CENTRE FOR DISTANCE & ONLINE EDUCATION

UNIVERSITY OF JAMMU

JAMMU

SELF LEARNING MATERIAL OF

FINANCIAL MARKET AND INSTITUTIONS

FOR M.COM SEM III

FOR THE YEAR 2023,2024,2025

COURSE NO. MCOMFE352 **UNIT: I - IV**

LESSON: 1 - 20

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CENTRE FOR DISTANCE & ONLINE EDUCATION UNIVERSITY OF JAMMU

SYLLABUS

M.COM THIRD SEMESTER (NCBCS)

FINANCIAL MARKETS AND INSTITUTIONS

Course: MCOMFE352 **Max. Marks: 100 Marks**

Credit: 4 **External: 80 Marks**

Time: 3.00 Hrs **Internal: 20 Marks**

(Syllabus for the examinations to be held in Dec., 2023, 2024, 2025)

COURSE OBJECTIVES

1. Understand the mechanics and interconnection of financial system and financial markets.
2. Determine and analyze various types of risk and hedging of these risks.
3. Research and analyze the working of financial institutions in light of various key development of Indian Economy.

COURSE OUTCOMES

After the completion of this course, the student will be able to :

1. apply concepts relevant ot financial markets and financial institutions, and the instruments of financial markets and institutions.
2. to have detailed knowledge of exchange rates and currency markets.
3. to make students aware of the credit policies of various financial institutions and the purpose of their establishment.
4. to familiarize with the various non-banking financial institutions and their functions.
5. to critically evaluate the recent financial news article & relevant research in financial markets & aids in decision making abilities.

SUGGESTIVE READINGS

1. Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill Company Ltd., New Delhi.
2. Bhole, L.M., Indian Financial System, Chugh Publications, Allahabad.
3. Edminster, R.O., Financial Institutions, Markets and Management, McGraw Hill, New York.
4. Goldsmith, R.W., Financial Structure and Development, Yale, London.
5. Hanson, J.A. and S. Kathuria (Eds.), India, A Financial Sector for The 21st Century.
6. Century, Oxford University Press, New Delhi.
7. Johnson, H.J. Financial Institutions and Markets, McGraw Hill, New York.
8. Khan, M.Y. Indian Financial System, Tata McGraw Hill, New Delhi.

NOTE FOR PAPER SETTING

The paper consists of two sections. Each section will cover the whole of the syllabus without repeating the question in the entire paper.

Section A: It will consist of eight short answer questions, selecting two from each unit. A candidate has to attempt any six and answer to each question shall be within 200 words. Each question carries four marks and total weightage to this section shall be 24 marks.

Section B: It will consist of six essay type questions with answer to each question within 800 words. One question will be set atleast from each unit and the candidate has to attempt four . Each question will carry 14 marks and total weightage shall be 56 marks.

TABLE OF CONTENTS

capital formation is indispensable to a speedy economic development and is universally recognized in academic literature. The main function of financial system is the collection of savings and their distribution for industrial investment, thereby stimulating the capital formation and, to that extent, accelerating the process of economic growth. The process of capital formation involves three distinct, although inter-related activities:

- **Savings:** The ability by which claims to resources are set aside and become available for other purposes.
- **Finance:** The activity by which claims to resources are either assembled from those released by domestic savings, obtained from abroad, or specially created usually as bank deposits or notes and then placed in the hands of the investors.
- **Investments:** The activity by which resources are actually committed to production.

1.2 OBJECTIVES

After going through this lesson you should be able to understand :

- The financial systems and its components
- Types of Financial intermediaries
- Various financial instruments

1.3 CONCEPT OF FINANCIAL SYSTEM

The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. The effective mobilization of savings, the efficiency of the financial organization/system and the channelization of these savings into the most desirable and productive forms of investment are all inter-connected and have a great bearing on capital formation to economic development. Their relevance to the saving- investment process is derived from what is called the transfer process.

1.4 STRUCTURE OF FINANCIAL SYSTEM

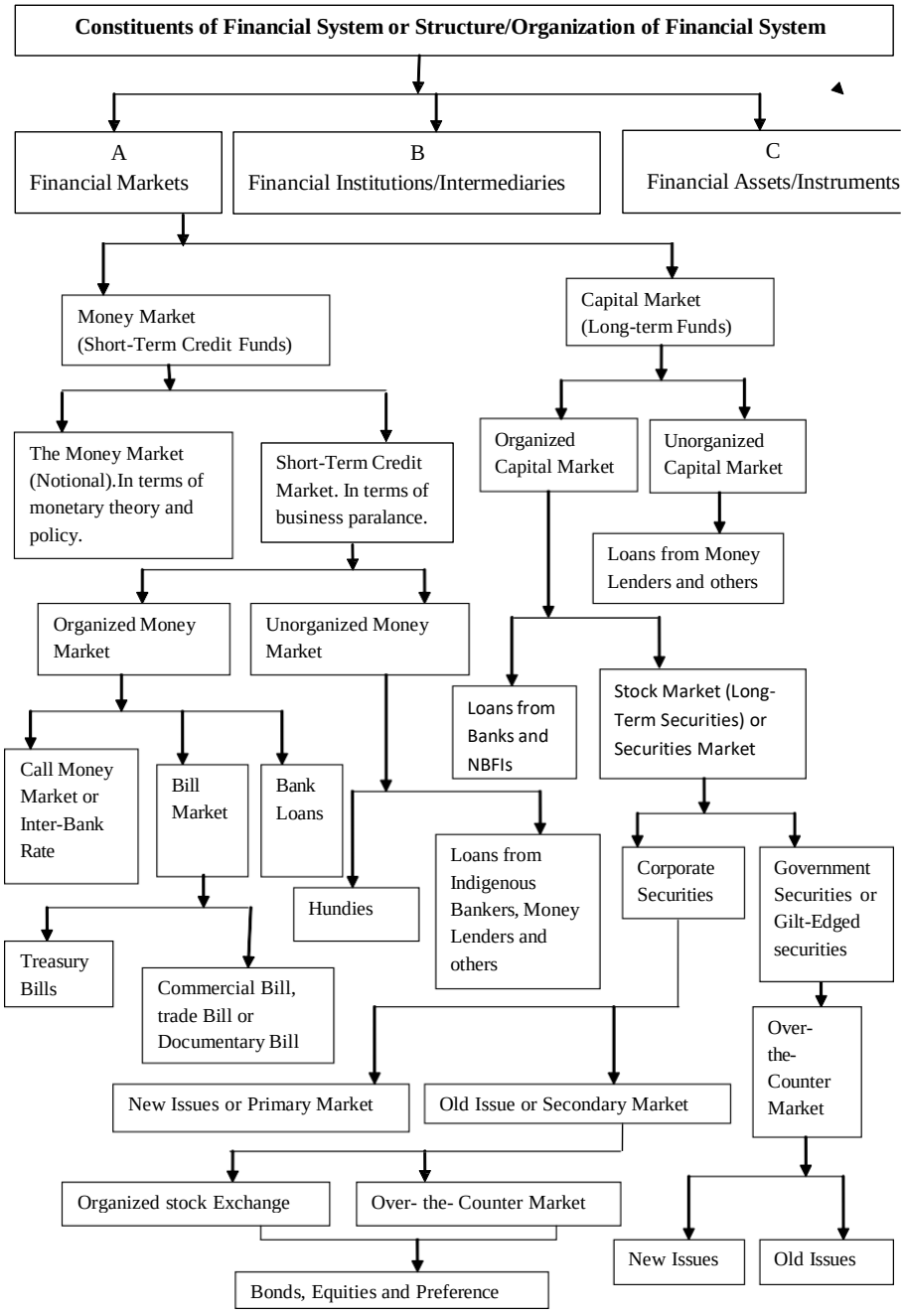

Figure 1.1 Constituents of Financial Systems

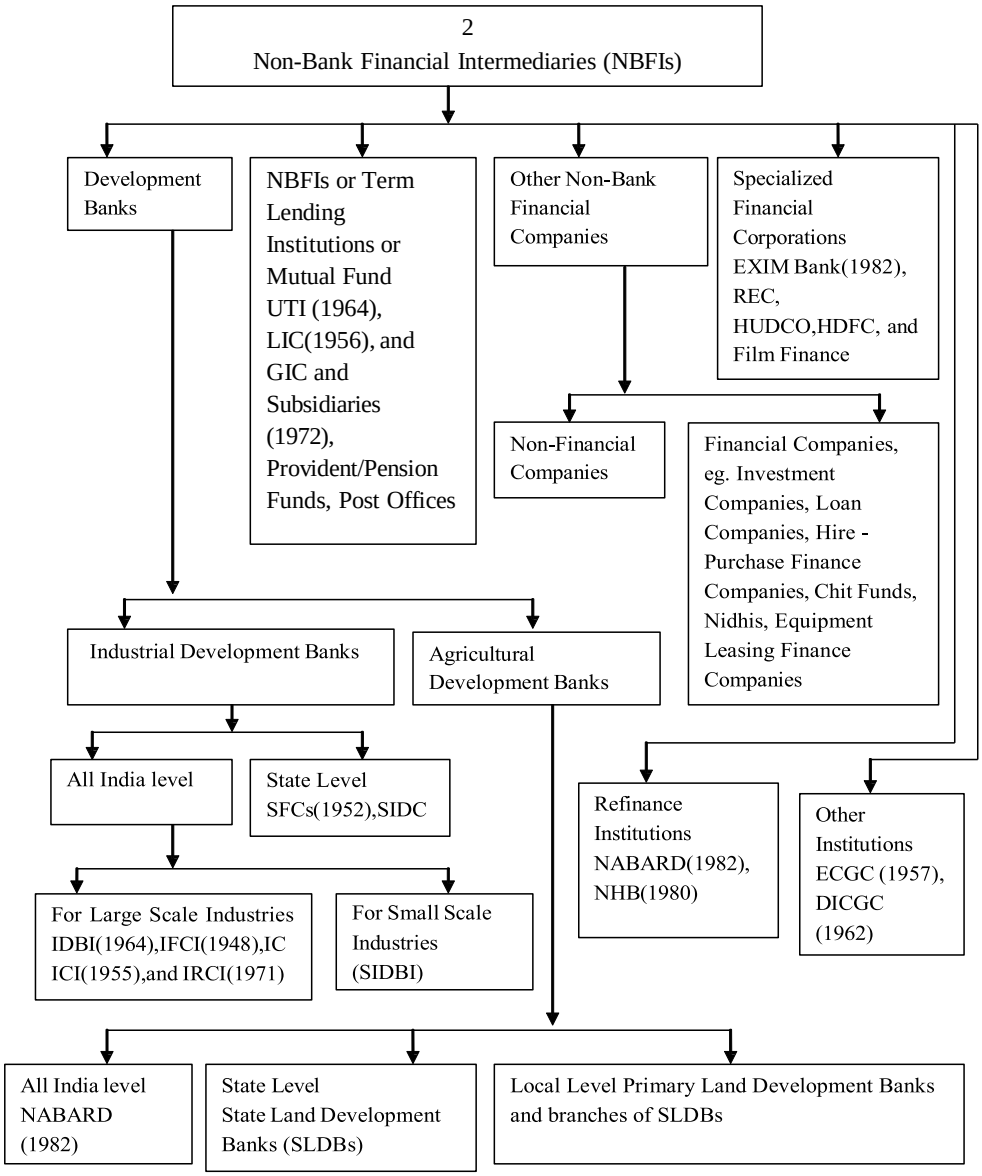

Figure 1.3 Types of Non Banking Financial Intermediaries

Notes : *1. NBFCs are leasing companies, housing finance companies, venture capital funds, merchant banking organisations, credit rating agencies, stock broking firms, factoring and forfeitingorganisations, Depositories*

2. Banks, NBFCs Mutual funds and Insurance fall into the categories of Financial Intermediaries

intermediaries to convert contracts with a given set of characteristics into a contract with very different features. In other words, the financial intermediaries make one type of contract with the lenders and another type with the borrowers. This arrangement permits them to tailor contracts to the preferences of both the borrowers and the lenders. Primary securities are issued by non-financial economic units. Indirect securities are financial assets issued by financial intermediaries.

Services: The services or economies provided by the financial intermediaries that tailor financial assets to the desires of savers and investors are: (i) convenience, (ii) lower risk, (iii) expert management, and (IV) economies of scale.

i. **Convenience:** Financial intermediaries provide convenience in two forms (i) first is divisibility, they divide primary securities of higher denomination into indirect securities of lower denominations so that even savings can be tapped from small pockets for ultimate investments in real assets. The other of indirect securities is their ability to transform a primary security of a certain maturityinto an indirect security of different maturity.

ii. **Lower risk:** Indirect securities also have the merit of exposing investors to lower risk as compared to primary securities. This is mainly because of the benefits of 'diversification' that become available to even small investors.Besides, economies of scale and expert management services are provided by financial intermediaries. Savings are institution elastic. The volume of savings as well as direction is considerably influenced by the structure of financial intermediaries.

1.6 TYPES OF FINANCIAL INTERMEDIARIES

Financial intermediaries are the institutions or agent that mobilize capital formation. They are the source of finance between survey and investment generally; financial intermediaries have been classified into banking and non-banking financial institutions. The banking institutions complex of scheduled commercial, non-schedule commercial and scheduled cooperative bank. Non-Banking financial institutions (NBFI) on the other hand, include development banks, NBFI's or mutual funds, specialized financial corporation e.g Exim Bank dt : It detailed classification is provided in fig 1.3 and

working capital finance. The main participants in the capital market are mutual funds, insurance organizations, foreign institutional investors, corporates and individuals. The capital market has two segments: (1) Primary/new issue market, and (2) Secondary market/stock exchange(s) market (s)

3. **Primary/new issue market (NIM):** The NIM deals in new securities, that is, securities were not previously available and are offered to the investors for the first time. Capital formation occurs in NIM as it supplies additional funds to the corporates directly. It does not have any organizational setup located in any particular place and is recognized only by the specialist institutional services that it tenders to the lenders/ borrowers (buyers/sellers) of capital funds at the time of any particular operation. It performs triple-service/function, viz. (i) origination that is investigation and analysis and processing of new issue proposals; (ii) underwriting, in terms of guarantee that the issue would be sold irrespective of public response and (iii) distribution of securities to the investors.

4. **Secondary market/stock exchange(s) market (s):** The stock exchange is a market for old or existing securities, that is, those already issued and granted stock exchange quotation/listing. It plays only an indirect role in industrial financing by providing liquidity to investments already made. It has physical existence and is located in a particular geographical area. The stock exchange discharges three vital functions in the orderly growth of capital formation: (i) nexus between savings and investments; (ii) liquidity to investors by offering a place of transaction in securities; (iii) continuous price formation

1.8 FINANCIAL INSTRUMENTS AND SERVICES

They represent claims on a stream of income and/or assets of another economic unit and are held as a store of value and for the return that is expected. The financial assets fall into three broad categories: (i) Direct/primary; (ii) Indirect and (iii) Derivatives.

1. Direct/primary securities: Direct/primary securities are:

- **Equity/Ordinary Shares:** They are ownership securities and represent risk capital. The owners of such security bear the risk, are residual claimants

to include (1) a security derived from debt instrument/shares/secured or unsecured loan/ risk instrument/contract for differences/any other form of security, (2) a contract which derives its value from the prices/ index of prices of underlying securities. **The most commonly used derivative contracts are forwards, futures and options and swaps.**

How does derivative work?: When and investor buys stock or index futures, he paysonly the margin money/upfront margin instead of the full value of the assets. Margin money/upfront margin is decided by the stock exchanges and which varies periodically, and take a "leveraged" position for one, two or three months. In case the stock moves up, you get the profit margin. In case the stock goes down, you might lose the entire margin money or even more in case the net loss exceeds the margin money. Example, say, an investor "goes long" or buys standard lot of 1 kg. gold futures contract, which is trading at Rs. 11000 per 10 gm, the exposure comes to Rs 11 lac. But unlike buying from the spot market where the investor would have had to pay the entire Rs.11 lac upfront, in futures contract, he pays only the margin of 4 per cent (of Rs. 11 lac) or Rs. 44000. While investors in futures can earn huge profits in a bull market, when tide turns, this leverage costs a fortune. But what tends to go wrong is that, with such low margins, they usually mismatch their risk appetite. The classic mistake investors make is to think that the margin money is all that they have to pay for the contract. As investors have to pay only margin money upfront, they don't understand the risksinvolved when they take the leverage. As a result, due to the lower margins, investors buy many more contracts than they can handle. So if the market price, say for gold, falls below Rs. 11000 per 10 gm, the losses mount manifold. This has to be settled with the exchanges.

What is the margin system?: The National Securities Clearing Corporation (NSCCL) has developed a comprehensive risk containment mechanism for the Futures & Options segment. The most critical component of a risk containments mechanism for NSCCL is the online position monitoring and margining system. The actual margining and position monitoring is done online, on an intra-day basis. It uses the Standard Portfolio Analysis of risk (SPAN) system for the purpose of margining, which is a portfolio–based system.

total loss or gain, but holders of futures experience that loss/gain in daily increments which track the forward's daily price changes, while the forward's spot price converges to the settlement price. Thus, while under mark to market accounting, for both assets the gain or loss accrues over the holding period; for a futures this gain or loss is realized daily, while for a forward contract the gain or loss remains unrealized until expiry.

Note that, due to the path dependenc**e** of funding, a futures contract is *not*, strictly speaking, a European-style derivative: the total gain or loss of the trade depends not only on the value of the underlying asset at expiry, but also on the path of prices on the way. This difference is generally quite small though.

With an exchange-traded future, the clearing house interposes itself on every trade. Thus there is no risk of counterparty default. The only risk is that the clearing house defaults (e.g. become bankrupt), which is considered very unlikely.

A closely related contract is a forward contract. A forward is likea futures in that it specifies the exchange of goods for a specified price at a specified future date. However, a forward is not traded on an exchange and thus does not have the interim partial payments due to marking to market. Nor is the contract standardized, as on the exchange.

Who trades futures: Futures traders are traditionally placed in one of two groups: hedgers, who have an interest in the underlying asset (which could include an intangible such as an index or interest rate) and are seeking to *hedge out* the risk of price changes; and speculators,who seek to make a profit by predicting market moves and opening a derivativescontract related to the asset "on paper", while they have no practical use for or intent to actually take or make delivery of the underlying asset. In other words, the investor is seeking exposure to the asset in a long futures or the opposite effect via a short futures contract.

Hedgers: Hedgers typically include producers and consumersof a commodity or the owner of an asset or assets subject to certain influences such as an interest rate.For example in traditional commodity market, farmers often sell futures contracts for the crops and livestock they produce to guarantee a certain price, making it easier for them to plan. Similarly, livestock producers often purchase futures to cover their feed

generally considered in the form of a profit or loss, by the purchasing party.

Forwards, like other derivative securities, can be used to hedgerisk (typically currency or exchange rate risk), as a means of speculation, or to allow a party to take advantage of a quality of the underlying instrument which is time-sensitive.

A closely related contract is a futures contract; they differ in certain respects. Forward contracts are very similar to futures contracts, except they are not exchange-traded, or defined on standardized assets. Forwards also typically have no interim partial settlements or "true-ups" in margin requirements like futures – such that the parties do not exchange additional property securing the party at gain and the entire unrealized gain or loss builds up while the contract is open. However, being traded over the counter (OTC) forward contracts, specification can be customized and may include mark-to-market and daily margining. Hence, a forward contract arrangement might call for the loss party to pledge collateral or additional collateral to better secure the party at gain

How a forward contract works: Suppose that Bob wants to buy a house a year from now. At the same time, suppose that Andy currently owns a $100,000 house that he wishes to sell a year from now. Both parties could enter into a forward contract with each other. Suppose that they both agree on the sale price in one year's time of $104,000 (more below on why the sale price should be this amount). Andy and Bob have entered into a forward contract. Bob, because he is buying the underlying, is said to have entered a long forward contract. Conversely, Andy will have the short forward contract.

At the end of one year, suppose that the current market valuation of Andy's house is $110,000. Then, because Andy is obliged to sell to Bob for only $104,000, Bob will make a profit of $6,000. To see why this is so, one needs only to recognize that Bob can buy from Andy for $104,000 and immediately sell to the market for $110,000. Bob has made the difference in profit. In contrast, Andy has made a potential loss of $6,000, and an actual profit of $4,000.

The similar situation works among currency forwards, where one party opens a forward contract to buy or sell a currency (ex. a contract to buy Canadian dollars) to expire/

For the holders of call and put options, the exercise of the right would be worthwhile only if the price of underlying securities, of the respective option, rise/falls above/ below the exercise price. There can be options on commodities, currencies, securities, stock index, and individual stock and even on futures. In order to acquire the right of option, the option buyer pays the option seller (option writer) and an option premium, which is the price paid for the right. The buyer of an option can lose no more than the option premium paid but his possible gain is unlimited. The option writers' possible loss is unlimited but his maximum gain is restricted to the option premium charged by him to the holder. The most critical aspect of option contract is the evaluation of the fairness of the option premium, that is, option pricing. The availability both financial futures and options would provide the users with the wider choice of hedging instruments. At issue time, to make hedging possible, the market should have speculators who are prepared to be counterparties to hedgers. A derivative market wholly/mostly consisting of speculators is unlikely to be a sound economic institutions, a sound derivative market requires the presence of both hedgers and speculators (M.Y. Khan).

For example, if Indian importer has to pay three months hence $10,000 to U.S. exporter, he has purchased a call option at a price (premium) of Rs. 0.04 per dollar or Rs.400 for $10,000, contracted for. In this case he has hedged his currency risk for his payment due in U.S. dollar. If by chance the spot price at the time of his is Rs.43.60 per $ he is in the money. He would exercise this option and buy $10,000 at the option exercise price of 43.30, when the spot price is 43.60 a gain of Rs.3000, which is, more than offset the premium of Rs.400 that he paid. If at the time of the payment, the spot price is less than Rs.43.30 the option is out of money and he will not exercise the option; he will buy the required dollars from the spot market and his loss on the contract is Rs. 400 only. The omporter will exercise the option only when the spot price is more than Rs.43.34 per $ inclusive of the premium paid for option (Rs.0.04) (spot 43.30+ 0.04)

The reverse is the case of put option. The exercise price and the premium paid may remain the same. Here the exporter wants to sell his $10,000 due to be received at the end of three months. The put option would be "in the money" at any price of

reports, provision of technical advice, market information about both domestic and export markets, and management of services.

NBFIs: They raise funds from the public directly or indirectly, to lend them to ultimate borrowers. The development banks like IDBI, IFCI, and ICICI, SFCs and land development bank etc. fall in this category. They specialize in making term loans to borrowers. LIC, GIC and UTI are term lending institutions. Out of these only UTI is a pure NBFI, the other raise funds as premia from sale of insurance.

NBFCs: NBFCs accept deposit from the public. The RBI divides them into two category: 1.financial companies and 2. Non-finance companies. Only the financial companies can be called NBFIs as they raise funds from the public and also lend to it, whereas non-financial companies basically engaged in manufacturing or trade and accept deposit from the public for their own use.

Over-the-Counter: These deals in such securities as are not listed on organized stock exchange. These are securities of small companies and have only a limited market. There prices are determined through direct negotiation between stock brokers and not through open bidding as is the case with listed securities on a stock exchange.

Investment companies: Investment companies are purely financial intermediaries that specialise in the mobilisation of public savings for investment in corporate securities. Unlike commercial banks and insurance companies, they do not render any other service other than that of financial intermediation.

1.9 SUMMARY

Financial System is the collection of saving and their distribution for industrial investment, thereby stimulating the capital formation and, to that extent, accelerating the process of economic growth. The process of capital formation involves three distinct, although inter-related activities: saving, finance and investment. Financial intermediaries play a vital role in economic development via capital formation. Their relevance to the flow of savings is derived from what is called transmutation effect. This term refers to the ability of the financial intermediaries to convert contracts with a given set of characteristics into a contract with very different features.Types of

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DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

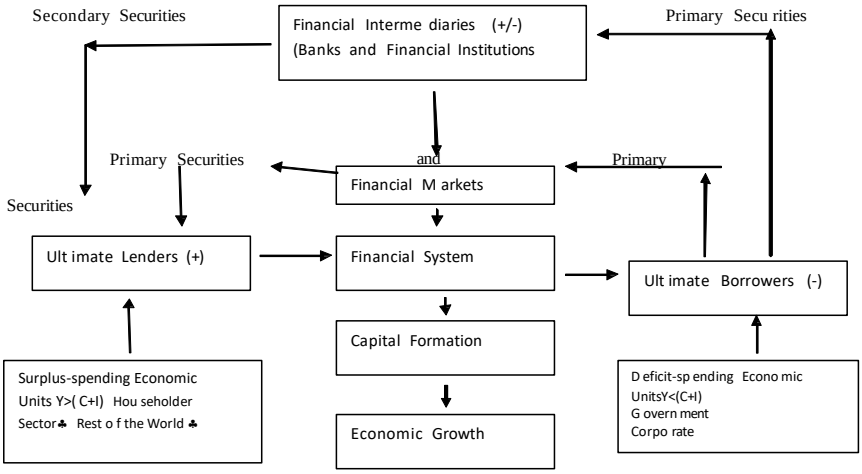
STRUCTURE

activities. In the process of capital formation, financial system helps not only in effective mobilisation of savings from a large number of scattered masses and canalisation of these savings into the most desirable and productive forms of investment but also affect the growth of real savings through their numerical spread over sections of population approached, accessibility, popularity, nature and extent of facilities offered and the rate of interest paid on deposits. The financial system, thus, helps to promote the process of capital formation by bringing together the supply of savings and demand for investible funds. In a modern economy, which is characterised by money exchange, the bulk of the investors are business firms, while the prime savers are the households. Business firms desiring funds for investment can and do borrow some of what they need directly from savers by selling to them stocks and bonds, but many savers are unwilling to lend their money directly to business in exchange for these types of financial claims. In such a situation, some intermediary is needed to bring the deficit and surplus units together. Indeed, this is the prime role of financial system. Financial system not only helps in mobilisation and collection of scattered savings from different sections of population, but they also help to increase the overall level of savings and investment and allocate more efficiently scarce savings among most desirable and productive investments in accordance with the national priorities. There is another important angle to the role of financial system in economic development, particularly of banks, which has been popularised by distinguished economists like Schumpeter, Kalecki and Keynes. To Schumpeter, bank credit plays a critical role in stimulating economic development. According to him, "created credit" enables an entrepreneur to proceed with his innovation in anticipation of savings. He wrote, "the banker, therefore, is not so much primarily a middleman in the commodity 'purchasing power', as a producer of this commodity". Newly created purchasing power by banks placed in the hands of the entrepreneur enables him to secure command over physical resources and thus push through his investment projects. Once the investment results in increased production, the initial credit inflation disappears and the equivalence between money and commodities streams is restored. Both Kalecki and Keynes regarded the availability of finance as a key factor in ensuring independence of investment from savings. Schumpeter had vehemently emphasised the crucial role of credit

effectively channelled into the hands of investors. Further, in the developing countries, institutional arrangements for the mobilisation and channelling of financial resources must be continuously expanded and adopted to the growing and varied needs of the economy. But whatever said, the important role of a financial system in any economy can be best understood with the help of Chart- 2.1.

Cha rt-2 .1

Financial System and Economic Growth



Note: + (Surplus) - (Deficit) Where Y = Income C = Consumption I = Planned Investment

Chart-2.1.very clearly shows the role of an efficient financial system in achieving economic growth. For the surplus spending units i.e., household sector, and rest of the world, income (Y) is greater than the combination of consumption and planned investment, hence they become the ultimate lenders in the economy. The deficit spending units like the government and corporate experience a function of Y< (C+I), that is income is less than the sum of consumption and planned investment and eventually they are the ultimate borrowers. The job of efficiently linking these economic units is done in a systemic and organised manner by the financial system. Besides linking savings and investment, the financial system helps in accelerating the rate of savings and investment by offering diversified financial services and instruments. This promotes a larger production of goods and services in the economy, leading to economic growth.

2. Elaborate various financial markets

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2.7 LESSON END EXERCISE

1. Discuss in detail financial market in India.

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2.8 SUGGESTED READINGS

- Babu, G. Ramesh, "Indian Financial System", 2005, Ist Edition, Himalayan Publishing House, Mumbai.
- Madura, Jeff (2009), "Financial Markets and Institution", 9th Edition, South-Western College Publication.
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- Desai, Vasant (2005), "The Indian Financial System and Development", 1st Edition, Himalayan Publishing House, Mumbai.

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3.1 Introduction

The financial markets are the centre that made provisions for buying and selling of financial claims and services. In India, the financial markets are the combination of money market and capital market. Money market refers to short term finance with a period of maturity of one year or less. It deals with relatively liquid and quickly marketable assets. Capital market is a market for long term securities. It contains financial instruments of maturity period exceeding one year.

Objectives

After going through this lesson you should be able to

- understand the concept of Money Market
- Know about the constituents of Money Market
- have a Knowledge of varios defects of Money Market

3.2 Need and Objectives of Money Market

Money market is a market for short-term funds. We define the short-term as a period of 364 days or less. In other words, the borrowing and repayment takes place in 364 days or less. The manufacturers need two types of finance: finance to meet daily expenses like purchase of raw material, payment of wages, excise duty, electricity charges etc., and finance to meet capital expenditure like purchase of machinery, installation of pollution control equipment etc.

The first category of finance is invested in the production process for a short-period of time. The market where such short-time finance is borrowed and lent is called 'money market'. Almost every concern in the financial system, be it a financial institution, business firm, a corporation or a government body, has a recurring problem of liquidity management, mainly because the timing of the expenditures rarely synchronize with that of the receipts.

The most important function of the money market is to bridge this liquidity gap. Thus, business and finance firms can be tide over the mismatches of cash receipts and cash expenditures by purchasing (or selling) the shortfall (or surplus) of funds in the money

call money market, bill market, etc.

6. Money market establishes a link between RBI and banks and provides information of monetary policy and management.

7. Transactions can be conducted without the help of brokers.

8. Variety of instruments are traded in money market.

Objectives of Money Market

Following are the objectives of money market:

To cater to the requirements of borrowers for short term funds, and provide liquidity to the lenders of these funds.

2. To provide parking place for temporary employment of surplus fund.

3. To provide facility to overcome short term deficits.

4. To enable the central bank to influence and regulate liquidity in the economy.

5. To help the government to implement its monetary policy through open market operation.

3.3 Structure of Indian Money Market

(i) Broadly speaking, the money market in India comprises two sectors- (a) Organised sector, and (b) Unorganised sector.

(ii) The organised sector consists of the Reserve Bank of India, the State Bank of India with its seven associates, twenty nationalised commercial banks, other scheduled and non-scheduled commercial banks, foreign banks, and Regional Rural Banks. It is called organised because its part is systematically coordinated by the RBI.

(iii) Non-bank financial institutions such as the LIC, the GIC and subsidiaries, the UTI also operate in this market, but only indirectly through banks, and not directly.

(iv) Quasi-government bodies and large companies also make their short-term surplus funds available to the organised market through banks.

(v) Cooperative credit institutions occupy the intermediary position between organised and unorganised parts of the Indian mo3n7ey market. These institutions have a three-

(a) The Reserve Bank of India;

(b) The State Bank of India and its associate banks;

(c) The Indian joint stock commercial banks (scheduled and non-scheduled) of which 20 scheduled banks have been nationalised;

(d) The exchange banks which mainly finance Indian foreign trade;

(e) Cooperative banks;

(f) Other special institutions, such as, Industrial Development Bank of India, State Finance Corporations, National Bank for Agriculture and Rural Development, Export-Import Bank, etc., which operate in the money market indirectly through banks; and

(g) Quasi-government bodies and large companies also make their funds available to the money market through banks.

II. Demand for Funds:

In the Indian money market, the main borrowers of short-term funds are: (a) Central Government, (b) State Governments, (c) Local bodies, such as, municipalities, village panchayats, etc., (d) traders, industrialists, farmers, exporters and importers, and (e) general public.

3.5 Sub-Markets of Organised Money Market:

The organised sector of Indian money market can be further classified into the following sub-markets:

Call Money Market:

The most important component of organised money market is the call money market. It deals in call loans or call money granted for one day. Since the participants in the call money market are mostly banks, it is also called interbank call money market.

The banks with temporary deficit of funds form the demand side and the banks with temporary excess of funds form the supply side of the call money market.

The main features of Indian call money market are as follows:

(i) Call money market provides the institutional arrangement for making the temporary

In the U.S.A. and the U.K., the treasury bills are the most important money market instrument:

(a) Treasury bills provide a risk-free, profitable and highly liquid investment outlet for short-term, surpluses of various financial institutions;

(b) Treasury bills from an important source of raising fund for the government; and

(c) For the central bank the treasury bills are the main instrument of open market operations.

On the contrary, the Indian Treasury bill market has no dealers expect the Reserve Bank of India. Besides the Reserve Bank, some treasury bills are held by commercial banks, state government and semi-government bodies. But, these treasury bills are not popular with the non-bank financial institutions, corporations, and individuals mainly because of absence of a developed treasury bill market.

3.7 Commercial Bill Market:

Commercial bill market deals in commercial bills issued by the firms engaged in business. These bills are generally of three months maturity. A commercial bill is a promise to pay a specified amount in a specified period by the buyer of goods to the seller of the goods. The seller, who has sold his goods on credit draws the bill and sends it to the buyer for acceptance. After the buyer or his bank writes the word 'accepted' on the bill, it becomes a marketable instrument and is sent to the seller.

The seller can now sell the bill (i.e., get it discounted) to his bank for cash. In times of financial crisis, the bank can sell the bills to other banks or get them rediscounted from the Reserved Bank. In India, the bill market is undeveloped as compared to the same in advanced countries like the U.K. There is absence of specialised institutions like acceptance houses and discount houses, particularly dealing in acceptance and discounting business.

3.8 Collateral Loan Market:

Collateral loan market deals with collateral loans i.e., loans backed by security. In the Indian collateral loan market, the commercial banks provide short- term loans against government securities, shares and debentures of the government, etc.

lending programmes are for very long periods, their role in the money market is a little less.

4. Mutual Funds:

Mutual funds offer varieties of schemes for the different investment objectives of the public. There are many schemes known as Money Market Mutual Fund Schemes or Liquid Schemes. These schemes have the investment objective of investing in money market instruments.

They ensure highest liquidity to the investors by offering withdrawal by way of a day's notice or encashment of units through Bank ATMs. Naturally, mutual funds invest the corpus of such schemes only in money market. They do not borrow, but only lend or invest in the money market.

5. Banks:

Scheduled commercial banks are very big borrowers and lenders in the money market. They borrow and lend in call money market, short-notice market, repo and reverse repo market. They borrow in rediscounting market from the RBI and IDBI. They lend in commercial paper market by way of buying the commercial papers issued by corporates and listed public sector units. They also borrow through issue of Certificate of Deposits to the corporates.

6. Corporates:

Corporates borrow by issuing commercial papers which are nothing but short-term promissory notes. They are issued by listed companies after obtaining the necessary credit rating for the CP. They also lend in the CBLO market their temporary surplus, when the interest rate rules very high in the market. They are the lender to the banks when they buy the Certificate of Deposit issued by the banks. In addition, they are the lenders through purchase of Treasury bills.

There are many other small players like non-banking finance companies, primary dealers, provident funds and pension funds. They mainly invest and borrow in the

CBLO market in a small way.

IV. Absence of All-India Money Market:

Indian money market has not been organised into a single integrated all-Indian market. It is divided into small segments mostly catering to the local financial needs. For example, there is little contact between the money markets in the bigger cities, like, Bombay, Madras, and Calcutta and those in smaller towns.

V. Inadequate Banking Facilities:

Indian money market is inadequate to meet the financial need of the economy. Although there has been rapid expansion of bank branches in recent years particularly after the nationalisation of banks, yet vast rural areas still exist without banking facilities. As compared to the size and population of the country, the banking institutions are not enough.

VI. Shortage of Capital:

Indian money market generally suffers from the shortage of capital funds. The availability of capital in the money market is insufficient to meet the needs of industry and trade in the country. The main reasons for the shortage of capital are- (a) low saving capacity of the people; (b) inadequate banking facilities, particularly in the rural areas; and (c) undeveloped banking habits among the people.

VII. Seasonal Shortage of Funds:

A Major drawback of the Indian money market is the seasonal stringency of credit and higher interest rates during a part of the year. Such a shortage invariably appears during the busy months from November to June when there is excess demand for credit for carrying on the harvesting and marketing operations in agriculture. As a result, the interest rates rise in this period. On the contrary, during the slack season, from July to October, the demand for credit and the rate of interest decline sharply.

VIII. Diversity of Interest Rates:

Another defect of Indian money market is the multiplicity and disparity of interest rates. In 1931, the Central Banking Enquiry Committee wrote- "The fact that a call rate of 3/4 per cent, a hundi rate of 3 per cent, a bank rate of 4 per cent, a bazar rate of small traders of 6.25 per cent and a Calcutta bazar rate for bills of small trader of 10 per cent can exist simultaneously indicates an extraordinary sluggishness of the

Market, the New York Money Market, etc., Indian money market is still an undeveloped money market. It is "a money market of a sort where banks and other financial institutions lend or borrow funds for short periods."

The following characteristics of Indian money market highlight its undeveloped nature:

(i) The Indian money market does not possess highly developed and adequately developed banking system.

(ii) It lacks sufficient and regular supply of short-term assets such as bills of exchange, treasury bills, short-term government bonds, etc.

(iii) There is no uniformity in the interest rates which vary considerably among different financial institutions as well as centres,

(iv) In the Indian money market, there are no dealers in short-term assets who can function as intermediaries between the government and the banking system,

(v) No doubt, a well-developed call money market exists in India, there is absence of other necessary sub-markets such as the acceptance market, commercial bill market, etc.

(vi) There is no proper coordination between the different sectors of the money market,

(vii) The Indian money market does not attract foreign funds and thus lacks international status.

3.10 Measures to Improve Indian Money Market:

3.10.1 General Measures

In a view of the various defects in the Indian money market, the following suggestions have been made for its proper development:

(i) The activities of the indigenous banks should be brought under the effective control of the Reserve Bank of India.

(ii) Hundies used in the money market should be standardised and written in the uniform manner in order to develop an all-India money market,

country have been given equal treatment by the Reserve Bank as regards licensing, opening of branches, share capital, the type of loans to be given, etc.

(v) In order to develop a sound money market, the Reserve Bank of Indian has taken measures to amalgamate and merge banks into a few strong banks and given encouragement to the expansion of banking facilities in the country,

(vi) The Reserve Bank of India has been able to reduce considerably the differences in the interest rates between different sections as well as different centres of the money market.

Now the interest rate structure of the country is much more sensitive to changes in the bank rate. Thus, the Reserve Bank of India has succeeded to a great extent in improving the Indian money market and removing some of its serious defects.

But, there are certain difficulties faced by the Reserve Bank in controlling the money market:

(i) The absence of bill market restricts the Reserve Bank's ability to withdraw surplus funds from the money market by disposing of bills.

(ii) The existence of indigenous bankers is the major hurdle in the way of integrating the money market.

(iii) Inadequate development of call money market is another difficulty in controlling the money market. The banks do not maintain fixed ratios between their cash reserves and deposits and the Reserve Bank has to undertake large open market operations to influence the policy of the banks.

Working Group on Money Market:

In, 1986, the Reserve Bank of India set up a Working Group under the chairmanship of Mr. N. Vaghul to examine the possibilities of enlarging the scope of money market and to recommend specific measures for evolving other suitable money market instruments.

The Working Group submitted its Report in January, 1987. It has made a number of recommendations for activating and developing the Indian money market.

(vi) Total deregulation of money market interest rates with effect from May 1, 1989 is a significant step taken by RBI towards the activation of money market. Removing the interest ceiling on money rates would make them flexible and lend transparency to transactions in the money market.

(vii) Certificates of Deposits (CDs) were introduced in June 1989 to give investors greater flexibility in employment of their short-term funds.

(viii) Another money market instrument, Commercial Paper (CP), was introduced in 1990-91 to provide flexibility to the borrowers rather than additionally of funds over and above the eligible credit limit.

(ix) Since July 1987, the Credit Authorisation Scheme (CAS) has been liberalised to allow for greater access to credit to meet genuine demand in production sectors without the prior sanction of the Reserve Bank.

(x) In April, the Discount and Finance House of Indian Limited (DFHI) was established with a view to increasing the liquidity of money market instruments.

(xi) In 1991, the scheduled commercial banks and their subsidiaries were permitted to set up Money Market Mutual Fund (MMMF) which would provide additional short-term avenue to investors and bring money market instruments within the reach of individuals and small bodies.

As a result of various measures taken by the RBI, the Indian money market has shown signs of notable development in many ways:

(i) It is becoming more and more organised and diversified.

(ii) The government trading in various instruments, like 364 Day treasury Bills, commercial bills and commercial paper, has increased considerably.

(iii) The volume of inter-bank call money, short notice money and term money transactions have grown significantly.

(iv) At present, scheduled commercial banks, cooperative banks, Discount and Finance House of India (DFHI) are participating in the money market both as lenders and borrowers of short-term funds, while Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), General Insurance Corporation of India (GIC), Industrial

Table 1 : Business of DFHI

(In Rs. Crores)

Item	1992	1993-94	1994-95
1. Lendings			
(a) Call Money Market	343441	482199	467108
(daily average)	(1249)	(1493)	(1446)
(b) Notice Money (2-14 days)	1332	5121	4519
(c) Term Money (15-90 days)	3673	1526	19
2. Turnover			
(a) Treasury Bills	13094	158926	23123
(b) Commercial Bills	565	26	75
(c) Certificates of Deposits	28	187	-
(d) Commercial Paper	-	211	-
(e) Government Securities	6233	14194	11385

Certificate of Deposit (CD) and Commercial Paper (CP):

In March 1989, Reserve Bank of India decided to introduced Certificates of Deposit (CD) and Commercial Paper (CP) in order to widen the range of money market instruments and give investors greater flexibility in the deployment of their short-term surplus funds.

I. Certificates of Deposit (CD):

The Certificates of Deposit (CD) can be issued only by the scheduled commercial banks in multiple of Rs. 25 lakhs subject to the minimum size of an issue being Rs. 1 crore. Their maturity will vary between three months and one year. CDs will be issued at discount to face value and the discount rate will be freely determined. They will be further freely transferable by endorsement and delivery. CDs will, however, be subject to reserve requirements. Banks will neither be allowed to grant loans against CDs, nor can they buy their own CDs.

II. Commercial Paper (CP):

Commercial Paper (CP) can be issued by a listed company which has a net worth of at least Rs. 10 crores and a working capital limit of not less than Rs. 25 crore. CPs will be issued in multiples of Rs. 25 lakhs subject to the minimum size of an issue being

3.13 Glossary

Money market: The money market is an avenue for borrowing and lending for the short-term. While on one hand the money market helps in shifting vast sums of money between banks, on the other hand, it provides a means by which the surplus of funds of the cash rich corporations and other institutions can be used (at a cost) by banks, corporations and other institutions which need short-term money.

Call Money Market: The banks with temporary deficit of funds form the demands side and the banks with temporary excess of funds form the supply side of the call money market.

Treasury Bill market: The treasury bill market deals in treasury bills which are the short-termliability of the Government of India.

3.14 Self Assessment Questions

1. Explain the concept of money market

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2. Discuss the various constituents of money market

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3.15 Lesson end Exercise

1. Discuss the various measures to improve money market.

_____

M.COM-III **COURSE NO.: MCOMFE352**
UNIT-I **LESSON NO. IV**

CAPITAL MARKETS

STRUCTURE

concentrated in major financial centers including New York, London, Singapore, and Hong Kong.

Capital markets are composed of the suppliers and users of funds. Suppliers include households and the institutions serving them—pension funds, life insurance companies, charitable foundations, and non-financial companies—that generate cash beyond their needs for investment. Users of funds include home and motor vehicle purchasers, non-financial companies, and governments financing infrastructure investment and operating expenses.

Capital markets are used to sell financial products such as equities and debt securities. Equities are stocks, which are ownership shares in a company. Debt securities, such as bonds, are interest-bearing IOUs.

These markets are divided into two different categories: primary markets—where new equity stock and bond issues are sold to investors—and secondary markets, which trade existing securities. Capital markets are a crucial part of a functioning modern economy because they move money from the people who have it to those who need it for productive use.

4.3.1 PRIMARYVERSUS SECONDARY CAPITAL MARKETS

Capital markets are composed of primary and secondary markets. The majority of modern primary and secondary markets are computer-based electronic platforms.

Primary markets are open to specific investors who buy securities directly from the issuing company. These securities are considered primary offerings or initial public offerings (IPOs). When a company goes public, it sells its stocks and bonds to large-scale and institutional investors such as hedge funds and mutual funds.

The secondary market, on the other hand, includes venues overseen by a regulatory body like the Securities and Exchange Commission (SEC) where existing or already-issued securities are traded between investors. Issuing companies do not have a part in the secondary market. The New York Stock Exchange (NYSE) and Nasdaq are examples of the secondary market.

Features of capital markets:

1. Link between Savers and Investment Opportunities:

Capital market is a crucial link between saving and investment process. The capital market transfers money from savers to entrepreneurial borrowers.

2. Deals in Long Term Investment:

Capital market provides funds for long and medium term. It does not deal with channelising saving for less than one year.

3. Utilises Intermediaries:

Capital market makes use of different intermediaries such as brokers, underwriters, depositories etc. These intermediaries act as working organs of capital market and are very important elements of capital market.

4. Determinant of Capital Formation:

The activities of capital market determine the rate of capital formation in an economy. Capital market offers attractive opportunities to those who have surplus funds so that they invest more and more in capital market and are encouraged to save more for profitable opportunities.

5. Government Rules and Regulations:

The capital market operates freely but under the guidance of government policies. These markets function within the framework of government rules and regulations, e.g., stock exchange works under the regulations of SEBI which is a government body.

4.5 INSTRUMENTS OF CAPITAL MARKET

1. Shares

Shares are a unit of ownership in an organisation or corporation. It is a part of the company's capital. Those individuals who are getting shares from any company, are called Shareholders. When a company wants to borrow and increase their capital, they issue their shares in the stock market (exchange) for their investors.

Fixed Deposit

Fixed Deposit is that kind of bank account, where the amount of deposit is fixed for a specified period of time. All Commercial banks are given these opportunities to their customers for opening a fixed account in their bank. In a Fixed account, the amount of deposit is fixed, which means we cannot withdraw an unlimited amount from this account, therefore it is also called a Fixed Deposit.

If an account holder wants to withdraw a small amount of money from their account, then he will require closing of the Fixed deposit account.

TOP 14 COMPANIES

Company Name	Last Price	% Chg	52 wk High	52 wk Low	Market Cap (Rs. cr)
Reliance	1,445.85	-2.29	1,617.80	1,095.65	916,553.74
TCS	2,133.00	-0.92	2,290.65	1,882.00	800,383.66
HDFC Bank	1,225.30	-0.86	1,304.10	1,011.50	671,100.13
HUL	2,066.35	-0.35	2,187.00	1,649.70	447,325.94
HDFC	2,411.40	0.32	2,499.65	1,821.55	416,937.73
ICICI Bank	529.80	0.64	552.40	336.25	342,746.37
Infosys	781.80	-0.97	847.40	615.00	332,933.28
Kotak Mahindra	1,629.30	-0.72	1,734.35	1,209.50	311,364.93
ITC	233.95	-1.22	310.00	230.50	287,550.89
SBI	309.75	-2.10	373.70	244.35	276,439.84
Bharti Airtel	490.65	0.12	527.20	269.25	267,676.92
Bajaj Finance	4,366.45	-1.25	4,444.40	2,360.95	262,724.52
Maruti Suzuki	7,021.30	0.13	7,755.00	5,447.00	212,099.47
Axis Bank	730.10	-0.71	826.55	622.60	205,870.1

4. Regulation of NRI Investments:

The Amendment of Foreign Exchange Regulation Act (FERA) into Foreign Exchange Management Act (FEMA) has given more encouragement to non resident investors. The percentage of NRI investment in Indian companies has been increased from 5% to 24%. In the year 1991, India faced an acute shortage of foreign exchange and the then finance minister adopted certain methods to improve the foreign exchange reserves. He allowed investment by any individual NRI in any Indian company from the then existing 5% of paid up capital to 24%. This had resulted in more inflow of foreign funds into India. Foreign financial institutions have been made to invest directly in the Indian capital market. The lock-in period of NRIs in equity shares in Indian companies has been reduced from 3 years to 1 year. Any profit earned while diluting the shares will attract 20% tax on profit.

5. Direct Foreign Investment:

The Foreign Investment Promotion Board, consisting of the Secretaries of industries, finance and foreign affairs, have allowed more direct foreign investment in core sector, especially in power sector.

6. FERA Companies:

Under the Foreign Exchange Regulation Act, a FERA company is one which has 40% equity participation by foreigners. This limit has been removed and now even foreign companies are allowed to have 51% equity participation. For example, Colgate Polmolive has increased its foreign equity participation from 40 to 51%. As a result, we are able to attract more foreign capital into Indian capital market. The FERAAct has since been amended and is now known as Foreign Exchange Management Act (FEMA).

7. Online Trading in Indian Capital Market:

Some of the leading stock markets in India have introduced computer system for their trading activities. The brokers can get hooked-up and do their trading on Online basis. The computer terminals will enable the public and the brokers to know the price prevailing in the market at any time. This will prevent speculation activities.

Since the market operations cannot be resumed for the day, share prices will fall. Wild speculation in shares will be a thing of the past.

12. Demating of shares in Indian Capital Market:

The introduction of demating has resulted in improving transactions further. Demating is a system under which physical delivery of shares is no more adopted. It is called *"scripless trade"*. The shares of individual investors are held by stock holding company and a pass book is given to individual investors. Any sale or purchase of shares will result in entries made in the pass book. The companies concerned are also informed for making due alterations in the share register. This has prevented blank transfer and speculation. Every transaction in the market is not only recorded but it brings revenue to the Government in the form of registration and stamp charges. Blank transfers will not be possible and short term speculation in shares cannot be done. Every share purchased or sold will have to go for registration and hence bogus or benami share transfer is not possible.

13. Market Makers in Indian Capital Market:

The share price of companies will be decided by the market forces of supply and demand. There are market makers who will ensure the supply and reasonable price for the stocks of companies. By the introduction of these market makers, manipulation of share price by the brokers is prevented.

14. Securities and Exchange Board of India:

The creation of Securities and Exchange Board of India (SEBI) is an important development in Indian capital market of India. SEBI has not only replaced the Controller of Capital issues, but has brought in uniformity in the transactions in all stock exchanges.

15. Renewal of Registration:

All the brokers and sub brokers have to register afresh with SEBI and any complaints against them will be inquired and if found guilty, punishment is given.

16. Over The Counter Exchange of India (OTCEI):

For the purpose of newly promoted companies, another stock exchange with lesser

invest more than 10% of their investable funds in any single company and not more than 10% of single company's issue of shares can be purchased by mutual funds.

22. Educating Public:

Press and media have contributed a lot in popularizing the Indian capital market and they are highlighting the prices of securities everyday. The mutual funds and merchant banks have been asked to set apart a portion of their funds towards educating the public on the developments in the Indian capital market.

23. Government Securities Market:

After the stock scam, the Central Government has de-linked Government securities from trading along with company securities. In other words, there will be separate market for Government securities and they will not be dealt along with company securities in the stock market. The measure was taken by Dr. Manmohan Singh when he was the Finance Minister.

24. Future trading in Indian Capital Market:

Future trading is a contract to buy or sell a particular financial instrument on a future date at a specific price. The contract enables the parties to transfer according to the changes in the price from one person to another. By this, the risk is minimized. In every future contract, we have a buyer and a seller. And if one makes a profit in a particular contract, the other person may try to minimize his loss through some other contract. Thus, the future market provides scope for the traders to minimize their loss or the risks in trading of financial instruments. We have different types of 'financial futures'.

25. Penalty for insider trading in Indian Capital Market:

In 2002, SEBI Act was amended to make insider trading punishable as a serious offense. The penalty rate has been enhanced to Rs. 1 lakh per day and the maximum penalty can go up to Rs. 25 crores.

26. Period of settlement in Indian Capital Market:

After removing the Badla, SEBI has introduced T+2…… – system for settling transactions in Indian capital market. Accordingly, all transactions entered in the capital

- **Mutual Fund Definition:** A mutual fund is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities, which is overseen by a professional money manager.

4.9 SELFASSESSMENT QUESTIONS

1. What is capital market?

2. Who is the regulator of capital market ?

3. Name the three components of capital market?

4.10 LESSON END EXERCISE

1. Which organisation regulates capital market?

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- https://economictimes.indiatimes.com/topic/Capital-markets.
- Capital Market and Financial System in India Book by Asheesh Pandey.

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5.1 Introduction

The Money Market is a component of the state economy which provides short-term funds. It deals in short-term loans, generally for a period of less than a financial year or equal to 365 days.

As money became a commodity, the money market became a component of the financial market for assets involved in short-term borrowing, lending, buying and selling.

Trading in money markets is done over the counter and is wholesale. There are several money market instruments in most Western countries, including treasury bills, commercial paper, bankers 'acceptances, deposits, certificates of deposit, bills of exchange, repurchase agreements, federal funds, and short-lived mortgage- and asset-backed securities. The instruments bear differing maturities, currencies, credit risks, and structures.

5.2 Objectives

After going through this lesson, you should be able to;

- Describe the objectives of money market.
- Discuss the difference between capital market and money market..
- Discuss the various instruments of money market.
- Understand derivatives and its types.

5.3 Money Market

Money markets, provide liquidity for the global financial system including for capital markets, are part of the broader system of financial markets. Broadly, Money markets serve in:

- to finance trade
- finance industry
- invest profitably

approach the central bank and borrow at a higher interest rate. They can instead meet their requirements by recalling their old short-run loans from the money market.

e. Help to central bank

Though the central bank can function and influence the banking system in the absence of a money market, the existence of a developed money market smoothes the functioning and increases the efficiency of the central bank.

Money markets help central banks in two ways:

Short-run interest rates serve as an indicator of the monetary and banking conditions in the country and, in this way, guide the central bank to adopt an appropriate banking policy,

Sensitive and integrated money markets help the central bank secure quick and widespread influence on the sub-markets, thus facilitating effective policy implementation

5.4 Money Market vs. Capital Market

A capital market can be either a primary market or a secondary market. In primary market, new stock or bond issues are sold to investors, often via a mechanism known as underwriting. The main entities seeking to raise long-term funds on the primary capital markets are governments (which may be municipal, local or national) and business enterprises (companies). Governments issue only bonds, whereas companies often issue both equity and bonds. The main entities purchasing the bonds or stock include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf. In the secondary market, existing securities are sold and bought among investors or traders, usually on an exchange, over-the-counter, or elsewhere. The existence of secondary markets increases the willingness of investors in primary markets, as they know they are likely to be able to swiftly cash out their investments if the need arises.The money markets are used for the raising of short-term finance, sometimes for loans that are expected to be paid back as early as overnight. In contrast, the “capital markets” are used for the

is	Money Market	Capital Market
aning	A random course of financial institutions, bill brokers, money dealers, banks, etc., wherein dealing on short-term financial tools are being settled is referred to as Money Market.	A kind of financial market where the company or government securities are generated and patronised for the intention of establishing long-term finance to coincide the capital necessary is called as Capital Market.
ure of rket	Informal	Formal
ancial ls	Commercial Papers, Treasury Certificate of Deposit, Bills, Trade Credit, etc.,	Bonds, Debentures, Shares, Asset Securitization, Retained Earnings, Euro Issues, etc.,
anizations	Commercial bank, bill brokers, non-financial institutions, the central bank, acceptance houses, and so on.	The stock exchange, Commercial banks, non-banking organisations like insurance companies etc.,
k Factor	Low	High
uidity	High	Low
pose	To achieve short term credit requirements of the trade.	To achieve long term credit requirements of the trade.
e Horizon	Within a year	More than a year
rit	Rises liquidity of capitals in the market.	Mobilization of Economies in the market.
urn on estment	Less	High

5.5 Capital market Versus Bank Loans

Regular bank lending is not usually classed as a capital market transaction, even when loans are extended for a period longer than a year. First, regular bank loans are not securitized (i.e. they do not take the form of a releasable security like a share or bond that can be traded on the markets). Second, lending from banks is more heavily regulated than capital market lending. Third, bank depositors tend to be more risk-averse than capital market investors. These three differences all act to limit institutional lending as a source of finance. Two additional

in mutual fund institutions and they diversify the funds in various schemes.

- Commercial paper – Short term instruments promissory notes issued by company at discount to face value and redeemed at face value
- Eurodollar deposit – Deposits made in U.S. dollars at a bank or bank branch located outside the United States.
- Federal agency short-term securities – In the U.S., short-term securities issued by government sponsored enterprises such as the Farm Credit System, the Federal Home Loan Banks and the Federal National Mortgage Association. Money markets is heavily used function.
- Federal funds – In the U.S., interest-bearing deposits held by banks and other depository institutions at the Federal Reserve; these are immediately available funds that institutions borrow or lend, usually on an overnight basis. They are lent for the federal funds rate.
- Municipal notes – In the U.S., short-term notes issued by municipalities in anticipation of tax receipts or other revenues
- Treasury bills – Short-term debt obligations of a national government that are issued to mature in three to twelve months
- Money funds – Pooled short-maturity, high-quality investments that buy money market securities on behalf of retail or institutional investors
- Foreign exchange swaps – Exchanging a set of currencies in spot date and the reversal of the exchange of currencies at a predetermined time in the future
- Short-lived mortgage- and asset-backed securities

5.7 Market for Derivatives

Derivatives

The derivatives market is not for faint-hearted. Derivative is a product/financial instruments whose value is derived from the value of one/more basic variables called base (underlying assets/ index/reference rate) in a contractual manner.

What is the margin system?

The National Securities Clearing Corporation (NSCCL) has developed a comprehensive risk containment mechanism for the Futures & Options segment. The most critical component of a risk containments mechanism for NSCCL is the online position monitoring and margining system. The actual margining and position monitoring is done online, on an intra-day basis. It uses the Standard Portfolio Analysis of risk (SPAN) system for the purpose of margining, which is a portfolio–based system.

What are the risks involved?

An individual or a corporation should carefully weigh the risks of using derivatives since losses can be greater than the sums put in these instruments. It should be understood that derivatives themselves are not to be considered investments since they are not an asset class. Investors pay only a part of the value of the underlying asset and settle the remaining when a contract expires. Hence, when asset prices move sharply, profits or losses can be huge.

Who can participate in derivatives?

Anybody with an appetite for risk can participate in the derivatives market- it can be an individual, a broker or a company (Business Today, February 28, 2008).

5.7.1 Future Contract and its features

In finance futures contract (more colloquially, **futures**) is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed today (the *futures price* or strike price) with delivery and payment occurring at a specified future date, the *delivery date*. The contracts are negotiated at a futures exchange, which acts as an intermediary between the two parties. The party agreeing to buy the underlying asset in the future, the "buyer" of the contract, is said to be "long" and the party agreeing to sell the asset in the future, the "seller" of the contract, is said to be "short." The terminology reflects the expectations of the parties—the buyer hopes or expects that the asset price is going to increase, while the seller hopes or expects that it will

Who trades futures?

Futures traders are traditionally placed in one of two groups: hedgers, who have an interest in the underlying asset (which could include an intangible such as an index or interest rate) and are seeking to *hedge out* the risk of price changes; and speculators,who seek to make a profit by predicting market moves and opening a derivativescontract related to the asset "on paper", while they have no practical use for or intent to actually take or make delivery of the underlying asset. In other words, the investor is seeking exposure to the asset in a long futures or the opposite effect via a short futures contract.

Hedgers: Hedgers typically include producers and consumers of a commodity or the owner of an asset or assets subject to certain influences such as an interest rate. For example in traditional commodity market, farmers often sell futures contracts for the crops and livestock they produce to guarantee a certain price, making it easier for them to plan. Similarly, livestock producers often purchase futures to cover their feed costs, so that they can plan on a fixed cost for feed. In modern (financial) markets, "producers" of interest rates swaps or equity derivative products will use financial futures or equity index futures to reduce or remove the risk on the swap.

Those that buy or sell commodity futures need to be careful. If a company buys contracts hedging against price increases, but in fact the market price of the commodity is substantially lower at time of delivery, they could find themselves disastrously non-competitive.

Speculators: Speculators typically fall into three categories: position traders, day traders, and swing traders (swing trading) though many hybrid types and unique styles exist. With many investors pouring into the futures markets in recent years controversy has risen about whether speculators are responsible for increased volatility in commodities like oil, and experts are divided on the matter. An example that has both hedge and speculative notions involves a mutual fundsor separately managed account,whose investment objective is to track the performance of a stock index such as the S&P 500 stock index.

Future market and Features

1. Trading is conducted in a competitive arena by "open country" of

of the instrument changes. This is one of the many forms of buy/sell orders where the time and date of trade is not the same as the value date where the securities themselves are exchanged. The forward price of such a contract is commonly contrasted with the spot price, which is the price at which the asset changes hands on the spot date. The difference between the spot and the forward price is the forward premiumor forward discount, generally considered in the form of a profit or loss, by the purchasing party. Forwards, like other derivative securities, can be used to hedge risk (typically currency or exchange rate risk), as a means of speculation, or to allow a party to take advantage of a quality of the underlying instrument which is time-sensitive. A closely related contract is a futures contract; they differ in certain respects. Forward contracts are very similar to futures contracts, except they are not exchange-traded, or defined on standardized assets. Forwards also typically have no interim partial settlements or "true-ups" in margin requirements like futures – such that the parties do not exchange additional property securing the party at gain and the entire unrealized gain or loss builds up while the contract is open. However, being traded over the counter (OTC) forward contracts, specification can be customized and may include **mark-to-market** and daily margining. Hence, a forward contract arrangement might call for the loss party to pledge collateral or additional collateral to better secure the party at gain

How a forward contract works ?

Suppose that Bob wants to buy a house a year from now. At the same time, suppose that Andy currently owns a $100,000 house that he wishes to sell a year from now. Both parties could enter into a forward contract with each other. Suppose that they both agree on the sale price in one year's time of $104,000 (more below on why the sale price should be this amount). Andy and Bob have entered into a forward contract. Bob, because he is buying the underlying, is said to have entered a long forward contract. Conversely, Andy will have the short forward contract. At the end of one year, suppose that the current market valuation of Andy's house is $110,000. Then, because Andy is obliged to sell to Bob for only $104,000, Bob will make a profit of $6,000. To see why this is so, one needs only to recognize that Bob can buy from Andy for $104,000 and immediately sell to the market for $$_{8}1_{7}$$10,000. Bob has made the difference in

the spot market and the forward market. It describes the relationship between the spot and forward price of the underlying asset in a forward contract.

Forward Market and its Features*:*

1. Trading is done by telex or telephone, with participants generally dealing directly with broker-dealers.
2. All contract terms are negotiated privately by the parties.
3. Participants deal typically on a principal -to-principal basis.
4. Participants are primarily institutions dealing with one other and other interested parties dealing through one or more dealers.
5. A participant must examine the credit risk and establish credit limits for each opposite party.
6. Typically, no money changes hands until delivery, although a small margin deposit might be required of non dealer customers on certain occasions.
7. Settlement occurs on date agreed upon between the parties to each transaction.
8. Forward positions are not as easily offset or transferred to other participants.
9. Most transactions result in delivery.
10. No commissions is typically charged if the transaction is made directly

5.7.4 Options/Currency Contract and its features

Options are contracts that give the holder the right (but not the obligation) to buy (call option) or sell (put option) securities at a pre-determined price (strike/ exercise price) within/at the end of a specified period (expiration period). For the holders of call and put options, the exercise of the right would be worthwhile only if the price of underlying securities, of the respective option, rise/falls above/ below the exercise price. There can be options on commodities, currencies, securities, stock index, and individual stock and even on futures. In order to acquire the right of option, the option buyer pays the option seller (option writer) and an option premium, which is the price paid for the right. The buyer of an option can lose no more than the option premium paid but his possible gain is unlimited. The option writers' possible loss is unlimited but his maximum gain is restricted to the option premium charged by him to the holder. The most critical aspect of option contract is the evaluation of the fairness of the option premium, that is, option pricing. The availability both financial futures and options would provide the users with the wider choice of hedging instruments. At issue time, to make hedging possible, the market should have speculators who are prepared to be counterparties to hedgers. A derivative market wholly/mostly consisting of speculators is unlikely to be a sound economic institutions, a sound derivative market requires the presence of both hedgers and speculatorsFor example, if Indian importer has to pay three months hence $10,000 to U.S. exporter, he has purchased a call option at a price (premium) of Rs. 0.04 per dollar or Rs.400 for $10,000, contracted for. In this case he has hedged his currency risk for his payment due in U.S. dollar. If by chance the spot price at the time of his is Rs.43.60 per $ he is in the money. He would exercise this option and buy $10,000 at the option exercise price of 43.30, when the spot price is 43.60 a gain of Rs.3000, which is, more than offset the premium of Rs.400 that he paid. If at the time of the payment, the spot price is less than Rs.43.30 the option is out of money and he will not exercise the option; he will buy the required dollars from the spot market and his loss on the contract is Rs. 400 only. The importer will exercise the option only when the spot price is more than Rs.43.34 per $ inclusive of the premium paid for option (Rs.0.04) (spot 43.30+ 0.04). The reverse is the case of put option. The exercise price and the premium paid may remain the

4. Expiration date: Every contract comes with a defined expiry date. This remains unchanged until the validity of the contract. If the option is not exercised within this date, it expires.
5. Intrinsic value: An intrinsic value is the strike price minus the current price of the underlying security. Money call options have an intrinsic value.
6. Settlement of an option: There is no buying, selling or exchange of securities when an options contract is written. The contract is settled when the holder exercises his/her right to trade. In case the holder does not exercise his/ her right till maturity, the contract will lapse on its own, and no settlement will be required.
7. No obligation to buy or sell: In case of option contracts, the investor has the option to buy or sell the underlying asset by the expiration date. But he is under no obligation to purchase or sell. If an option holder does not buy or sell, the option lapses.

5.7.5 Swap Contract

Swap and switches are derivatives and synthetic markets among the financial markets. Swap is defined as an exchange contract between two parties for two instruments of different yields, interest rates and currencies. Switch is also similar to swap. Switch is not exchange of a security for cash but an exchange of one security for another both in the spot market. Swap is an agreement for exchanging of forward dollars for spot dollars and vice-versa or of floating rate of instrument for a fixed rate instrument.Swap and switches reduce the risks, and costs involved. They are hedge instruments use as an risk management instruments A swap is an agreement between two counterparties to exchange financial instruments for a certain time. The instruments can be almost anything but most swaps involve cash based on a notional principal amount. The general swap can also be seen as a series of forward contracts through which two parties exchange financial instruments, resulting in a common series of exchange dates and two streams of instruments. This principal usually does not change hands during or at the end of the swap, contrary to a future, a forward or an optionSwaps are primarily over- the-counter contracts between companies or financial institutions. Retail investors

seller on a notional principal for a period of time so long as a specified credit event has not occurred. The credit event can refer to a single asset or a basket of assets, usually debt obligations. In the event of default, the payer receives compensation, for example the principal, possibly plus all fixed rate payments until the end of the swap agreement, or any other way that suits the protection buyer or both counterparties. The primary objective of a CDS is to transfer one party's credit exposure to another party. Subordinated risk swapsA subordinated risk swap (SRS), or equity risk swap, is a contract in which the buyer (or equity holder) pays a premium to the seller (or silent holder) for the option to transfer certain risks. These can include any form of equity, management or legal risk of the underlying (for example a company). Through execution of the equity holder can (for example) transfer shares, management responsibilities or else. Thus, general and special entrepreneurial risks can be managed, assigned or prematurely hedged. Those instruments are traded over-the-counter (OTC) and there are only a few specialized investors worldwide. Equity swap An agreement to exchange future cash flows between two parties where one leg is an equity-based cash flow such as the performance of a stock asset, a basket of stocks or a stock index. The other leg is typically a fixed-income cash flow such as a benchmark interest rate. Other variationsThere are myriad different variations on the vanilla swap structure, which are limited only by the imagination of financial engineers and the desire of corporate treasurers and fund managers for exotic structuresAtotal return swap is a swap in which party A pays the total return of an asset, and party B makes periodic interest payments. The total return is the capital gain or loss, plus any interest or dividend payments. Note that if the total return is negative, then party A receives this amount from party B. The parties have exposure to the return of the underlying stock or index, without having to hold the underlying assets. The profit or loss of party B is the same for him as actually owning the underlying asset.

- An option on a swap is called a swaption. These provide one party with the right but not the obligation at a future time to enter into a swap.
- A variance swap is an over-the-counter instrument that allows investors to trade future realized (or historical) volatility against current implied volatility.

within a preagreed range. The received payments are maximized when the second rate stays entirely within the range for the duration of the swap.

- A three-zone digital swap is a generalization of the range accrual swap, the payer of a fixed rate receives a floating rate if that rate stays within a certain preagreed range, or a fixed rate if the floating rate goes above the range, or a different fixed rate if the floating rate falls below the range.

5.8 Summary

On a broader view, 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.

5.9 Glossary

- **Cashflow**: the total amount of money being transferred into and out of a business, especially as affecting liquidity.
- **Inflation**: general increase in prices and fall in the purchasing value of money.

3. Discuss various types of deri vatives

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5.12 Suggested Readings

- Brooks, John: The Fluctuation: The Little Crash in '62
- "U.S. National Debt Clock : Real Time". *usdebtclock.org*
- "Money Market", Investopedia.
- Frank J. Fabozzi, Steve V. Mann, Moorad Choudhry, The Global Money Markets, Wiley Finance, Wiley & Sons (2002)
- IMF Global Financial Stability Report Oct 2012
- EU's capital markets union 2.0, explained.

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6.1 Introduction:

In finance, an exchange rate is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in relation to another currency. For example, an interbank exchange rate of 114 Japanese yen to the United States dollar means that ¥114 will be exchanged for each US$1 or that US$1 will be exchanged for each ¥114. In this case it is said that the price of a dollar in relation to yen is ¥114, or equivalently that the price of a yen in relation to dollars is $1/114.The government has the authority to change exchange rate when needed.

6.2 Objectives:

After going through this lesson you should be able to

- Define Exchange rates;
- Explain the working of foreign exchange markets;
- Access the significance of exchange rate systems;
- Discuss the factors influencing the determinants of exchange rates.

6.3 Concept of Exchange rates:

Exchange rates are determined in the foreign exchange market, which is open to a wide range of different types of buyers and sellers, and where currency trading is continuous: 24 hours a day except weekends, i.e. trading from 20:15 GMT on Sunday until 22:00 GMT Friday. The spot exchange rate refers to the current exchange rate. The forward exchange rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

6.4 Significance of Exchange rates:

The exchange rate expresses the national currency's quotation in respect to foreign ones. For example, if one US dollar is worth 10 000 Japanese Yen, then the exchange rate of dollar is 10 000 Yen. If something costs 30 000 Yen, it automatically costs 3 US dollars as a matter of accountancy. Going on with fictious

effect. Multilateral exchange rates are computed in order to judge the general dynamics of a country's currency toward the rest of the world. One takes a basket of different currencies, select a (more or less) meaningful set of relative weights, then computes the "effective" exchange rate of that country's currency.

For instance, having a basket made up of 40% US dollars and 60% German marks, a currency that suffered from a value loss of 10% in respect to dollar and 40% to mark will be said having faced an "effective" loss of 10%x0.6 + 40%x0.4 = 22%. Some countries impose the existence of more than one exchange rate, depending on the type and the subjects of the transaction. Multiple exchange rates then exist, usually referring to commercial vs. public transactions or consumption and investment imports. This situation requires always some degree of capital controls. In many countries, beside the official exchange rate, the black market offers foreign currency at another, usually much higher, rate.

6.6 Exchange rate regimes:

When the exchange rate can freely move, assuming any value that private demand and supply jointly establish, "freely floating exchange rate" will be the name of currency institutional regime. Equivalently, it is called "flexible" exchange rate as well. If the central bank timely and significantly intervenes on the currency market, a "managed floating exchange rate regime" takes place. The central bank intervention can have an explicit target, for example in term of a band of currency acceptable values. In "freely" and "managed" floating regimes, a loss in currency value is conventionally called a "depreciation", whereas an increase of currency's international value will be called "appreciation". If the dollar rise from 10 000 yen to 12 000 yen, then it has shown an appreciation of 20%. Symmetrically, the yen has undergone an 8.3% depreciation.

But central banks can also declare a fixed exchange rate, offering to supply or buy any quantity of domestic or foreign currencies at that rate. In this case, one talks of a "fixed exchange rate". Under this regime, a loss of value, usually forced by market or a purposeful policy action, is called a "devaluation", whereas an

iii) Past and expected values of the same financial market with its autonomous dynamics.

Let's see them separately for the case of the exchange rate.

Real variables

1. Exports, imports and their difference (the trade balance) influence the demand of currency aimed at real transactions. A rising trade surplus will increase the demand for country's currency by foreigners, so that there should be a pressure for appreciation. A trade deficit should weaken the currency. Were exports and imports largely determined by price competitiveness and were the exchange rate very reacting to trade unbalances, then any deficit would imply depreciation, followed by booming exports and falling imports. Thus, the initial deficit would be quickly reversed. Net trade balance would almost always be zero. This is hardly the case in contemporary world economy. Trade unbalances are quite persistent, as you can verify with these real world data. Additionally, not so seldom, exchange rates go in the opposite direction than one would infer from trade balance only.

2. An even more radical form of real determination of exchange rate is offered by the "one price law", according to which any good has the same price worldwide, after taken into account nominal exchange rates. If a hamburger costs 3 US dollars in the United States and 30 000 yen in Japan, then the exchange rate must be 10 000 yen per dollar. The forex market would passively adjust to permit the functioning of the "one price law". But in order to equalise the price of several goods, more than one exchange rate may turn out to be "necessary". Moreover the "one price law" seems to suffer from too many exceptions to be accepted as the fundamental determinant of exchange rates. Large, persistent and systematic violations of Purchasing Power Parity are connected to price-to- market decisions of firms in this paper of September 2007.

Monetary and financial variables in cross-linked markets

1. Interest rates on Treasury bonds should influence the decision of foreigners to purchase currency in order to buy them. In this case, higher interest rates attract capital from abroad and the currency should appreciate. Decisive would

exchange rate change may turn out to be "necessary". In reference to the overall price level of the economy, if exchange rates would move exactly counterbalancing inflation dynamics, then real exchange rates should be constant. On the contrary, this is not true as a strict universal rule. Still, even if this weak version of the "law" does not always hold, high inflation usually give rise to depreciation, whose exact dimension need not match the inflation itself or its difference with foreign inflation rates.

3. The balance of payments can highlight pressures for devaluation or revaluation, reflected in large and systematic trend of foreign currency reserves at the central bank. In particular, large inflows, due for instance to a rise in the world price of main export items, tend to raise the exchange rate. Conversely, a collapse in the trust of government to manage the economic conditions might provoke a flight of capital, the exhaustion of foreign currency reserves and force devaluation / depreciation.

6.8 Dynamics on the Forex market:

Past and expected values of the exchange rate itself may impact on current values of it. The activities of forex specialists and investors may turn out to be extremely relevant to the determination of market exchange rate also thanks to their complex interaction with central banks. Sophisticated financial instruments like futures on exchange rates may play an important role. Imitation and positive feedbacks give rise to herd behaviour and financial fashions. Fears and confidence in a currency are heterogeneosly distributed across agents, with special events (as unexpected news) realigning them and generating large movement in the exchange rate.

Impact on other variables

Levels and fluctuations in the exchange rate exert a powerful impact

on exports, imports and the trade balance. A high and rising exchange rate tends to depress exports, to boost import and to deteriorate the trade balance, as far as these variables respond to price stimuli. Consumers find foreign goods cheaper so the consumption composition will change. Similarly, firms will reduce their costs by purchasing intermediate goods abroad.

Exchange rate influences also the external purchasing power of residents abroad, for example in term of purchasing real estate and other assets (e.g. firm equity as a foreign direct investment), so by different channels, also the balance of payments. Exchange rate devaluation (or depreciation) gives rise to inflationary pressures: imported good become more expensive both to the direct consumer and to domestic producer using them for further processing. In reaction to inflation (actual and feared), the central bank can rise the interest rates, thus sending a recessionary impulse. Similiarly, a package of fiscal austerity (expenditure cuts and selective tax increase), freezing wages and privatising loss-generating public assets is sometimes imposed after the currency crisis. Currency crisis have a sweeping impact on income distribution. The few rich able to borrow (because they have collateral and the banks trust them) will get richer and the people purchasing imported goods facing inflation and reduction of real incomes. Symmetrically, the central bank may use a fixed exchange rate as a nominal anchor for the economy to keep inflation under control, compelling domestic producer to face tougher competition if they were to decide to increase prices or accept to pay higher wages.

Were adjustment perfect, as rational expectations models would normally posits, inflation would immediately go to zero and there would be no effect on the real economy. Instead, real-world experiences show that even when successful in taming inflation (which is not always the case) the nominal anchor leadd to appreciation in real tirms (as the remaining inflation is not compensated by devaluation), which over the years can provoke structural trade deficit and loss of competitiveness (together with foreing debt with countries having a lower nominal interest rate). This conditions is usually unsustainable in the long run. For a small economy, joining a monetary union makes the exchange rate to fluctuate according to fundamentals and market pressures referring to a much larger area, erratically going in directions that are (or are not) coherent with positive macroeconomic developments.

For statistics purposes, international comparisons of current values converted to a common currency are “distorted” by wide exchange rate fluctuations.

rate of exchange of one country in terms of another's where as devaluation means a deliberate reduction of the value of the national currency in terms of other currencies. A most commonly adopted method consists in devaluation of the currency of a country faced with an adverse balance of payments. It is an alternative to exchange depreciation. Hedging a particular currency exposure means establishing an offsetting currency position such that whatever is lost or gained on the original currency exposure is exactly offset by a corresponding foreign exchange gain or loss on the currency hedge.

6.10 Glossary

* **Foreign exchange market.** The foreign exchange market (forex, FX, or currency market) is a form of exchange for the global decentralized trading of international currencies. Financial centers around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock, EBS and Reuters' dealing 3000 are two main interbank FX trading platforms. The foreign exchange market determines the relative values of different currencies.

* **Exchange rate.** Exchange rate (also known as a foreign-exchange rate, forex rate, FX rate or Agio) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency.

* **Bank rate.** Bank rate, also referred to as the discount rate, is the rate of interest which a central bank charges on the loans and advances to a commercial bank.

* **GDP Gross domestic product.** (GDP) is the market value of all officially recognized final goods and services produced within a country in a given period of time.

* **Inflation.** Inflation is a rise in the general level of prices of goods and services in an economy over a period of time When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation reflects a reduction in the purchasing power per unit of money - a loss of real value in the medium of exchange and unit of account within the economy.

* **Deflation.** Deflation is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0% (a negative inflation rate).

* **International trade.** International trade is the exchange of capital, goods, and services

6.12 LESSON END EXCERCISE

1. Describe the various deteriments of exchange rate

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2. Explain the exchage rate regimes

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6.13 SUGGESTED READINGS

- The Essentials of risk Management by Michel Crouhy, Dan Galai and Robert Mark.
- A Practical guide to risk Management by Thomas S.Coleman
- Financial Risk Management! By Jason Schenker

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7.1 Introduction

Devaluation and Depreciation look same but the meaning of both differs somewhat. Both these words are used in a foreign exchange market and both are affected by the international economy elements. Both these words are used when the value of the currency falls as compared to the other currency. Both have different causes and long term effects on the economy.

The meaning of Devaluation:

- Devaluation of currency occurs when in the country the monetary policy authority or government intentionally reduces the value of its currency by lowering the exchange rate as compared to another country's exchange rate.
- The authority devalues the currency by lowering the fixed exchange rate in the international market.
- It is changed by only the country's authority by comparing the worth of the goods and services in the international market.
- It helps the economy in the short period.
- There is no fixed time for it to devalue the currency but when the need occurs or authority think there is a need to devalue the currency, it happens.

Effects:

- Exports cheaper.
- Imports more expensive.
- Increased aggregate demand
- Improvement in the current account.
- Higher Inflation

The meaning of Depreciation:

- The depreciation of currency$_1$o$_1$c$_5$curs by forces of demand and supply in

exchange rate means that the global investment market determines the value of a country's currency. The exchange rate among various currencies changes every day as investors reevaluate new information. While a country's government and central bank can try to influence its exchange rate relative to other currencies, in the end it is the free market that determines the exchange rate. All major economies use a floating exchange rate. Depreciation occurs when a country's exchange rate goes down in the market. The country's money has less purchasing power in other countries because of the depreciation.

Devaluation

Devaluation happens in countries with a fixed exchange rate. In a fixed-rate economy, the government decides what its currency should be worth compared with that of other countries. The government pledges to buy and sell as much of its currency as needed to keep its exchange rate the same. The exchange rate can change only when the government decides to change it. If a government decides to make its currency less valuable, the change is called devaluation. Fixed exchange rates were popular before the Great Depression but have largely been abandoned for the more flexible floating rates. China was the last major economy to openly use a fixed exchange rate. It switched to a floating system in 2005.

would be the ways to make necessary adjustments. These issues form the subject-matter of the present unit. However, the learners shall be acquainted with the recent trends in India's balance of payments in order to make the discussion even more meaningful.

The various types of transactions leading to international financial flows need some discussion here. Trade flows, invisibles, foreign direct and portfolio investment, external assistance and external commercial borrowings and some short-term flows

Merchandise Trade Flows

Trade may be related to goods. Alternatively, it may be related to services. The merchandise trade has two sides. While one is export, the other is import. If India exports various goods, it will get convertible currencies and that will be an inflow of funds. On the contrary, it has to make payments in convertible currencies for the imports it makes. Thus export and import of goods lead to international financial flows.

Invisibles

Invisibles include, broadly, trade in services, investment income and unilateral transfers. If an Indian shipping company carries goods of a foreign exporter/ importer and gets the freight charges, it will be treated as inflow of funds on account of trade in services. Similarly, if a foreign shipping company carries goods of an Indian exporter, there will be outflow of funds in form of freight charges. There are many examples of international flow of funds on account of trade in services. Investment income relates to the receipt and payment of dividend, technical service, fees, royalty, interest on loan, etc. A foreign company operating in India remits dividend, etc. to its home country that will represent an outflow of funds. Similarly, an Indian company operating abroad remits to India the dividend and other fees that will represent inflow of funds. Likewise, payment of interest on foreign borrowings represents outflow of funds. Any receipt of interest manifests in inflow of funds. Unilateral transfers are unidirectional. They represent international financial flows without any services rendered. If an Indian makes a gift to his/her friend in England, it will be a case of outflow of funds on account

Short-term Flow of funds

Normally loans and foreign direct investment are meant for a period exceeding one year 8tit there are financial flows that occur for less than a year. Movement of funds relating to banking channels, euro notes, speculative and arbitrage activities, etc. are the examples of short=term funds that move across countries.

7.6 SUMMARY

Depreciation happens in countries with a floating exchange rate. A floating exchange rate means that the global investment market determines the value of a country's currency. The exchange rate among various currencies changes every day as investors reevaluate new information. While a country's government and central bank can try to influence its exchange rate relative to other currencies, in the end it is the free market that determines the exchange rate. All major economies use a floating exchange rate. Depreciation occurs when a country's exchange rate goes down in the market. The country's money has less purchasing power in other countries because of the depreciation.Devaluation happens in countries with a fixed exchange rate. In a fixed-rate economy, the government decides what its currency should be worth compared with that of other countries. The government pledges to buy and sell as much of its currency as needed to keep its exchange rate the same. The exchange rate can change only when the government decides to change it. If a government decides to make its currency less valuable, the change is called devaluation.

7.7 Glossary

Devaluation of currency occurs when in the country the monetary policy authority or government intentionally reduces the value of its currency by lowering the exchange rate as compared to another country's exchange rate.

The depreciation of currency occurs by forces of demand and supply in the global market not by the government. (If under any circumstances the government sells a lot of currency more than needed in that case depreciation occurs.)

7.10 Suggested Readings

- The Essentials of risk Management by Michel Crouhy, Dan Galai and Robert Mark.
- A Practical guide to risk Management by Thomas S.Coleman
- Financial Risk Management by Jason Schenker

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8.1 Introduction

Risk is the possibility that an outcome will not be as expected, specifically in reference to returns on investment in finance. However, there are several different kinds or risk, including investment risk, market risk, inflation risk, business risk, liquidity risk and more. Generally, individuals, companies or countries incur risk that they may lose some or all of an investment.

In an investor context, risk is the amount of uncertainty an investor is willing to accept in regard to the future returns they expect from their investment. Risk tolerance, then, is the level of risk an investor is willing to have with an investment - and is usually determined by things like their age and amount of disposable income.

Risk is generally referred to in terms of business or investment, but it is also applicable in macroeconomic situations. For example, some kinds of risk examine how inflation, market dynamics or developments and consumer preferences affect investments, countries or companies.

8. 2 OBJECTIVES

At the end of this lesson you all should be able to;

- Understand risk and its types
- Explain risk hedging
- Understand risk and financial assets.

8.3 CONCEPT OF RISK AND TYPES OF RISKS

Risk can be referred to like the chances of having an unexpected or negative outcome. Any action or activity that leads to loss of any type can be termed as risk. There are different types of risks that a firm might face and needs to overcome. Widely, risks can be classified into three types: Business Risk, Non- Business Risk, and Financial Risk.

1. **Business Risk**: These types of risks are taken by business enterprises themselves in order to maximize shareholder value and profits. As for example,

Asset Liquidity risk arises either due to insufficient buyers or insufficient sellers against sell orders and buys orders respectively.

- **Operational Risk:**

  This type of risk arises out of operational failures such as mismanagement or technical failures. Operational risk can be classified into **Fraud Risk** and **Model Risk**. Fraud risk arises due to the lack of controls and Model risk arises due to incorrect model application.

- **Legal Risk:**

  This type of financial risk arises out of legal constraints such as lawsuits. Whenever a company needs to face financial loses out of legal proceedings, it is a legal risk.

- **Types of Risks on the basis of scale**

  There a number of differing types of risk that can affect your investments. While some of these risks can be reduced through a number of avenues – some of them simply have to be accepted and planned for in any investment decision.

- **Macro Risk Levels :**

On a *macro* (large-scale) level there are two main types of risk, these are *systematic risk* and *unsystematic risk.*

- Systematic risk is the risk that cannot be reduced or predicted in any manner and it is almost impossible to predict or protect yourself against this type of risk. Examples of this type of risk include interest rate increases or government legislation changes. The smartest way to account for this risk, is to simply acknowledge that this type of risk will occur and plan for your investment to be affected by it.
- Unsystematic risk is risk that is specific to an assets features and can usually be eliminated through a process called diversification (refer below). Examples of this type of risk include employee strikes or management decision changes.

currency. If exchange rate risk is high – even though a substantial profit may have been made overseas, the value of the home currency may be less than the overseas currency and may erode a significant amount of the investments earnings. That is, the more volatile an exchange rate between the home and investment currency, the greater the risk of differing currency value eroding the investments value.

- Country Risk – This is also termed political risk, because it is the risk of investing funds in another country whereby a major change in the political or economic environment could occur. This could devalue your investment and reduce its overall return. This type of risk is usually restricted to emerging or developing countries that do not have stable economic or political arenas.
- Market Risk – The price fluctuations or volatility increases and decreases in the day-to-day market. This type of risk mainly applies to both stocks and options and tends to perform well in a bull (increasing) market and poorly in a bear (decreasing) market (see bull vs bear). Generally with stock market risks, the more volatility within the market, the more probability there is that your investment will increase or decrease.

8.4 Risk Hedging

Hedging in finance refers to protecting investments. A hedge is an investment status, which aims at decreasing the possible losses suffered by an associated investment. Hedging is used by those investors investing in market-linked instruments. To hedge, you technically invest in two different instruments with adverse correlation.

The best example of hedging is availing car insurance to safeguard your car against damages arising due to an accident. The hedging techniques are not only employed by individuals but also by asset management companies (AMCs) to mitigate various risks and to avoid the potential negative impacts. Hedging does not prevent the investments from suffering losses, but it just reduces the extent of negative impact.

Hedging is employed in the following areas:

price mechanism.

Hedging provides a means for traders and investors to mitigate market risk and volatility. It minimizes the risk of loss. Market risk and volatility are an integral part of the market, and the main motive of investors is to make profits. However, you are not in a position to control or manipulate markets in order to safeguard your investments. Hedging might not prevent losses, but it can considerably reduce the effect of negative impacts.

8.5 Risk Hedging with Future Contracts:

Hedging can be performed by using different derivatives. The first method is by using futures. Both producers and end-users can use futures to protect themselves against adverse price movements. They offset their price by obtaining a futures contract on a futures exchange, hereby securing themselves of a pre- detrisk ermined price for their product. The Future Contract is a standardized forward contract between two parties wherein they agree to buy or sell the underlying asset at a predefined date in the future and at a price specified today. The future contracts are a relatively less risky alternative of hedging against the fluctuations in the currency market. The parties to the currency future contracts fix the rate today while the actual payment or the delivery is made on the specified date in the future. There are two types of futures: Commodity Futures and Financial Futures. In commodity future, the contract is for the commodity such as cocoa or aluminum, while the financial futures refer to the future contract in financial instruments such as treasury bills, stock or currency.

The investor has a choice to exchange his currency either in the spot market or the futures market. In the spot market, the currency is exchanged at the current rate and the payment is made right away, whereas, in the future market, the exchange rate is fixed today while the actual payment is made at the defined future date. The difference between the spot and the future market can be illustrated in the form of an equation given below:

Future Price/ (1+Risk-free rate of interest) = Spot price – Present value of interest or dividend forgone

Where, the Spot price is the curren$_1$t$_3$e$_1$xchange rate prevailing at the time the

the price obtained at the spot market. This will be the actual price the producer has obtained for selling their product. Just like a long hedge, the prediction of the basis is a crucial factor for determining the price a producer will receive before hedging the commodity. This price can be calculated using the following formula

Futures price + basis – broker commission = net selling price

8.6 Risk and financial assets

What is risk in financial terms? It is the degree of uncertainty that the realized return on an investment will not equal the expected return. It may also be expressed as the degree of volatility or variability in returns. Past volatility is easy to measure. Future volatility is not and this is where the probability of return enters the picture. Above we identified two sources of investment return: income and price change. To this we now add a third: reinvestment of income, which plays a substantial role in the final investment outcome. Thus we have three sources of investment return in the case of the financial markets:

- Income (dividends in the case of equity).
- Change in price (capital gain or loss).
- Reinvestment of income.

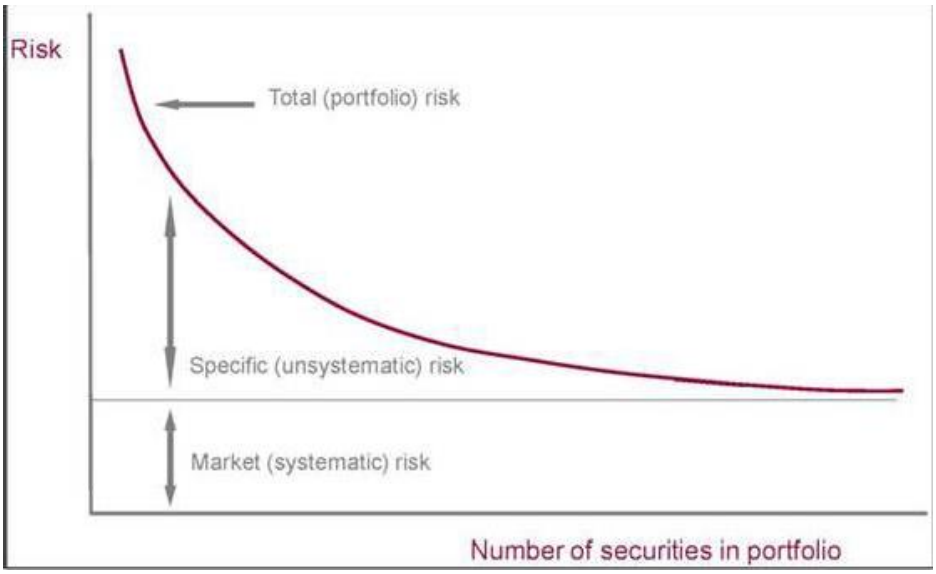
Investment risk thus arises from the variability of return in these sources. For example:

- Companies may perform badly from year to year and some may even go out of business. These events will affect the prices of the relevant shares.
- Earnings may change from year to year.
- Dividends may change from year to year.
- Interest rates may be volatile at times, which affects reinvestment income.

In investment literature risk is classified into two "types": systematic risk and unsystematic risk. Systematic risk is defined as risks that are inherent in the financial and/or economic system (hence the name). Little can be done about

Risk may be portrayed as in the Figure 1. Market (systematic) risk is out of the sphere of influence of the investor and the companies and this type of risk cannot be "diversified away". However, unsystematic risk can be "diversified away", by which is meant that risk is reduced by increasing the number of shares in the portfolio. Although this subject is the domain of portfolio theory, it is touched upon in the following section.

Figure 1: risk



Risk predisposition

Investors have one of three basic predispositions or preferences for risk: risk-seeking, risk-indifferent and risk-averse (see Figure 2). The risk-indifferent investor is not a wise one because s/he is willing to accept more risk without expecting / requiring a higher rate of return.

The risk-seeking investor has a brain problem because s/he is willing to accept more risk for a decline in return (in fact the risk-seeker will not be an "investor" for long, but a deficit economic unit). The risk-averse investor is the normal investor, i.e. s/he has a healthy attitude toward risk, and will only accept more risk if there is a chance of a higher return. This means that s/he requires or expects a higher return for a greater level of risk.

8.9 Self Assessment Questions

Q1. What is risk?

Q2. Explain the various types of risks.

8.10 Lesson End Exercise

1. What is Hedging and its types?

2. List the various cases where hedging can be employed.

M.COM-III **COURSE NO.: MCOMFE352**
UNIT-II **LESSON NO. IX**

CRITERIA TO EVALUATE ASSETS

STRUCTURE:

9.3 CRITERIATO EVALUATE ASSETS

9.3.1 What is Asset Valuation?

Asset valuation simply pertains to the value assigned to a specific property, including stocks, options, bonds, buildings, machinery, or land, that is conducted usually when a company or asset is to be sold, insured, or taken over. The assets may be categorized into tangible and intangible assets. Valuations can be done on either an asset or a liability, such as bonds issued by a company.

9.3.2 Asset Valuation – Valuing Tangible Assets

Tangible assets refer to a company's assets that are physical or that can be seen, which have been purchased by an organization to produce its products or goods or to provide the services that it offers. Tangible assets can be categorized as either fixed, such as structures, land, and machinery, or current, such as cash.

Other examples of assets are company vehicles, IT equipment, investments, payments, and on-hand stocks, as well as confirmed orders.

To compute for the value of a tangible asset:

- The company needs to look at its balance sheet and identify tangible and intangible assets.
- From the total assets, deduct the total value of the intangible assets.
- From what is left, deduct the total value of the liabilities. What is left are the net tangible assets or asset valuation.

Consider the following simple example:

- Balance sheet total assets: **$5 million**
- Total intangible assets: **$1.5 million**
- Total liabilities: **$1 million**
- Total tangible assets: **$2.5 million**

In the example above, the total assets of Company ABC equal $5 million. When the total intangible assets of $1.5 million are deducted, that leaves $3.5 million. After the

and organizations. There are many reasons for valuing assets, including the following:

1. Right Price

Asset valuation helps identify the right price for an asset, especially when it is offered to be bought or sold. It is beneficial to both the buyer and the seller because the former won't need to pay more than the asset's value nor will the latter be paid less than the asset's value.

2. Taxes

Every individual or organization that owns property or other assets needs to pay taxes for their assets. By doing asset valuation, taxes are calculated accurately.

3. Company Merger

In the event that two companies are merging, or if a company is to be taken over, asset valuation is important because it helps both parties size up the business.

4. Loan Application

When a company applies for a loan, the bank or financial institution may require collateral as protection against possible debt default. Asset valuation is needed then for the lender to determine the loan amount that can be covered by the company offering its assets as collateral.

5. Audit

Companies, especially public ones, are regulated, which means they need to present financial audits and reports for transparency. Part of the audit process involves verifying the value of assets.

9.6 RETURN ON ASSETS

What Is Return on Assets—ROA?

Return on assets (ROA) is an indicator of how profitable a company is relative to its total assets. ROA gives a manager, investor, or analyst an idea as to how efficient a company's management is at using its assets to generate earnings. Return on assets is displayed as a percentage.

for ROA. In other words, the impact of taking more debt is negated by adding back the cost of borrowing to the net income and using the average assets in a given period as the denominator. Interest expense is added because the net income amount on the income statement excludes interest expense.

9.7 LIMITATIONS OF RETURN ON ASSETS—ROA

The biggest issue with return on assets (ROA) is that it can't be used across industries. That's because companies in one industry—such as the technology industry—and another industry like oil drillers will have different asset bases.

Some analysts also feel that the basic ROA formula is limited in its applications, being most suitable for banks. Bank balance sheets better represent the real value of their assets and liabilities because they're carried at market value (via mark-to-market accounting), or at least an estimate of market value, versus historical cost. Both interest expense and interest i **Return on Asset (ROA)**

$$\text{Return on Asset} = \frac{\text{Operating Income}}{\text{Total Assets}}$$

9.8 THEORIES OF LEVEL OF INTEREST RATE

1 Classical Theory

2 loanable fund Theory

3 Keynesian Theory

9.8.1 Classical Theory: The Classical Theory

The classical theory of the rate of interest is the result of the contributions of many writers of the classical school. According to this theory, the rate of interest is determined by the supply of and demand for savings. The rate of interest is that rate which is earned from risk- free, easily manageable loans.The factors behind the demand for savings and supply of savings were variously interpreted but the idea common to all classical writers was that both the demand and supply of savings are interest-elastic. Some writers called the interest rate the reward for a saver's abstinence from consuming Iris income while others called it a charge for the borrower's preference for the present

classical writers that since capital is productive and it can be built out of real saving only, the demand for saving depends upon the productivity of capital.

Every type of capital asset has a particular rate of productivity for the future which the producer estimates before purchasing the capital asset. Capital assets were also thought to be subject to diminishing returns like any other factor of production; as producers demand more and more of a particular type of capital goods, their marginal productivity diminishes.

Thus the rate of return from the investment of more and more savings was supposed to fall due to the falling marginal productivity of capital. The classical writers assumed perfect competition to prevail in the factor market; their contention was that a producer would hire capital up to the point at which the marginal cost (= price) of capital is equal to the marginal productivity of capital. They regarded the marginal productivity of capital to be the marginal productivity of savings invested to produce the capital assets. Rate of interest in their view, was the cost of procuring the necessary saving for producing a capital asset.

The investor, they argued, would continue to make investments in capital assets as long as their marginal productivities are greater than the cost of borrowing for them which is the rate of interest. As more investment is done in particular types of capital assets, the cost of borrowing needed for financing them could rise while its marginal productivity would continue to fall.

An investor was thus assumed to invest up to the point at which the marginal cost of borrowing—the rate of interest—is equal to the marginal productivity of the capital asset. Since the marginal productivity curve of a capital asset was assumed to be downward-sloping and the demand for capital assets was thought to depend only upon their marginal productivity, the various points on the marginal productivity curve at which an investor would equate the marginal productivity to the rate of interest he paid for borrowing, were supposed to give the demand curve for capital or saving.

The demand curve for saving (investment) was thus assumed to slope from left down to the right as shown in Fig. 7.1. Given the supply curve and the demand curve for saving, equilibrium rate of interest is that at which the volume of saving demanded for investment equals the savings coming forth at that rate of interest. In Fig. 7.1 Oi is the equilibrium rate. In other words, the equilibrium rate of interest is that which equates

funds for hoarding purpose is a decreasing function of the rate of interest. At low rate of interest demand for loanable funds for hoarding will be more and vice-versa.

3. Dissaving (DS):

Dissaving's is opposite to an act of savings. This demand comes from the people at that time when they want to spend beyond their current income. Like hoarding it is also a decreasing function of interest rate.

Supply of Loanable Funds:

The supply of loanable funds is derived from the basic four sources as savings, dishoarding, disinvestment and bank credit.

They are explained as:

1. Savings (S):

Savings constitute the most important source of the supply of loanable funds. Savings is the difference between the income and expenditure. Since, income is assumed to remain unchanged, so the amount of savings varies with the rate of interest. Individuals as well as business firms will save more at a higher rate of interest and vice-versa.

2. Dishoarding (DH):

Dishoarding is another important source of the supply of loanable funds. Generally, individuals may dishoard money from the past hoardings at a higher rate of interest. Thus, at a higher interest rate, idle cash balances of the past become the active balances at present and become available for investment. If the rate of interest is low dishoarding would be negligible.

3. Disinvestment (DI):

Disinvestment occurs when the existing stock of capital is allowed to wear out without being replaced by new capital equipment. Disinvestment will be high when the present interest rate provides better returns in comparison to present earnings. Thus, high rate of interest leads to higher disinvestment and so on.

4. Bank Money (BM):

Banking system constitutes another source of the supply of loanable funds. The banks

theory does.

2. Indeterminate:

Like classical theory, loanable funds theory is also indeterminate. This theory assumes that savings and income both are independent. But savings depend on income. As the income changes savings also change and so does the supply of loanable funds.

3. Impracticable:

This theory assumes savings, hoarding, investment etc. to be related to interest rate. But in actual practice investment is not only affected by interest rate but also by the marginal efficiency of capital whose affect has been ignored.

4. Unsatisfactory Integration of Real and Monetary Factors:

This theory makes an attempt to integrate the monetary as well as real factors as the determinants of interest rate. But, the critics have maintained that these factors cannot be integrated in the form of the schedule as is evident from the frame work of this theory.

5. Constancy of National Income:

Loanable funds theory rests on the assumption that the level of national income remains unchanged. In reality, due to the change in investment, income level also changes accordingly.

Improvement over the Classical Theory:

Loanable funds theory is considered to be an improvement over the classical theory on the following aspects:

1. Loanable funds theory recognizes the importance of hoarding as a factor affecting the interest rate which the classical theory has completely overlooked.

2. Loanable funds theory links together liquidity preference, quantity of money, savings and investment.

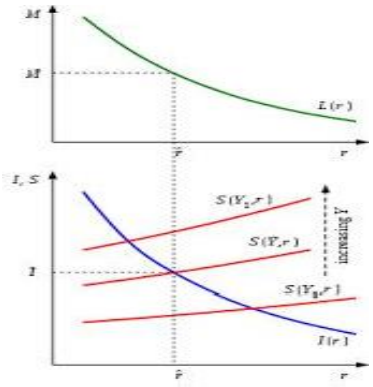
3. Loanable funds theory takes into consideration the role of bank credit which acts as a very important source of loanable funds.

deficit spending. Central banks don't need politicians' help to manage the economy. They would merely adjust the money supply.

Examples

President Roosevelt ended the Great Depression by spending on job creation programs. He created Social Security, the U.S. minimum wage, and child labor laws. The Federal Deposit Insurance Corporation prevents bank runs by insuring deposits.

President Ronald Reagan promised to reduce government spending and taxes. He called these traditional Republican policies, Reaganomics. But instead of cutting spending, Reagan increased the budget 2.5 percent each year. He increased defense spending from $444 billion to $580 billion by the end of his first term. He also cut income taxes and the corporate tax rate. Instead of reducing the debt, Reagan more than doubled it. But that helped end the 1981 recession.



Bill Clinton's expansionary economic policies fostered a decade of prosperity. He created more jobs than any other president. Home ownership was 67.7 percent, the highest rate ever recorded. The poverty rate dropped to 11.8 percent.

Barack Obama's policies ended the Great Recession with the Economic Stimulus Act. This act spent $224 billion in extended unemployment benefits, education, and health care. It created jobs by allocating $275 billion in federal contracts, grants, and loans. It cut taxes by $288 billion. Obamacare slowed the growth of health care costs. Summery of valuation of assets.

- Asset valuation is the process of determining the fair market value of an asset.

and cashflows may be modified to match the special characteristics of the firm/asset - current earnings for firms/assets which have normal earnings or normalized earnings for firms/assets whose current earnings may be distorted either by temporary factors or cyclical effects. In the context of multiples, you can use either equity or firm value as your measure of value and relate it to a number of firm-specific variables – earnings, book value and sales. The multiples themselves can be estimated by using comparable firms in the same business or from cross-sectional regressions that use the broader universe. Contingent claim models can also be used in a variety of scenarios. When you consider the option that a firm has to delay making investment decisions, you can value a patent or an undeveloped natural resource reserve as an option. The option to expand may make young firms with potentially large markets trade at a premium on their discounted cashflow values. Finally, equity investors may derive value from the option to liquidate.

Which approach should you use? The values that you obtain from the four approaches described above can be very different and deciding which one to use can be a critical step. This judgment, however, will depend upon several factors, some of which relate to the business being valued but many of which relate to you, as the analyst.

9.10 GLOSSARY

- **Return on assets:** Return on assets (ROA) is a financial ratio that shows the percentage of profit a company earns in relation to its overall resources. It is commonly defined as net income divided by total assets. Net income is derived from the income statement of the company and is the profit after taxes.
- **Classical theory**: The classical theory of interest also known as the demand and supply theory was propounded by the economists like Marshall and Fisher. Later on, Pigou, Cassel, Knight and Taussig worked to modify the theory. According to this theory rate of interest is determined by the intersection of demand and supply of savings.
- **Loanable theory**: Loanable funds. In economics, the loanable funds doctrine is a theory of the market interest rate. According to this approach, the interest rate is determined by the demand for and supply of loanable funds. The term loanable funds includes all forms of credit, such as loans, bonds, or savings deposits.

9.13 SUGGESTED READINGS:

- The Essentials of risk Management by Michel Crouhy, Dan Galai and Robert Mark.
- A Practical guide to risk Management by Thomas S.Coleman
- Financial Risk Management! By Jason Schenker

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10.1 INTRODUCTION

The interest rate is the amount a lender charges for the use of assets expressed as a percentage of the principal. The interest rate is typically noted on an annual basis known as the annual percentage rate (APR). The assets borrowed could include cash, consumer goods, or large assets such as a vehicle or building.

Borrowing and lending in the financial market depend to a significant extent on the rate of interest. In economics, interest is a payment for the services of capital. It represents a return on capital. In other words, interest is the price of hiring capital. Capital, as a factor of production, takes the form of machinery, equipment or any other physical assets used in production of goods. On the other hand, funds must be made available to the entrepreneurs for buying these physical assets. Purchase of capital assets is called investment and funds made available for the purchase of such capital assets is called financial capital. Some persons have to supply this financial capital to the entrepreneurs who would use it for investment in real capital assets. The payment to those who supply financial capital for its use is called the market rate of interest. This is expressed as a percentage of sums of funds borrowed. On the other hand, the entrepreneur who buys capital equipment and uses it in the process of production gets addition to his revenue, which is called return on capital. The return on capital is the addition to production which increases his revenue**:**

10.2 Objectives

The main objectives of this unit are to:

- Identify the factors influencing market interest rates
- Describe the effects of changes in interest rates
- Distinguish between short-term and long term rates of interest
- Identify the salient features of appropriate interest rate policy

10.3 FACTORS AFFECTING MARKET INTEREST RATES:

There are many interest rates in the market and they do not always move in the

would rise. When bank rate is raised, the commercial banks also raise their lending rates. When the rate of interest charged by commercial banks are high, businessmen are discouraged to borrow more. This would tend to contract bank credit and hence would result in reduced aggregate demand for money. This would reduce prices and check inflation or rising prices. On the other hand, by lowering the bank rate, the Reserve Bank encourages or induces the commercial bank to borrow more funds from it. This enhances their capacity to make more credit available to the businessmen.

ii) Open Market Operations:

The term 'open market operation' means the purchase and sale of securities by the Central Bank of the country. The sale of securities by the central bank leads to contraction of credit and purchase of securities that leads to credit expansion. When the economy is in the grip of depression, purchase of securities by central bank from the open market is called for. The central bank will pay the price of the, securities to the sellers, which are generally the commercial banks. As a result of this, the quantity of cash at the disposal of commercial banks will go up and they will be in a position to expand credit to the businessmen. With this, the aggregate demand will increase which will help to cure depression. On the other hand, during inflation the central bank sells the securities and thereby contracts money supply.

iii) Cash Reserve Ratio (CRR)

A cash reserve is the fraction of total deposits of the banks, which is required to keep as deposit with RBI. When RBI wants to contract credit or lending by banks, it raises the CRR. On the other hand, when it wants to increase the availability of credit, it lowers the CRR.

iv) Supply of Money:

One of the primary objectives is to achieve stable economic growth with a low rate of inflation. Generally the faster the reserves are allowed to grow, the greater the volume of lending, the faster the growth rate of money supply. If the supply of money grows faster than the needs of the economy or a considerable period of time, nominal interest rates will rise due to an increase

1) It will add to the balance of payment difficulties as current account by increasing the cost of short term borrowing from abroad.

2) It will increase the cost of serving the national debt.

3) It may also tend to pull up the long term rate of interest as of people may begin to expect rise in the long term rate of interest, and thus, they may begin to sell long- term securities in consequence of which their prices will fall and long-term rate of interest yielded by them will rise.

Interest can be defined as the price paid by the borrower for the use of funds saved by the lender and the compensation to the lender for deferring expenditures. This compensation comprises two elements, namely a payment equal to the loss of purchasing power of the principal during the term of the loan and a balance that represents the real interest accruing to the lender.

However this simplicity does not extend into the area of rate determination since rates vary not only because of inflation, as implied above, but also because of a number of other influences, including: the amount, purpose and period of the transaction; the credit-worthiness of the borrower; the collateral offered and/or other guarantees/guarantors available; the competition for the transaction; government policy. Interest rates are shown as short-term, generally 3 months, and long-term, generally 10 years, with forecast data available for both. For short and long term interest rates, annual and quarterly data are normally averages of monthly figures. The interest rate is the amount charged on top of the principal by a lender to a borrower for the use of assets. Most mortgages use simple interest. However, some loans use compound interest, which is applied to the principal but also to the accumulated interest of previous periods. A loan that is considered low risk by the lender will have a lower interest rate. A loan that is considered high risk will have a higher interest rate. Consumer loans typically use an APR, which does not use compound interest. The APY is the interest rate that is earned at a bank or credit union from a savings account or certificate of deposit (CD). Savings accounts and CDs use compounded interest.

10.5 SHORT-TERM AND LONG-TERM INTEREST RATE

10.5.1 Short-term interest rates

decisions. For instance, bank lending rates, in particular mortgage rates, may be linked formally or informally to long-term rates. Temporary movements in short-term rates may therefore have little impact on aggregate demand for goods and services. Long interest rates are also important because they are used by monetary policy-makers as informal indicators of inflation expectations in the financial markets. In addition, many central banks, in particular those which target inflation directly, use forward interest rates computed on the basis of the term structure of interest rates as indicators of expected future inflation rates.

Although long-term rates rate play an important role in the design and implementation of monetary policy, there is a broad consensus between economists in and outside the central banking community that the determination of long-term rates is poorly understood. In particular, there is considerable evidence, both anecdotal and more formal, that long interest rates are "excessively" volatile in the sense that they seem to vary more than is warranted by economic fundamentals. If sufficiently large, such excess volatility would reduce the information content of long interest rates and could render them of little value as information variables. Moreover, by weakening the link between short and long-term interest rates, excess volatility would make it more difficult for central banks to anticipate the responses of long rates to policy changes, and thus complicate the conduct of monetary policy.

10.6.1 Identifying Possible Risks

The future is uncertain, and the further you project into the future the less certain it becomes. This uncertainty is translated into increased risk. Regardless of whether an interest rate is referred to as long term or short term, one thing remains consistent: financial products with longer maturities involve a greater level of risk than those with shorter maturities, all other factors being equal. For example, a 30-year AAA-rated corporate bond involves greater risk than a 10- year AAA-rated corporate bond.

10.6.2 Risks Vs Rewards

One of the prime maxims of investing is that greater reward typically requires greater risk. Since longer-term debt investments involve greater risk than

different sections depending on the progress of degree of interest rate liberalization.

RESTRICTIVE CUM EXPANSIONARY INTEREST RATE POLICY:

"During 2008-09, the conduct of monetary policy was confronted with several new challenges thrown out by the global financial and economic crisis. The stance of monetary policy underwent a shift from "monetary tightening in the first half of 2008-09 reflecting the response to rising inflationary expectations to aggressive "monetary easing in the second half using conventional tools so as to minimize the impact of global crisis on India. Following the deepening of the global financial crisis since September 2008, the Reserve Bank took several measures to bring down the policy rates to step up the liquidity in the system (Report on Trend and Progress of Banking in India, 2008-09). There prevailed low interest rate regime required in the existing situation to revive economic growth. In this policy stance, the cash reserve ratio (CRR) was reduced by 400 basis points, repo rate by 425 basis points and reverse repo rate by 275 basis points. Deposit rates of scheduled commercial banks across various bank groups showed a generally upward movement during the first half of the year 2008-09. Taking cue from the Reserve Bank's monetary policy actions, the scheduled commercial banks reduced their deposit rates in the second half of 2008-09. In tandem with the "deposit rates , the lending rates of scheduled commercial banks also exhibited similar trend during this year. The "accommodative monetary policy stance, which "aimed at stimulating a faster recovery in growth , continued through the first half of 2009-
10. "The stance of monetary policy emphasized the need to ensure a monetary and interest rate policy regime that would enable credit expansion at viable rates while preserving credit quality so as to support the return of the economy to a high growth path. It was observed that there was a scope for the overall interest rate structure to move down within the policy rate easing as effected earlier by the Reserve Bank"(Economic Survey, 2009-10).

"Easy access to liquidity at low cost was the critical component of the overall policy response during 2009-10. The most important concern that dominated the credit markets was weak transmission of policy rates to lending rates and deceleration in the pace of credit growth"(www.rbi.org.in). "The major factors

operations for supporting liquidity. In response to the prevailing inflationary pressures and anticipated inflation trajectory during April-November 2011, the Reserve Bank raised the policy rates 5 times by 175 basis points with the increase in May and July of the order of 50 basis points each. As proposed in the Second Quarter Review of Monetary Policy 2010-11, the Reserve Bank decided to deregulate the only interest rate that continued to remain regulated, i.e. the saving deposit interest rate effective October 25, 2011". In nutshell, it can be said that interest rate policy in India, over the years, made a calibrated transition from administered interest rate regime to deregulated interest rate regime, which further moved towards preferably stable and low interest rate regime. Keeping in view the adverse economic conditions and inflationary situation, the monetary policy moved towards restrictive cum expansionary policy with an objective to pursue an interest rate environment which was considered conducive to the macroeconomic and price stability in the economy to maintain momentum of growth.

10.8 SUMMARY

The policy interest rate is an interest rate that the monetary authority (i.e. the central bank) sets in order to influence the evolution of the main monetary variables in the economy (e.g. consumer prices, exchange rate or credit expansion, among others). The policy interest rate determines the levels of the rest of the interest rates in the economy, since it is the price at which private agents-mostly private banks-obtain money from the central bank. These banks will then offer financial products to their clients at an interest rate that is normally based on the policy rate.

Different countries have different policy interest rates. The most common are the overnight lending rate, discount rate and repurchase rate (of different maturities). Normally, central banks use the policy interest rate to perform contractive or expansive monetary policy. A rise in interest rates is commonly used to curb inflation, currency depreciation, excessive credit growth or capital outflows. On the contrary, by cutting interest rates, a central bank might be seeking to boost economic activity by fostering credit expansion or currency depreciation in order to gain competitiveness.

10.10 SELFASSESSMENT QUESTIONS

1. Define Interest Rate.

2. Define Short-term interest rate.

3. Define Long-term interest rate.

10.11 LESSON END EXERCICE

1. What is the relationship between Short-term and Long-term interest rate?

2. What is meant by Interest rate policy?

M.COM-III **COURSE NO.: MCOMFE352**
UNIT-III **LESSON NO. XI**

FINANCIAL INSTITUTIONS & CREDIT POLICIES

STRUCTURE

guaranteeing that the bank will be able to repay the borrowed funds.

11.4 FINANCIAL INSTITUTIONS IN INDIA

The Financial Institutions in India mainly comprises of the Central Bank which is better known as the Reserve Bank of India, the commercial banks, the credit rating agencies, the securities and exchange board of India, insurance companies and the specialized financial institutions in India.

Reserve Bank of India:

The Reserve Bank of India was established in the year 1935 with a view to organize the financial frame work and facilitate fiscal stability in India. The bank acts as the regulatory authority with regard to the functioning of the various commercial bank and the other financial institutions in India.

The bank formulates different rates and policies for the overall improvement of the banking sector. It issue currency notes and offers aids to the central and institutions governments.

Commercial Banks in India:

The commercial banks in India are categorized into foreign banks, private banks and the public sector banks. The commercial banks indulge in varied activities such as acceptance of deposits, acting as trustees, offering loans for the different purposes and are even allowed to collect taxes on behalf of the institutions and central government.

11.5 CREDIT RATINGAGENCIES IN INDIA

The credit rating agencies in India were mainly formed to assess the condition of the financial sector and to find out avenues for more improvement. The credit rating agencies offer various services as:

- Operation Up gradation
- Training to Employees
- Scrutinize New Projects and find out the weak sections in it
- Rate different sectors

some stocks is carried out, a person generally pays a transaction fee. He pays this fee for the efforts the brokerage company puts in, to implement the trade.

11.6 FUNCTIONS OF FINANCIAL INSTITUTIONS

Financial institutions provide services to individuals and consumers to help them with their monetary needs. These institutions include banks, credit unions, brokerage firms, and insurance companies. Financial institutions have several functions that assist the public with various needs in that sector.

1) Directing the Payment System

One of the primary – and most public – functions of financial institutions is managing the payment system. That phrase refers to everyday commercial transactions that involve individuals and businesses.

Financial institutions keep the payment system in motion through checking and savings accounts, credit cards, and wire transfers. These methods of exchange allow Americans to handle their financial transactions on a daily basis.

2) Assisting With Resources and Capital

Financial institutions help individuals and corporations with resources and capital management by extending credit to those who can pay it back. Banks and other institutions can pool resources together to allow others to borrow money. Loans and credit cards allow families and companies to borrow funds and pay them back on a regular schedule.

Acquiring capital for a new or existing business or personal project can be difficult, so financial institutions allow people and businesses to have access to the capital they need to be successful.

3) Moving Financial Resources

Another important function of financial institutions is the moving of resources around from place to place. These institutions assist with larger transfers of funds like corporate investments, purchases of real estate, and construction loans, as well as other larger transactions, such as paying annuities.

Financial institutions can transfer resources from one party to another more easily

more stable. Problems with one function can reflect on the other capacities of the financial system as well. The health of the financial sector rests on a delicate balance between the various functions of financial institutions.

11.7 ROLE OF FINANCIAL INSTITUTIONS

Financial institutions are critical organizations that have an important role to play in the economy. Such institutions include commercial banks, savings and credit societies as well as investment institutions and together they help individuals, businesses and other organizations use their finances properly. Before such institutions came to the scene, individuals and business didn't have a secure place to store their excess cash and this caused a lot of chaos. There were no licensed lenders at that time as well and this resulted in a lot of exploitation. Financial institutions, therefore, brought a lot of order in the financial sector and this article takes a look at some of the roles such institutions play in the economy.

1. **Holding cash deposits**.

Individuals and businesses with more cash than they need at a given time can use financial institutions like banks to store the extra cash. Commercial banks provide individuals and businesses with a safe platform to store their cash and other valuables and this has gone a long way to reduce the instances of insecurity. Walking around with a lot of cash or having it stored in a drawer in the office makes individuals and businesses a target for burglars and by offering them a safe storage solution, financial institutions have enhanced the safety and security of people, organizations and their money. The institutions have easy cash withdrawal mechanisms and this allows the individuals and the organizations to access their cash reserves when they need them.

2. **The provision of credit facilities.**

Sometimes, individuals and business enterprises may not have all the resources they need to start new ventures or to finance business expansion. This, however, is not a challenge anymore since there are financial institutions that offer cash advances to their members. All you need to do access such facilities to prove that you can pay the advance back and the institutions will offer you as much

microeconomic factors. From a macroeconomic perspective, the crisis has been attributed to the persistence of global imbalances, an excessively accommodative monitory policy and lack of recognition of asset prices in policy formulation. From a microeconomic perspective, the crisis has been attributed to rapid financial innovations without adequate regulations, credit boom and the lowering of credit standards, inadequate corporate governance, inappropriate incentive schemes in the financial sector and overall lax oversight in financial systems. The same can be listed as:

1. Subprime mortgage.
2. Securitisation and repackaging of loans.
3. Excessive leverage.
4. Misleading credit rating.
5. Unbridled financial innovations in products and services.
6. Imperfect understanding of the implications of derivative products.
7. Unfair valuation of assets.
8. Failure in corporate governance.
9. Complex interplay of multiple factors.
10. Typical characteristics of financial systems.

India: Where does it stand?

The Indian banking system has had no direct exposure of sub-prime mortgage assets or failed institutions. It has very limited off balance sheet exposure. India's growth is driven predominantly by domestic consumptions and investments.

However, with the advent of globalisation, India's two-way trade — trade globalization and financial integration with the world, which includes Indian corporate sector's access to external funding — India has been hit by the crisis. Despite India not being part of the financial sector, the problem has been created due to external shocks and domestic vulnerabilities.

The Indian financial system largely $e_1s_8c_1$aped unhurt with the intervention of the

through one of the worst crisis in history. Since the last three years, banking in the public sector is almost stagnant. Of the 21 public sector banks, only two are showing profits. With continued losses, capital of those banks has been eroded. Thanks to the central government with whose support those banks are surviving.

It can be perceived that the overall situation in Indian banking, more or less, is similar to the US in 2008. As stated in the financial stability report by the RBI, of the total credit, corporates share 55% of which 86% are the NPA. This indicates that the present crisis in banking is linked with the corporates who have borrowed from the banks disproportionately by resorting to lapses in the system and by so-called imaginative and innovative financial instruments, products and services.

While big bang financial sector reforms could not be pursued mainly because of opposition from Left parties and trade unions, incremental liberalisation and integration with the global financial markets has continued in India. The reason why India did not witness a financial crisis as witnessed in the US or elsewhere is mainly because the Indian financial system is far more regulated and the public sector dominates the market.

However, policy makers in India are consistently pursuing the path of liberalisation, globalisation and privatisation in all spheres of the economy, including in finance and banking. Perhaps this crisis will precipitate in NBFC and mutual funds and possibly the entire financial sector may have to pass through rough weather once again.

The Indian economy is more connected with the global financial system today than it was a decade before. The exposure to FII has increased drastically which tends to be volatile, making the economy more vulnerable to any external shocks.

There is trust among the people in the country about the strength of the banking system mainly because public sector banking dominates the scene. Thus, despite majority of them having faced losses, the public continues to have faith in them. It is the public sector character which matters and not their capital or compliances with BASEL or otherwise. Now, the current political dispensation in Delhi is taking a contrary position and is initiating a discourse in favour of privatisation,

2. Explain functions of Financial Institution

11.12 LESSON END EXERCISE

l. Describe the impact of credit crisis in financial institutions.

2. What is the role of financial institutions ?

11.13 SUGGESTED READINGS

- The Story of Reserve Bank of India- Rahul Bajoria.
- The Reserve Bank of India (Part A and Part B) - vol. 4:1981-1997.
- Reserve Bank of India - By Disha Experts.
- India's Financial Sector: an Assessment.
- Changing India- By Dr. Manmohan Singh(Former Prime Minister of India).

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12.1 INTRODUCTION

The preamble of the Reserve Bank of India describes the basic functions of the reserve bank as:

"To regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy, to maintain price stability while keeping in mind the objective of Gowth".

12.2 OBJECTIVES

The main objectives of this unit are to:

- Understand hat a central bank is
- Identify the main differences between a central bank and a commercial bank
- List the various functions performed by a central bank
- Explian the historical development of central bank of India

12.3 RESERVE BANK OF INDIA : FUNCTION, ROLE, ORGANISATION & MANAGEMENT

The Reserve Bank of India (RBI) is India's central bank, which controls the issue and supply of the Indian rupee. RBI is the regulator of entire Banking in India. RBI plays an important part in the Development Strategy of the Government of India.

RBI regulates commercial banks and non-banking finance companies working in India. It serves as the leader of the banking system and the money market. It regulates

fully owned by Government of India (GoI).

- **1935-1949**

The Reserve Bank of India was founded on 1 April 1935 to respond to economic troubles after the First World War. The Reserve Bank of India was conceptualised based on the guidelines presented by the Central Legislative Assembly which passed these guidelines as the RBI Act 1934. RBI was conceptualised as per the guidelines, working style and outlook presented by Dr. B. R. Ambedkar in his book titled "The Problem of the Rupee - Its origin and its solution" and presented to the Hilton Young Commission. The bank was set up based on the recommendations of the 1926 Royal Commission on Indian Currency and Finance, also known as the Hilton-Young Commission. The original choice for the seal of RBI was the East India Company Double Mohur, with the sketch of the Lion and Palm Tree. However, it was decided to replace the lion with the tiger, the national animal of India. The Preamble of the RBI describes its basic functions to regulate the issue of bank notes, keep reserves to secure monetary stability in India, and generally to operate the currency and credit system in the best interests of the country. The Central Office of the RBI was established in Calcutta (now Kolkata) but was moved to Bombay (now Mumbai) in 1937. The RBI also acted as Burma's (now Myanmar) central bank until April 1947 (except during the years of Japanese occupation (1942-45)), even though Burma seceded from the Indian Union in 1937. After the Partition of India in August 1947, the bank served as the central bank for Pakistan until June 1948 when the State Bank of Pakistan commenced operations. Though set up as a shareholders' bank, the RBI has been fully owned by the Government of India since its nationalisation in 1949. RBI has monopoly of note issue.

- **1950-1960**

In the 1950s, the Indian government, under its first Prime Minister Jawaharlal Nehru, developed a centrally planned economic policy that focused on the agricultural sector. The administration nationalised commercial banks and established, based on the Banking Companies Act, 1949 (later called the Banking Regulation Act), a central bank regulation as part of the RBI. Furthermore, the central bank was ordered to support economic plan with loans.

House of India began its operations in the monetary market in April 1988; the National Housing Bank, founded in July 1988, was forced to invest in the property market and a new financial law improved the versatility of direct deposit by more security measures and liberalisation.

- **1991-1999**

The national economy contracted in July 1991 as the Indian rupee was devalued. The currency lost 18% of its value relative to the US dollar, and the Narsimham Committee advised restructuring the financial sector by a temporal reduced reserve ratio as well as the statutory liquidity ratio. New guidelines were published in 1993 to establish a private banking sector. This turning point was meant to reinforce the market and was often called neo-liberal. The central bank deregulated bank interests and some sectors of the financial market like the trust and property markets. This first phase was a success and the central government forced a diversity liberalisation to diversify owner structures in 1998.

The National Stock Exchange of India took the trade on in June 1994 and the RBI allowed nationalised banks in July to interact with the capital market to reinforce their capital base. The central bank founded a subsidiary company-the Bharatiya Reserve Bank Note Mudran Private Limited-on 3 February 1995 to produce banknotes.

- **Since 2000**

The Foreign Exchange Management Act, 1999 came into force in June 2000. It should improve the item in 2004-2005 (National Electronic Fund Transfer). The Security Printing & Minting Corporation of India Ltd., a merger of nine institutions, was founded in 2006 and produces banknotes and coins.

The national economy's growth rate came down to 5.8% in the last quarter of 2008-2009[38] and the central bank promotes the economic development.

In 2016, the Government of India amended the RBI Act to establish the Monetary Policy Committee (MPC) to set. This limited the role of the RBI in setting interest rates, as the MPC membership is evenly divided between members of the RBI (including the RBI governor) and independent members appointed by the government. However, in the event of a tie, the vote of the RBI governor is decisive.

tory audit and internal audit functions in banks and financial institutions. The audit sub-committee includes deputy governor as the chairman and two directors of the Central Board as members. The BFS oversees the functioning of the Department of Banking Supervision (DBS), the Department of Non-Banking Supervision (DNBS) and the Financial Institutions Division (FID) and gives directions on the regulatory and supervisory issues.

2. Regulator and supervisor of the financial system

The institution is also the regulator and supervisor of the financial system and prescribes broad parameters of banking operations within which the country's banking and financial system functions. Its objectives are to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public. The Banking Ombudsman Scheme has been formulated by the Reserve Bank of India (RBI) for effective addressing of complaints by bank customers. The RBI controls the monetary supply, monitors economic indicators like the gross domestic product and has to decide the design of the rupee banknotes as well as coins.

3. Regulator and supervisor of the payment and settlement systems

Payment and settlement systems play an important role in improving overall economic efficiency. The Payment and Settlement Systems Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country. In this role, the RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms. Two payment systems National Electronic Fund Transfer (NEFT) and Real-Time Gross Settlement (RTGS) allow individuals, companies and firms to transfer funds from one bank to another. These facilities can only be used for transferring money within the country.

NEFT operates on a deferred net settlement (DNS) basis and settles transactions in batches. The settlement takes place for all transactions received until a particular cut-off time. It operates in hourly batches - there are twelve settlements from 8 am to 7 pm on weekdays and six between 8 am and 1 pm on Saturdays. Any transaction initiated after the designated time would have to wait until the next settlement time. In RTGS, transactions are processed continuously, all through the business hours. RBI's

back the currency with assets of equal value, to enhance public confidence in paper currency. The objectives are to issue banknotes and give the public adequate supply of the same, to maintain the currency and credit system of the country to utilise it in its best advantage, and to maintain the reserves.

The RBI maintains the economic structure of the country so that it can achieve the objective of price stability as well as economic development because both objectives are diverse in themselves.

For the printing of notes, RBI uses four facilities:

- **The Security Printing and Minting Corporation of India Limited (SPMCIL),** a wholly owned company of the Government of India, has printing presses at Nashik, Maharashtra and Dewas, Madhya Pradesh.
- **The Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL),** owned by the RBI, has printing facilities in Mysore, Karnataka and Salboni, West Bengal.

For the minting of coins, SPMCIL has four mints at Mumbai, Noida, Kolkata and Hyderabad for coin production.

Whilst coins are minted by, and ?1 notes are issued by the Government of India (GoI), the RBI works as an agent of GoI for the distribution and handling of coins. RBI also works to prevent counterfeiting of currency by regularly upgrading security features of currency.

The RBI is authorised to issue notes with face values of up to ?10,000 and coins up to ?1,000 rupees.

New ?500 and ?2,000 notes were been issued on 8 November 2016. The old series of ?1,000 and ?500 notes were demonetized from midnight on 8 November 2016.

Earlier ?1,000 notes have been discarded by the RBI.

7. Banker's bank

Nagpur branch holds most of India's gold deposits. Reserve Bank of India also works as a central bank where commercial banks are account holders and can deposit money. RBI maintains banking accounts of all scheduled banks. Commercial banks create

10. Developmental role

The central bank has to perform a wide range of promotional functions to support national objectives and industries. The RBI faces a lot of inter-sectoral and local inflation-related problems. Some of these problems are results of the dominant part of the public sector.

Key tools in this effort include Priority Sector Lending such as agriculture, micro and small enterprises (MSE), housing and education. RBI work towards strengthening and supporting small local banks and encourage banks to open branches in rural areas to include large section of society in banking net.

- **Related functions**

The RBI is also a banker to the government and performs merchant banking function for the central and the state governments. It also acts as their banker. The National Housing Bank (NHB) was established in 1988 to promote private real estate acquisition. The institution maintains banking accounts of all scheduled banks, too. RBI on 7 August 2012 said that Indian banking system is resilient enough to face the stress caused by the drought-like situation because of poor monsoon this year.

- **Custodian to foreign exchange**

The Reserve Bank has custody of the country's reserves of international currency, and this enables the Reserve Bank to deal with crisis connected with adverse balance of payments position.

12.3.2 ORGANISATION AND MANAGEMENT

The central board of directors is the main committee of the central bank. The Government of India appoints the directors for a four-year term. The board consists of a governor, and not more than four deputy governors; four directors to represent the regional boards; two - usually the economic affairs secretary and the Financial Services Secretary - from the Ministry of Finance and ten other directors from various fields. The Reserve Bank - under Raghuram Rajan's governorship - wanted to create a post of a chief operating officer (COO), in the rank of deputy governor and wanted to re-allocate work between the five of them (four deputy governor and COO).

Kolkata, New Delhi and Chennai.

12.3.3 Difference between Central bank and Commercial Bank:

BASIS FOR COMPARISON	CENTRAL BANK	COMMERCIAL BANK
Meaning	The bank which looks after the monetary system of the country is known as Central Bank.	The establishment, which provides banking services to the public is known as Commercial Bank.
What is it?	It is a banker to the banks and the government of the country.	It is the banker to the citizens of the nation.
Governing Statute	Reserve Bank of India Act, 1934.	Banking Regulation Act, 1949.
Ownership	Public	Public or Private
Profit motive	It does not exist for making profit for its owners	It exist for making profit for its owners.
Monetary Authority	It is the supreme monetary authority with wide powers.	No such authority.
Objective	Public welfare and economic development.	Earning Profits
Money supply	Ultimate source of money supply in the economy.	No such function is performed by it.
Right to print and issue currency notes	Yes	No
Deals with	Banks and Governments	General Public
How many banks are there?	Only one	Many

cost of credit restricts the total availability of money in the economy, and hence may prove an anti-inflationary measure of control.

Likewise, a fall in the bank rate causes other rates of interest to come down. The cost of credit falls, i. e., and credit becomes cheaper. Cheap credit may induce a higher demand both for investment and consumption purposes. More money, through increased flow of credit, comes into circulation.

A fall in bank rate may, thus, prove an anti-deflationary instrument of control. The effectiveness of bank rate as an instrument of control is, however, restricted primarily by the fact that both in inflationary and recessionary conditions, the cost of credit may not be a very significant factor influencing the investment decisions of the firms.

3. Variable Reserve Ratios:

Variable reserve ratios refer to that proportion of bank deposits that the commercial banks are required to keep in the form of cash to ensure liquidity for the credit created by them. A rise in the cash reserve ratio results in a fall in the value of the deposit multiplier. Conversely, a fall in the cash reserve ratio leads to a rise in the value of the deposit multiplier.

A fall in the value of deposit multiplier amounts to a contraction in the availability of credit, and, thus, it may serve as an anti-inflationary measure.

A rise in the value of deposit multiplier, on the other hand, amounts to the fact that the commercial banks can create more credit, and make available more finance for consumption and investment expenditure. A fall in the reserve ratios may, thus, work as anti-deflationary method of monetary control. The Reserve Bank of India is empowered to change the reserve requirements of the commercial banks.

4. **Credit rationing** : Rationing of credit is a method by which the Central Bank seeks to limit the maximum amount of loans and advances and, also in certain cases, fix ceiling for specific categories of loans and advances.

5. Moral suasion : Moral suasion and credit monitoring arrangement are other methods of credit control. The policy of moral suasion will succeed only if the Central Bank is strong enough to influence the commercial banks.

8. CRR and SLR mechanism : CRR and SLR are the two ratios. CRR is a cash reserve ratio and SLR is statutory liquidity ratio. Under CRR a certain percentage of the total bank deposits has to be kept in the current account with RBI which means banks do not have access to that much amount for any economic activity or commercial activity. Banks can't lend the money to corporates or individual borrowers, banks can't use that money for investment purposes. So, that CRR remains in current account and banks don't earn anything on that.

SLR, statutory liquidity ratio is the amount of money that is invested in certain specified securities predominantly central government and state government securities. Once again this percentage is of the percentage of the total bank deposits available as far as the particular bank is concerned. The SLR, the money goes into investment predominantly in the central government securities as I mentioned earlier which means the banks earn some amount of interest on that investment as against CRR where it earns zero.

12.5 AIMS & OBJECTIVES OF MONETARY POLICY OF RBI

RBI normally declares the monetary policy twice a year. These policies are called busy season policy (declared in October every year) and slack season policy (declared in April every year).

The objective behind such monetary policy is to:

- Ensure price stability of commodities in the country
- Ensure balanced credit expansion
- Ensure growth of long term investments in the economy
- Ensure proper balance of exports and imports.
- Encourage food procurement operations
- Ensure proper distribution of credit to all sectors of the economy.

In order to achieve these objectives RBI resorts to various methods / techniques, like:-

- Open Market Operations

Banks and put its members of the Boards of the Bank to ensure proper Governance and sound banking practices.

7. As a developmental function, RBI promotes various specialized institutions. It has promoted IDBI (Industrial Development Bank of India), NABARD (National Bank for Agriculture & Rural Development), Small Industrial Development Bank of India (SIDBI), Deposit Insurance & Credit Guarantee Trust for Small and Medium Enterprises (DI & CGTSME) / Export Credit Guarantee Corporation of India (ECGC) etc.

8. RBI issues monetary policy twice a year to provide guidance to flow of credit and safety measures to the banking and financial sector. It issues busy season policy in October every year and slack season policy in May-June. This sets the tone for the money market as well as financial activities.

9. For good governance, RBI resorts to moral suasion on banking and financial sector.

10. It disseminates financial data on banking, economy and other aspects of monetary aspects.

11. RBI is sole authority to handle overall monetary and credit policy in the country.

12. To regulate the flow of credit in the economy RBI also resorts to selling and purchasing of short term or even long term securities.

13. RBI provides 'ways and means' credit facility to the Government of India and State Governments in order to overcome tight money position between payment and receipt of the client. The period of such 'ways and means' credit is maximum 90 days (3 months). Such power to lend money to governments is given under section 17 (5) of Reserve Bank of India Act, 1934.

14. RBI also acts as a lender of the last resort, which means meeting the genuine financial requirements of commercial banks.

15 Management of raising of finance by the Government and issuance of new loans/ advances on behalf of the Government of India / State Government is handled by the Public Debt Office of the Reserve Bank of India.

India. It change from time to time is part of economic policy to control inflation etc. Any change in CRR percentage means either increased availability of funds with the banks or reduced funds available in the market.

- Unchanged CRR means no additional funds available for banks to lend.
- As on 17.02.2020 the CRR fixed by RBI is 4 per cent.

3. Bank Rate

It means the rate of interest at which RBI buys or rediscounts the bills of exchange including commercial papers etc. as permissible under RBI Act, 1934. As per the need of the hour, RBI raises the Bank Rate in order to squeeze the credit expansion whereas it reduces the Bank Rate when it needs to allow more flow of credit in the economy. As on 17.02.2020 the Bank Rate fixed by RBI is 5.40 per cent.

4. Repo Rate

Repo Rate is the rate at which banks borrow from the Reserve Bank of India (RBI). A lower repo rate means bank's borrowing cost will go down which could prompt banks to cut lending rates.

. As on 17.02.2020 the Repo Rate fixed by RBI is 5.15 per cent.

5. Reverse Repo Rate

Reverse repo rate means the rate of interest at Which RBI borrows from the banks.

. As on 17.02.2020 the Revese Repo Rate fixed by RBI is 6.25 per cent.

12.6 SUMMARY:

The Reserve Bank of India has defined a vision for digital payments from 2019 to 2021, to "empower every Indian with access to a bouquet of e-payment options that is safe, secure, convenient, quick and affordable." To this end, it says it intends to follow an approach that enhances customer experience, empowers payment systems operators and infrastructure, puts in forward looking regulation, and establishes a risk-focused supervision system.

The RBI has identified the following 12 specific outcomes:

5% year-on-year.

12 Improvement in Turn Around Time (TAT) for resolution of customer com plaints by Payments System Operators.

13. Fraud to Sales (Fraud value / Sales value) x 10000] count for payment sys tems is expected to be less than 10 bps for most of the payment systems.

14. Enhanced healthy competition in the payments space and establishment of new Payments System Operators.

12.7 GLOSSARY:

- **Economic capital:** Economic capital (EC) also known as risk capital refers to the amount of capital that a bank estimates to run the business and remain solvent at a given confidence level and time horizon.
- **Capital contribution :** The capital adequacy frame work in banking business emphasizes adequate resource to absorb any losses arising from the risks in its business. The Capital is divided into different tiers according to the characteristics / qualities of each qualifying instrument.
- **Capital Management :** indicates that the sufficient capital contribution in the business provides stable resources to help the owner to absorb any losses arising from the risks in a business. The objective of Capital management as well as its risk appetite is to reach solvency ratio adequate for its lending activities during a period of difficult business conditions.
- **Capital reserves:** The term capital reserve is sometimes used for the capital buffers that banks have to establish to meet regulatory requirements which are different from cash reserves that banks to maintain as per Central Bank (RBI) regulations. • **Risk Weighted Assets (RWA):** The Risk Weighted Asset (RWA) is a measurement designed to evaluate the element of risk involved in each asset held by the bank.
- **Revaluation reserves:** A business usually owns capital assets like Plant and machinery, land and building, equipment etc. The values of these assets are periodically depreciated over their useful life span both for accounting and tax purposes.

3. How inflation effect on money and price?

12.13 LESSON END EXERCICE

1. Why Reserve bank of India is known as Banker's Bank?

2. Who is the first and Present Governor of Reserve Bank of India?

3. Differnce Between CRR and SLR?

4. Difference between Repo Rate and Reverse Repo Rate?

M.COM-III **COURSE NO.: MCOMFE352**
UNIT-III **LESSON NO. XIII**

CREDIT CREATION AND ITS CONTROL

STRUCTURE

for money again in terms of IS-LM model.

We know that the point of intersection of the IS and LM curves gives us the equilibrium combinations of income level and the rate of interest. This is a situa-tion of simultaneous equilibrium of both prod-uct market and money market. We call it also a situation of general equilibrium. There we did not make any specific reference to the elasticities of either the IS function or the LM function.

If these elasticities are taken into ac-count, our previous conclusions need to be modified and qualified. However, we won't consider here elasticity of IS schedule. Since we are interested in knowing the effectiveness of monetary policy, we will deal even some extreme cases of elasticity of the LM function.

Monetary policy aims at achieving the macroeconomic policy objectives through the control over money supply. The slope of the LM curve depends on the interest elasticity of money demand. If the interest elasticity of money demand is assumed to be high, the LM curve will be relatively flat.

On the other hand, LM curve becomes relatively steep if the in-terest elasticity of money demand becomes low. Let us consider two extreme cases: (i) if interest elasticity of money demand is perfectly elastic (i.e., liquidity trap), the LM curve becomes horizontal, and (ii) if the interest elasticity of money demand is zero, the LM curve becomes vertical. Consequences of an increase in money supply on interest rate and national income have been shown in Fig. 6.1.

It is seen from Fig. 6.1 that the initial equilibrium interest rate and income combination is r_0-Y_0 in all the figures. Further, the effect of an increase in money supply has been shown by the shifting of the LM curve from LM_0 to LM_1 in the rightward direction. In Fig. 6.1(a) we have assumed a high in-terest elasticity of money demand causing the LM curve to become relatively flat. Following an expansion in money supply, interest rate declines marginally from Or_0 to Or_1 and in-come, too, rises insignificantly from OY_0 to OY_1. The fact is that monetary policy is least effective.

The reason is, that an increase in money supply at the initial level means an excess money supply over money demand. This then causes interest rate to fall. A fall in interest rate by a very small amount causes investment to rise by a very small

13.2 CREDIT CREATION

Credit creation separates a bank from other financial institutions. In simple terms, credit creation is the expansion of deposits. And, banks can expand their demand deposits as a multiple of their cash reserves because demand deposits serve as the principal medium of exchange.

Demand deposits are an important constituent of money supply and the expansion of demand deposits means the expansion of money supply. The entire structure of banking is based on credit. Credit basically means getting the purchasing power now and promising to pay at some time in the future. Bank credit means bank loans and advances.

A bank keeps a certain part of its deposits as a minimum reserve to meet the demands of its depositors and lends out the remaining to earn income. The loan is credited to the account of the borrower. Every bank loan creates an equivalent deposit in the bank. Therefore, credit creation means expansion of bank deposits.

The two most important aspects of credit creation are:

1. **Liquidity** – The bank must pay cash to its depositors when they exercise their right to demand cash against their deposits.

2. **Profitability** – Banks are profit-driven enterprises. Therefore, a bank must grant loans in a manner which earns higher interest than what it pays on its deposits.

The bank's credit creation process is based on the assumption that during any time interval, only a fraction of its customers genuinely need cash. Also, the bank assumes that all its customers would not turn up demanding cash against their deposits at one point in time.

Basic Concepts of Credit Creation

- ***Bank as a business institution*** – Bank is a business institution which tries to maximize profits through loans and advances from the deposits.
- ***Bank Deposits*** – Bank deposits form the basis for credit creation and are of two types:

Rounds	Primary Deposits	Cash Reserves(r = 20%)	Credit Creations or Derivative deposits(ΔD)
1.Person A	Rs.1000 (Initial Primary Deposit)	Rs. 200	Rs. 800 (Initial excess reserve(ΔR)
2.Person B	Rs.800	Rs. 160	Rs.640
3. Person C	Rs. 640	Rs. 128	Rs.512
4. Person D	Rs. 512	Rs. 102	Rs. 410
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Total	5000	1000	4000

Let's assume that the bank requires to maintain a CRR of 20 percent.

- If a person (person A) deposits 1,000 rupees with the bank, then the bank keeps only 200 rupees in the cash reserve and lends the remaining 800 to another person (person B). They open a credit account in the borrower's name for the same.
- Similarly, the bank keeps 20 percent of Rs. 800 (i.e. Rs. 160) and advances the remaining Rs. 640 to person C.
- Further, the bank keeps 20 percent of Rs. 640 (i.e. Rs. 128) and advances the remaining Rs. 512 to person D.

This process continues until the initial primary deposit of Rs. 1,000 and the initial additional reserves of Rs. 800 lead to additional or derivative deposits of Rs. 4,000 (800+640+512+….).

Adding the initial deposits, we get total deposits of Rs. 5,000. In this case, the credit multiplier is 5 (reciprocal of the CRR) and the credit creation is five times the initial excess reserves of Rs. 800.

Multiple Credit Creation by the Banking System

The banking system has many banks in it and it cannot grant loans in excess of the cash it creates. When a bank creates a derivative deposit, it loses cash to other banks.

The loss of deposit of one bank is the gain of deposit for some other bank. This

Capacity to create credit is a matter of:

- The availability of cash deposits with banks
- The factors which determine their cash deposit ratio

As regards the demand for credit:

- The demand must exist in the market
- Creditworthy borrowers (to avoid bad debts)
- The amount of loan granted should not exceed the paying capacity of the borrower

Leakages

- If the banks are unwilling to utilize their surplus funds for granting loans, then the economy is headed towards recession
- If the public withdraws cash and holds it with themselves, then it reduces the bank's power to create credit

Credit Control

Some of the methods employed by the RBI to control credit creation are:

I. Quantitative Method

II. Qualitative Method.

The various methods employed by the RBI to control credit creation power of the commercial banks can be classified in two groups, viz., quantitative controls and qualitative controls. Quantitative controls are designed to regulate the volume of credit created by the banking system qualitative measures or selective methods are designed to regulate the flow of credit in specific uses.

Quantitative or traditional methods of credit control include banks rate policy, open market operations and variable reserve ratio. Qualitative or selective methods of credit control include regulation of margin requirement, credit rationing, regulation of consumer credit and direct action.

I. Quantitative Method:

A fall in the total cash reserves is leads to a cut in the credit creation power of the commercial banks. With reduced cash reserves at their command the commercial banks can only create lower volume of credit. Thus, a sale of securities by the Central Bank serves as an anti-inflationary measure of control.

Likewise, a purchase of securities by the Central Bank results in more cash flowing to the commercials banks. With increased cash in their hands, the commercial banks can create more credit, and make more finance available. Thus, purchase of securities may work as an anti deflationary measure of control.

The Reserve Bank of India has frequently resorted to the sale of government securities to which the commercial banks have been generously contributing. Thus, open market operations in India have served, on the one hand as an instrument to make available more budgetary resources and on the other as an instrument to siphon off the excess liquidity in the system.

(iii) Variable Reserve Ratios:

Variable reserve ratios refer to that proportion of bank deposits that the commercial banks are required to keep in the form of cash to ensure liquidity for the credit created by them.

A rise in the cash reserve ratio results in a fall in the value of the deposit multiplier. Conversely, a fall in the cash reserve ratio leads to a rise in the value of the deposit multiplier.

A fall in the value of deposit multiplier amounts to a contraction in the availability of credit, and, thus, it may serve as an anti-inflationary measure.

A rise in the value of deposit multiplier, on the other hand, amounts to the fact that the commercial banks can create more credit, and make available more finance for consumption and investment expenditure. A fall in the reserve ratios may, thus, work as anti-deflationary method of monetary control.

The Reserve Bank of India is empowered to change the reserve requirements of the commercial banks.

The Reserve Bank employs two types of reserve ratio for this purpose, viz. the

(ii) Credit Rationing:

Rationing of credit is a method by which the Central Bank seeks to limit the maximum amount of loans and advances and, also in certain cases, fix ceiling for specific categories of loans and advances.

(iii) Regulation of Consumer Credit:

Regulation of consumer credit is designed to check the flow of credit for consumer durable goods. This can be done by regulating the total volume of credit that may be extended for purchasing specific durable goods and regulating the number of installments through which such loan can be spread. Central Bank uses this method to restrict or liberalise loan conditions accordingly to stabilise the economy.

(iv) Moral Suasion:

Moral suasion and credit monitoring arrangement are other methods of credit control. The policy of moral suasion will succeed only if the Central Bank is strong enough to influence the commercial banks.

In India, from 1949 onwards, the Reserve Bank has been successful in using the method of moral suasion to bring the commercial banks to fall in line with its policies regarding credit. Publicity is another method, whereby the Reserve Bank marks direct appeal to the public and publishes data which will have sobering effect on other banks and the commercial circles.

Effectiveness of Credit Control Measures:

The effectiveness of credit control measures in an economy depends upon a number of factors. First, there should exist a well-organised money market. Second, a large proportion of money in circulation should form part of the organised money market. Finally, the money and capital markets should be extensive in coverage and elastic in nature.

Extensiveness enlarges the scope of credit control measures and elasticity lends it adjustability to the changed conditions. In most of the developed economies a favourable environment in terms of the factors discussed before exists, in the

2. How do banks create credit? What are the limits to their credit creation power?

13.7 LESSON END EXECISE

1. The selective instruments of credit control are more effective than general instruments in an underdeveloped economy. Discuss.

2. Discuss briefly the objectives of central bank to control credit

13.8 SUGGESTED END READING

* Bhole, L. M. (2004), "Financial Institutions and Markets", 4th Edition, Tata McGraw-Hill Publishing Company Limited, New Delhi.

* Bhole, L. M. (2004), "Financial Institutions and Markets", 4th Edition, Tata McGraw-Hill Publishing Company Limited, New Delhi.

* Paul, R. R. (2012), "Money, Banking and International Trade", 10th Edition, Kalyani Publishers, New Delhi.
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14.1 INTRODUCTION

Development of a country's banking system is one of the most significant factors affecting wealth of the economy. It plays a crucial role in the main operations of both private as well as public sectors. Many studies have shown that development of the banking sector has high positive correlation with the level of the economy development. The banking sector contributes to the biggest part of Gross Domestic Product (GDP) and playing crucial role in the country's economy. Any changes in banking system will have crucial effect on the economy of the country.

14.2 Objective

After going through this lesson you should be able to

- know about Profitability in Banking Sector
- understand the efficiency of the Banking sector

14.3 PROFITABILITY IN BANKING SECTOR

The goal of any bank is to generate revenues that will be sufficient to cover their expenditures. Moreover banks just like any businesses aim for profit. The main source of income comes from interest charge on loans. Profitability is the primary goal of all business ventures, which is important for viability in the long-run. In this respect, it is extremely important to evaluate past, current and future profitability, in order to predict and avoid negative consequences. The factors which determine profitability are income and expenditure which significantly shown in financial statements during annual period

14.4 EFFICIENCY OF THE BANKING

Sector Efficiency is one of the central terms used in assessing and measuring the performance of organizations (Mouzas, 2006). Efficiency is concerned with minimizing the cost and deals with the distribution of assets across best alternative uses. Efficiency determines the level of output achieved with a given amount of input, such as cost per unit. A more efficient unit means it obtains a higher level of output using the same amount of input, or it obtains the same level of output using a lower level of input. An efficient bank can be defined as the one that can

14.8 LESSON END EXECISE

1. Describe the different types of banks and functions performed by them.

2. Give an account of the new trends in modern commercial banking.

14.9 SUGGESTED END READING

- Bhole, L. M. (2004), "Financial Institutions and Markets", 4th Edition, Tata McGraw-Hill Publishing Company Limited, New Delhi.

- Bhole, L. M. (2004), "Financial Institutions and Markets", 4th Edition, Tata McGraw-Hill Publishing Company Limited, New Delhi.

- Paul, R. R. (2012), "Money, Banking and International Trade", 10th Edition, Kalyani Publishers, New Delhi.
- Mithani, D. M. (1998), "Money, Banking, International Trade and Public Finance", 11th Edition, Himalaya Publishing House, Mumbai.

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15.1 INTRODUCTION

A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit.

In fact, commercial banks, as their name suggests, axe profit-seeking institutions, i.e., they do banking business to earn profit. They generally finance trade and commerce with short-term loans. They charge high rate of interest from the borrowers but pay much less rate of Interest to their depositors with the result that the difference between the two rates of interest becomes the main source of profit of the banks. Most of the Indian joint stock Banks are Commercial Banks such as Punjab National Bank, Allahabad Bank, Canara Bank, Andhra Bank, Bank of Baroda, etc.

The two most distinctive features of a commercial bank are borrowing and lending, i.e., acceptance of deposits and lending of money to projects to earn Interest (profit). In short, banks borrow to lend. The rate of interest offered by the banks to depositors is called the borrowing rate while the rate at which banks lend out is called lending rate. The difference between the rates is called 'spread' which is appropriated by the banks. Mind, all financial institutions are not commercial banks because only those which perform dual functions of (i) accepting deposits and (ii) giving loans are termed as commercial banks. For example post offices are not bank because they do not give loans.

RRB (Regional Rural Bank) is also known as *'Gramin Bank'*. It was established in 26th September 1975 with the objective of the economic development of India. The ideology behind RRB is to focus on the upliftment of the rural economy because it is assumed that Real growth of Indian Economy lied in the freeing of rural masses from unemployment, acute poverty and socio-economic backwardness.

RRBs works for fulfilling the needs of rural population comprised of: -

- Agricultural laborers

- Artisans

ii. Chairman & Managing Director

iii. General Manager

iv. Chief manager /regional managers

v. Senior manager

vi. Manager

vii. Assistant manager

viii. Assistants

15.2 Objectives

The main objectives of this unit are to:

- Describe the structure of commercial banks
- Identify the functions of commercial banks
- Explain the significance of commercial banks
- Describe the process of credit creation by commercial banks.

15.3 COMMERCIAL BANKS:

- One of the main features of the commercial bank is to take the savings of people's money through different types of accounts. People can open their accounts according to their convenience and submit their accumulated money to the bank. These accounts are the current accounts, savings accounts, and permanent accounts.
- A prominent feature of the commercial bank is that people are more interested in saving through extensive publicity. This ensures that more saving storage is collected. It is possible to form capital in the country. encourage saving is the most effective characteristics of a commercial bank. Increasing the attractiveness of the customer's mind has resulted in an increase in the amount of storage.
- Although the commercial bank does not introduce money or currency, it

constitute nerve centre of production, trade and industry of a country.

In the words of Wick-sell, "Bank is the heart and central point of modern exchange economy."

The following points highlight the objectives of commercial banks:

(i) They promote savings and accelerate the rate of capital formation.

(ii) They are source of finance and credit for trade and industry.

(iii) They promote balanced regional development by opening branches in backward areas.

(iv) Bank credit enables entrepreneurs to innovate and invest which accelerates the process of economic development.

(v) They help in promoting large-scale production and growth of priority sectors such as agriculture, small-scale industry, retail trade and export.

(vi) They create credit in the sense that they are able to give more loans and advances than the cash position of the depositor's permits.

(vii) They help commerce and industry to expand their field of operation.

(viii) Thus, they make optimum utilisation of resources possible.

15.3.2 Function of Commercial Banks

Functions of commercial banks are classified into two main categories—(A) Primary functions and (B) Secondary functions.

(A) Primary Functions:

1. It accepts deposits:

A commercial bank accepts deposits in the form of current, savings and fixed deposits. It collects the surplus balances of the Individuals, firms and finances the temporary needs of commercial transactions. The first task is, therefore, the collection of the savings of the public. The bank does this by accepting deposits from its customers. Deposits are the lifeline of banks.

also called **time deposits,** are deposits which are payable only after the expiry of the specified period.

(ii) Demand deposits do not carry interest whereas time deposits carry a fixed rate of interest.

(iii) Demand deposits are highly liquid whereas time deposits are less liquid,

(iv) Demand deposits are chequable deposits whereas time deposits are not.

2. It gives loans and advances:

The second major function of a commercial bank is to give loans and advances particularly to businessmen and entrepreneurs and thereby earn interest. This is, in fact, the main source of income of the bank. A bank keeps a certain portion of the deposits with itself as reserve and gives (lends) the balance to the borrowers as loans and advances in the form of cash credit, demand loans, short-run loans, overdraft as explained under.

(i) Cash Credit:

An eligible borrower is first sanctioned a credit limit and within that limit he is allowed to withdraw a certain amount on a given security. The withdrawing power depends upon the borrower's current assets, the stock statement of which is submitted by him to the bank as the basis of security. Interest is charged by the bank on the drawn or utilised portion of credit (loan).

(ii) Demand Loans:

A loan which can be recalled on demand is called demand loan. There is no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Those like security brokers whose credit needs fluctuate generally, take such loans on personal security and financial assets.

(iii) Short-term Loans:

Short-term loans are given against some security as personal loans to finance working capital or as priority sector advances. The entire amount is repaid either in one instalment or in a number of instalments over the period of loan.

but in the case of overdraft, the borrower is given the facility of borrowing only as much as he requires.

(iii) Whereas the borrower of loan pays Interest on amount outstanding against him but customer of overdraft pays interest on the daily balance.

5. Agency functions of the bank:

The bank acts as an agent of its customers and gets commission for performing agency functions as under:

(i) Transfer of funds:

It provides facility for cheap and easy remittance of funds from place-to-place through demand drafts, mail transfers, telegraphic transfers, etc.

(ii) Collection of funds:

It collects funds through cheques, bills, bundles and demand drafts on behalf of its customers.

(iii) Payments of various items:

It makes payment of taxes. Insurance premium, bills, etc. as per the directions of its customers.

(iv) Purchase and sale of shares and securities:

It buys sells and keeps in safe custody securities and shares on behalf of its customers.

(v) Collection of dividends, interest on shares and debentures is made on behalf of its customers.

(iv) Acts as Trustee and Executor of property of its customers on advice of its customers.

(vii) Letters of References:

It gives information about economic position of its customers to traders and provides similar information about other traders to its customers.

6. Performing general utility services:

say, Y who is actually not given loan but only demand deposit account is opened in his name and the amount is credited to his account.

This is the first round of credit creation in the form of secondary deposit (Rs 1800), which equals 90% of primary (initial) deposit. Again 10% of Y's deposit (i.e., Rs 180) is kept by the bank as cash reserve (LRR) and the balance Rs 1620 (=1800 – 180) is advanced to, say, Z. The bank gets new demand deposit of Rs 1620. This is second round of credit creation which is 90% of first round of increase of Rs 1800. The third round of credit creation will be 90% of second round of 1620. This is not the end of story.

The process of credit creation goes on continuously till derivative deposit (secondary deposit) becomes zero. In the end, volume of total credit created in this way becomes multiple of initial (primary) deposit. The quantitative outcome is called money multiplier. If the bank succeeds in creating total credit of, says Rs 18000, it means bank has created 9 times of primary (initial) deposit of Rs 2000. This is what is meant by credit creation.

In short, money (or credit) creation by commercial banks is determined by (i) amount of initial (primary) deposits and (ii) LRR. The multiple is called credit creation or money multiplier.

Symbolically:

Total Credit creation = Initial deposits x 1/LRR.

Money Multiplier:

It means the multiple by which total deposit increases due to initial (primary) deposit. Money multiplier (or credit multiplier) is the inverse of Legal Reserve Ratio (LRR). If LRR is 10%, i.e., 10/100or 0.1, then money multiplier = 1/0.1 = 10.

Smaller the LRR, larger would be the size of money multiplier credited to his account. He is simply given the cheque book to draw cheques when he needs money. Again, 20% of Sohan's deposit which is considered a safe limit is kept for him by the bank and the balance Rs640 (= 80% of 800) is advanced to, say, Mohan. Thus, the process of credit creation goes on continuously and in the end

and its subsidiary banks, nationalised banks, foreign banks, etc. Further, scheduled commercial banks are further classified into three types:

- **Private Bank**: When the private individuals own more than 51% of the share capital, then that banking company is a private one. However, these banks are publicly listed companies in a recognized exchange.
- **Public Bank**: When the Government holds more than 51% of the share capital of a publicly listed banking company, then that bank is called as Public sector bank.
- **Foreign Bank**: Banks set up in foreign countries, and operate their branches in the home country are called as foreign banks.

Non-scheduled Banks:

The banks which are not included in Second Schedule of RBI are known as non-scheduled banks. A non-scheduled bank has a paid-up capital and reserves of less than Rs 5 lakh. Clearly, such banks are small banks and their field of operation is also limited.

15.3.4 CHALLENGES IN COMMERCIAL BANKING

According to a 2018 commercial banking customer survey, more than three-quarters of company executives polled responded that commercial banks should make investing in new capabilities their top priority. But with the IT infrastructure that is currently in place – infrastructure that is older than the legacy tech on the retail side in most cases – it is nearly impossible for most commercial banks to deliver the kind of experience their clients have come to expect. For commercial banking customers operating on a global scale, dated banking infrastructure poses a particular set of challenges when it comes to making cross-border settlements. To help chip away at these challenges, the industry needs to address the ways in which data is shared and how systems communicate with one another.

Another challenge is banks may not fully understand the cost of *not* investing in innovation. Ernst & Young states that digitization is lacking in commercial banking in large part because of "management's reluctance to consider strategies that will be costly in the short term, even if they will drive long-

Automation is dramatically increasing the number of financial transactions in an organisation. However, while it can track and store more processes than humans can – and more accurately – it currently can't provide the next level service many clients are coming to expect of their financial partners: planning and modelling.[1]

AI is rapidly establishing itself as the missing piece of the puzzle that takes the data flows created by automated transactions and knits them together to discover patterns. All this is important to commercial banks because patterns in spending and efficiency can potentially deliver valuable insights to help clients improve their financial health.

3. APIs

Customers' demands, and expectations are moving rapidly, so there is growing pressure on the banking industry to provide new, easy-to-use, frictionless digital services fast.

Application programming interfaces (APIs) provide the technology to exchange customer data with other parties in a simple and secure way[2], facilitating rapid innovation in products and services. Creating new applications such as voice banking, P2P, loan processing and risk management and using APIs as building blocks, is now seen as the best way to keep up with the innovation challenges facing the financial industry.

15.4 REGIONAL RURAL BANKS OF INDIA

Rural banking institutions are playing a very important role for all-round development of rural areas of the country. In order to support the rural banking sector in recent years, Regional Rural Banks have been set up all over the country with the objective of meeting the credit needs of the most under privileged sections of the society.

These Regional Rural Banks (RRBs) have been receiving a high degree of importance and attention in the rural credit system.

Considering the gross absence of banking facilities in the rural areas of the country, the Reserve Bank of India in consultation with the Central Government, State Governments and some major nationalized sponsored banks had set up some Regional Rural Banks in the late 1970s with a view to elevate the economic status of the rural poor as well as to inculcate a habit of saving among the rural masses.

As per the recommendations of the Working Group on Rural Banks, the regional rural banks were established in 1975 for supplementing the commercial banks and co-operatives in supplying rural credit. The main objective of regional rural banks in India is to advance credit and other facilities, especially to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in order to develop agriculture, trade, commerce, industry and other usual productive activities in different rural areas of the country.

At the initial stage, five regional rural banks were established on October 2, 1975 at Gorakhpur and Moradabad in Uttar Pradesh, Jaipur in Rajasthan, Bhiwani in Haryana and Malda in West Bengal under the sponsorship of State Bank of India, the Syndicate Bank, United Commercial Bank, Punjab National Bank and United Bank of India respectively.

All these five RRBs have an authorised capital of Rs 1 crore and paid-up capital of Rs 25 lakh. The share capital of RRB is subscribed in the following manner— as the Central Government—50 per cent, the State Government concerned—15 per cent and the sponsoring commercial bank—35 per cent.

15.4.2 FEATURES OF REGIONAL RURAL BANKS

The regional rural banks are the newest form of banks that have been set up in the country on the sponsorship of individual nationalised commercial banks. At the end of March 1994, they numbered 196, with about 14,500 branches covering 408 districts.

These banks have been set up with the express objective of developing the rural economy by providing credit and other facilities for agriculture and other productive activities of all kinds in rural areas. The main emphasis is supposed to be on the provision of such facilities to small and marginal farmers, agricultural labourers, rural artisans, and other small entrepre-neurs working in rural areas.

The paid-up capital of each rural bank is Rs. 25 lakhs, 50 per cent of which has been contributed by the Central Government, 15 per cent by the state government concerned and 35 per cent by the sponsoring public- sector commercial banks, which are also responsible for the actual setting up of RRBs. Thus, the latter are also public sector banks.

At the end of April 1995, their total deposits (mostly savings and fixed) were of about Rs. 8,800 crore and advances outstanding (more than 90% of them to weaker sections) were of about Rs. 5,260 crore. Their lending operations suffer- from the problem of very high percentage of over-dues.

They are helped by higher-level agencies in various ways. The spon-soring banks lend them funds and advise and train their senior staff; the NABARD gives them short-term and medium term loans, the RBI has kept the CRR for them at 3% and SLR at 25% of their total net liabilities, whereas for other commercial banks the respective minimum required ratios have been varied over time.

The RRB are a step in the right direction a step towards the proper implementation of multi-agency approach to credit in rural areas. But right from the beginning their viability has been posing a serious problem. To become (and stay) viable and play the important role of small man's credit institutes assigned to them, these banks will have to exert hard to build up efficient credit delivery and supervision system so as to reduce their high over-dues and not let them (over-

15.4.3 LIST OF REGIONAL RURAL BANKS

Sr. No.	Name of Regional Rural Bank & Website Link	Sponsor Bank	State
1	Allahabad UP Gramin Bank	Allahabad Bank	Uttar Pradesh
2	Andhra Pradesh Grameena Vikas Bank	State Bank of India	Andhra Pradesh
3	Andhra Pragathi Grameena Bank	Syndicate Bank	Andhra Pradesh
4	Arunachal Pradesh Rural Bank	State Bank of India	Arunachal Pradesh
5	Assam Gramin Vikash Bank	United Bank of India	Assam
6	Bangiya Gramin Vikash Bank	United Bank of India	West Bengal
7	Baroda Gujarat Gramin Bank	Bank of Baroda	Gujarat
8	Baroda Rajasthan Kshetriya Gramin Bank	Bank of Baroda	Rajasthan
9	Baroda UP Gramin Bank	Bank of Baroda	Uttar Pradesh
10	Bihar Gramin Bank	UCO Bank	Bihar
11	Central Madhya Pradesh Gramin Bank	Central Bank of India	Madhya Pradesh

25	Madhyanchal GraminBank	State BankofIndia	MadhyaPradesh
26	Madhya Bihar GraminBank	PunjabNational Bank	Bihar
27	Maharashtra GraminBank	Bankof Maharashtra	Maharashtra
28	MalwaGraminBank	State BankofIndia	Punjab
29	Manipur Rural Bank	United Bankof India	Manipur
30	Meghalaya Rural Bank	State BankofIndia	Meghalaya
31	MizoramRural Bank	State BankofIndia	Mizoram
32	NagalandRural Bank	State BankofIndia	Nagaland
33	NarmadaJhabua Gramin Bank	Bankof India	MadhyaPradesh
34	Odisha Gramya Bank	IndianOverseas Bank	Odisha
35	Pallavan Grama Bank	IndianBank	Tamil Nadu
36	PandyanGrama Bank	IndianOverseas Bank	Tamil Nadu
37	PaschimBangaGramin Bank	UCOBank	West Bengal

49	Telangana Grameena Bank	State Bank of India	Telangana
50	Tripura Gramin Bank	United Bank of India	Tripura
51	Utkal Grameen Bank	State Bank of India	Odisha
52	Uttar Banga Kshetriya Gramin Bank	Central Bank of India	West Bengal
53	Uttar Bihar Gramin Bank	Central Bank of India	Bihar
54	Uttarakhand Gramin Bank	State Bank of India	Uttarakhand
55	Vananchal Gramin Bank	State Bank of India	Jharkhand
56	Vidharbha Konkan Gramin Bank	Bank of India	Maharashtra

to the agriculture by the RRBs increased considerably from Rs 6,069.79 crore in 2002-03 to Rs 43,968 crore in 2010-11.

Evaluation of Regional Rural Banks

Regional Rural Banks have made commendable progress in advancing various types of loan to the weaker and under privileged section of the rural society. As per our recent RBI report, "The RRBs have fared well in achieving the objective of providing access to weaker sections of the society to institutional credit but the recovery position on the whole is not satisfactory."

The working of RRBs was evaluated by the Narasimham Committee on the Financial System. Although RRBs were set up in order to provide a low cost alternative to the operation of commercial bank branches, particularly in the rural areas but the functioning of RRBs was not up to the mark.

The Committee mentioned three basic problems of RRBs

RRBs have a low earning capacity due to so many restrictions placed on the business undertaken by these banks;

With the recent award of a tribunal the wages and salary scales of RRBs would be similar to that of commercial banks and thus the very idea of low cost alternative to the operation of commercial bank has been nullified; and

The very area of operations of RRBs is also being utilised by the sponsoring banks by running their own rural branches leading to certain anomalies like duplication of services and expenditures on control and administration.

Thus the Narasimham Committee is of the opinion that the viability of RRBs should be improved without sacrificing the basic objective. The Government should also try to evolve a rural banking structure and base of RRBs with adequate financial strength and management and organisational skills of the commercial banks.

15.4.5 FUNCTIONAL SUPERIORITY OF REGIONAL RURAL BANKS

Regional Rural Banks have also established functional superiority over other commercial banks of the country. This superiority of RRBs has been brought out

losses suffered by the RRBs has been very high overheads; in which a sizeable component is salaries. Employees of RRBs earlier received lower scales of salaries compared to their counterparts in the scheduled nationalized banks.

However, in 1990, with implementation of the National Industrial Tribunal (NIT) Award in case of the employees of the RRBs, the structure of their emoluments was brought at par with that of the staff of the scheduled commercial banks.

The NIT award has enhanced the salary-allowance bill of RRBs by 35 per cent during the last three years, apart from increase in its other concomitant expenditure. Moreover, it also placed on the banks shoulder an arrear burden of Rs 225 crore.

While the annual wage liability of the RRBs has increased substantially, their income was declining rapidly on account of inadequate loan recoveries and scanty profits. Only 23 of the 196 RRBs were making a profit and the rest were all running losses. The aggregate level of loss at the end of March 1994 was Rs 906 crore.

Over the last three years, the credit-deposit ratio of RRBs had also declined from 85.6 in 1989-90 to as low as 68.7 in 1991-92. Further, the increasing number of defaulters has hampered the recycling of cash. In 1992, the loan over dues stood at Rs 1,314 crore.

Due to the constant efforts, at recapitalizing RRBs, at the end of March, 2000, 158 RRBs are posting operating profits. Out of these, 48 RRBs have been able to wipe out their accumulated losses. In view of the importance of RRBs in rural financing, the government has decided to continue with this programme of strengthening the RRBs in the coming years.

15.14.2 Restructuring of Regional Rural Banks

The present situation is forcing the bank to initiate corrective measures to put them back in stream. The government of India has undertaken restructuring of the RRBs. Towards that end their issue capital has been raised from Rs 25 lakh to Rs one crore in the case of 140 banks and Rs 50 lakh in the remaining cases.

form a National Rural Bank of India, for which NABARD would contribute 76 per cent of the equity.

The organizational structure for RRB's varies from branch to branch and depends upon the nature and size of business done by the branch. The Head Office of an RRB normally had three to nine departments.

15.5 SUMMARY

Major portion of commercial banking in 1ndia is undertaken in the public sector. Within the public sector, the State Bank of India and its subsidiaries constitute State Bank Croup on the basis of their ownership pattern. New private sector banks include ICICI Bank Ltd; which is the second biggest bank after State Bank of India. Banks get the status of Scheduled Banks on the fulfilment of prescribed conditions. The main sources of banks' funds are deposits. Interest Rates on deposits are now completely deregulated (except savings). Borrowings from Reserve Bank and other institutions also augment their funds. Commercial Banks employ their funds in liquid assets, semi liquid assets and profit earning assets like loans and advances. They are required to maintain a prescribed percentage of deposits with Reserve Bank of India as CRR and also to maintain Statutory Liquidity Ratio of 25%. Funds are lent for diversified purposes-priority sector advances constitute over 40 % of total advances. They also lend for housing, consumer durables, real state financing and other personal purposes also. Reserve Bank of India has prescribed prudential norms to be followed by the commercial banks. Capital Adequacy Norm of 9% is to be fulfilled by them. The biggest problem of Commercial Banks presently is the existence of huge amount of non-performing assets. Efforts are being made to solve it through Debt Recovery Tribunals and otherwise also. Banking Sector Reforms have been undertaken since 1991, still further reforms are needed to improve the functioning of commercial banks

Rural banking institutions are playing a very important role for all-round development of rural areas of the country. In order to support the rural banking sector in recent years, Regional Rural Banks have been set up all over the country with the objective of meeting the credit needs of the most under privileged sections of the society.

- **Cash Concentration-** A consolidation of funds from multiple accounts into a single master account. This improves efficiency of cash management, especially for businesses with multiple locations or branches.
- **Certificate of Deposit (CD)-** A bank-issued certificate for a deposit that earns interest at a certain rate for a specified amount of time. CDs are generally considered safe investments and usually have a higher interest rate than regular savings accounts.
- **Compound Interest-** Interest paid on the principal account balance and on the interest it has already earned.
- **Credit Score-** A number that indicates to the lender an individual's ability to repay a loan. Credit scores can affect your credit approval for credit cards, loans and mortgages. They can also affect how much youpay in loan rates, approval for renting and insurance costs. The number is usually between 300 and 800.
- **Direct Payroll Deposit-** A process that allows for the direct disbursal of net pay to employee accounts. This streamlines payroll for business owners and deposits paychecks into employees' accounts on payday.Direct Debit- A system that allows creditors to automatically withdraw payments from a customer's bank account at regular intervals. This allows customers to automatically make regular payments such as rent, mortgage or other recurring bills.
- **Electronic Funds Transfer (EFT)-** An electronic-based system that transfers funds between accounts. This includes Automated Clearing House (ACH) and wire transfers.
- **Federal Deposit Insurance Corporation (FDIC)-** An independent government agency that insures deposits of all national and state banks that are members of the Federal Reserve. This promotes public confidence in the U.S. financial system because the agency insures banks' deposits for up to $250,000 per depositor. The agency monitors and addresses risk of each member bank.
- chit agreement" means the document containing the articles of agreement

15.8 LESSON END EXERCISE

1. State The Meaning Of Commercial Banks?

2. State The Principles Of The Investment Policy Of Commercial Banks?

3. Give The List Of Commercial Banks In India?

15.9 SUGGESTED READINGS

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16.1 INTRODUCTION

Development bank is essentially a multi-purpose financial institution with a broad development outlook. A development bank may, thus, be defined as a financial institution concerned with providing all types of financial assistance (medium as well as long term) to business units, in the form of loans, underwriting, investment and guarantee operations, and promotional activities — economic development in general, and industrial development, in particular.

A development finance institution (DFI) also known as a development bank or development finance company (DFC) is a financial institution that provides risk capital for economic development projects on non commercial basis. They are often established and owned by governments or charitable institutions to provide funds for projects that would otherwise not be able to get funds from commercial lenders. Some development banks include socially responsible investing and impact investing criteria into their mandates. Governments often use development banks to form part of their development aid or economic development initiatives. DFIs can include multilateral development banks, national development banks, bilateral development banks, microfinance institutions, community development financial institution and revolving loan funds. These institutions provide a crucial role in providing credit in the form of higher risk loans, equity positions and risk guarantee instruments to private sector investments in developing countries. DFIs are typically backed by countries with developed economies.

As of 2005, total commitments (as loans, equity, guarantees and debt securities) of the major regional, multilateral and bilateral DFIs totalled US$45 billion (US$21.3 billion of which went to support the private sector). DFIs often provide finance to the private sector for investments that promote development and to help companies to invest, especially in countries with various restrictions on the market.

16.2 OBJECTIVES:

The main objectives of this unit are to:

- Describe the meaning, functions and objectives of development banks.

Development banks in India are classified into following four groups:

1. **Industrial Development Banks**: It includes, for example, Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), and Small Industries Development Bank of India (SIDBI).
2. **Agricultural Development Banks**: It includes, for example, National Bank for Agriculture & Rural Development (NABARD).
3. **Export-Import Development Banks**: It includes, for example, Export-Import Bank of India (EXIM Bank).
4. **Housing Development Banks**: It includes, for example, National Housing Bank (NHB).

16.5 ROLE OF DEVELOPMENT BANKS

1. Capital Formation:

The significance of Development Finance Institutions or DFIs lies in their making available the means to utilize savings generated in the economy, thus helping in capital formation. Capital formation implies the diversion of the productive capacity of the economy to the making of capital goods which increases future productive capacity. The process of Capital Formation involves three distinct but interdependent activities, viz., saving financial intermediation and investment. However, poor country/economy may be, there will be a need for institutions which allow such savings, as are currently forthcoming, to be invested conveniently and safely and which ensure that they are channeled into the most useful purposes. A well-developed financial structure will therefore aid in the collections and disbursements of investible funds and thereby contribute to the capital formation of the economy. Indian capital market although still considered to be underdeveloped has been recording impressive progress during the post-interdependence period.

2. Support to the Capital Market:

The basic purpose of DFIs particularly in the context of a developing economy, is to accelerate the pace of economic development by increasing capital formation,

prompt of installments to the supplier of such machinery or capital under a scheme called 'Deferred Payments Guarantee'.

6. Assistance to Backward Areas:

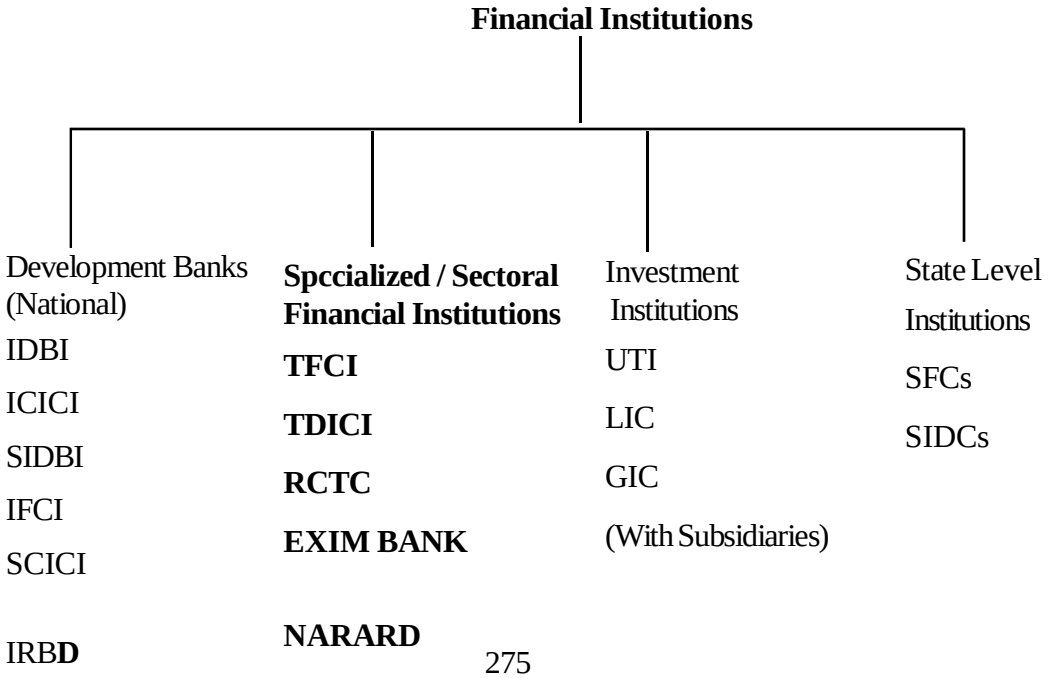
Operations of DFI's in India have been primarily guided by priorities as spelt out in the Five-Year Plans. This is reflected in the lending portfolio and pattern of financial assistance of development financial institutions under different schemes of financing. Institutional finance to projects in backward areas is extended on concessional terms such as lower interest rate, longer moratorium period, extended repayment schedule and relaxed norms in respect of promoters' contribution and debt-equity ratio. Such concessions are extended on a graded scale to units in industrially backward districts, classified into the three categories of A, B and c depending upon the degree of their backwardness. Besides, institutions have introduced schemes for extending term loans for project/area- specific infrastructure development. Moreover, in recent years, development banks in India have launched special programs for intensive development of industrially least developed areas, commonly referred to as the No-industry Districts (NID's) which do not have any large-scale or medium-scale industrial project. Institutions have initiated industrial potential surveys in these areas.

7. Promotion of New Entrepreneurs:

Development banks in India have also achieved a remarkable success in creating a new class of entrepreneurs and spreading the industrial culture to newer areas and weaker sections of the society. Special capital and seed Capital schemes have been introduced to provide equity type of assistance to new and technically skilled entrepreneurs who lack financial resources of their own even to provide promoter's contribution in view of long-term benefits to the society from the emergence of a new class of entrepreneurs. Development banks have been actively involved in the entrepreneurship development programs and in establishing a set of institutions which identify and train potential entrepreneurs. Again, to make available a package of services encompassing preparation of feasibility of reports, project reports, technical and management consultancy etc. at a reasonable cost, institutions have sponsored a chain of 16 Technical Consultancy organizations covering practically the entire country. Promotional

operation, as adopted by any financial institution like commercial banks and development responsibilities. It emphasizes the long term financing of a project rather than collateral based financing apart from provision of long term loans , equity capital guarantees and underwriting functions , a development institution normalize also expected to upgrade the managerial and the other operational requirements of the assisted projects. Its association with its clients is of an on-going nature and of being a companion in the project than that of a plain lender like banks. Hence the basic stress of a DFI is on long term finance and support for activities to the sector of the economy where the risks may be higher that may not be feasible for commercial banks to finance them. So role of DFIs is not just long term financing but more of development of significant sectors of our economy for hastening growth. These DFIs are also known as Development banks.

After independence the role of commercial banking was limited to working capital financing on short term basis so thrust of DFIs was on long term finance to industry and infrastructure sector in India. India's first DFI was operationalised in 1948 and it set up State Financial Corporations(SFCs) at the State level after passing of the SFCs Act, 1951, succeeded by the development of Industrial Finance Corporation India (IFCI).



India. It is an apex institution in rural credit structure for providing credit for promotion of agriculture, small scale industries, cottage and village industries, handicrafts etc.

Role of NABARD:

1. It is an apex institution which has power to deal with all matters concerning policy, planning as well as operations in giving credit for agriculture and other economic activities in the rural areas.

2. It is a refinancing agency for those institutions that provide investment and production credit for promoting the several developmental programs for rural development.

3. It is improving the absorptive capacity of the credit delivery system in India, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, and training of personnel.

4. It co-ordinates the rural credit financing activities of all sorts of institutions engaged in developmental work at the field level while maintaining liaison with Government of India, and State Governments, and also RBI and other national level institutions that are concerned with policy formulation.

5. It prepares rural credit plans, annually, for all districts in the country.

6. It also promotes research in rural banking, and the field of agriculture and rural development.

Milestones in NABARD's activities are:

Business Operations:

1. **Production Credit:** NABARD sanctioned aggregating of 66,418 crore short term loans to Cooperative Banks and Regional Rural Banks (RRBs) during 2012-13, against which, the maximum outstanding was 65,176 crore.

2. **Investment Credit:** Investment Credit for capital formation in agriculture & allied sectors, non-farm sector activities and services sector to commercial banks, RRBs and co-operative banks reached a level of 17,674.29 crore as on 31 March

Corporation, among others, were set up with the financial assistance of IFCI.

The company has played a pivotal role in setting up various market intermediaries of repute in several niche areas like stock exchanges, entrepreneurship development organisations, consultancy organisations, educational and skill development institutes across the length and breadth of the country. The Govt. of India has placed a Venture Capital Fund of Rs. 200 crore for Scheduled Castes (SC) with IFCI with an aim to promote entrepreneurship among the Scheduled Castes (SC) and to provide concessional finance. IFCI has also committed a contribution of Rs.50 crore as lead investor and Sponsor of the Fund. IFCI Venture Capital Funds Ltd., a subsidiary of IFCI Ltd., is the Investment Manager of the Fund. The Fund was operationalized during FY 2014-15 and IVCF is continuously making efforts for meeting the stated objective of the scheme. Further, the Government of India designated IFCI as a nodal agency for the "Scheme of Credit Enhancement Guarantee for Scheduled Caste (SC) Entrepreneurs" in March, 2015, with the objective of encouraging entrepreneurship in the lower strata of society. Under the scheme, IFCI would provide guarantees to banks against loans to young and start-up entrepreneurs belonging to scheduled castes. Until the establishment of ICICI in 1991, IFCI remained solely responsible for implementation of the government's industrial policy initiatives. On 1 July 1993, it was reconstituted as a company to impart higher degree of operational flexibility. Because there was NPA are increase and going lose then gov get private. IFCI was allowed to access the capital markets directly.

16.7.2 IDBI

Industrial Development Bank of India (**IDBI Bank Limited** or **IDBI Bank** or **IDBI**) was established in 1964 by an Act to provide credit and other financial facilities for the development of the fledgling Indian industry. Many institutes of national importance finds their roots in IDBI like SIDBI, Exim bank, NSE and NSDL.

Initially it operated as a subsidiary of Reserve Bank of India and later RBI has transferred it to Government of India. On June 29, 2018 Life Insurance

export credit, like other export credit agencies in the world, Exim Bank India has, over the period, evolved into an institution that plays a major role in partnering Indian industries, particularly the Small and Medium Enterprises, in their globalisation efforts, through a wide range of products and services offered at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre- shipment and post-shipment and overseas investment.

16.7.8 ICICI

ICICI Bank Limited is an Indian multinational banking and financial services company headquartered in Mumbai, Maharashtra with its registered office in Vadodara, Gujarat. As of 2018, ICICI Bank is the second largest bank in India in terms of assets and market capitalisation. It offers a wide range of banking products and financial services for corporate and retail customers through a variety of delivery channels and specialised subsidiaries in the areas of investment banking, life, non-life insurance, venture capital and asset management. The bank has a network of 5,275 branches and 15,589 ATMs across India and has a presence in 17 countries including India.

ICICI jyBank is one of the *i* of India.] The bank has subsidiaries in the United Kingdom and Canada; branches in United States, Singapore, Bahrain, Hong Kong, Qatar, Oman, Dubai International Finance Centre, China and South Africa and representative offices in United Arab Emirates, Bangladesh, Malaysia and Indonesia. The company's UK subsidiary has also established branches in Belgium and Germany.

16.8 SUMMARY

"Development banks are those financial institutions whose prime goal (motive) is to finance the primary (basic) needs of the society. Such funding results in the growth and development of the social and economic sectors of the nation. However, needs of the society vary from region to region due to differences were seen in its communal structure, economy and other aspects."

2. Role of developmetn banks in India.

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17.1 INTRODUCTION:

At the Bretton Woods Conference in 1944 it was decided to establish a new monetary order that would expand international trade, promote international capital flows and contribute to monetary stability. The IMF and the World Bank were borne out of this Conference of the end of World War II. The World Bank was established to help the restoration of economies disrupted by War by facilitating the investment of capital for productive purposes and to promote the long-range balanced growth of international trade. On the other hand, the IMF is primarily a supervisory institution for coordinating the efforts of member countries to achieve greater cooperation in the formulation of economic policies. It helps to promote exchange stability and orderly exchange relations among its member countries. It is in this context that the present chapter reviews the purpose and working of some of the international financial institutions and the contributions made by them in promoting economic and social progress in developing countries by helping raise standards of living and productivity to the point of which development becomes self-sustaining.

17.2 OBJECTIVES

- Understand the objective, functions and process of funding pattern of World Bank.
- Learn the objectives, functions and lending policies of International Development Association and International Finance Corporation.
- Know the function of ADB.

17.3 WORLD BANK

The International Bank for Reconstruction and Development (IBRD), better known as the World Bank, was established at the same time as the International Monetary Fund to tackle the problem of international investment. Since the IMF was designed to provide temporary assistance in correcting the balance of payments difficulties, an institution was also needed to assist long-term investment purposes. Thus, IBRD was established for promoting long-term investment loans on reasonable terms.

17.4 INTERNATIONAL DEVELOPMENTASSOCIATION (IDA)

The IDA was formed in 1960 as a part of the World Bank Group to provide financial support to

LDCs on a more liberal basis than could be offered by the IBRD. The IDA has 137 member countries, although all members of the IBRD are free to join the IDA. IDA's funds come from

subscriptions from its developed members and from the earnings of the IBRD. Credit terms usually are extended to 40 to 50 years with no interest. Repayment begins after a ten-year grace period and can be paid in the local currency, as long as it is convertible. Loans are made only to

the poorest countries in the world, those with an annual per capita gross national product of $480 or less. More than 40 countries are eligible for IDA financing. An example of an IDA project is a $8.3 million loan to Tanzania approved in 1989 to implement the first stage in the longer-term process of rehabilitating the country's agricultural research system. Co financing is expected from several countries as well as other multilateral lending institutions. Although the IDA's resources are separate from the IBRD, it has no separate staff. Loans are made for similar projects as those carried out by IBRD, but at easier and more favourable credit terms. As mentioned earlier, World Bank/IDA assistance historically has been for developing infrastructure. The present emphasis seems to be on helping the masses of poor people in the developing countries become more productive and takes an active part in the development process. Greater emphasis is being placed on improving urban living conditions and increasing productivity of small industries.

17.4.1 Working of IDA

Thus, IDA is looked upon as a means of furthering the development activities of the World Bank and as a supplementary to the Bank's activities. Under its charter, the IDA is to support projects which are calculated to contribute to the development of the country concerned, whether they are directly productive or not. The IDA credits would be called development credits to distinguish them

of projects such as steel, textile production, mining, manufacturing, machinery production, food processing, tourism and local development finance companies. Some projects are locally owned, whereas others are joint ventures between investors in developing and developed countries. In a few cases, joint ventures are formed between investors of two or more developing countries. The IFC has also been instrumental in helping to develop emerging capital markets.

17.5.1 Working of IFC

The IFC considers only such investment proposals whose objective is the establishment, expansion or improvement of productive private enterprises which will contribute to the development of the economy of the country concerned. Industrial, agricultural, financial, commercial, and other private enterprises are eligible for IFC financing, provided their operations are productive in character. The IFC is authorised to invest its funds in many forms it deems appropriate, with the exception of capital stocks and shares. It does not have a policy of uniform interest rates for its investments. The interest rate is to be negotiated in each case in the light of all relevant factors, including the risks involved and any right to participation in profits, etc. IFC makes investments only when it is satisfied that the enterprise has or will have experience and competent management and it looks to that management to conduct the business of the enterprise. It does not itself assume responsibility of managing the enterprise. In India the IFC has so far made six investment commitments totaling over $ 7 million. However, the actual working of the IFC has been rather slow. That there is great scope for its work is quite evident from its resources and investment portfolios. It is hoped that IFC will in future be more fully able to play a dynamic investor's role in the economic development of the poor nations.

17.6 ASIAN DEVELOPMENT BANK (ADB)

The Asian Development Bank is a multilateral developmental finance institution founded in 1966 by 31 member governments to promote social and economic progress of Asian and the Pacific region. The Bank gives special attention to the needs of smaller or less developed countries and gives priority to regional/non-regional national programmes. In early 1960, the United National Economic

of its Developing Member Countries (DMCS);

• To provide technical assistance for the preparation and execution of development projects and programmes and for advisory services;

• To promote and facilitate investment of public and private capital for development purposes; and

• To respond to requests for assistance in coordinating development policies and plans of its DMCs.

17.6.2 Shareholders

The two largest shareholders of the Bank, as of31 December 1997, were Japan and the United States, each accounting for 16 per cent of the total subscribed capital. Forty one regional members accounted for 63 per cent of total shareholding while 16 non-regional members contributed 37 per cent of the total. Location The Bank's headquarters are in Manila, Philippines. It has resident missions in Bangladesh, Cambodia, India, Indonesia, Nepal, Pakistan, Sri Lanka and Vietnam and has opened resident missions in Kazakhstan and Uzbekistan. These resident missions improve the Bank's coordination with the governments and donor agencies; assist with activities related to country programming and processing of new loans and technical assistance projects; and help ensure project quality.

17.6.3 Operations of ADB

ADB works in partnership with governments and public and private enterprises in its developing

member countries on projects and programs that will contribute to economic and social development, based on the country's needs and priorities. In 2008, ADB approved loans worth $10.5 billion for 86 projects, most of which went to the public sector. Technical assistance, which is used to prepare and implement projects and support advisory and regional activities, amounted to $274 million. Grant-financed projects totaled $811 million.

* **International trade:** International trade is the exchange of capital, goods, and services across international borders or territories.

* **International Financial System:** The financial system consisting of institutions, their customers, and financial regulators that act on a global level is termed as International Financial System.

* **Human Resource Development (HRD):** Human Resource Development (HRD) is the framework for helping employees develops their personal and organizational skills, knowledge, and abilities. Human Resource Development includes such opportunities as employee training, employee career development, performance management and development, coaching, mentoring, succession planning, key employee identification, tuition assistance, and organization development.

* **Risk Capital:** Risk capital refers to funds used for high-risk, high-reward investments such as junior mining or emerging biotechnology stocks. Such capital can either earn spectacular returns over a period of time, or may dwindle to a fraction of the initial amount invested if several ventures prove unsuccessful. Diversification is a key for successful investment of risk capital. In the context of venture capital, risk capital may also refer to funds invested in a promising start-up.

* **Productivity:** Productivity is the ratio of economic output to economic inputs; it is a measure of the efficiency of production.

17.9 SELFASSESSMENT QUESTIONS

1. Examine the functions and working of the World Bank.

M.COM-III **COURSE NO.: MCOMFE352**
UNIT-IV **LESSON NO. XVIII**

NON BANKING FINANCIAL INSTITUTIONS

STRUCTURE

companies could accept deposits to the extent of their net owned funds, as per the key recommendations of James S. Raj Study Group formed in 1975. The Companies were also required to maintain liquid assets in the form of unencumbered approved government securities.

- Between the 1980s and 1990s, NBFCs, with their customer-friendly reputation, began to attract a huge number of investors. The number of NBFCs rose swiftly from a mere 7000 in 1981 to around 30000 in 1992, which made the RBI feel the need to regulate the industry. In 1992, the RBI formed a Committee headed by the former Chairman of Bank of Baroda, Mr. A. C. Shah, to suggest measures for effective regulation of the industry. The Shah Committee's recommendations included most things from compulsory registration to prudential norms.

- In January 1997 there were huge changes in the RBI Act, 1934, especially the Chapters III-B, III-C, and V of the Act seeking to put in place a complete regulatory and supervisory structure, which would protect the interests and also ensure the smooth functioning of NBFCs.

- After the amendment of the Act in 1997, the NBFCs have grown significantly in terms of operations, range of instruments and market products, technological advancement, among others.

- In the last 20 years, the NBFCs have gained prominence and added depth to the financial sector. In August 2016, the union cabinet gave the go-ahead for foreign direct investment (FDI) under the automatic route in regulated NBFCs.

The Non-Banking Finance Companies operating in India fall in the following broad categories.

(1) Equipment Leasing Company is a company which carries on as its principal business, the business of leasing of equipments or the financing of such activity. Apart from their Net Owned Funds (NOF), the leasing companies raise finds in the form of deposits from other companies, banks and the financial institutions.

Public deposits and inter-corporate deposits account for 74 percent of their total funds. Leasing is a form of rental system. A lease is a contractual arrangement

prominent industrial groups have their own investment companies.

(5) Loan Company is a company which carries on as its principle business, the providing of finance whether by making loans or advances or otherwise for any activity other than its own. (This category excludes No.1 to No. 3 above categories). These types of companies are generally small partnership concerns which obtain funds in the form of deposits from the public and give loans to wholesale and retail traders, small scale industries and self-employed persons. These companies collect fixed deposits from the public by offering higher rates of interest and give loans to others at relatively higher rates of interest.

(6) Mutual Benefit Finance Company (i.e. Nidhi Company) means any company which is notified by the Central Government under section 620A of the Companies Act, 1956. The main sources of funds for nidhis are share capital, deposits from their members and deposits from the public. Nidhis give, loans to their members-for several purposes like marriages, redemption of old debts, construction and etc. The nidhis normally follow the easy procedures and offer saving schemes and make credits available to those whose credit needs remain unmet by his commercial banks.

(7) Chit Fund Company is a company which collects subscriptions from specified number of subscribers periodically and in turn distributes the same as prizes amongst them. Any other form of chit or kuri is also included in this category. The chit fund companies operations are governed by the Chit Fund Act, 1982, which is administered by State Governments. Their deposit taking activities are regulated by the Reserve Bank. The chit fund companies enter into an agreement with the subscribers that everyone of them shall subscribe a certain amount in installments over a definite period and that every one of such subscriber shall in his turn, as determined by lot or by auction or by tender, be entitled to a prize amount.

(8) Residuary Non-Banking Company is a company which receives deposits under any scheme by way of subscriptions/contributions and does not fall in any of the above categories.

There are few challenges in the operations of these companies; (i) Negative NOF

- They cannot offer gifts/incentives or any other additional benefit to the depositors.
- They should have the minimum investment grade credit rating
- Their deposits are not insured.
- RBI does not guarantee the repayment of deposits by NBFCs.

18.5 ROLE AND GROWTH OF INVESTMENT COMPANIES

Concept of Investment Company

An investment company is a corporation or trust engaged in the business of investing the pooled capital of investors in financial securities. This is most often done either through a closed-end fund or an open-end fund (also referred to as a mutual fund). In the U.S., most investment companies are registered with and regulated by the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. An investment company is also known as "fund company" or "fund sponsor." They often partner with third-party distributors to sell mutual funds.

Investment companies are business entities, both privately and publicly owned, that manage, sell and market funds to the public. The main business of an investment company is to hold and manage securities for investment purposes, but they typically offer investors a variety of funds and investment services, which include portfolio management, recordkeeping, custodial, legal, accounting and tax management services.

An investment company can be a corporation, partnership, business trust or limited liability company (LLC) that pools money from investors on a collective basis. The money pooled is invested, and the investors share any profits and losses incurred by the company according to each investor's interest in the company. For example, assume an investment company pooled and invested $10 million from a number of clients, who represent the fund company's shareholders. A client who contributed $1 million will have a vested interest of 10% in the company, which would also translate into any losses or profits earned.

their hard-earned money is even worthwhile anymore. While this reaction is certainly understandable, it is important to keep in mind that no matter how bad things are the economy will recover eventually. When that recovery begins, stocks and mutual funds may once again be the places to be, and those who were able to ride out the storm and keep investing may find themselves in an enviable position.

An investment company is a company whose main business is holding securities for investment purposes. Investment companies invest money on behalf of their clients who, in turn, share in the profits and losses. In general, each of these investment companies must register under the Securities Act of 1933 and the Investment Company Act of 1940. A major type of company not covered under the Investment Company Act is Private Investment Companies, which are simply private companies that make investments in stocks or bonds, but are limited to under 100 investors and are not regulated by the SEC.These funds are often composed of very wealthy investors.

1. Collect Investments

· Investment companies collect funds by issuing and selling shares to investors. There are basically two types of investment companies: close-end and open-end companies. Close-end companies issue a limited amount of shares that can then be traded in the secondary market—on a stock exchange—whereas open-end company funds, e.g. mutual funds, issue new shares every time an investor wants to buy its stocks.

2. Invest in Financial Instruments

· Investment companies invest in financial instruments according to the strategy of which that they made investors aware. There are a wide range of strategies and financial instruments that investment companies use, offering investors different exposures to risks. Investment companies invest in equities (stocks), fixed-income (bonds), currencies, commodities and other assets.

3. Pay Out the Profits

· The profits and losses that an investment company makes are shared among

18.7 REGISTRATION OF NBFC

The Reserve Bank of India (Amendment) Act, 1997 provides for compulsory registration with the Reserve Bank of all NBFCs, irrespective of their holding of public deposits, for commencing and carrying on business, minimum entry point norms, maintenance of a portion of deposits in liquid assets, creation of Reserve Fund and transfer of 20 percent of profit after tax annually to the fund.

The act provides for an entry point norm of Rs. 25 lakh as the minimum Net Owned Fund (NOF). Subsequently, for new NBFC's seeking registration with the Reserve Bank to commence business on or after April 21, 1999, the requirement of minimum level of NOF was revised upwards to Rs. 2 crore.

No NBFC can commence or carry on business of a financial institution including acceptance of public deposit without obtaining a Certificate of Registration (COR) from the Reserve Bank.

18.8 SUPERVISION OF NBFCS

The Supervisory framework for NBFCs is based on three aspects—(a) the size of NBFC, (b) type of activity (c) the acceptance or otherwise of public deposits. Towards this end, a four-pronged supervisory strategy comprising

(a) On-site inspection based on CAMELS (Capital, Assets, Management, Earnings, Liquidity, Systems and Procedures) methodology.

(b) Computerized off-site surveillance through periodic control returns,

(c) An effective market intelligence network, and

(d) A system of submission of exception reports by auditors of NBFCs

Task Force:

To review the regulatory framework and supervision of NBFCs, the Government appointed a task force which submitted its report in October 1998. The recommendations made by the Task Force covering different aspects like ceiling on public deposits, investments in real estate and unquoted shares, minimum of NOF to be raised, registration, inspection disclosures etc. have been

Deep understanding of the Customers segment:

NBFC's have strongly focused on unorganized & Under-served segments of the economy, which led the companies to create a niche for themselves through frequent interactions with their Customer segments & deeply understanding needs. They are ensuring last-mile delivery & enhanced customer experience of products & services.

Customized product offerings by NBFC's:

Several NBFCs have focused on a limited line (or often a mono-line set of products) to serve the target customer segment. Armed with a thorough comprehension of their target segment, NBFCs have customized product offerings to address unique characteristics of the customer segment and focus on meeting the right needs. Several NBFCs are adopting non-standard pricing models for product lines, in-line with the customer profile and inherent risk of lending.

Leveraging Technology for Improved Efficiency and Enhanced Experience:

The use of technology is helping nbfc Companies customize credit assessment models and optimize business processes, thereby reducing the time to market and helping improve customer experience. NBFCs are investing in data analytics and artificial intelligence to build robust relationships with their target customer segments.

Wider and Effective reach:

NBFCs are now reaching out to Tier-2, Tier-3 and Tier-4 markets, distributing

loans across several customer touch-points, building a connected channel experience, that provides an omnichannel seamless experience with 24/7 sales and service, as the consumers of today evolving and accessing digital media like never before, NBFCs have embarked on new and better ways to engage with the customer.

Co-lending Arrangements:

NBFCs have been tying up with multiple alternative lenders with digital platforms and commercial banks as well, which has been adding to their targeted customer

Deposit Insurance Corporation a federal institution with regulatory powers. A loan company in Canada may accept deposits but the amount so held should not exceed the aggregate amount of its paid-up and unimpaired capital stock and of its cash actually in hand or deposited in any chartered Bank in Canada. A trust company may receive money on deposit and allow interest thereon at such rate as agreed upon and also advance money to protect any estate, trust or property entrusted to it; it has to maintain at all times, reserves at an aggregate of at least 25 percent of the amount of funds received for guaranteed investment repayable on demand or becoming due in less than one hundred days. It can borrow upon the credit of the company or against the hypothecation, pledge or mortgage of its property.

- **France:** The Jurisdiction of the National Credit Council which is entrusted with the enforcement of the regulation of banking has been extended to two categories, namely, banks and financial institutions. Institutions other than banks cannot accept public deposits repayable on demand or on notice for less than two years. Financial institutions have been defined as enterprise which, without receiving public funds, carry out one or several of the following operations.

(1) Effect short or medium-term credit operations and exchange operations.

(2) Discount, take as security or collect bills of exchange, cheques and public securities.

(3) Serve as commission agents, brokers or intermediaries in the operations concerning securities and funds of the state, bills of exchange and public securities.

The financial institutions are not classified into legal categories. However, the National Credit Council imposes upon them a de facto specialization in strictly limiting their activities to specific types of operations which the institutions declare in their application for registration. This specialization permits categorisation of financial institutions are: Group finance companies, House of securities, Houses for financing hire purchase, Loan securities or real estate societies, Societies for lease (movable and immovable property), Miller union and miscellaneous. The

diversity of financial institutions themselves have become measures of economic development of a country.

18.11 SUMMARY

Financial intermediaries bring together the suppliers and demanders of financial resources. These include commercial banks, investment trusts, insurance companies, share brokers, hire purchase companies, etc. Except commercial banks, all other institutions mentioned above fall under the category of non - bank financial institutions. Non-bank financial institutions help the individual investors by providing them steady returns with capital appreciation: These institutions provide funds to business and industry in backward areas at softer terms and reasonable cost. Moreover, these nonbank financial institutions also provide technical and managerial consultancy. The Life Insurance Corporation was constituted under the LIC Act, 1956 as a wholly owned government organization. Its main objective4 include spreading the message of life insurance to every corner of India, to conduct the business of life insurance to the best advantage of the society and to channelize the accumulated public savings in accordance with the economic policy of the nation. While investing funds the LIC takes into account several considerations like safety of funds, diversification of investment portfolio, time of maturity of the securities, etc. Since inception the investible funds of the LIC have been continuously growing. During 1988-89 it grew at 18% and stood at Rs. 20,428 crore. Out of its resources, maximum investment flows to the government and other approved securities - its share in the total investment being 49.2% in 1988-89. The chemicals and chemical product industry was sanctioned maximum direct assistance (33.1%) followed by basic metal (14.4%) and textiles (9.7%). During 1988-89, Andhra Pradesh and Gujarat together were sanctioned more than half of the total sanctioned investment. The LIC has succeeded in mobilizing large amounts of' savings of the people, but it has not been successful in 'diversifying its investment portfolio, region-wise or industry wise. Its contribution to new industrial ventures and to the agricultural sector is very limited. GIC is a holding company with four subsidiaries. It invests funds in socially oriented sectors of the economy which include government securities, and agencies engaged in housing and urban activities. During 1988-

18.13 SELFASSESSMENT QUESTIONS

1. What is a Non-Banking Financial Institution (NBFI)?

2. What does conducting financial activity as “principal business” mean?

3. Is it necessary that every NBFI should be registered with RBI?

18.14 LESSON END EXERCISE

1. NBFIs are doing functions similar to banks. What is difference between banks & NBFIs?

2. What are systemically important NBFIs?

M.COM-III **COURSE NO.: MCOMFE352**
UNIT-IV **LESSON NO. XIX**

HIRE PURCHASE COMPANIES LEASE FINANCE

STRUCTURE

methods of capital budgeting.

2. Having decided the above, the firm shall have to make a choice between buying the asset or leasing it, based on the relative costs involved therein.

3. In the case of outright purchase of an asset, the company will need the total amount of funds equal to the cost of the asset at the time of acquisition. If the company has sufficient funds of its own, it may like to go for outright purchase of the same.

4. If the funds required for outright purchase are not sufficient with the firm, it shall have to raise the same through issue of shares or in the form of long term borrowings. Both of these sources will entail cost to the firm, which is to be estimated realistically.

5. In case of outright purchase, the firm shall be entitled to charge depreciation on the asset and interest on the borrowed funds as deductible expenses for Income Tax purposes. Thus, the cost of buying option is reduced by the extent of reduction in tax liability. Only the after-tax cost of buying decision is considered for comparing the same with the cost of leasing decision.

6. In case of purchase, the scrap value of the asset is also to be considered.

7. In case of the leasing option, the company shall have to make payment of lease rental regularly over the lease period. The entire amount of lease rental is tax deductible expense. Hence, the after-tax cost of lease rentals (cash outflows) each year is calculated as follows:

   Lease rental payment × (1 – tax rate)

8. It is important that the period of total after tax cash outflows in both the alternatives must be identical, e.g., if the lease period is 10 years, the net cash outflows in the buying decision should also be calculated for 10 year period.

9. Compare the present value (PV) of cash outflows under leasing decision with the present value of the buying alternative by employing after-tax cost of debtas the discount rate for this purpose.

Table 1: Present value of total lease payments

Year-End	Lease payment (L) after tax L(1-0.5) (Rs.)	PV factor at after tax cost of debt 7% or 14% (1-0.5)	Total PV of Lease payments Col.(2) X Col.(3) (Rs.)
1	2	3	4
1-5	60,000	4,100	2,46,000

Table 1: Present value of total lease payments

Table 2: Determination of the interest and Principal Components and Laon Installment

Year-End	Loan installment (Rs.)	Loan at the beginning of the year (Rs.)	Payment of Interest on loan (Col. 3 X 14%) (Rs.)	Principle re-payment (Col. 2-Col.4) (Rs.)	Principle outstanding at the end of the year (Col.3-Col.5) (Rs.)
1	2	3	4	5	6
1	1,00,000*	3,43,300	48,062	51,938	2,91,362
2	1,00,000	2,91,362	40,791	59,209	2,32,153
3	1,00,000	2,32,153	32,501	67,499	1,64,654
4	1,00,000	1,64,654	23,052	76,948	87,706
5	1,00,000	87,706	12,294	87,706	-

*Determination of loan installment

$$\frac{Amount\ of\ loan}{PV\ factor\ of\ annuity\ of\ Re.for\ 5\ years\ at\ 14\%\ rate\ of\ interest} = \frac{Rs.3,43,300}{3,433} = \text{Rs. } 1,00,000$$

19.4 HIRE PURCHASE

Hire purchase is another method of acquiring a capital asset for use, without paying its price immediately. Under hire purchase arrangement goods are let on hire, the hirer (user) is allowed to pay the purchase price in installments and enjoys an option to purchase the goods after all the installments have been paid. Thus the ownership in the asset is passed on to the hirer on payment of the last installment. The amount and number of installments is fixed at the time of delivering the asset to the hirer. If the hirer makes default in making payment of any installment, the seller is entitled to recover the asset from the hirer. The hirer may, on his own also, return the asset to the hiree without any commitment to pay the remaining installments. The installments for this purpose are treated as hire charges. Thus, the property in the asset remains vested in the seller (hiree) till, the right of purchase is exercised by the hirer after making payment of all the installments.

The hire purchase transaction takes place in the following manner:

i. The seller (hiree) purchases the asset from the supplier/manufacturer and hires it to the hirer who is required to make a cash down payment of, say 20-25% of the cost of the asset.

ii. The balance of the cost price of the asset with interest thereon is payable in equated monthly installments either in advance or in arrears, over a pre- determined period which ranges between 36 months to 48 months.

iii. Sometimes, in place of cash down payment, a fixed deposit is required to be made with the seller and the entire amount of the cost is recovered through EMIs. The amount of FDR plus interest is returned to the hirer on payment of the last installment.

iv. Each installment comprises of the (a) cost of the asset, and (b) interest thereon. Interest is computed on the basis of a flat rate of interest. Thereafter the effective rate of interest is applied to the reducing balance of the original cost of asset to find out the interest component of each installment. The effective rate of interest happens to be higher than the flat rate of interest.

v. The hirer is entitled to terminate the hire purchase contract by giving due notice to the seller (hiree).

repayment components, let us consider an example.

Example: ABC Finance offers a hire-purchase proposal to one of its customers, Synthetic Chemicals, which requires an equipment costing Rs.10 lakhs on the following terms

i. a flat interest rate of 15 per cent, and

ii. a hire-purchase period of 36 months.

Given this information, the total interest burden and the monthly hire-purchase instalment would be as follows.

Total interest burden: Rs. 10,00,000 (0.15) (3) = Rs. 4,50,000

Monthly hire-purchase installments: $\frac{Rs.10,00,000+Rs.4,50,000}{36}$ = Rs. 40, 277

The annual hire-purchase installment would simply be:

(Rs. 10,00,000 + Rs. 4,50,000)/3 = Rs. 4,83,333

To determine the split of the hire-purchase installments between interest and principal repayments, let us first allocate the interest burden of Rs. 4,50,000 over the three years as per the sum of the years digit method. According to this method, the proportions of interest allocated to the three years would be as follows:

1st year: $\frac{36+35+34+\cdots+25}{36+35+34+\cdots+1} = \frac{366}{666}$

2nd year: $\frac{24+23+22+\cdots+13}{36+35+34+\cdots+1} = \frac{222}{666}$

3rd year: $\frac{12+11+10+\cdots+1}{36+35+34+\cdots+1} = \frac{78}{666}$

Based on these proportions, the interest allocations would be as follows:

1st year: x Rs. 4,50,000 = Rs. 247,297

2nd year: x Rs. 4,50,000 = Rs. 1,50,000

3rd year: x Rs. 4,50,000 = Rs. 52,703

the lessee to use the asset and to leave the asset in peaceful possession of the lessee during the lease period.

2. The lessor has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset at the expiry of the lease period.

Main Elements of Leasing

The essential features of a leasing contract are as follows:

a) A Valid Contract of Leasing: A leasing arrangement is undertaken by entering into a valid contract between the lessor and the lessee. Both the parties must be competent to contract. The lessor must have clear and undisputed title to the assets to be leased. The agreement must satisfy the essentials of a valid contract as per the Indian Contract Act.

b) Delivery of Goods: The movable property, generally termed as 'goods' must be delivered by the lessor to the lessee. Delivery of the goods may be either actual delivery or constructive delivery. In the former case physical possession of the goods is handed over to the lessee, but in the latter case, there is no change in the physical possession, but some instruction or direction is given to the possessor of the goods to hold the same on behalf of the lessee rather than the lessor.

c) Purpose: Goods are delivered to the lessee with the specific purpose of using them for his specified lawful activity throughout the lease period.

d) Consideration: The lessee undertakes to pay to lessor regularly lease rental, as consideration for the use of the goods.

e) Return of the Goods: The goods must be returned to the lessor exactly in the same form, after the lease period is over.

f) Ownership: The lessor, after handing over possession of the leased asset, remains owner of the asset throughout the lease period and even thereafter.

g) Methodology: The prospective lessee identifies the equipment to be leased

lessee avails of the maintenance and other services provided by the lessor, who is well equipped, qualified and experienced to provide such services efficiently. Of course, the lessee pays for such services in the form of higher rentals.

d) Low Administrative and Transactions Costs: Many leasing companies specialize in leasing a few types of equipments, machines or vehicles only. They can easily bargain with the suppliers/manufacturers etc. and acquire the assets at better prices and can economize in other administrative expenses also. The lessee may get a concession in lease rent on the basis of the economies derived by the lessor.

e) Debt-Equity Ratio remains unchanged: When an asset is acquired on lease basis, lease rentals are shown as an expense in the firm's profit and loss account. Neither the leased asset nor the liability under the lease agreement are shown in the Balance Sheet. Hence the debt-equity ratio remains unaffected as compared to a firm which buys the asset with borrowed funds. The following example will make this difference clear.

There are two firms in an industry with identical balance sheets as shown below:

Balance Sheet				
Equity Capital	100		Fixed Assets	100
Debts	100		Current Assets	100
Total	**200**		**Total**	**200**

Debt Equity Ratio = 1:1

Fund Based Services

Firm A borrows Rs. 100 to buy a fixed asset, while firm B takes it on lease. The respective balance sheets of the two firms will appear as follows:

19.7 TYPES OF LEASE

The terms and conditions on which an asset is leased, the rights and obligations of the lessor and the lessee are clearly incorporated in the Lease Agreement. On the basis of variations in all these, leases are classified into the following categories:

1. Operating Lease

In case of operating lease, the lessor not only leases the asset of which he remains the owner throughout, but also undertakes to provide services attached to such assets, e.g., maintenance, repairs, technical advice, etc. Such lease is also called service lease. Computers, office equipments, automobiles and trucks are the typical capital assets which are leased under operating lease arrangement. The main features of an operating lease are as follows:

i. The lease contract is generally for a period which is considerably shorter than the useful life of the leased asset. For example, a machine may be acquired on lease for a period of 5 years, while its useful life may be 10 years.

ii. The lessor does not, therefore, recover the full cost of the asset from one lessee only. The leased asset is returned back to the lessor at the end of the lease period and is, thereafter, leased again to another lessee for another lease period. After its useful life is over, it is sold off and its scrap value is realised by the lessor.

iii. Operting lease generally contains a cancellation clause also, wherein the lessee retains the right to cancel the lease any time before the lease period is over. Such clause is beneficial to the lessee as he may terminate the lease, if the asset becomes obsolete or his need for the asset is over.

iv. The lease agreement contains a maintenance clause whereby the lessor is required to maintain the leased assets. Thus, necessary repairs, fuel, support staff may be provided by the lessor, as agreed upon.

v. The lease rental includes: (a) a part of the amortisation of the cost of the equipment, (b) cost of the maintenance services provided, and (c) profit ofthe lessor.

5. Domestic Lease and International Lease

This classification is based on the domicile of the parties to a lease contract. If all the parties, viz. equipment supplier, lessor and the lessee are residing in the same country, the lease is called domestic lease. If they are residing in different countries, it is called international lease. If the lessor and the lessee are domiciled in the same country and equipment is imported from another country, it is called import lease. If the lessor and lessee are domiciled in different countries, the lease is called cross-border lease. In such cases, the equipment supplier may be the resident of any country. In case of international lease, there are two additional risks, i.e., country risk and currency risk.

19.8 MAIN CLAUSES IN THE LEASE AGREEMENT

After the lease transaction is finalised, lease agreement is prepared and executed by the parties. The lease agreement incorporates the legal rights and obligations of the lessor and the lessee so as to bind them and serve the purpose of evidence, if any dispute arises during the lease period. The main clauses which are usually incorporated in a lease agreement are as follows:

1) **Nature of the Lease:** This clause specifies the nature of the lease (i.e., operating lease, financial lease or a leveraged lease) and the names of the parties to the Agreement.

2) **Description of the Asset:** This clause gives the description of the equipment to be leased, its make, model, size, specification etc.

3) **Duration of Lease Period:** This clause specifies the period for which the asset is leased, which is called the primary period. The clause generally also gives an option to the lessee to renew the agreement for a further period. The second term of the lease is known as secondary period.

4) **Lease Rentals:** This clause specifies the lease rental payable by the lessee, which is fixed by taking into consideration the cost of funds, depreciation, repairs, profit expected, and risk involved in the lease transaction etc. The rent may be payable monthly or quarterly. The quantum of such rental, the time within which it is payable and the consequences of failure to pay the same are stipulated in this clause.

(named therein as the owner). Lessee shall pay the premium and renew the policy every year.

14) **Other Charges:** This clause shall specify which party will pay the various expenses and charges in connection with the purchase and installation of equipment.

19.9 SUMMARY

In this chapter we have considered two alternative methods of financing the assets, namely leasing and hire purchase. Leasing is a contract whereby the owner of an asset transfers the asset to another person with the exclusive right to use it for an agreed period of time, in return for the payment of lease rental. In hire purchase, the purchaser pays the price plus interest in equal periodic installments spread over a period of time. In both the forms of acquiring the assets, the ownership remains vested in the lessor and hiree respectively till all the installments are paid.

We have also discussed different types of leases and the main clauses usually incorporated in the leasing agreements. Method of evaluating a lease proposal from the point of view of lessor and the lessee had been discussed with examples. In case of hire purchase the method of splitting hire purchase installments, interest and repayment of principal has also been explained.

19.10 GLOSSARY

- ***Cash Price: It is the actual price of goods charged under normal cash sale or the amount paid for outright purchase.***
- Hire Purchase Price: The total amount payable under the terms of hire purchase agreement in the form of down payment and installments. It consists of cash price plus interest.
- Down Payment: It is the amount paid by hire purchaser to hire vendor at the time of signing of agreement or at the time of delivery of good.
- Hire Purchaser: Also known as hirer, the one who purchases goods under hire purchase agreement.
- Hire Vendor: The person who sells goods under hire purchase agreement.

19.12 LESSON END EXERCISE

1. Discuss the points of difference between leasing and hire purchase.

2. What are the various types of leases? Discuss.

19.13 SUGGESTED READINGS

- Financial Accounting-Dr. S.M.Shukla
- Financial Accounting, Concepts and Applications- J.R.Monga
- Essentials of Financial Accounting- Ashish.K.Bhattacharyya

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20.1 INTRODUCTION

Housing finance is a broad topic, the concept of which can vary across continents, regions and countries, particularly in terms of the areas it covers. For example, what is understood by the term "housing finance" in a developed country may be very different to what is understood by the term in a developing country.

The International Union for Housing Finance, as a multinational networking organisation, has no official position on what the best definition of housing finance is. However, the selection of quotes below is offered as a snapshot of what housing finance as a topic covers:

"Housing finance brings together complex and multi-sector issues that are driven by constantly changing local features, such as a country's legal environment or culture, economic makeup, regulatory environment, or political system"

Loïc Chiquier and Michael Lea, Housing Finance Policy in Emerging Markets, p. xxx (2009) .

In addition, the concept of housing finance and housing finance systems has been evolving over time. Looking at definitions from the mid-1980s, we see that housing finance was defined primarily in terms of residential mortgage finance:

"The purpose of a housing finance system is to provide the funds which home-buyers need to purchase their homes. This is a simple objective, and the number of ways in which it can be achieved is limited. Notwithstanding this basic simplicity, in a number of countries, largely as a result of government action, very complicated housing finance systems have been developed. However, the essential feature of any system, that is, the ability to channel the funds of investors to those purchasing their homes, must remain."

Mark Boleat, National Housing Finance Systems – A Comparative Study, p. 1 (1985) .

However, in more recent years, a number of other much wider definitions have appeared:

the emergence of several specialized financial institutions which have considerably strengthened the organization of the housing finance system in the country. At present there are about 320 housing finance companies of which only 37 are registered with the NHB which accounts for 98% of the total housing loan disbursed.

2. Central and State Governments:

Till mid-eighties, the responsibility to provide housing finance rested by and large with the govt. The Central and State government supports the housing building effort indirectly. The Central govt. has introduced, from time to time, various social housing schemes. The Central govt. had set up the Housing and Urban Development Corporation (HUDCO). The Central government supports the equity support to HUDCO and guarantees the bonds issued by it. Both Central and State government provides house building advances to their employees. While the Central government formulates the housing schemes, the State governments are the actual implementation agencies.

3. Housing and Urban Development Corporation (HUDCO):

HUDCO Incorporated on 25th April, 1970. HUDCO was an expression of the concern of the Central government with regard to the deteriorating housing conditions in the country and a desire to assist various agencies in dealing with it in a positive manner. The principle mandate of HUDCO was to ameliorate the housing conditions of all groups with a thrust to the needs of the Low Income Group (LlG) and Economically Weaker Sections (EWS). HUDCO today has emerged as the leading national techno-financing institution with the major objective of financing/encouraging the housing activity in the country and alleviating housing shortage of all groups in rural and urban areas and also the development of urban infrastructure of various shades in human settlements.

4. National Housing Bank (NHB):]

The National Housing Bank (NHB), the apex level financial institution for the housing sector in the country, was established on 9th July 1988 under the National Housing Bank Act, 1987. The NHB works as a facilitator in promoting Housing Institutions and providing financial and other support to such institutions. As per

of Mr .H.T.Parekh. HDFC from its very first day of operations has built a principle centered organization. An organization built on the basis of fairness, kindness, efficiency and for effectiveness. It had gradually built trust among the people by strengthening communications and participative management style. Trust is the very cement for meaningful relationships and an open and creative management style. It is the very foundation for measuring worth.

7) Commercial Banks and Housing Finance Companies:

Commercial banks lending to individuals for housing emerged in the wake of the report of the working group on the role of Banking System in Providing Finance for Housing schemes (R.C.SHAH working group, RBI,1978). They have been lending to the housing sector based on annual credit allocations made by RBI. The policies of the government have made it easier for banks as well as consumers to seek and procure home loans.

Different types of Home Loans in India:

a. Home Improvement Loans.

b. Home Extension Loans.

c. Home Equity Loans.

d. Topup Loans.

e. Home Purchase Loans.

f. Land Purchase Loans.

g. Commercial Property Loans.

MERCHANT BANK

In modern terms, a merchant bank is a firm or financial institution that invests equity capital directly in businesses and often provides those businesses with advisory services. A merchant bank offers the same services as an investment bank, however, it typically services smaller clients and makes direct equity investments in them.

Merchant banks mainly work with small-scale enterprises that are unable to raise

20.4.1 FUNCTIONS OF MERCHANT BANKS

Merchant banks perform a number of functions, including the following:

Equity Underwriting

Large companies often employ the services of merchant banks in acquiring capital through the stock market. Equity underwriting is achieved by evaluating the amount of stock to be issued, the value of the business, the use of proceeds, and the timing of issuance of the new stock. Merchant banks handle all the necessary paperwork and liaison with the appropriate marketing division to advertise the stock.

Credit Syndication

Merchant banks help in processing loan applications for short and long-term credit from financial institutions. They provide these services by estimating total costs involved, developing a financial plan for the entire project, as well as adopting a loan application for commercial lenders. Also, they assist in choosing the ideal financial institutions to provide credit facilities and act on the terms of the loan application with the financiers. Merchant banks also ensure the lender's willingness to participate, organize bridge finance, and engage in legal formalities regarding investment to be approved and checking the working capital requirements.

Portfolio Management

Merchant banks provide portfolio management services to institutional investors and other investors. They help in the management of securities to enhance the value of the underlying investment. Merchant banks may assist their clients in the purchase and sale of securities to help them attain their investment objectives.

20.4.2 DIFFERENCE BETWEEN AN INVESTMENT BANK AND A MERCHANT BANK

Although there is somewhat a thin line between traditional merchant banks and investment banks, the financial institutions differ in several ways. First, merchant banks serve small-scale companies that may not be big enough to attract funding

at regular intervals. The three main types are mentioned below:

Early Stage Financing

This is the initial stage of investment or the first step. Due to the complex nature of business, this is further divided into 3 substages - seed financing, startup financing and first stage financing. Seed financing is the first set of money given to the founder for establishing their startup. Startup financing is when the set of money is given for the development of products and services. When a startup intends to expand business, it requires first stage financing.

Expansion Financing

This is the second stage, once the startup has utilized its seed funding and requires funds for expansion and marketing. Expansion financing also includes bridge financing - the funds that are required by a startup during an IPO (Initial Public Offering).

Acquisition or Buyout Financing

When a company needs funds to acquire another company or parts of a company, it is known as acquisition financing. A buyout financing is when a company seeks to acquire another company's particular product.

20.5.2 Functions of Venture Capital

In the past five years, venture capital has played a critical role in sparking the startup revolution in India. They have successfully boosted the Indian economy by creating a new paradigm of disruptive economic growth. Many startups have become unicorns, rivaling the best of India Inc, simply because of venture capital funds.

Listed below are the various functions performed by venture capital funds.

- Through VCFs, many startups and small businesses have finance and skills to develop their product even at the pre-start stage. The primary focus here is to provide resources for overall technological innovation.
- VCF is managed by a group of experienced professionals who help the

20.5.4 BENEFITS OFVENTURE CAPITAL

- **Business expertise -** Venture capitalists come with valuable expertise, advice and industry connections. They are expert professionals who have deep knowledge of specific market standards and can keep your business from experiencing many downsides that are usually associated with startups.
- **Additional resources and connections -** Along with monetary aid, VCs can act as HR consultants for the startup. They are specialists in hiring the best staff for your business. This helps in avoiding the hiring of the wrong person. It also offers a number of other such services such as mentoring, alliances and skill training.
- **Business expansion -** Venture capital provides large funding that a startup requires to expand its business. This form of investment is not possible through bank loans or other methods.
- **Better Management -** Since venture capitalists hold a percentage of equity in the business, they have a say in the management of the business. So, if you are not good at managing the business, the VCs can offer great assistance.
- **Risk Aversion -** For a promoter or founder of a startup, there is no obligation to pay back the seed funding in comparison to a bank loan where it is mandatory to repay. The VCs take the investment risk because they believe in the company's future success.

20.6 SUMMARY

Housing finance is a broad topic, the concept of which can vary across continents, regions and countries, particularly in terms of the areas it covers. For example, what is understood by the term "housing finance" in a developed country may be very different to what is understood by the term in a developing country.The financial institutions differ in several ways so, in modern terms, a merchant bank is a firm or financial institution that invests equity capital directly in businesses and often provides those businesses with advisory services. A merchant bank

20.9 LESSON END EXERCISE

1. Write an essay on the growth of merchant banking in India.

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2. What is issue management? Discuss the role of merchant bankers in pre-issue and post-issue activities of issue management

_____

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