management agrees with the propositions of the investment banker, the prospectus is issued with the price range as suggested by the investment banker. The lower end of the price range is known as the floor price whereas the higher end is known as the ceiling price. The final price at which securities are indeed offered for sale after the entire book building process is called the cut-off price.
2. **Collecting Bids:** Investors in the market are requested to bid to buy the shares. They are requested to bid the number of shares that they are willing to buy at varying price levels. These bids along with the application money are supposed to be submitted to the investment bankers. It must be noted that it is not a single investment banker who is engaged in the collection of bids. Rather, the lead investment banker can appoint sub-agents to tap into their network especially for receiving the bids from a larger group of individuals.
3. **Price Discovery:** Once all the bids have been aggregated by the lead investment banker, they begin the process of price discovery. The final price chosen in simply the weighted average of all the bids that have been received by the investment banker. This price is declared as the cut-off price. For any issue which has received substantial publicity and which is being anticipated by the public, the ceiling price is usually the cut-off price.
4. **Publicizing:** In the interest of transparency, stock exchanges all over the world require that companies make public the details of the bids that were received by them. It is the lead investment banker's duty to run advertisements containing the details of the bids received for the purchase of shares for a given period of time (let's say a week). The regulators in many markets are also entitled to physically verify the bid applications if they wish to.
5. **Settlement:** Lastly, the application amount received from the various bidders has to be adjusted and shares have to be allotted. For instance, if a bidder has bid a lower price than the cut-off price then a call letter has to be sent asking for the balance money to be paid. On the other hand, if a bidder has bid a higher price than the cut-off, a refund cheque needs to be processed for them. The settlement process ensures that only the cut-off amount is collected from the investors in lieu of the shares sold to them.

Partial Book Building

Partial book building is another variation of the book building process. In this process, instead of inviting bids from the general population, investment bankers invite bids from certain leading institutions. Based on their bids, a weighted average of the prices is created and cut-off price is decided. This cut-off price is then offered to the retail investors as a fixed price. Therefore, the bidding only happens at an institutional level and not at a retail level.

This is also an efficient mechanism to discover prices. Also the cost and complications involved in conducting a partial book building are substantially low.

How is Book Building Better Than the Fixed Price Mechanism ?

First of all, the book building process brings flexibility to the pricing of IPO's. Prior to the introduction of book building, a lot of IPO's were either underpriced or overpriced. This created problems because if the issue was underpriced, the company was losing possible capital. On the other hand, if the issue was overpriced it would not be fully subscribed. In fact, if it was subscribed below a given percentage, the issue of securities had to be cancelled and the substantial costs incurred over the issue would simply have to be written off. With the introduction of book building process, such events no longer happen and the primary market functions more efficiently.

TYPE OF INVESTOR

There are plenty of stories about people "bootstrapping" startups with their own money. That's not always possible. Many startups come to the point where they have to depend on investors.

When doing so, it's important to know the different types of investors. The most common types are:

- Banks
- Angel investors
- Peer-to-peer lenders
- Venture capitalists
- Personal investors

Regardless of which investor you choose, get it in writing with forms from our business center.

Banks

A bank loan may be available to help you with startup costs. A bank will want to see a detailed business plan and a thorough description of your business and its prospects. A business proposal document also states the product or services being offered, your financial and management projections, and how you plan to implement your goals.

It's easiest to get a loan when you go to a bank with which you already have a relationship. Be prepared to prove financial responsibility and wait the time it may take to process the loan.

Check into seeking a loan backed by the Small Business Administration. The SBA sets guidelines for its partners-including lenders, community development organizations and microlending institutions-to follow. It guarantees that the loans will be repaid, adding some leverage to help the lender decide whether to loan you the money.

There are three different loan programs:

7(a) loan program

Eligibility for a 7(a) loan program comes by meeting certain requirements. Among them is owning a business impacted by NAFTA, implementing pollution control requirements or seeking a loan from a small community/rural-based lender. Check out the website to learn about these and other possible areas that may be eligible for a 7(a) loan.

Microloan program

Small businesses may be eligible for an SBA-backed microloan. Microloans are available for up to $50,000 while the average loan is about $13,000. Microloans, according to SBA, can be used to provide working capital or buy inventory or supplies, furniture or fixtures and machinery or equipment.They can't be used to pay existing debts or buy real estate.

504 loan program

The 504 loan program, administered through Certified Development Companies, provides small businesses with the assets needed to expand or modernize. It covers expenses including:

- Buying existing buildings
- Buying land and making improvements
- Building new facilities or modernizing, renovating or converting existing facilities
- Buying long-term machinery
- Refinancing debt to help a business expand through new or renovated facilities or equipment

SBA states that a 504 loan is often structured so that the SBA provides 40 percent of the project cost and a participating lender pays up to 50 percent. That leaves you to cover about 10 percent.

A bank, even when seeking an SBA-backed loan, will want to see a solid business plan. It helps having personal experience in the industry or a good mentor who is well versed in the industry. You may also have to talk collateral, including possibly a home equity loan, and provide as much startup cash as you can.

Bank lending is also more conservative than it was before the mortgage crisis of 2007. Be ready to make your case.

Angel Investors

There are angels on your side when it comes to seeking outside financing. This type of investor is typically an entrepreneur who has enough wealth to help others. Angel investors invest in businesses in which they believe but they realize may struggle to find other financing.

An angel investor may buy stock from a company or make a loan. Some serve as mentors and advisors. Some may specialize, such as high-tech angels who prefer helping to bring new technology to the marketplace and may or may not want to actively participate in the company.

Another type is a return on investment angel, who expects to see a financial payback from a high-risk investment. Return on investment angels are more likely to invest when the economy is stable or improving. They may not want to be involved past investing but are often hopeful that they will get a huge payoff if the company goes public or gets purchased by a bigger corporation.

Considerations when approaching angel investors include:

- How much control does the investor expect?
- How much control are you willing to share?
- What is the investor's motivation?
- How experienced is the investor?
- Does your venture meet the investor's investment requirements?

A promissory note spells out the repayment terms of the loan. We offer a promissory loan document template for free.

Peer-to-Peer Lending

Welcome to starting a business in the high-tech world of today. Peer-to-peer lending lets people list projects online for consideration by potential investors. This type of investor brings the startup and small business owners together with entrepreneurs willing to help and invest.

Prosper and Lending Club are among websites that specialize in peer-to-peer or P2P lending. "We cut out the middleman to connect people who need money with those who have money to invest," Prosper states on its website.

Peer-to-peer lending steps, shared by the Small Business Administration, include:

- Have a plan. Make sure to include what you find out from market research, competitive analysis, financial forecasts, expected returns and more.
- Tell your story. Tell what you hope to achieve and what your background is.
- Share your achievements and progress. Basically, sell yourself and your business. How much have you invested yourself and at what stage is your business? What milestones have you reached? You want to prove to potential investors that your business is on the path to success. Going peer-to-peer lending may cut out the middleman, but not financial common sense on the part of investors.

Your credit history plays a part in whether you can engage in peer-to-peer lending. You grant access to your credit score when you apply for a peer-to-peer loan. This type of investor may require you to improve your credit history before finding you loan-worthy.

If engaging in peer-to-peer lending, make sure you understand the terms of your loan and make payments on time. Falling behind can increase your fees and prevent you from seeking another peer-to-peer loan.

Check in your state to see if there are any specific regulations concerning peer-to-peer lending. Our On Call legal service can help you find a local attorney with that knowledge.

Venture Capitalists

Once you've proven yourself a bit more, it's time to consider venture capitalists. This type of investor expect you to show you have a solid business plan. A venture capitalist also wants to see a high return of profit.

Venture capitalists may invest as much as millions of dollars. They will invest the money needed to help that happen. They do that by securing equity capital, or a share in your company. They are betting that the share will be worth more within time and will wait to get a return on the investment.

Giving up that equity capital means giving up some ownership or say in the company. Venture capitalists may also want a steeper return on their investment than what the interest rate may be on a business loan.

Consider having all parties sign a limited partnership agreement to spell out the rights and duties of each partner.

Personal Investors

Your friends and family may be willing to lend you the cash to start a business, and you may be willing to take it. But think twice before heading in this direction.

Mixing business with family is risking, bringing business disputes to family gatherings and other events. You risk hurting not only your finances but also a relative's or friend's if the business doesn't take off as well as you anticipate. There are stories about people successfully choosing this option, but before you do, make sure your family ties are strong enough to withstand the pressures of doing business. Have each party sign a promissory note that spells out the repayment terms or, if you are partnering with a friend or family member, sign a partnership agreement.

These are the different types of investors that may help you launch your dream company. Remember, each situation is different, and take legal precautions before reaching out to any investor. Our On Call attorney service can match you up with a lawyer well versed in business law.

ASBA-APPLICATION SUPPORTED BY BLOCKED AMOUNT

ASBA stands for **"**Application Supported by Blocked Amount**."** It is a term given to a process of applying IPO in India. Moreover, from January 2016 onward it is mandatory to apply for an initial public offering (IPO) through this method by Securities and Exchange Board of India, the SEBI. The SEBI is the regulator of an IPO in India. ASBA is an authorization to block the application money in a bank account.

Thus, ASBA is a process of applying for an IPO. Here your application allows your bank to hold the subscription amount on your account until you accept allotments of shares or refunds, if not allowed.

Your bank blocks the subscription amount in your account when you apply for the IPO. And you cannot use the funds for any other purpose. However, it permits you to earn interest on the subscription amount.

As per definition in clause (d) of sub-Regulation (1) of Regulation 2 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009, ASBA is –

"An application containing an authorization to block the application money in the Bank account for subscribing to an IPO/FPO or Rights Issue."

In order to use ASBA, you first fill in the designated IPO application form. Then you submit it to any self-certified syndicate bank (SCSB) through any of its authorized branches. There are two ways on which any retail investor can apply to IPO through ASBA**.** First in online through net banking facility and second, through physical application method. Furthermore, the online method is simple then application method.

Who are eligible to apply through ASBA?

A retail investor is only eligible to apply through ASBA process if he/she –

1. is a resident retail individual investor
2. has the Demat account with any Depository participants like CDSL or NSDL along with a valid permanent account number (PAN)
3. has the sufficiently clear credit balance (no overdraft) in his/her savings or current account
4. is bidding at cut-off, with the single option as to the number of shares bid for,
5. is applying through blocking of funds in a bank account with the SCSB,
6. has agreed not to revise his/her bid and
7. is not bidding under any of the reserved categories.

An investor who applies through ASBA is known as 'ASBA investors'.

What is the benefit of applying through ASBA?

The following are the main benefits to a retail investor who chooses to apply through ASBA –

1. The amount remains blocked in your bank account for the IPO application.

2. There is no loss of interest. The account continues to earn interest on the funds blocked. The blocked fund is debited post allotment and then the interest stops on the debited part.
3. There is no need to wait for your refund cheques/ECS credits.
4. SCSB unblock the application money from the frozen accounts in case the application is rejected or there is no allotment or the issue is withdrawn. For this, the SCSB receive instructions from the registrar of the issue.
5. The blocked amount is considered while calculating average quarterly balance (AQB) in the account.
6. The application form is simple and you can apply online through net-banking
7. The applicant need not have to submit any physical documentation to avail of this facility.
8. This facility is absolutely free.

Before proceeding further, look at the 30 *most commonly asked questions on IPO bidding* through ASBA. This will help clear your doubts around it.

The application process of ASBA method if applying online through net-banking

1. Log in to the net-banking portal of your bank.
2. Select the "IPO Application" option from the menu.
3. This re-directed to the IPO Online System.
4. Fill in the required information.
5. ASBA IPO application is for individuals. The Corporate, HUF, Trust, etc. cannot use it for applying.
6. Please note that the names of the applicants should be as per the sequence of names on his/her depository account.
7. By default, the net-banking user will be the 1st applicant.
8. In the account, a hold is marked on the total amount at the highest price bid
9. Application money will remain blocked up to the finalization of allotment.
10. Your application money is debited only after the allotment of shares. Also, there are cases of non-allotment. In such cases, the blocked amount is released but after registrar's notification.

The application process of the ASBA method if applying through physical application

- First, you need to visit the Self Certified Syndicate Bank (SCSB) branch of the bank where you hold your account. Further, it is not necessary to hold an account in the same branch. An applicant can maintain the account with any of the branches. You can check the list of banks and their branches self-certified syndicate banks (SCSBs) for Syndicate ASBA on the SEBI website.

- Download ASBA bid-cum-application forms and print it. You can download this form from the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) website. The links for the same are –Put correctly your bank account number, PAN, Demat account particulars, etc. and submitted to the branch.
- After receiving your filled application, for which the bank will provide with an acknowledgment, the bank will block the amount in your account and will send the application information to the designated stock exchange.
- An applicant should maintain sufficient funds in their bank account, equivalent to the IPO application amount.
- Finally, the applicant may check their application status on the following links.
- Furthermore, please note that the application status is available on both NSE and BSE portal until 6 days after the issue closure date. To avail this facility from NSE the applicant needs to register over the NSE website. However, no such registration is required when accessing the BSE website.

What circumstances results in ASBA IPO application form rejection?

The ASBA application is subject to rejection when the below mentioned circumstances met –

1. The insufficient amount in the bank account
2. Any discrepancy in the application form
3. Information furnished by the applicant is incorrect
4. Name on the PAN card miss-matches with the Demat holder's name.
5. Multiple application by the same applicant through ASBA or no-ASBA method.

What is the importance of ASBA for the retail **investor?**

Earlier until January 2016, most of the retail investors used to apply IPOs or rights offers using physical application forms. Those forms were accompanied by drafts or cheques. This used to lock the funds for several days until the finalization of IPO allotment. Sometimes cheques/drafts went missing.

There are situations of over-subscription of an offer. And in such case, the opportunity cost of committing the retail investors' money and waiting for a refund was usually high. However, ASBA completely eliminates such costs.

Do your own research on Indian IPO at market intelligence section of IPO. Get in-depth IPO news, IPO result, upcoming IPO calendar, and latest upcoming IPO.

As the retail applications are now moved to ASBA, the entire method of an offer being made till listing of the security on an exchange has come down to just six days. This benefits investors achieve fast returns from one IPO. And maybe helping redeploy the same funds in another IPO. ASBA also allows a built-in mechanism to withdraw bids, following you put them in.

Why should investor care for ASBA?

ASBA diminishes the losses in opportunity cost and any risk linked with applying to an IPO. An IPO does stack up in bull markets. So ASBA enables you to shift instantly from one offer to another. This is possible without waiting for the refunds of the amount of the bid.

However, ASBA faces three limitations. Firstly, the compulsory requirement implies that you can now only apply to an IPO by assigned banks. And this restricts your choices.

Secondly, if you don't own a three-in-one trading account, there are chances for the delay in the ASBA process. The three-in-one trading account links your bank, broking and demat accounts. And you also need to empower your broker to deal with your bank.

Lastly, the limit of five applications per account for an ASBA transaction is also a big constraint.

However, there is a piece of good news. There are certain *IPO bidding rules* through ASBA that you need to follow so that the chances for allotment increases. Error-free application form, upper-band bidding, and proper bidding quantity help increase such allotment chances.

OVERVIEW OF BOND MARKET AND RECENT DEVELOPMENTS.

What Is the Bond Market?

The bond market—often called the debt market or credit market—is the collective name given to all trades and issues of debt securities debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements. Publicly-traded companies issue bonds when they need to finance business expansion projects or maintain ongoing operations.

Bond investors should be mindful of the fact that junk bonds, while offering the highest returns, present the greatest risks of default.
Understanding Bond Markets

The bond market is broadly segmented into two different silos: the primary market and the secondary market. The primary market is frequently referred to as the "new issues" market in which transactions strictly occur directly between the bond issuers and the bond buyers. In essence, the primary market yields the creation of brand new debt securities that have not previously been offered to the public.

In the secondary market, securities that have already been sold in the primary market are then bought and sold at later dates. Investors can purchase these bonds from a broker, who acts as an intermediary between the buying and selling parties. These secondary market issues may be packaged in the form of pension funds, mutual funds, and life insurance polices—among many other product structures.

Types of Bond Markets

The general bond market can be segmented into the following bond classifications, each with its own set of attributes.

Corporate Bonds

Companies issue corporate bonds to raise money for a sundry of reasons, such as financing current operations, expanding product lines, or opening up new manufacturing facilities. Corporate bonds usually describe longer-term debt instruments that provide a maturity of at least one year.

Government Bonds

National-issued government bonds entice buyers by paying out the face value listed on the bond certificate, on the agreed maturity date, while also issuing periodic interest payments along the way. This characteristic makes government bonds attractive to conservative investors.

Municipal Bonds

Municipal bonds—commonly abbreviated as "muni" bonds—are locally issued by states, cities, special-purpose districts, public utility districts, school districts, publicly-owned airports and seaports, and other government-owned entities who seek to raise cash to fund various projects.

Mortgage-Backed Bonds

These issues, which consist of pooled mortgages on real estate properties, are locked in by the pledge of particular collateralized assets. They pay monthly, quarterly, or semi-annual interest.

KEY TAKEAWAYS

- The bond market broadly describes a marketplace where investors buy debt securities that are brought to the market by either governmental entities or publicly-traded corporations.
- National governments generally use the proceeds from bonds to finance infrastructural improvements and pay down debts.
- Companies issue bonds to raise the capital needed to maintain operations, grow their product lines, or open new locations.
- Bonds are either issued on the primary market, which rolls out new debt, or on the secondary market, in which investors may purchase existing debt via brokers or other third parties.

Recent Developments in Corporate Bond Market in India

Recent Developments in the Corporate Bond Market in India are given below:

The most important recent development on the corporate bond market is the migration away from physical certificates into dematerialised holdings at the depository. This process began in 2000, but got major support from RBI’s regulations:

i. From October 31, 2001 onwards banks, FIs, PDs and SDs were required to make fresh investments in bonds and debenture only in dematerialised form.

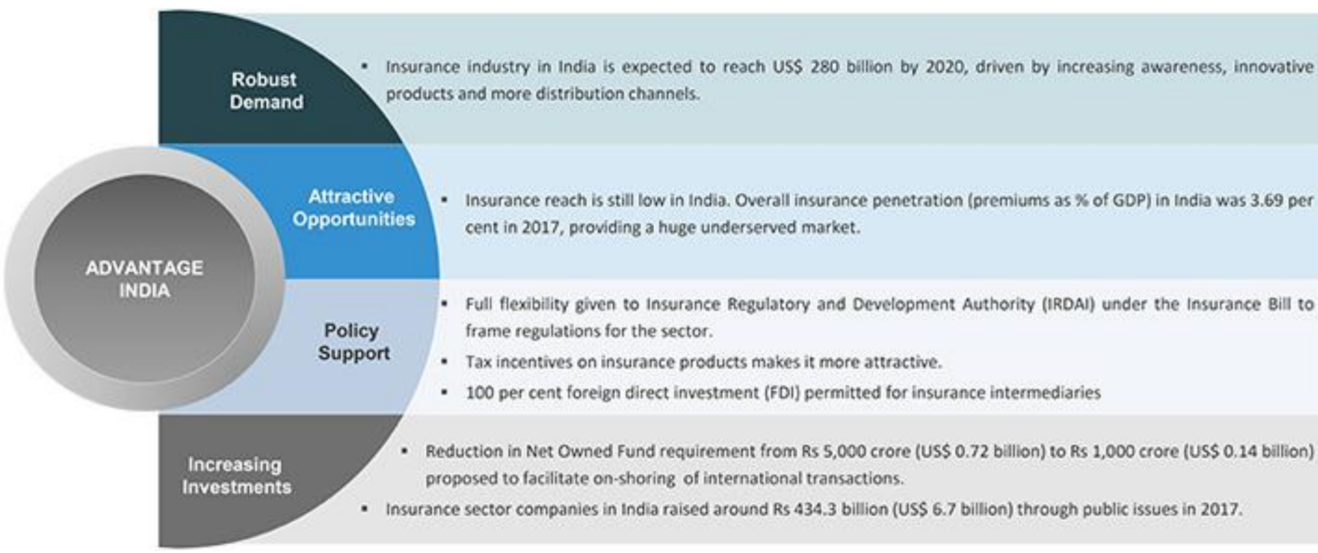
ii. By June, 2002, these entities will be required to dematerialise all outstanding holdings of corporate debt securities.

This led to a sharp rise in the stock and settlement of dematerialised corporate debt securities at National Securities Depository Limited (NSDL). The corporate bond market is highly non-transparent; hence these trends should be treated as being indicative only. The credit spread for the AAA bond has risen steadily from I

MODULE 4

- **Small Savings, Provident Funds,**
- **Insurance Companies,**
- **Mutual Funds and NBFC NonBank Financial intermediaries -Leasing,**
- **Hire purchase,**
- **Credit rating,**
- **Factoring,**
- **Forfaiting Non-Bank Statutory Financial Organisations***

INSURANCE COMPANIES



Introduction

The insurance industry of India consists of 57 insurance companies of which 24 are in life insurance business and 33 are non-life insurers. Among the life insurers, Life Insurance Corporation (LIC) is the sole public sector company. Apart from that, among the non-life insurers there are six public sector insurers. In addition to these, there is sole national re-insurer, namely, General Insurance Corporation of India (GIC Re). Other stakeholders in Indian Insurance market include agents (individual and corporate), brokers, surveyors and third party administrators servicing health insurance claims.

Market Size

Government's policy of insuring the uninsured has gradually pushed insurance penetration in the country and proliferation of insurance schemes.

Gross direct premiums of non-life insurers in India reached US$ 13.66 billion in FY20 (up to September 2019), gross direct premiums reached Rs 410.71 billion (US$ 5.87 billion), showing a year-on-year growth rate of 14.47 per cent. Overall insurance penetration (premiums as per cent of GDP) in India reached 3.69 per cent in 2017 from 2.71 per cent in 2001.

In FY19, premium from new life insurance business increased 10.73 per cent year-on-year to Rs 2.15 trillion (US$ 30.7 billion). In FY20 (till July 2019), gross direct premiums of non-life insurers reached US$ 5.7 billion, showing a year-on-year growth rate of 16.65 per cent.

The market share of private sector companies in the non-life insurance market rose from 13.12 per cent in FY03 to 55.70 per cent in FY20 (up to April 2019).

Investments and Recent Developments

The following are some of the major investments and developments in the Indian insurance sector.

- The non-life insurance companies witnessed a rise of 13.1 per cent in their collective premium in November to Rs 14,590.50 crore (US$ 20.09 billion).
- In November 2019, Airtel partnered with Bharti AXA Life to launch prepaid bundle with insurance cover.
- In September 2019, Competition Commission of India (CCI) approved acquisition of shares in SBI General Insurance by Napean Opportunities LLP and Honey Wheat.
- As of November 2018, HDFC Ergo is in advanced talks to acquire Apollo Munich Health Insurance at a valuation of around Rs 2,600 crore (US$ 370.05 million).
- In October 2018, Indian e-commerce major Flipkart entered the insurance space in partnership with Bajaj Allianz to offer mobile insurance.
- In August 2018, a consortium of WestBridge Capital, billionaire investor Mr Rakesh Jhunjunwala announced that it would acquire India’s largest health insurer Star Health and Allied Insurance in a deal estimated at around US$ 1 billion.
- In September 2018, HDFC Ergo launched ‘E@Secure’ a cyber insurance policy for individuals.
- Insurance sector companies in India raised around Rs 434.3 billion (US$ 6.7 billion) through public issues in 2017.
- In 2017, insurance sector in India saw 10 merger and acquisition (M&A) deals worth US$ 903 million.
- India's leading bourse Bombay Stock Exchange (BSE) will set up a joint venture with Ebix Inc to build a robust insurance distribution network in the country through a new distribution exchange platform.

Government Initiatives

The Government of India has taken a number of initiatives to boost the insurance industry. Some of them are as follows:

- As per Union Budget 2019-20, 100 per cent foreign direct investment (FDI) permitted for insurance intermediaries.
- In September 2018, National Health Protection Scheme was launched under Ayushman Bharat to provide coverage of up to Rs 500,000 (US$ 7,723) to more than 100 million vulnerable families.

The scheme is expected to increase penetration of health insurance in India from 34 per cent to 50 per cent.

- Over 47.9 million famers were benefitted under Pradhan Mantri Fasal Bima Yojana (PMFBY) in 2017-18.
- The Insurance Regulatory and Development Authority of India (IRDAI) plans to issue redesigned initial public offering (IPO) guidelines for insurance companies in India, which are to looking to divest equity through the IPO route.
- IRDAI has allowed insurers to invest up to 10 per cent in additional tier 1 (AT1) bonds that are issued by banks to augment their tier 1 capital, in order to expand the pool of eligible investors for the banks.

Road Ahead

The future looks promising for the life insurance industry with several changes in regulatory framework which will lead to further change in the way the industry conducts its business and engages with its customers.

The overall insurance industry is expected to reach US$ 280 billion by 2020. Life insurance industry in the country is expected grow by 12-15 per cent annually for the next three to five years.

Demographic factors such as growing middle class, young insurable population and growing awareness of the need for protection and retirement planning will support the growth of Indian life insurance.

MUTUAL FUND

A mutual fund is an investment security that enables investors to pool their money together into one professionally managed investment. Mutual funds can invest in stocks, bonds, cash or a combination of those assets. The underlying security types, called *holdings*, combine to form one mutual fund, also called a *portfolio*.

In simpler terms, mutual funds are like baskets. Each basket holds certain types of stocks, bonds or a blend of stocks and bonds to combine for one mutual fund portfolio.

For example, an investor who buys a fund called XYZ International Stock is buying one investment security — the basket — that holds dozens or hundreds of stocks from all around the globe, hence the "international" moniker.

It's also important to understand that the investor does not actually *own* the underlying securities — the holdings — but rather a representation of those securities; investors own shares of the mutual fund, not shares of the holdings. For example, if a particular mutual fund includes shares of stock in Apple, Inc. (AAPL) among other portfolio holdings, the mutual fund investor does not directly own Apple stock.

Instead, the mutual fund investor owns shares of the mutual fund. However, the investor can still benefit by the appreciation of shares in AAPL.

Since mutual funds can hold hundreds or even thousands of stocks or bonds, they are described as diversified investments. The concept of diversification is similar to the idea of strength in numbers. Diversification helps the investor because it can reduce market risk compared to buying individual securities.

The Advantages of Mutual Funds

To summarize, the advantages of mutual funds can be described in four words — simplicity, versatility, diversity, and accessibility:

- **Simplicity:** Most investors do not have the knowledge, time or resources to build their own portfolio of stocks and bonds. Stock investors often have extensive knowledge of fundamental analysis or technical analysis. However, buying shares of a mutual fund enables an investor to own a professionally managed, diverse portfolio, although the investor may have little or no knowledge of investing concepts and strategies. Mutual funds are professionally managed, which means the investor does not need knowledge of investing in capital markets to be successful with them.

- **Diversity:** All investors, beginners and pros alike, know that putting all of their eggs into one basket is not wise. This speaks to the wisdom of diversification with mutual funds. To diversify with stocks, an investor may need to buy 20 or more securities to reach sufficient diversification. However, many mutual funds offer complete diversification in just one security that can be easily purchased. Therefore, a mutual fund investor can break the eggs-in-one-basket rule with mutual funds, at least when getting started, and then add more mutual funds later to increase diversity in the mutual funds portfolio. For more on this idea, be sure to read our article on how to get started investing with just one mutual fund.
- **Versatility:** There are so many types of mutual funds that investors can gain access to almost any segment of the market imaginable. For example, sector funds make it possible for investors to buy into focused areas of the market, such as healthcare, technology, financials, and even social media. Beyond sector funds, investors can also access other asset types, such as gold, oil and other natural resources. This versatility can be used for further diversification as an investor's portfolio grows. Professional money managers often use sector funds for this purpose in building client portfolios.

- **Accessibility:** With as little as $100 an investor can get started investing with mutual funds. And the fact that mutual funds hold dozens, hundreds, or even thousands of other securities, an investor can gain access to an entire market of investable securities. For example, an investor buying shares in one of the total stock market index funds, gains exposure to over 3,000 stocks in just one fund. This returns to the simplicity and diversification of mutual funds.

Although investing concepts and strategies are rarely taught in schools, the beginning investor can find easy tips about how to buy mutual funds online or in bookstores and get started investing within minutes or just a few hours.

Basic Types of Mutual Funds

There are thousands of mutual funds in the investment universe but they can be divided into a few basic types and categories of funds. The two primary types of mutual funds are stock funds and bond funds. From there, the categories of funds get more specialized and diverse.

For example, stock funds can be further broken into three sub-categories of capitalization — small-cap, mid-cap, and large-cap. They are then categorized further as either growth, value, or growth and income. Stocks can also be classified as international, global or foreign, all of which have similar objectives.

Bond funds are primarily categorized by the duration of the bonds, which are described as short-term, intermediate-term, or long-term. They are then broken into sub-categories of corporate bonds, municipal bonds, and U.S. Treasury bonds.

Most mutual fund categories can be purchased as index funds, which can be described as passively-managed funds. This means that the portfolio manager does not actively buy and sell securities but rather matches the holdings of a benchmark index, such as the S&P 500 index or the Dow Jones Industrial Average. Beginners often start with one of the best S&P 500 Index funds.

From there, investors can learn more about the various types of mutual funds, such as those mentioned here, and how to build a portfolio of mutual funds around that core investment. Index funds often have hundreds of holdings and offer investors the greatest features of mutual funds — simplicity, diversity and low-cost.

Understanding the Risks of Investing in Mutual Funds

Stocks, bonds, and mutual funds all involve some level of market risk, which is the possibility of fluctuation in value or even the loss of principal (the amount you originally invested).

For example, you could invest $1,000 for 10 years and end up with $950. Although receiving a negative return like this over a 10-year period is extremely rare, it is possible. It is more reasonable to expect an average of return of somewhere between 7 and 10 percent for stock investments, including stock mutual funds, for periods of 10 years or more. However, there are short periods, such as 1 year, where your stock mutual fund can decline in value by as much as 30 to 40 percent. Similarly, you could have gains of more than 50% in one year.

So whether you're investing in individual stocks or a stock mutual fund, you need to have some reasonable expectations about how the stock market behaves. And more importantly, how you will react in the brief but inevitable extremes? Will you sell your mutual funds if they lose 10% in 3 months? Before you begin investing, it's best to get an idea of your risk tolerance.

Detail Info: https://www.goodreturns.in/mutual-funds/

NON BANKING FINANCIAL COMPANY

History of NBFCs in India:

A Non Banking Financial Company provides Banking services to People without holding a Bank license. It is a company registered under the Companies Act, 1956 of India, engaged in the business of loans and advances, acquisition of shares, stock, bonds hire-purchase, insurance business or chit business.

But it does not include any institution whose principal business includes agriculture, industrial activity or the sale, purchase or construction of immovable property.

Different types of Committees to Review existing framework of NBFCs:

1. **James S. Raj Committee**

In 1972, Banking Commission recommended Uniform Chit Fund Legislation to whole country. Reserve Bank of India prepared Model Bill to regulate the conduct of chit funds and referred to study group under the Chairmanship of James S. Raj.

2. **Chakravarty Committee**

Dr Manmohan Singh, former Governor of RBI appointed committee in December 1982 under the Chairmanship of 'Prof. Sukhamoy Chakravarty' to review functioning of monetary system in India.

Differences from Banks:

NBFCs perform functions similar to that of banks but there are a few differences between them. They are:

- Provides Banking services to People without holding a Bank license,
- An NBFC cannot accept Demand Deposits,
- An NBFC is not a part of the payment and settlement system and as such,
- An NBFC cannot issue Cheques drawn on itself, and
- Deposit insurance facility of the Deposit Insurance and Credit Guarantee Corporation is not available for NBFC depositors, unlike banks,
- An NBFC is not required to maintain Reserve Ratios (CRR, SLR etc.)

- An NBFC cannot indulge Primarily in Agricultural, Industrial Activity, Sale-Purchase, Construction of Immovable Property
- Foreign Investment allowed up to 100%.

Operations of NBFC:

The NBFC is a financial institution which carries out the following operations as their principle business.

- Hire purchase finance
- Housing finance
- Investment
- Loan
- Equipment leasing

Regulations related to accepting deposits:

Some of the important regulations relating to acceptance of deposits by NBFCs are as under:

1. The NBFCs are allowed to accept/renew public deposits for a minimum period of 12 months and maximum period of 60 months. They cannot accept deposits repayable on demand.
2. NBFCs cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time. The present ceiling is 12.5 per cent per annum. The interest may be paid or compounded at rests not shorter than monthly rests.
3. NBFCs cannot offer gifts/incentives or any other additional benefit to the depositors.
4. NBFCs should have minimum investment grade credit rating.
5. The deposits with NBFCs are not insured.
6. The repayment of deposits by NBFCs is not guaranteed by RBI.
7. Certain mandatory disclosures are to be made about the company in the Application Form issued by the company soliciting deposits.

Types and Categories of NBFCs:

1. NBFCs accepting public deposits (NBFCs-D)
2. NBFCs not accepting public deposits (NBFCs-ND)
3. NBFCs’ categories based on their businesses. They are:

Asset Finance Company (AFC):

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

Investment Company (IC):

IC means any company which is a financial institution carrying on as its principal business the acquisition of securities

Loan Company (LC):

LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

Infrastructure Finance Company (IFC):

Infrastructure finance companies which has followings,

1. Deploys a minimum of 75% of their total assets in infrastructure loans,
2. The net owned funds are more than 300 crores,
3. a minimum crediting rating of 'A' and
4. The Capital to Risk-Weighted Assets Ratio is 15%.

Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC):

IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raises resources through Multiple-Currency bonds of minimum 5-year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

NBFC-Factors:

NBFC Factors has principle business of factoring. Factoring is a financial transaction and a type of debtor finance. In the factoring business the financial assets should constitute at least 75% of its total assets and its income derived from factoring business should not be less than 75% of its gross income.

Gold Loan NBFCs in India:

Gold loan NBFCs witnessed an upsurge in Indian financial market, owing mainly to the recent period of appreciation in gold price and consequent increase in the demand for gold loan by all sections of society, especially the poor and middle class to make ends meet. Though there are many NBFCs offering gold loans in India, about 95 per cent of the gold loan business is handled by three Kerala based companies, viz., Muthoot Finance, Manapuram Finance and Muthoot Fincorp.

Growth of gold loan NBFCs eventuating from various factors including Asset Under Management (AUM), number of branches, and also the number of customers etc. Growth of gold loan NBFCs occurred both in terms of the size of their balance sheet and their physical presence that compelled to increase their dependence on public funds including bank finance and non-convertible debentures.

Residuary Non-Banking Companies (RNBCs):

Residuary Non-Banking Company is a class of NBFC which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Asset Financing, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets.

NBFC- Non-Operative Financial Holding Company (NOFHC) :

a) A financial institution through which promoter / promoter groups will be permitted to set up a new bank.

b) It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI to the extent permissible under the applicable regulatory prescriptions.

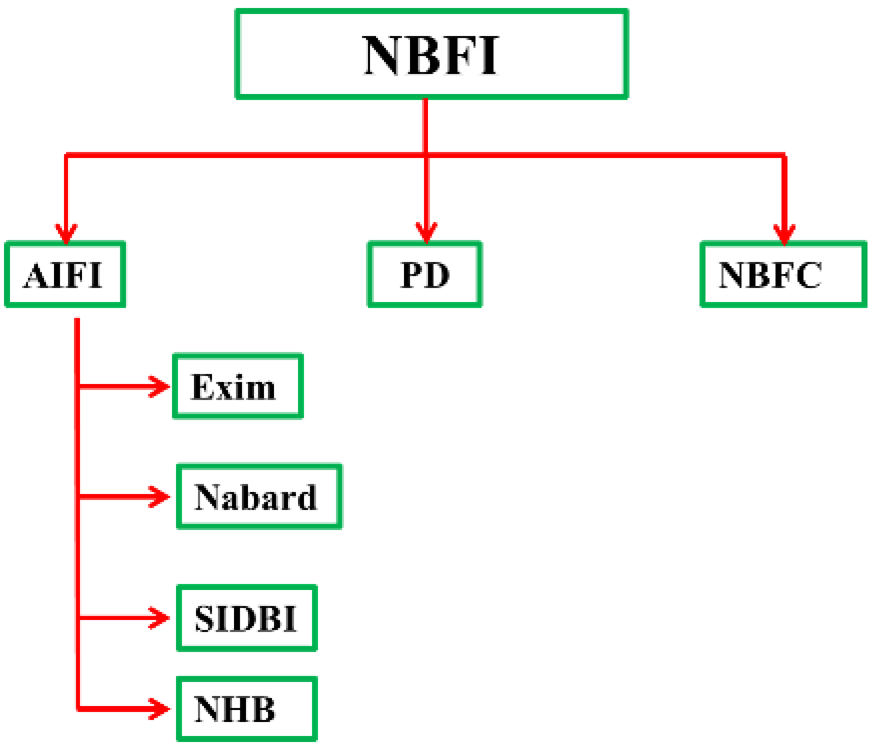
Top 10 NBFCs in India:

- Power Finance Corporation Limited
- Rural Electrification Corporation Limited
- Shriram Transport Finance Company Limited
- Bajaj Finance Limited
- Indian Railway Finance Corporation Limited
- Mahindra & Mahindra Financial Services Limited
- Muthoot Finance Limited
- HDB Financial Services Limited
- Cholamandalam Investment and Finance Company Limited
- Shriram City Union Finance Limited

NON BANKING FINANCIAL INTERMEDIARIES (NBFI)

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering. Examples include:

- All India Financial Institutions (AIFI)
- Exim
- Nabard
- Sidbi
- NHB
- Primary Dealers (PD)
- Non banking financial companies



All India Financial Institutions (AIFI)

EXIM Bank	▪ Export-Import Bank of India – Established in 1982 ▪ Controlled by Government of India (100%) ▪ Provides Loan/credit/finance to exporters and importers ▪ Promotes cross border trade and investment
NABARD	▪ National Bank for Agriculture and Rural Development – Established in 1982 ▪ Controlled by → GoI (99.3%) + RBI (0.7%) ▪ Regulatory authority of Cooperative banks + RRBs

	▪ Manage Rural infra. Development fund (RIFD) ▪ Finances State cooperative banks (SCB), RRBs, MFIs, Cottage/handicraft (SHG) etc.
NHB	▪ National Housing Bank – Established in 1988 ▪ Apex institution for housing finance in India ▪ Controlled by RBI (100%) ▪ Provides finance to banks and NBFCs for housing projects ▪ Manages RESIDEX index (Housing sector-inflation index)
SIDBI	▪ Small industries development bank of India – Established in 1990 ▪ Controlled by SBI, LIC, IDBI other public sector banks, insurance companies etc. ▪ Manages SEDF (Small enterprises development fund – Funded by Foreign banks < 20 branches if PSL not met) ▪ Provides finance to State Industrial Development Corporation (SIDC), State finance corporations, MSME sector and banks

Primary Dealers (PD)

- Deal in "primary" market
- Directly buy G-sec via "auction".
- Can Participate in OMO (Open Market Operations)
- Must get license from RBI
- Examples → Morgan Stanley, Goldman Sachs, JP Morgan Chase, Standard Chartered Bank, HSBC + SBI, BoB, Kotak Mahindra etc.

LEASING

Lease : Lease is a contractual arrangement where the owner of the asset transfer the right to use the asset to user (Lessee) in return for rentals. Main aspects of lease are :

(i) **Parties to Lease** : There are two parties in lease i.e. Lesser and Lessee.

(ii) **Asset under Lease**: The subject matter of lease is a tangible asset movable or immovable.

(iii) **Term of Lease** : Period for which agreement for lease would be in operation.

(iv) **Rentals of lease** – These are periodic payments (rentals) that forms the consideration for lease transaction.

(v) **Ownership** – Ownership remains with lesser and he allows use of asset to lessee during lease tenure.

Types of Lease

(1) **Operating Lease** : Also known as short term lease and lease period is less than usual life of asset. The lessee has the option to renew the lease after the lease period and he is responsible for maintenance insurance and taxes of asset. As period of lease is short, it implies high risk to lesser and high lease rental to lessee. Operating lease is of two types.

Wet lease : Where lesser is responsible for maintenance insurance and taxes.

Dry lease: Where lessee is responsible for maintenance, insurance and taxes on asset.

(2) **Financial lease**: Also called capital lease is one which usually covers useful economic life of an asset or a period that is close to economic life of asset. It is usually a non-cancellation lease where lesser receives the lease rentals during the lease period so as to recover fully not only the cost of asset but also a reasonable return on funds used to buy asset. This lease is of following types.

(i) Direct lease : The lesser purchases the asset and handover the asset to lessee.

(ii) Leveraged Lease: Where lesser borrows a portion of purchase price from lender and loan is secured by asset and lease rentals. The loan is repaid out of lease rentals either directly by lessee or the lesser.

(iii) Sale and lease back - Under sale and lease back the lessee not only retains the use of the asset ;but also get funds from the sale of asset to lesser.

Lease, hire purchase and installment sale

Lease – In case of lease asset is handed over to lessee in return of lese rentals. The ownership and title to the asset remains with lesser.

Hire Purchase – The seller handover the asset to buyer but title of goods is not transferred. The buyer becomes the owner of goods and acquires the title to the goods only when he makes payment of all installments. In case of default, in payment, by the buyer, the seller can repossess the goods.

Installment Sale : In this case, title of goods is immediately transferred to the buyer though payment of price to be made in future. This is just like a credit sale. In case of default, the seller has no option but to claim the money in court of law. The seller can‟t repossess the goods as is available in Hire Purchase

Difference between Financial Lease and Operating Lease

Basis of Difference	Finance Lease	Operating Lease
1. Life of Contract	Approximates the economic life of project	Shorter than economic life.
2. Maintenance	Provided by lessee or covered by a separate agreement.	Provided by lesser and included in lease rentals.
3. Lease payments	Return the cost of asset and allow a profit to the lesser.	Not sufficient to cover the cost of asset.
4. Cancellation	May be cancelled if both lesser and lessee agree.	May be cancelled before expiry date.

Hire Purchase : Hire purchase involves a system under which term loan for purchase of goods and services are advanced to be liquidated in stages through a contractual obligation. It is considered to be a sale of asset, the title of which rests with seller until the purchaser has paid all the installments and exercised his option ;to purchase the asset at the end of contract.

Features :

(i) At the time of hire purchase agreement, the buyer pays an agreed amount and balance amount in higher purchase installments.

(ii) Hire purchase installment cover both principal amount and interest.

(iii) Ownership passes to the buyer after payment of last installment.

Difference between Leasing & Hire Purchase :

Leasing	Hire purchase
1) Ownership rests with lesser.	1) Ownership passes to the buyer after payment of last installment.
2) Depreciation and investment allowable can be claimed by lesser.	2) Can be claimed by buyer/hirer
3) Lease rental is tax deductible expenditure.	3) Only interest component is tax deductible
4) Lease does not enjoy salvage value of asset.	4) Buyer/Hirer enjoys salvage value of asset.
5) Cost of maintenance is borne by lesser. In case of financial lease, it is borne by lessee.	5) Cost of maintenance is borne by buyer/hirer.

FACTORING AND FORFAITING

Factoring can be defined as an arrangement between financial institution or banker (factor) and a business concern (seller/supplier) selling goods or providing securities to trade customers where by factor purchases book debts and administers the sales ledger of the supplier. In other words, the outright sale of accounts receivables is known as factoring.

In this mechanism, factor purchases the clients trade debts/accounts receivable either with recourse (where risk of non payment by debtor is of factoring agency). In this process, client is immediately paid around 80% of trade debt and for remaining 20% payment is done on recovery of debt by factor. Factoring agency gets commission/fee for performing the duties on behalf of client.

Main types of factoring are :

1. **Recourse or non recourse factoring** – In case of recourse, the risk of non payment by debtor is not of factor but in case of non recourse, such risk is assumed by factor.
2. **Maturity factoring** – In this, the factor does not provide immediate cash payment to the client, but he pays cash as and when amount of debt is collected from debtor.

3. **Bulk factoring or invoice factoring** – In case of bulk factoring, the factor simply collects the debt on behalf of client and the work like maintaining sales ledger or credit control is done by client. In case of invoice factoring, the factor provides finance to client by telling the client about this arrangement. Hence, this is also known as confidential invoice discounting.
4. **Agency factoring** – In this case, factor has to provide finance and assure credit risk and client has to undertake maintenance and collection work.

International factoring – Here the factor provides services to international business by providing factoring services to exporting agency.

FORFAITING

Forfaiting is another source of financing against receivables like factoring. This technique of forfaiting is mostly employed to help an exporter for financing goods exported on a medium term basis. It is a form of financing of receivables pertaining to International Trade. In this process of forfeiting, the exporter gives up his right to receive payment in future under an export bill for immediate cash payment by forfaiter. The cash payment involves 100% of the amount of bill less discount charges. It is a unique medium which can convert a credit sale into a cash sale for an exporter.

In this process of forfaiting, four parties are involved which are:

(i) The Exporter – One who immediately converts the credit into cash. He is also referred as client.
(ii) The Forfeiter – One who takes the responsibility of collection of debts.
(iii) The importer – One who has to pay the debt. Also known as debtor.
(iv) The bank – One who makes payment on maturity to the forfaiter on presentation of ;bill of exchange. Also known as guarenter of the importer.

Advantages of forfaiting

(i) Exporter gets better liquidity.
(ii) No risk to exporter for non settlement of claim.
(iii) No risk of exchange rate fluctuations.
(iv) Most simple and flexible in nature
(v) Provides specialized service in credit management

Difference between factoring and forfaitring

Factoring	Forfeit ring
1. It refers to domestic trade	It applies to international trade only
2. Done for short term financing	It is for medium term financing
3. Invoice of client is purchased	Export bill is purchased
4. It may be with or without recourse to client.	It is without recourse to client.
5. Around 80% to 85% of total	Forfeiter pays 100% of the value
invoice price is paid.	of export bill less discount.
6. Broader term which also includes maintenance of sales ledger, advisory services etc.	Mainly concentrates on collection of debt.