

Directorate of Distance Education

UNIVERSITY OF JAMMU
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SELF LEARNING MATERIAL

For

M.COM

SEMESTER - THIRD

Course Title : FINANCIAL MARKETS AND INSTITUTIONS Unit : I-IV

Course No. : FE-314

Lesson No. 1-20

Course Coordinator :
Prof Sandeep Kour Tandon
Room No 111, 1st Floor DDE
University of Jammu

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Financial Markets And Institutions

Course Contributor :

Dr. Amisha Gupta
Sr. Asstt. Professor
The Business School
University of Jammu

**Proof reading and
Editing by :**

Dr. Rupa Mahajan
Teacher Incharge
M.Com
DDE

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SYLLABUS
FINANCIAL MARKETS AND INSTITUTIONS

Course No.M.COM-FE 314

Maximum Marks: 100

Credit :4

a) External: 80 Marks

Time 3.00 Hrs

b) Internal: 20 Marks

OBJECTIVE : To acquaint the students with various types of financial markets and institutions and their contribution towards growth and development of Indian economy.

**UNIT 1 : NATURE OF FINANCIAL SYSTEM AND MARKETS Page no
(5-98)**

Structure of Financial Systems : Financial institutions, financial markets , financial instruments and services ; Development of financial system in India: Financial system and economic development ; Financial markets in India : Indian money markets Meaning , need call money market treasury bill market commercial bill market markets for commercial paper & certificate of deposit Capital markets Features of capital market instruments recent development in Indian capital markets Money market vs capital market Markets for derivatives General Features of forwards futures forwards vs future options swaps , types of swaps

UNIT II : EXCHANGE RATES & CURRENCY MARKETS

(99-170)

Concept of Exchange rates: Determinants of exchange rates Devaluation depreciation, Devaluation vs depreciation International financial flows ;Types of risks ; Risks hedging and futures Risk and financial assets Criteria to evaluate assets Return on assets , Theories of the level of interest rates Classical theory loanable funds theory Keynesian Theory Relationship between long term and short term rates Appropriate interest rates policy

UNIT III : FINANCIAL INSTITUTIONS AND CREDIT POLICIES

(171-268)

Meaning, functions, role of financial institutions; Impact of credit crisis on financial institutions; Reserve Bank of India- Functions and role, organisation & management ;

Aims and objectives of the monetary policy of RBI, effectiveness of monetary policy; Credit creation and its control; Profitability and efficiency of banks; Commercial banks Nature , types functions, banking innovation, Regional rural banks. Functions purpose

UNIT IV : DEVELOPMENT AND INVESTMENT BANKING

(269-351)

Development banks: Role, functions; Development financial institutions IFCL, IDBI, IDFC, EXIM bank, NABARD, ICICI; Lending operation of World Bank and its affiliates working of IDA, IFC, & ADB, Non -banking financial institutions : types features role and growth of investment companies hire-purchase companies , lease finance , housing finance , merchant banks venture capital funds.

Working of IDA, IFC and ADB, Development Banks and India; Types of Non-banking financial institutions-Role, growth and impact on India's economic development; Investment Trust Companies; Mutual funds, Critical appraisal of UTI in the Indian financial system.

BOOKS RECOMMENDED

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 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.

MODEL QUESTION PAPER
FINANCIAL MARKETS AND INSTITUTIONS

Time: 3 Hrs

M. Marks: 80

SECTION-A

Attempt any six questions. Each question carries 4 marks. Answer to each question should be within 200 words.

1. Explain the role and functions of participants in the financial markets.
2. What is secondary market? Describe the market participants of secondary markets.
3. Explain the roles of SEBI and RBI in the regulation of capital markets.
4. What is international Monetary Fund? And also explain the role of IMF.
5. Explain briefly Euro dollar and Euro currency market.
6. What is money market? What are the various instruments of money market?
7. What is the role of NABARD in economic development?
8. Discuss the nature of mutual fund markets in India.

SECTION-B

Attempt any four questions. Each question carries 14 marks. Answer to each question should be within 800 words.

1. Briefly explain the various types of NBFCs and also explain the regulatory frame work of NBFCs.

2. Explain about derivatives market and also explain about its structure and operations.
3. What is capital market? Explain evolution and development of capital market.
4. Discuss about the stock exchanges. How are stock exchanges regulated?
5. Explain the functions of Asian development Bank (ADB) and New development Bank (NDB).
6. Discuss in detail the operation and trends in foreign exchange market.

NATURE OF FINANCIAL SYSTEM AND MARKETS

STRUCTURE OF FINANCIAL SYSTEM

STRUCTURE

- 1.1 Introduction**
- 1.2 Objectives**
- 1.3 Concept of Financial system**
- 1.4 Structure of financial System**
- 1.5 Financial Intermediaries or institutions**
- 1.6 Types of Financial Intermediaries**
- 1.7 Financial Market**
- 1.8 Financial instruments**
- 1.9 Summary**
- 1.10 Glossary**
- 1.11 Self Assessment Questions**
- 1.12 Lesson End Exercise**
- 1.13 Suggested Reading**

1.1 INTRODUCTION

Financial systems are of crucial significance to **capital formation**. The adequate **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

- know about the financial systems
- Types of Financial intermediaries
- Understand various financial instruments

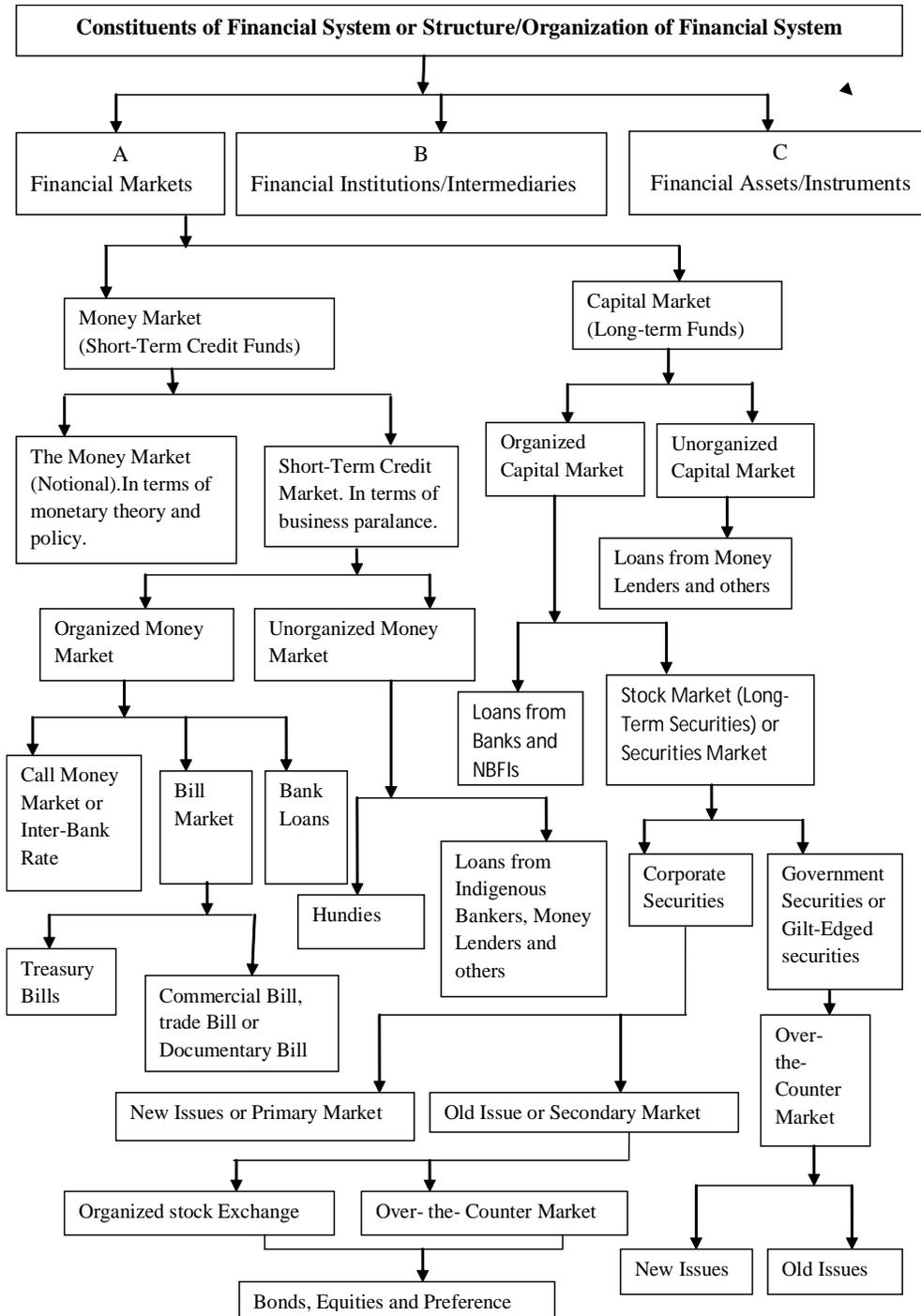
1.3 Concept of Financial System

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

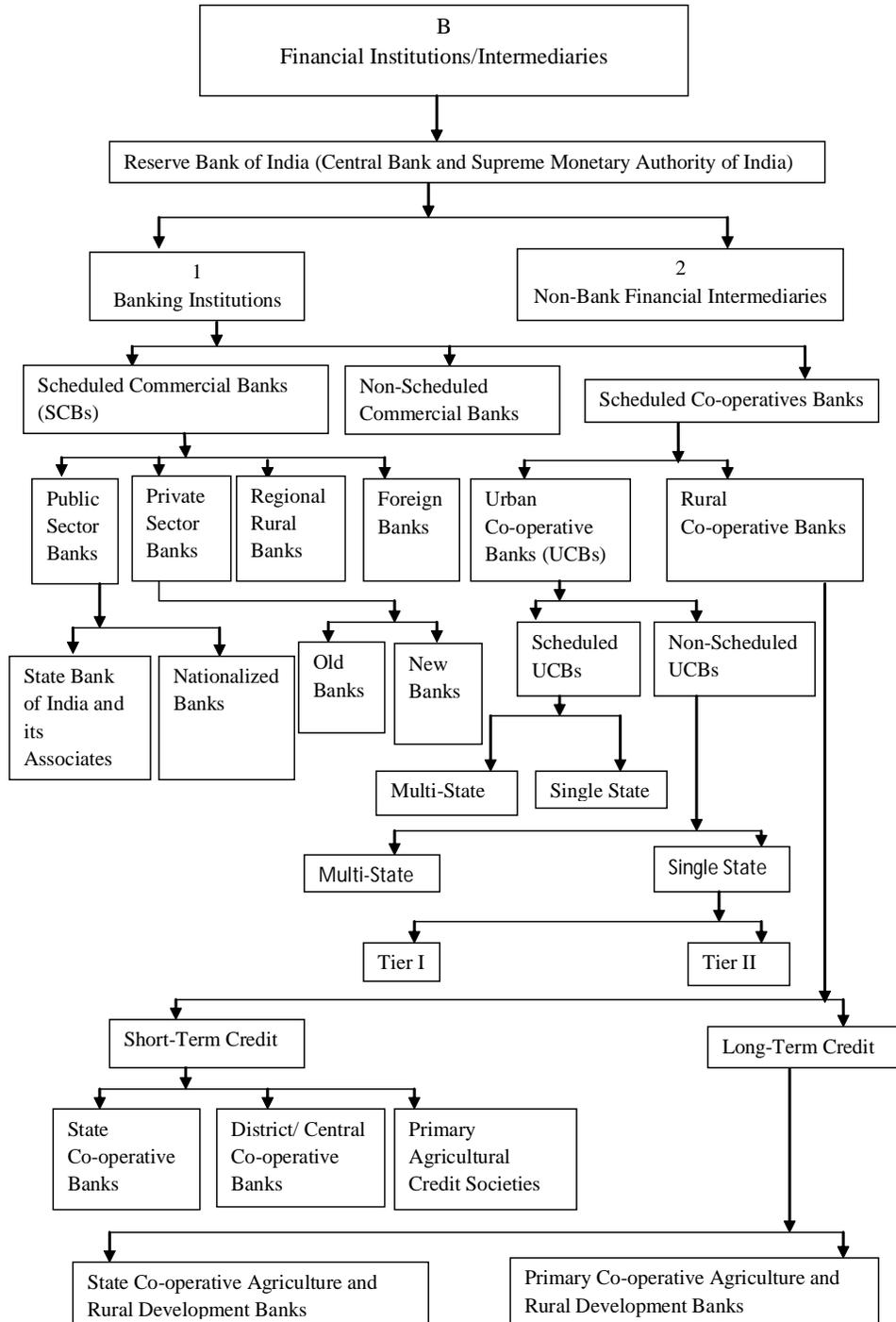
savings into the most desirable and productive forms of investment are all interconnected and have a great bearing on capital formation to economic development. Their relevance to the saving- investment process is derived from what is called the **transfer process**.

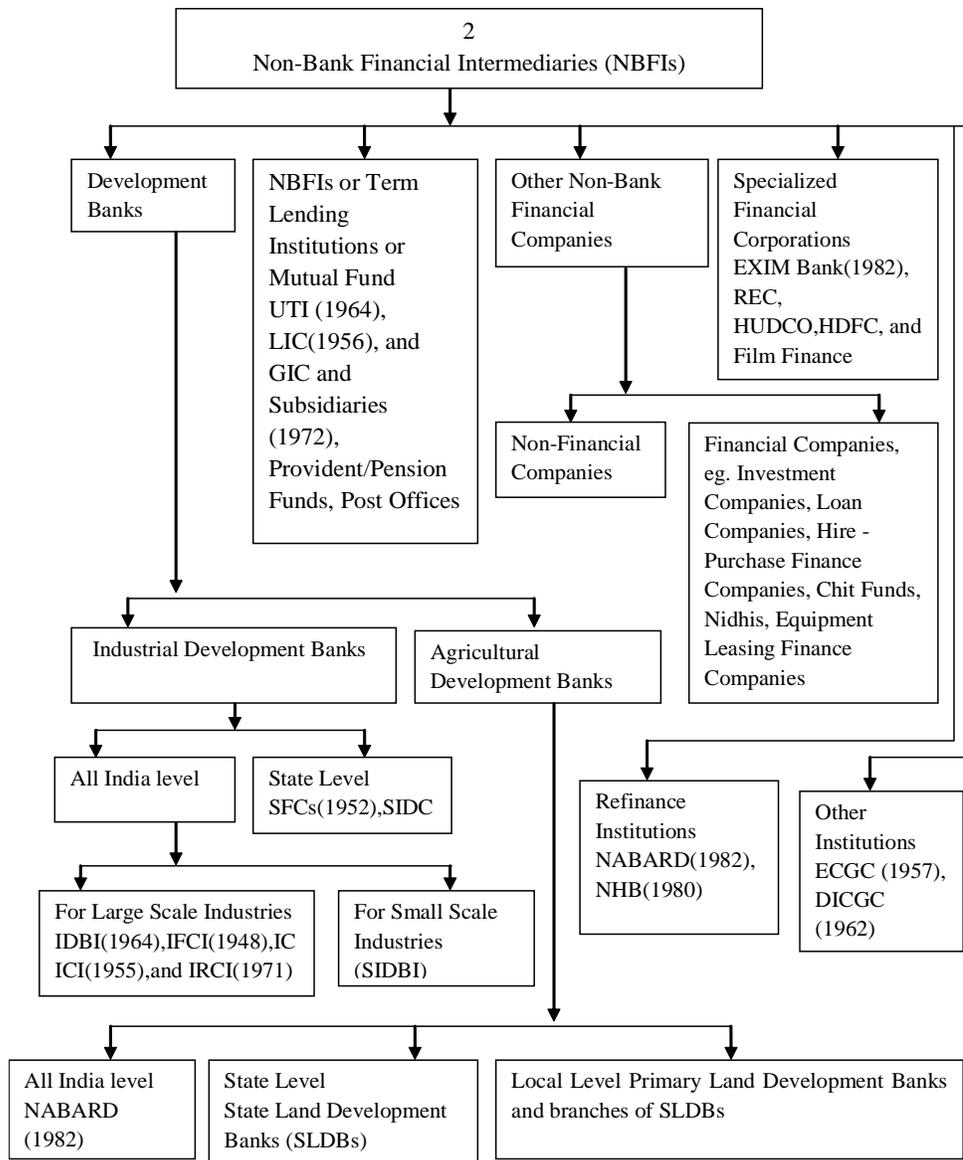
Transfer Process: The genesis of the financial system is traceable to the divorce between savings defined as the excess of current income over current expenditure, and investment representing expenditure on durable assets. The relationship between savings and investments varies considerably among economic units. Goldsmith has designated the various economic units into three categories: (i) **Saving-surplus units**, that is, those units whose savings are in excess of investments, (ii) **Saving-deficit units**, that is, those units whose investment exceeds savings, and (iii) **Neutral units** in whose case savings are equal to investment. If capital formation is to take place, the savings of the saving-surplus units must be transferred to the saving-deficit units. This is precisely what the financial systems do by acting as a link between the savers and the investors, thereby facilitating the flow of savings into the industrial investment. They are important in the process of capital formation, because the act of investment is usually confined to a special class of businessmen who command the requisites technical and market information and temperament to use it, while the activity of saving is largely diffused between innumerable individuals who lack the skills, capacity and personal characteristics for active investment. Hence transferred process is crucial to facilitate the economic growth. Besides, there are geographical and technical limitations that inhibit the process of investment. This gap is filled by the financial systems which promote the process of capital formation by bringing together the supply of savings and the demand for investible funds.

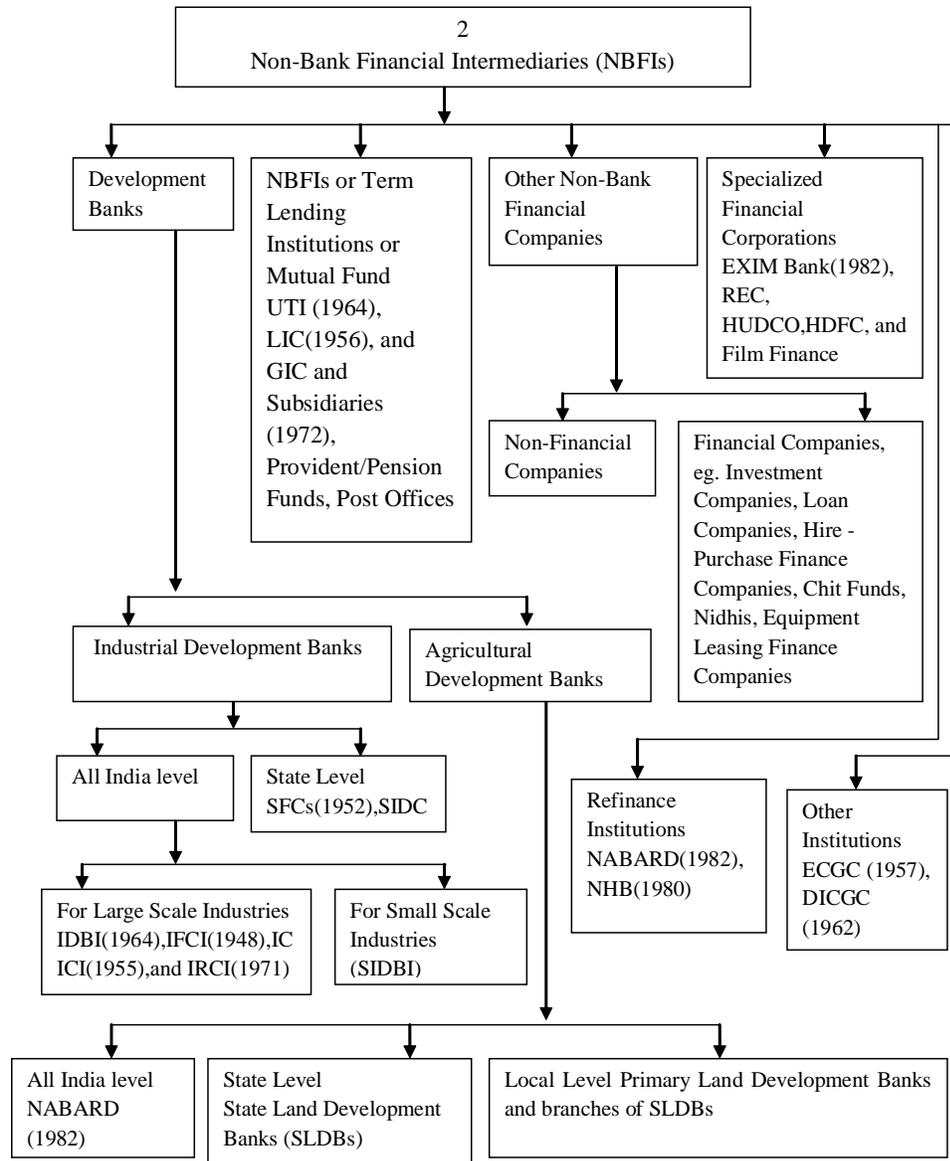
1.4 STRUCTURE OF FINANCIAL SYSTEM



1.5 FINANCIAL INTERMEDIARIES OR INSTITUTIONS

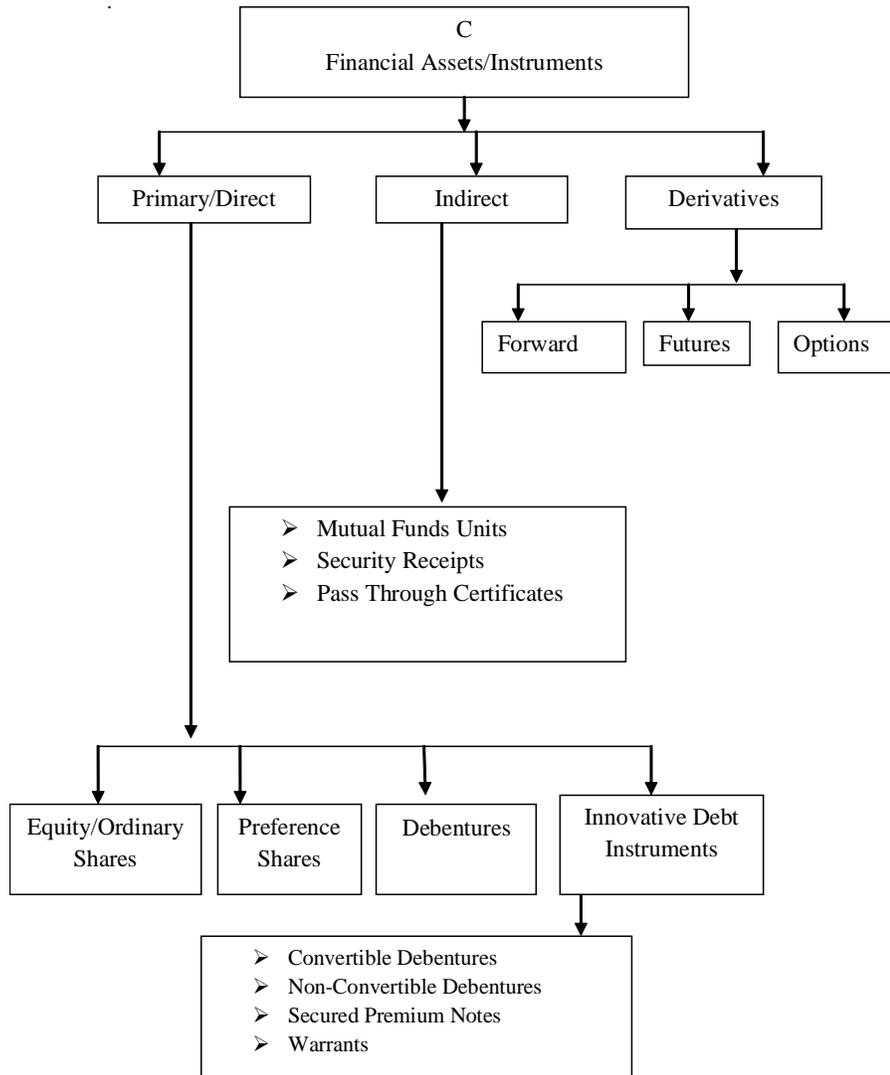






Notes: 1. NBFCs are leasing companies, housing finance companies, venture capital funds, merchant banking organisations, credit rating agencies, stock broking firms, factoring and forfeiting organisations, Depositories

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



Source: Compiled from Suraj B. Gupta(1999), “Monetary Economics Institutions, Theory and Policy”, RBI Report on Trend and Progress of Banking in India,2000-01 and 2009-10, M.Y. Khan (2007), “Indian Financial System

1. Financial Intermediaries: 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.* 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.

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 **maturity** into an indirect security of different maturity.

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 are commercial banks, non-banking financial companies, mutual funds, insurance organisation

1.7 FINANCIAL MARKETS: Financial intermediaries are source of finance between saving and investment while financial markets are not source of finance but link between savers and investors both individual as well as institutional. Financial markets perform a crucial function in the savings-investment process as facilitating organizations. Based on the nature of funds which are their stock-in-trade, the financial markets are classified into (1) Money Market and (2) Capital/Securities Market.

Money Market: Money market is a market for dealing in monetary assets of short-term nature. The major participants in the money market are the RBI and commercial banks. The major objectives are:

- An equilibrating mechanism for evening out short-term surpluses and deficiencies,
- A focal point of RBI intervention for liquidity in the economy, and
- A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable/price/cost.

Money market comprises number of interrelated sub-markets, that is, call money market, treasury bill market, commercial bill market, commercial paper, certificate of deposits market, money market mutual funds and repo (repurchase) market and so on.

Capital Market: It is a market for long term funds. Its focus is on financing of fixed investment in contrast to money market which is the institutional source of 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)

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.

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 ASSETS/INSTRUMENTS (SECURITIES) : 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.

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 on the income and assets and participate in management of the company.

Debentures: A debenture is a creditorship security. Their holders are entitled to a pre-specified interest rate and first claim on the assets of the entity. They have no right to vote in the meetings of the company. Debentures can be either bearer/ negotiable/ transferable by delivery or registered which are payable to the registered holders only. They can be secured or unsecured/naked. Debentures can be convertible and non-convertible into equity shares.

Preference Shares: A preference share is hybrid security and partakes the features of both equity and debentures. It combines both ownership and creditorship privileges. The holders of such security have preference over the equity holders in respect of fixed dividend as well as return of capital.

Warrants: These are also referred to as **sweeteners**. A warrant is a security which entitles the holders to purchase a specified number of shares at a stated price before a stated date/ period. They are issued with either debentures or equity shares.

Indirect Securities/Financial Assets: Indirect securities are financial assets issued by financial intermediaries such as units of mutual funds, policies of insurance companies, deposits of banks and so on. The indirect financial assets are coined from the underlying primary security and bearing their own utilities (Khan, M. Y).

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. They generally take the form of contracts under which parties agree to make payment to each other based on the value of the assets at a particular point in time. The underlying assets can be equity/ forex/ any other assets. The price of the derivative is driven by the spot price of the asset price which is 'underlying.' The Securities Contract (Regulation) Act defines derivatives 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 an investor buys stock or index futures, he pays only 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 risks involved 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 containment 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).

Futures Contract: 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 decrease in near future.

Example: Consider a futures contract with a \$100 price: Let’s say that on day 50, a futures contract with a \$100 delivery price (on the same underlying asset as the future) costs \$88. On day 51, that futures contract costs \$90. This means that the “mark-to-market” calculation would require the holder of one side of the future to pay \$2 on day 51 to track the changes of the forward price (“post \$2 of margin”). This money goes, via margin accounts, to the holder of the other side of the future. That is, the loss party wires cash to the other party.

A forward-holder, however, may pay nothing until settlement on the final day, potentially building up a large balance; this may be reflected in the mark by an allowance for credit risk. So, except for tiny effects of convexity bias (due to earning or paying interest on

margin), futures and forwards with equal delivery prices result in the same 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 dependence** 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 like a 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 derivatives contract 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 fund or separately managed account, whose investment objective is to track the performance of a stock index such as the S&P 500 stock index.

Forward Contract: In finance, a **forward contract** or simply a **forward** is a non-standardized contract between two parties to buy or sell an asset at a specified future time at a price agreed upon today. This is in contrast to a spot contract, which is an agreement to buy or sell an asset today. The party agreeing to buy the underlying asset in the future assumes a **long position** and the party agreeing to sell the asset in the future assumes a **short position**. The price agreed upon is called the delivery price, which is equal to the forward price at the time the contract is entered into.

The price of the underlying instrument, in whatever form, is paid before control 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 premium or 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 \$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/settle at a future date, as they do not wish to be exposed to exchange rate/currency risk over a period of time. As the exchange rate between U.S. dollars and Canadian dollars fluctuates between the trade date and the earlier of the date at which the contract is closed or the expiration date, one party gains and the counterparty loses as one currency strengthens against the other. Sometimes, the buy forward is opened because the investor will actually need Canadian dollars at a future date such as to pay a debt owed that is denominated in

Canadian dollars. Other times, the party opening a forward does so, not because they need Canadian dollars nor because they are hedging currency risk, but because they are speculating on the currency, expecting the exchange rate to move favourably to generate a gain on closing the contract.

In a currency forward, the notional amount of currencies are specified (ex: a contract to buy \$100 million Canadian dollars equivalent to, say \$114.4 million USD at the current rate—these two amounts are called the notional amount(s)). While the notional amount or reference amount may be a large number, the cost or margin requirement to command or open such a contract is considerably less than that amount, which refers to the **leverage** created, which is typical in derivative contracts.

Examples of how forward prices should be agreed upon: Continuing on the example above, suppose now that the initial price of Andy's house is \$100,000 and that Bob enters into a forward contract to buy the house one year from today. But since Andy knows that he can immediately sell for \$100,000 and place the proceeds in the bank, he wants to be compensated for the delayed sale. Suppose that the risk free rate of return R (the bank rate) for one year is 4%. Then the money in the bank would grow to \$104,000, risk free. So Andy would want at least \$104,000 one year from now for the contract to be worthwhile for him – the opportunity cost will be covered.

Spot-forward Parity: For liquid assets (“tradable”), spot–forward parity provides the link between 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.

Options/Currency options: 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 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 Rs.43.26 or less. Break-even point is Rs.43.26. At any price of Rs.43.34 and above, the option would be out of money. If the spot price at the time of expiration date and the date of receipt of dollars, is Rs. 43.10, he will exercise the option and sell the \$ to the writer of the option at Rs.43.30. That means he will receive Rs.4,33,000, but if he has sold in the spot market at that time, he would have received only Rs. 4,31,000. His notional gain is the difference between the premium price paid for the put option. This means that he would have gained Rs.2000 minus Rs.400, viz, Rs.1,600 in the option contract. If on the other hand, the spot price has gone up to Rs.43.60 he would not exercise his option but sell in the market and get Rs. 4,36,000 instead of Rs.4,33,000, which he would have got under option. From this gain he would have to deduct the option premium paid for the contract, namely, Rs.400. Either way, he does not lose but may gain, if at all, the loss may be the premium paid for the option.

Swap Market: 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 a risk management instruments.

Notes:

UTI: Unit Trust of India which is called Axis Bank Now, **LIC:** Life Insurance Corporation, **GIC:** General Insurance Corporation, **EXIM:** Export- Import Bank, **REC:** Rural Electrification Corporation, **HUDCO:** Housing and Urban Development Corporation, **SFCs:** State Finance Corporations, **SIDCs:** State Industrial Development Corporations, **NABARD:** National Bank for Agriculture and Rural Development, **NHB:** National Housing Bank, **ECGC:** Export Credit and Guarantee Corporation of India, **DICGC:** Deposit Insurance and Credit Guarantee Corporation of India, **IDBI:** Industrial Development Bank of India, **IFCI:** Industrial Finance Corporation of India, **ICICI:** Industrial Credit and Investment Corporation of India, **IRCI:** Industrial Reconstruction Corporation of India, and **SIDBI:** Small Industries Development Bank of India.

Development Banks: These banks are specialised financial institutions, which perform twin functions of providing medium and long-term finance to private entrepreneurs and of performing various promotional roles conducive to economic development. As banks they provide finance but they are unlike ordinary commercial banks in three ways. First they don't accept deposit from the public as ordinary bank do. Second, they specialise in providing medium and long-term finance. Third and most important, they are not mere purveyors of long-term finance like any ordinary term-lending institutions. Their chief role is the promotion of economic development by way of promoting investment and enterprise. This promotional role may take a variety of forms, like provision of risk capital, underwriting of new issues, arranging for foreign (exchange) loans, identification of investment projects, preparation and evaluation of project 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. Their 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 financial intermediaries are commercial banks, non-banking financial companies, mutual funds, insurance organisation. Financial markets perform a crucial function in the savings-investment process as facilitating organizations. Based on the nature of funds which are their stock-in-trade, the financial markets

are classified into (1) Money Market and (2) Capital/Securities Market. The financial assets fall into three broad categories: (i) Direct/primary; (ii) Indirect and (iii) Derivatives. The concept of globalized financial markets has given rise to an opportunity for corporate entities and the government around the world to raise capital funds across the different markets in the world.

1.10 GLOSSARY

- **Financial System:** The financial system is the system that allows the transfer of money between savers and borrowers. It is a set of complex and closely interconnected financial institution, markets, instruments, services and transaction.
- **Financial Market :** Financial market is a market where financial instruments such as financial assets and securities are traded.
- **Financial Assets/Instruments :** 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.

1.11 SELF ASSESSMENT QUESTIONS

1 . What do you mean by financial system.

2. Elaborate the various financial markets

1.12 LESSON END EXERCISE

1. Discuss various types of financial intermediaries

2. Describe the structure of financial system

1.13 SUGGESTED READINGS

- Business Environment: Indian and Global Perspectives- by Faisal Ahmed, M. Absar Alamm.
- Research on the Indian Capital Market: A Review by Samir K. Barua, V. Raghunathan and Jayanth R. Varma published by IIM Ahemdabad, 2014
- Research paper on Capital Market –An overview, published in International Journal of Science Technology and Management, volume 5, issue 12, December 2016.
- Research paper on Globalization and the Indian Capital Market by Dr. Vandana K. Mishra, Volume : 4 | Issue : 4 | April 2015 ISSN - 2250-19914 | Paripex - Indiann Journal of Commerce.
- <https://www.primedatabase.com/article/2017/10.Article-Ramesh%20NGS.pdf>
- <https://economictimes.indiatimes.com/topic/Capital-markets>.
- Capital Market and Financial System in India Book by Asheesh Pandey.

Development of Financial System in India

STRUCTURE

2.1 Introduction

2.2 Objectives

2.3 Financial System and Economic Development

2.4 Summary

2.5 Glossary

2.6 Self Assessment Question

2.7 Lesson End Exercise

2.8 Suggested Reading

2.1 INTRODUCTION

Financial System and Economic Growth The process of economic development requires as one of its accompanying structural changes in the economy, the development of a capital market which will provide an adequate and properly distributed supply of finance to the entrepreneurs setting up new industrial plants or thinking of expanding or modernising the already established one. While finance itself produces no output, but it enables the entrepreneurs to gain control over

real resources which enable them to engage in industry by producing and distributing industrial products. At an early stage of development, the would-be entrepreneurs normally find their own financial resources inadequate and resort to external sources. Such finances are made available by the financial intermediaries.

2.2 Objectives

After going through this lesson you should be able to

- Understand the financial systems
- Know about Financial system in India

2.3 Financial System and Economic Development

The adequate capital formation is *sin-qua-non* for speedy economic development. The process of capital formation involves three distinct, although interrelated activities.

- a) Savings, the ability by which claims to resources are set aside and so become available for other purposes.
- b) Finance, the activity by which claims to resources are either assembled from those released by domestic savings or obtained from abroad or specially created as bank deposits or notes and then placed in the hands of investors.
- c) Investment, the activity by which resources are committed to production.

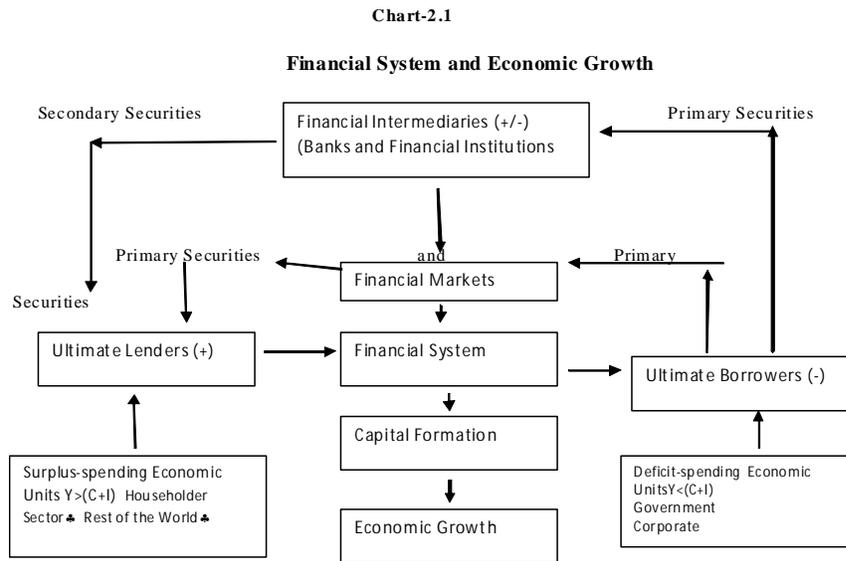
The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. Financial system helps to promote these activities. In the process of capital formation, financial system helps not only in effective mobilisation of savings from a large number of scattered 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 institutions in the financing of innovations and thus facilitating economic development. Besides performing the financial functions, financial system also provides entrepreneurial assistance to the loanee concerns/ individual entrepreneurs/ projects, and the system also act as an agency for securing foreign technical advice, and raising funds from the capital markets of advanced countries.

The intermediaries also facilitate the expansion of markets through distributive techniques and undertake other promotional jobs of an essential nature, such as, marketing and investment research surveys, techno-economic feasibility and cost-benefit studies of different growth sectors or a region, particularly the backward regions of the country so as to identify the potential for economic growth. Adequate financial resources are vital for increasing the pace of industrialisation and, therefore, the existence of suitable agencies to mobilise and develop resources that are internally available becomes necessary. It is at this stage, that financial system comes into the picture. While financial system is not only an engine of growth, it also acts as a growth inducing factor in desirable directions. In a rudimentary economy, where there are no financial systems, there are restraints on savings, on capital accumulation and on efficient allocation of savings to investment. These factors act as an impediment to the growth of output and income. This is true of developing countries where financial system is generally immature and, therefore, acts as an obstacle to economic growth. In a developed financial system, the efficient operation of specialised financial institutions can raise savings and investment above the level that would have occurred had there been no such institutions. In addition, by bringing about a better allocation of investment, the productivity of capital is improved and this promotes the 'real' economic growth of country.

In developing countries, availability of finance is one of the important bottlenecks in the process of rapid economic development. Since personal savings are meagre due to lower per capita income in these countries, the chances of increasing the rate of savings appear to be poor. However, much can be done by putting greater emphasis on institutionalisation of savings. 11 Therefore, one of the most pressing needs of the developing countries is to promote financial integrity, establish effective and cheap protection for rights of creditors and create financial institutions through which the savings of the community can be increased and 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-1



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

Chart-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.

2.4 SUMMARY

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 popularized by distinguished economists like Schumpeter, Kalecki and Keynes. In developing countries, availability of finance is one of the important bottlenecks in the process of rapid economic development. In the developing countries, institutional arrangements for the mobilization and channeling of financial resources must be continuously expanded and adopted to the growing and varied needs of the economy.

2.5 GLOSSARY

- **Securities:** an investment a company or in a govt. debt that can be traded on the financial markets and produces an income for the investor.
- **Mutual fund:** A mutual fund is a type of professionally managed collective investments vehicle that pools money from many investors to purchase securities.

2.6 SELF ASSESSMENT QUESTIONS

1. What are the economic developments taking place in financial systems

2. Elaborate various financial markets

2.7 LESSON END EXERCISE

1. Discuss in detail financial market in India.

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.
- Guruswamy, S. (2004), "Financial Markets and Institution", Vijay Nicole Imprints Private Limited, Chennai.
- Desai, Vasant (2005), "The Indian Financial System and Development", 1st Edition, Himalayan Publishing House, Mumbai.

STRUCTURE

- 3.1 Introduction**
- 3.2 Objective**
- 3.3 Meaning of money market**
- 3.4 Structure of Indian Money Markets**
- 3.5 Constituents of money market**
- 3.6 Participants in Money Market**
- 3.7 Defects of Indian Money Market**
- 3.8 Undeveloped Nature of Indian Money Market**
- 3.9 Measures to Improve Indian Money Market**
- 3.10 Reserve Bank and Indian Money Market**
- 3.11 Recent Measures Taken by RBI**
- 3.12 Summary**
- 3.13 Glossary**
- 3.14 Self Assessment Questions**
- 3.15 Lesson End Exercise**
- 3.16 Suggested Readings**

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.

3.2 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 various defects of Money Market

3.3 MEANING 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 take 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 tide over the mismatches of cash receipts and cash expenditures by purchasing (or selling) the shortfall (or surplus) of funds in the money market. In simple words, 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.

A supplier of funds to the money market can be virtually anyone with a temporary excess of funds. The government bonds, corporate bonds and bonds issued by banks are examples of money market instruments, where the instrument has a ready market like the equity shares of a listed company. The money markets refer to the market for short-term securities (one year or less in original maturity) such as treasury bills, certificates of deposits, commercial paper etc. Money market instruments are more liquid in nature. The money market is a market where money and highly liquid marketable securities are bought and sold. It is not a place like the stock market but an activity and all the trading is done through telephones. One of the important features of the money market is honor of commitment and creditworthiness.

The money market form an important part of the financial system by providing an avenue for bringing equilibrium of the surplus funds of lenders and the requirements of borrowers for short periods ranging from overnight up to a year. Money market provides a non-inflationary way to finance government deficits and allow governments to implement monetary policy through open market operations and provide a market based reference point for setting interest rate.

FEATURES AND OBJECTIVES OF MONEY MARKET

Features of Money Market:

Following are the features of money market:

1. Money market has no geographical constraints as that of a stock exchange. The financial institutions dealing in monetary assets may be spread over a wide geographical area.
2. Even though there are various centers of money market such as Mumbai, Calcutta, Chennai, etc., they are not separate independent markets but are inter-linked and interrelated.
3. It relates to all dealings in money or monetary assets.
4. It is a market purely for short-term funds.
5. It is not a single homogeneous market. There are various sub-markets such as 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.

3.4 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 money market. These institutions have a three-tier structure. At the top, there are state cooperative banks. At the local level, there are primary credit societies and urban cooperative banks. Considering the size, methods

of operations, and dealings with the RBI and commercial banks, only state and central, cooperative banks should be included in the organised sector. The cooperative societies at the local level are loosely linked with it.

(vi) The unorganised sector consists of indigenous banks and money lenders. It is unorganised because activities of its parts are not systematically coordinated by the RBI.

(vii) The money lenders operate throughout the country, but without any link among themselves.

(viii) Indigenous banks are somewhat better organised because they enjoy rediscount facilities from the commercial banks which, in turn, have link with the RBI. But this type of organisation represents only a loose link with the RBI.

3.5 CONSTITUENTS OF INDIAN MONEY MARKET

Money market is a centre where short-term funds are supplied and demanded. Thus, the main constituents of money market are the lenders who supply and the borrowers who demand short-term credit.

I. Supply of Funds:

There are two main sources of supply of short-term funds in the Indian money market:

- (a) Unorganised indigenous sector, and
- (b) Organised modern sector.

(i) Unorganized Sector:

The unorganised sector comprises numerous indigenous bankers and village money lenders. It is unorganized because its activities are not controlled and coordinated by the Reserve Bank of India.

(ii) Organized Sector:

The organized modern sector of Indian money market comprises:

- (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.

Sub-Markets of Organised Money Market:

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

A. 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 surplus of some banks available to other banks which are temporary in short of funds.

(ii) Mainly the banks participate in the call money market. The State Bank of India is always on the lenders' side of the market.

(iii) The call money market operates through brokers who always keep in touch with banks and establish a link between the borrowing and lending banks.

(iv) The call money market is highly sensitive and competitive market. As such, it acts as the best indicator of the liquidity position of the organised money market.

(v) The rate of interest in the call money market is highly unstable. It quickly rises under the pressures of excess demand for funds and quickly falls under the pressures of excess supply of funds.

(vi) The call money market plays a vital role in removing the day-to-day fluctuations in the reserve position of the individual banks and improving the functioning of the banking system in the country.

B. Treasury Bill Market:

The treasury bill market deals in treasury bills which are the short-term (i.e., 91, 182 and 364 days) liability of the Government of India. Theoretically these bills are issued to meet the short-term financial requirements of the government.

But, in reality, they have become a permanent source of funds to the government. Every year, a portion of treasury bills are converted into long-term bonds. Treasury bills are of two types: ad hoc and regular.

Ad hoc treasury bills are issued to the state governments, semi- government departments and foreign central banks. They are not sold to the banks and the general public, and are not marketable.

The regular treasury bills are sold to the banks and public and are freely marketable. Both types of ad hoc and regular treasury bills are sold by Reserve Bank of India on behalf of the Central Government.

The treasury bill market in India is underdeveloped as compared to the treasury bill markets in the U.S.A. and the U.K.

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 except 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.

C. 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 Reserve 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.

D. 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.

E. Certificate of Deposit and Commercial Paper Markets:

Certificate of Deposit (CD) and Commercial Paper (CP) markets deal with certificates

of deposit and commercial papers. These two instruments (CD and CP) were introduced by Reserve Bank of India in March 1989 in order to widen the range of money market instruments and give investors greater flexibility in the deployment of their short-term surplus funds.

3.6 PARTICIPANTS IN MONEY MARKET:

A large number of borrowers and lenders make up the money market.

Some of the important players are listed below:

1. Central Government:

Central Government is a borrower in the money market through the issue of Treasury Bills (T-Bills). The T-Bills are issued through the RBI. The T-Bills represent zero risk instruments. They are issued with tenure of 91 days (3 months), 182 days (6 months) and 364 days (1 year). Due to its risk free nature, banks, corporates and many such institutions buy the T-Bills and lend to the government as a part of its short-term borrowing programme.

2. Public Sector Undertakings:

Many government companies have their shares listed on stock exchanges. As listed companies, they can issue commercial paper in order to obtain its working capital finance. The PSUs are only borrowers in the money market. They seldom lend their surplus due to the bureaucratic mindset. The treasury operations of the PSUs are very inefficient with huge cash surplus remaining idle for a long period of time.

3. Insurance Companies:

Both general and life insurance companies are usual lenders in the money market. Being cash surplus entities, they do not borrow in the money market. With the introduction of CBLO (Collateralized Borrowing and Lending Obligations), they have become big investors. In between capital market instruments and money market instruments, insurance companies invest more in capital market instruments. As their 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.

3.7 DEFECTS OF INDIAN MONEY MARKET

A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. The central bank controls and -regulates the money

supply in the country through the money market. But, unfortunately, the Indian money market is inadequately developed, loosely organised and suffers from many weaknesses.

Major defects are discussed below:

I. Dichotomy between Organised and Unorganised Sectors:

The most important defect of the Indian money market is its division into two sectors- (a) the organised sector and (b) the unorganised sector. There is little contact, coordination and cooperation between the two sectors. In such conditions it is difficult for the Reserve Bank to ensure uniform and effective implementations of its monetary policy in both the sectors.

II. Predominance of Unorganised Sector:

Another important defect of the Indian money market is its predominance of unorganised sector. The indigenous bankers occupy a significant position in the money-lending business in the rural areas. In this unorganised sector, no clear-cut distinction is made between short- term and long-term and between the purposes of loans.

These indigenous bankers, which constitute a large portion of the money market, remain outside the organised sector. Therefore, they seriously restrict the Reserve Bank's control over the money market.

III. Wasteful Competition:

Wasteful competition exists not only between the organised and unorganised sectors, but also among the members of the two sectors. The relation between various segments of the money market is not cordial; they are loosely connected with each other and generally follow separatist tendencies.

For example, even today, the State Bank of Indian and other commercial banks look down upon each other as rivals. Similarly, competition exists between the Indian commercial banks and foreign banks.

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 movement of credit between various markets.”

The interest rates also differ in various centres like Bombay, Calcutta, etc. Variations in the interest rate structure are largely due to the credit immobility because of

inadequate, costly and time-consuming means of transferring money. Disparities in the interest rates adversely affect the smooth and effective functioning of the money market.

IX. Absence of Bill Market:

The existence of a well-organised bill market is essential for the proper and efficient working of money market. Unfortunately, in spite of the serious efforts made by the Reserve Bank of India, the bill market in India has not yet been fully developed.

The short-term bills form a much smaller proportion of the bank finance in India as compared to that in the advanced countries.

Many factors are responsible for the underdeveloped bill market in India:

- (i) Most of the commercial transactions are made in terms of cash.
- (ii) Cash credit is the main form of borrowing from the banks. Cash credit is given by the banks against the security of commodities. No bills are involved in this type of credit,
- (iii) The practice of advancing loans by the sellers also limits the use of bills,
- (iv) There is lack of uniformity in drawing bills (hundies) in different parts of the country,
- (v) Heavy stamp duty discourages the use of exchange bills.
- (vi) Absence of acceptance houses is another factor responsible for the underdevelopment of bill market in India.
- (vii) In their desire to ensure greater liquidity and public confidence, the Indian banks prefer to invest their funds in first class government securities than in exchange bills,
- (viii) The Reserve Bank of India also prefers to extend rediscounting facility to the commercial banks against approved securities.

3.8 UNDEVELOPED NATURE OF INDIAN MONEY MARKET

An insight into the various defects and inadequacies of the Indian money market reveals that as compared to the advanced international money markets like the London Money 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.

3.9 MEASURES TO IMPROVE INDIAN MONEY MARKET:

Suggestions to Remove Defects:

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,
- (iii) Banking facilities should be expanded especially in the unbanked and neglected areas,

(iv) Discounting and rediscounting facilities should be expanded in a big way to develop the bill market in the country.

(v) For raising the efficiency of the money market, the number of the clearing houses in the country should be increased and their working improved.

(vi) Adequate and less costly remittance facilities should be provided to the businessmen to increase the mobility of capital.

(vii) Variations in the interest rates should be reduced.

3.10 RESERVE BANK AND INDIAN MONEY MARKET

The Reserve Bank of Indian has taken various measures to improve the existing defects and to develop a sound money market in the country.

Important among them are:

(i) Through the introduction of two schemes, one in 1952 and the other in 1970, the Reserve Bank has been making efforts to develop a sound bill market and to encourage the use of bills in the banking system. The variety of bills eligible for use has also been enlarged.

(ii) A number of measures have been taken to improve the functioning of the indigenous banks. These measures include- (a) their registration; (b) keeping and auditing of accounts; (c) providing financial accommodation through banks; etc.

(iii) The reserve bank is fully effective in the organised sector of the money market and has evolved procedures and conventions to integrate and coordinate the different components of money market.

Due to the efforts of the Reserve Bank, there is now much more coordination in the organised sector than that in the unorganised sector or that between organised and unorganised sectors.

(iv) The difference between various sections of the money market has been considerably reduced. With the enactment of the Banking Regulation Act, 1949, all banks in the 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.

Some Important recommendations are as follows:

(i) Measures should be taken to improve the operation of the call money market,

- (ii) Rediscounting market should be developed with a view to facilitating the emergence of genuine bill culture in the country.
- (iii) A short-term commercial paper should be introduced.
- (iv) An active secondary market for Government paper, especially a '182 days Treasury Bill' Refinance facility, should be developed.
- (v) A Finance House should be set up to deal in short-term money market instruments.
- (vi) Banks and private non-bank financial institutions should be encouraged to provide factoring services.
- (vii) There should be continuing development and refinement of money market instruments, and every new instrument must be approved by the Reserve Bank.

3.11 RECENT MEASURES TAKEN BY RBI

The Reserve Bank of India has taken the following measures to implement the recommendation of the Working Group since 1987:

- (i) With a view to make bill financing attractive to the borrowers, from April 1987, the effective interest rate on bill discounting for categories subject to the maximum lending rate has been fixed at a rate one percentage point lower than the maximum lending rate.
- (ii) In order to attract additional funds into rediscount market, the ceiling on the bill rediscounting rate has been raised from 11.5% to 12.5%
- (iii) Access to bill rediscounting market has been increased by selectively increasing the number of participants in the market.
- (iv) 182 Day Treasury Bills have been introduced in 1987. In 1992-93, 364 Day Treasury Bills were introduced and the auction of 182 Day Bill has been discontinued. Like 182-Day Treasury bills, 364 Day Bills can be held by commercial banks for meeting Statutory Ratio.
- (v) In August 1989, the government remitted the duty on usance bills. This step removed a major administrative constraint in the use of bill system.

(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 India 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

Development Bank of India (IDBI) and National Bank for Agriculture and Rural Development (NABARD) are participating as lenders.

Discount and Finance House of India (PFHI):

The Working Group of Money Market, in its Report submitted in 1987, recommended, among other things, that a Finance House should be set up to deal in short-term money market instruments.

As a follow-up on the recommendations of the Working Group, the Reserve Bank in India, in collaboration with the public sector banks and financial institutions, set up the Discount and Finance House of India Limited (DFHI) in April 1988.

DFHI is the apex body in the Indian money market and its establishment is a major step towards developing a secondary market for money instruments. DFHI, which commenced its operations from April 25, 1988 deals in short-term money market instruments.

As a matter of policy, the aim of the DFHI is to increase the volume of turnover rather than to become the repository of money market instruments. The initial paid up capital of DFHI is Rs. 150 crores. Apart from this, it has lines of refinance from RBI and a line of credit from the consortium of public sector banks.

As the apex agency in the Indian money market, the DFHI has been playing an important role ever since its inception. It has been promoting the active participation of the scheduled commercial banks and their subsidiaries, state and urban cooperative banks and all-Indian financial institutions in the money market.

The objective is to ensure that short-term surplus and deficits of these institutions are equilibrated at market-related rates through inter-bank transactions and various money market instruments. In 1990-91 the DFHI opened its branches at Delhi, Calcutta, Madras, Ahmedabad and Bangalore in order to decentralise its operations and provide money market facilities at the major money market centres in the country.

DFHI has been providing secondary market for money instruments and Government of India Treasury Bills.

Details of turnover of DFHI in various instruments in 1992 (upto Dec.), 1993-94 and 1994-95 are given in Table 1:

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 Rs. 1 crore. Their maturity ranges from three months to six months. They will be freely transferable by endorsement and delivery.

The company issuing CP will have to obtain every six months a specified rating from an agency approved by the Reserve Bank. The company can raise money through CP upto a maximum amount equivalent to 20% of its working capital limits. Banks will not be permitted to either underwrite or co- accept the issue of CP.

On January 3, 1990, the Reserve Bank issued guidelines, for issue of CP, according to which a company will have to obtain P1 + rating from Credit Rating Information Service of India Ltd. and also classification under Health Code Number from its financing banks and it has also to maintain the current ratio of 1.33 : 1 to be eligible to issue CP.

3.12SUMMARY

The market where such short-time finance is borrowed and lent is called 'money market'. The most important function of the money market is to bridge this liquidity gap. Thus, business and finance firms can tide over the mismatches of cash receipts and cash expenditures by purchasing (or selling) the shortfall (or surplus) of funds in the money market. In simple words, the money market is an avenue for borrowing and lending for the short-term. Money market is a centre where short-term funds are supplied and demanded. Thus, the main constituents of money market are the lenders who supply and the borrowers who demand short-term credit. A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. The central bank controls and -regulates the money supply in the country through the money market. But, unfortunately, the Indian money market is inadequately developed, loosely organized and suffers from many weaknesses. An insight into the various defects and inadequacies of the Indian money market reveals that as compared to the advanced international money markets like the London Money Market, the New York Money Market, etc. The Reserve Bank of Indian has taken various measures to improve the existing defects and to develop a sound money market in the country. The money market is a market where money and highly liquid marketable securities are bought and sold. It is not a place like the stock market but an activity and all the trading is done through telephones. One of the important features of the money market is honor of commitment and creditworthiness.

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-term liability of the Government of India.

3.14 SELF ASSESSMENT QUESTIONS

1. Explain the concept of money market

2. Discuss the various constituents of money market

3.15 LESSON END EXERCISE

1. Discuss the various measures to improve money market.

2. What are the various measure taken by RBI regarding money market.

3.16 SUGGESTED READINGS

- Business Environment: Indian and Global Perspectiv- by Faisal Ahmed, M. Absar Alamm.
- Research on the Indian Capital Market: A Review by Samir K. Barua, V. Raghunathan and Jayanth R. Varma published by IIM Ahembdabad, 2014
- Research paper on Capital Market –an overview, published in International Journal of Science Technology and Management, volume 5, issue 12, December 2016.
- Research paper on Globalization and the Indian Capital Market by Dr. Vandana K. Mishra, Volume : 4 | Issue : 4 | April 2015 ISSN - 2250-19914 | Paripex - Indiann Journal of Commerce.
- <https://www.primedatabase.com/article/2017/10.Article-Ramesh%20NGS.pdf>
- <https://economictimes.indiatimes.com/topic/Capital-markets>.
- Capital Market and Financial System in India Book by Asheesh Pandey.

**CAPITAL MARKETS: FEATURES OF CAPITAL MARKET
INSTRUMENTS RECENT DEVELOPMENTS IN INDIAN CAPITAL
MARKETS**

STRUCTURE

- 4.1 Introduction**
- 4.2 Objectives**
- 4.3 Meaning of Capital Markets**
 - 4.3.1 Primary Versus Secondary Capital Markets**
 - 4.3.2 Capital Markets Expanded**
- 4.4 Features of Capital Markets**
- 4.5 Instruments of Capital Markets**
- 4.6 Recent development in Indian Capital Markets**
- 4.7 Summary**
- 4.8 Glossary**
- 4.9 Self Assessment Questions**
- 4.10 Lesson End Exercise**
- 4.11 Suggested Reading**

4.1 INTRODUCTION:

What Are Capital Markets?

Capital markets are venues where savings and investments are channeled between the suppliers who have capital and those who are in need of capital. The entities that have capital include retail and institutional investors while those who seek capital are businesses, governments, and people.

Capital markets are composed of primary and secondary markets. The most common capital markets are the stock market and the bond market. Capital markets seek to improve transactional efficiencies. These markets bring those who hold capital and those seeking capital together and provide a place where entities can exchange securities.

Capital markets refer to the places where savings and investments are moved between suppliers of capital and those who are in need of capital.

- Capital markets consist of the primary market, where new securities are issued and sold, and the secondary market, where already-issued securities are traded between investors.
- The most common capital markets are the stock market and the bond market.

4.2 OBJECTIVES

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

- Describe the concept of concept of capital market
- Understand the features of capital market
- Examine the recent trends in capital market

4.3 MEANING OF CAPITAL MARKETS:

The term capital market broadly defines the place where various entities trade different financial instruments. These venues may include the stock market, the bond market, and the currency and foreign exchange markets. Most markets are 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 Primary Versus 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.

4.3.2 Capital Markets Expanded

Capital markets can refer to markets in a broad sense for any financial asset.

Corporate Finance

In this realm, the capital market is where investable capital for non-financial companies is available. Investable capital includes the external funds included in a weighted average cost of capital calculation—common and preferred equity, public bonds, and private debt—that are also used in a return on invested capital

calculation. Capital markets in corporate finance may also refer to equity funding, excluding debt.

Financial Services

Financial companies involved in private rather than public markets are part of the capital market. They include [investment banks](#), [private equity](#), and venture capital firms in contrast to broker-dealers and public exchanges.

Public Markets

Operated by a regulated exchange, capital markets can refer to equity markets in contrast to debt, bond, fixed income, money, derivatives, and commodities markets. Mirroring the corporate finance context, capital markets can also mean equity as well as debt, bond, or fixed income markets.

Capital markets may also refer to investments that receive [capital gains tax](#) treatment. While short-term gains—assets held under a year—are taxed as income according to a tax bracket, there are different rates for long-term gains income according to a tax bracket, there are different rates for long-term gains.

4.4 FEATURES OF A CAPITAL MARKET

Capital market is a market for medium and long term funds. It includes all the organizations, institutions and instruments that provide long term and medium term funds. It does not include the instruments or institutions which provide finance for short period (up to one year). The common instruments used in capital market are shares, debentures, bonds, mutual funds, public deposits etc.

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.

However, companies also require to refund the amount from their Net Profit. Therefore, shares play a significant role in the lives of companies and investors / shareholders. Companies can issue two types of shares, which they offer to investors/shareholders. The two types of shares are:

(a) Equity shares

(b) Preference shares

2. Bonds

Bonds are issued by the banks, organisations and financial institutions. They issue bonds for getting an amount of money from public (as a loan) and commit them a refund with an actual interest and within a maturity period. They issue their bonds for financing their capital expenses and their various projects or activities.

This is one of the most frequently used methods for increasing their capital and profits. When companies offer their bonds to public, they define a specified interest rate and maturity period in an applicant form.

Bonds have various types(i.e risk free bonds, high interest bonds, etc.) and different companies issued various types of bond to public.

Debentures

Debenture is an instrument which is used by the Corporations and Government for getting a loan from public and it is given under the company's Stamp Act. Corporations and Government can secure their debenture on company assets which it issues as long term loans. In Debentures, companies are required to announce a fixed return at the time of issuing.

Therefore, holders know that, how much amount they will get in future by issuer. Debentures have various advantages for holders and issuers. It implies that holders know that how much amount they will get in future, therefore they do not worry about their payment and, in general, debentures are freely transferable by their holder to others. Therefore, holders have a right to transfer their shares to anyone before their redemption.

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 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

4.6 RECENT DEVELOPMENT IN INDIAN CAPITAL MARKET

1. Economic Liberalization due to Indian Capital Market:

The economic liberalization has led to more deregulation, liberalization and privatization of some of the public sector undertakings in India. This has resulted in the shares of some of the public sector undertakings being made available to the public. The Industrial policy adopted by the government earlier did not allow investment in core sector by

either individuals or private sector. But, with the privatization of some of the public sector undertakings, the shares are now available to the public for contribution. Example: Steel Authority of India (SAIL). The Navarathna companies, consisting of major public sector undertakings such as ONGC, BHEL, Oil India Ltd, Gas Authority etc., are some of the companies which are yet to be privatized. Recently, the shares of VSNL were bought by TATAs.

2. Promoting more private sector banks:

Opening of more private sector banks has resulted in the public contributing to the shares of these banks in Indian capital Market. Recently, the government has announced 74% equity participation by foreigners in private sector banks in India. This has not only promoted new banks but also paved the way for the merger of existing banks with other banks. Example: The merger of Bank of Madura with ICICI Bank.

3. Promotion of Mutual Funds:

The promotion of mutual funds by nationalized as well as non-nationalized banks has also improved the Indian capital market. They were helpful to the public by way of tax saving schemes. Example: UTI's monthly income scheme. Mutual Funds promoted by nationalized banks have increased investments. SEBI has regulated the working of mutual funds and the banks have to publish their net asset value every week by furnishing the details in leading newspapers. At present, the condition of some of the mutual funds is very alarming, with the value of their investment going below the face value of the securities. Hence, there is every possibility of the public losing their confidence in the mutual funds. example: Unit Trust of India.

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 FERA Act 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.

8. Transparency through Online trading:

The online trading through computer has brought in transparency to the transactions in the market. People are able to know prices prevailing in the market at any time and as such the brokers cannot deprive their clients of their profits. The manipulation in the opening and closing prices of shares by the brokers in the market is no longer possible.

9. National Stock Exchange:

A new stock market called [National Stock Exchange](#) has been created which has a large number of companies listed. It is a big competitor to the Bombay Stock Exchange and it is able to even influence the Bombay Stock Exchange. The National Stock Exchange deals in shares of companies throughout India and the prices prevailing in the market is a benchmark for stock prices. The creation of National Stock Exchange has not only widened the market, but has also subdued the Bombay Stock Exchange. It has paved the way for all the leading companies' equities being traded through a single market. Thus, it enables the public to know the true picture of the companies and their real strength.

10. Sensitivity Index in Indian Capital Market:

The calculation of index number has also undergone a change. Sensitivity index has been introduced which represents important 30 companies whose volume and value of shares determines the market condition. The sensitivity index is an indication of the conditions prevailing in the market and the conditions that are likely to be encountered by the market.

11. Circuit-Breaker in Indian Capital Market:

Wild fluctuations in the stock market is a thing of the past. There cannot be any more '*stock scam*' as engineered by Harshad Metha. For this purpose, the Bombay stock market has introduced a cut-off switch which is called circuit breaker. Whenever the market index goes up by more than 10%, the circuit breaker will go off, bringing the entire operations in the market to a standstill. This will be for a period of 30 minutes after which the market will resume. This will bring down the share price. The stock market operates for two hours each day and any termination in the circuit breaker, after initial 1 and half hours of working will result in the market closing for the day. 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 degree of conditions has been promoted and it is called Over The Counter Exchange of India (OTCEI). It may not be possible for all the newly companies to list their shares with the existing stock exchanges. The share capital of these companies will be low and hence there should be an arrangement for listing such companies' shares. The creation of Over The Counter Exchange of India (OTCEI) is helpful to these newly promoted companies.

17. Merchant banker:

Merchant bankers have been permitted to take part in the stock market. operations and their functions are also regulated by SEBI. They not only help companies in capital budgeting but also guide the foreign investors in the purchase of securities. The merchant bankers, through the financial markets, help some of the Indian companies to obtain fresh capital. They also go in for syndication of loans and help the newly started companies in the issue of shares.

18. Non Banking Financial Companies:

The role of non-financial companies has also been controlled. RBI has introduced new conditions, restricting their activities. New norms with regard to capital of non banking financial companies have been introduced. For chit funds, a separate Act has been passed and it restricts the maximum bidding to 40%.

19. Forward trading in Indian Capital market:

Forward trading has been introduced since 9th June 2000 in Bombay Stock Exchange on a trial basis and if found successful, it will be extended. It will be helpful to the investors in ascertaining the true colors of existing companies.

20. Badla transactions in Indian Capital Market:

Badla is a transfer of a contract from one period to another, where, either the buyer or the seller is unable to execute the contract for which purpose, the defaulting parties will pay Badla charges (which are decided by the Stock exchange). At present, SEBI has banned Badla transactions.

21. Restrictions on Mutual Fund's Investment:

There have been restrictions on the role of mutual funds in the market. They cannot 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 market, should be completed within 2 days excluding the date of trading.

All the above measures have improved the working of stock markets in India. If the present situation continues, we can expect in future the uplinking of our stock market with that of the developed countries.

4.7 SUMMARY

The capital market provides the support to the system of capitalism of the country. The Securities and Exchange Board of India (SEBI), along with the Reserve Bank of India are the two regulatory authority for Indian securities market, to protect investors and improve the microstructure of capital markets in India. With the increased application of information technology, the trading platforms of stock exchanges are accessible from anywhere in the country through their trading terminals India has a fair share of the world economy and hence the capital markets or the share markets of India form a considerable portion of the world economy. The capital market is vital to the financial system.

The capital Markets are of two main types. The Primary markets and the secondary markets. In a primary market, companies, governments or public sector institutions can raise funds through bond issues. Alos, Corporations can sell new stock through an initial public offering (IPO) and raise money through that. Thus in the primary market, the party directly buys shares of a company. The process of selling new shares to investors is called underwriting.

4.8 GLOSSARY

- **Equity Capital Market (ECM)** The equity capital market, where financial institutions help companies raise equity capital, comprises the primary market and secondary market.
- **Security:** A security is a fungible, negotiable financial instrument that represents some type of financial value, usually in the form of a stock, bond, or option.
- **Bond:** A bond is a fixed income investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate.
- **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 SELF ASSESSMENT QUESTIONS:

1. What is capital market?

2. Capital market regulator is:

3. Name the three components of capital market?

4.10 LESSON END EXERCISE

1. Which organisation regulates capital market?

2. What do we call a market instrument which has features of equity as well as debenture?

3. What do you mean by short term capital?

4. What is the tenor of market repo?

4.11 SUGGESTED READINGS:

- Business Environment: Indian and Global Perspectiv- by Faisal Ahmed, M. Absar Alamm.
- Research on the Indian Capital Market: A Review by Samir K. Barua, V. Raghunathan and Jayanth R. Varma published by IIM Ahembdabad, 2014
- Research paper on Capital Market –an overview, published in International Journal of Science Technology and Management, volume 5, issue 12, December 2016.
- Research paper on Globalization and the Indian Capital Market by Dr. Vandana K. Mishra, Volume : 4 | Issue : 4 | April 2015ISSN - 2250-19914 | Paripex - Indiann Journal of Commerce.

- <https://www.primedatabase.com/article/2017/10.Article-Ramesh%20NGS.pdf>
- <https://economictimes.indiatimes.com/topic/Capital-markets>.
- Capital Market and Financial System in India Book by Asheesh Pandey.

NATURE OF FINANCIAL SYSTEM AND MARKETS Unit-I

**Money market vs. Capital market, Markets for Derivatives:
General features of Forwards, Futures, Forward vs. Futures,
Options, Swaps, types of Swaps**

STRUCTURE:

5.1 Introduction

5.2 Objective

5.3 Money Market

5.4 Money Market vs. Capital Market

5.5 Capital market Versus bank loans

5.6 Money Market Instruments

5.7 Market for Derivatives

5.7.1 Future Contract and its features

5.7.2 Forward Contract and its features

5.7.3 Forward vs. Future

5.7.4 Options/Currency Contract and its features

5.7.5 Swap Contract

5.8 Summary

5.9 Glossary

5.10 Self Assessment Questions

5.11 Lesson End Exercise

5.12 Suggested Readings

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
- enhance commercial banks' self-sufficiency,
- lubricate central bank policies

a. Financing trade

The money market plays crucial role in financing domestic and international trade. Commercial finance is made available to the traders through bills of exchange, which are discounted by the bill market. The acceptance houses and discount markets help in financing foreign trade.

b. Financing Industry

The money market contributes to the growth of industries in two ways:

- 1 They help industries secure short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.
- 2 Industries generally need long-term loans, which are provided in the capital market. However, the capital market depends upon the nature of and the conditions in the money market. The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

c. Profitable Investments

The money market enables commercial banks to use their excess reserves in profitable investments. The main objective of commercial banks is to earn income from its reserves as well as maintain liquidity to meet the uncertain cash demand of its depositors. In the money market, the excess reserves of commercial banks are invested in near money assets (e.g., short-term bills of exchange), which are easily converted into cash. Thus, commercial banks earn profits without sacrificing liquidity.

d. Self-sufficiency of commercial banks

Developed money markets help commercial banks to become self-sufficient. In an emergency, when commercial banks have scarcity of funds, they need not 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 raising of long-term finance, such as the purchase of shares/equities, or for loans that are not expected to be fully paid back for at least a year.

Funds borrowed from money markets are typically used for general operating expenses, to provide liquid assets for brief periods. For example, a company may have inbound payments from customers that have not yet cleared, but need immediate cash to pay its employees. When a company borrows from the primary capital markets, often the purpose is to invest in additional physical capital goods, which will be used to help increase its income. It can take many months or years before the investment generates sufficient return to pay back its cost, and hence the finance is long term.

Together, money markets and capital markets form the financial markets, as the term is narrowly understood. The capital market is concerned with long-term finance. In the widest sense, it consists of a series of channels through which the savings of the community are made available for industrial and commercial enterprises and public authorities

	Money Market	Capital Market
Definition	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.
Structure of Market	Informal	Formal
Financial Instruments	Commercial Papers, Treasury Certificate of Deposit, Bills, Trade Credit, etc.,	Bonds, Debentures, Shares, Asset Securitization, Retained Earnings, Euro Issues, etc.,
Organizations	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.,
Risk Factor	Low	High
Liquidity	High	Low
Purpose	To achieve short term credit requirements of the trade.	To achieve long term credit requirements of the trade.
Time Horizon	Within a year	More than a year
Objective	Rises liquidity of capitals in the market.	Mobilization of Economies in the market.
Return on Investment	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 differences, this time favoring lending by banks, are that banks are more accessible for small and medium-sized companies, and that they have the ability to create money as they lend. In the 20th century, most company finance apart from share issues was raised by bank loans. But since about 1980 there has been an ongoing trend for disintermediation, where large and creditworthy companies have found they effectively have to pay out less interest if they borrow directly from capital markets rather than from banks. The tendency for companies to borrow from capital markets instead of banks has been especially strong in the United States. According to the Financial Times, capital markets overtook bank lending as the leading source of long-term finance in 2009, which reflects the risk aversion and bank regulation in the wake of the 2008 financial crisis.

Compared to in the United States, companies in the European Union have a greater reliance on bank lending for funding. Efforts to enable companies to raise more funding through capital markets are being coordinated through the EU's Capital Markets Union initiative

5.6 MONEY MARKET INSTRUMENTS

Money market instruments are securities that provide businesses, banks, and the government with large amounts of low-cost capital for a short time. Money market instruments allow managers to get cash quickly when they need it. For that reason, money market instruments must be very safe.

Types of Money Market Instruments

- Certificate of deposit – Time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions.

- Repurchase agreements – Short-term loans—normally for less than one week and frequently for one day—arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.
- Money market mutual funds- it means it's a short term investment debt, operated by professional institutions. In other words 'money market mutual funds are the investment fund, here number of investors invest their money 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. They generally take the form of contracts under which parties agree to make payment to each other based on the value of the assets at a particular point in time. The underlying assets can be equity/ forex/ any other assets. The price of the derivative is driven by the post price of the asset price which is ‘underlying.’ The Securities Contract (Regulation) Act defines derivatives 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 futures, forwards, , options and swaps.**

How does derivative work?:

When an investor buys stock or index futures, he pay only 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 risks involved 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 containment 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 decrease in near future.

Example: Consider a futures contract with a \$100 price: Let’s say that on day 50, a futures contract with a \$100 delivery price (on the same underlying asset as the future) costs \$88. On day 51, that futures contract costs \$90. This means that the “mark-to-market” calculation would require the holder of one side of the future to pay \$2 on day 51 to track the changes of the forward price (“post \$2 of margin”). This money goes, via margin accounts, to the holder of the other side of the future. That is, the loss party wires cash to the other party.

A forward-holder, however, may pay nothing until settlement on the final day, potentially building up a large balance; this may be reflected in the mark by an allowance for credit risk. So, except for tiny effects of convexity bias (due to earning or paying interest on margin), futures and forwards with equal delivery prices result in the same 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 dependence** 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 like a 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 derivatives contract 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 bids, offers, and amount.
2. Contract terms are standardized with all buyers and sellers negotiating only with respect to price.
3. Non-member participants deal through brokers.
4. Participants include banks, corporations, financial institutions, individual investors are speculators.
5. The clearing house of the exchange becomes the opposite side to each cleared transactions; therefore, the credit risk for a futures market participant is always the same and there is no need to analyze the credit of other market participations.
6. Margins deposits are to be required of all participants
7. Settlements are made daily through the exchange clearing house. Gains on open positions may be withdrawn and losses are collected daily.
8. Long and short positions are usually liquidated easily.
9. Settlements are normally made in cash, with only a small percentage of all contracts resulting actual delivery.
10. A single, round tip (in and out of the market) commission is charged. It is negotiated between broker and customer and is relatively small in relation to the value of the contract.

5.7.2 FORWARD CONTRACT AND ITS FEATURES

In finance, a **forward contract** or simply a **forward** is a non-standardized contract between two parties to buy or sell an asset at a specified future time at a price agreed upon today. This is in contrast to a spot contract, which is an

agreement to buy or sell an asset today. The party agreeing to buy the underlying asset in the future assumes a **long position** and the party agreeing to sell the asset in the future assumes a **short position**. The price agreed upon is called the delivery price, which is equal to the forward price at the time the contract is entered into. The price of the underlying instrument, in whatever form, is paid before control 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 premium or 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 \$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/settle at a future date, as they do not wish to be exposed to exchange rate/currency risk over a period of time. As the exchange rate between U.S. dollars and Canadian dollars fluctuates between the trade date and the earlier of the date at which the contract is closed or the expiration date, one party gains and the counterparty loses as one currency strengthens against the other. Sometimes, the buy forward is opened because the investor will actually need Canadian dollars at a future date such as to pay a debt owed that is denominated in Canadian dollars. Other times, the party opening a forward does so, not because they need Canadian dollars nor because they are hedging currency risk, but because they are speculating on the currency, expecting the exchange rate to move favourably to generate a gain on closing the contract.

In a currency forward, the notional amount of currencies are specified (ex: a contract to buy \$100 million Canadian dollars equivalent to, say \$114.4 million USD at the current rate—these two amounts are called the notional amount(s)). While the notional amount or reference amount may be a large number, the cost or margin requirement to command or open such a contract is considerably less than that amount, which refers to the **leverage** created, which is typical in derivative contracts.

Examples of how forward prices should be agreed upon

Continuing on the example above, suppose now that the initial price of Andy's house is \$100,000 and that Bob enters into a forward contract to buy the house one year from today. But since Andy knows that he can immediately sell for

\$100,000 and place the proceeds in the bank, he wants to be compensated for the delayed sale. Suppose that the risk free rate of return R (the bank rate) for one year is 4%. Then the money in the bank would grow to \$104,000, risk free. So Andy would want at least \$104,000 one year from now for the contract to be worthwhile for him – the opportunity cost will be covered. **Spot-forward Parity:** For liquid assets (“tradable”), spot–forward parity provides the link between 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 with another dealer. A commission is charged to both buyer and seller, however, if transacted through a broker.
11. Trading is mostly unregulated.

12. The delivery price is the forward price.

5.7.3 FORWARDS VS. FUTURES

BASIS FOR COMPARISON	FORWARD CONTRACT	FUTURES CONTRACT
Meaning	Forward Contract is an agreement between parties to buy and sell the underlying asset at a specified date and agreed rate in future.	A contract in which the parties agree to exchange the asset for cash at a fixed price and at a future specified date, is known as future contract.
What is it?	It is a tailor made contract.	It is a standardized contract.
Traded on	Over the counter, i.e. there is no secondary market.	Organized stock exchange.
Settlement	On maturity date.	On a daily basis.
Risk	High	Low
Default	As they are private agreement, the chances of default are relatively high.	No such probability.
Size of contract	Depends on the contract terms.	Fixed
Collateral	Not required	Initial margin required.
Maturity	As per the terms of contract.	Predetermined date
Regulation	Self regulated	By stock exchange

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 speculators. 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 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 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 Rs.43.26 or less. Break-even point is Rs.43.26. At any price of Rs.43.34 and above, the option would be out of money. If the spot price at the time of expiration date and the date of receipt of dollars, is Rs. 43.10, he will exercise the option and sell the \$ to the writer of the option at Rs.43.30. That means he will receive Rs.4,33,000, but if he has sold in the spot market at that time, he would have received only Rs. 4,31,000. His notional gain is the difference between the premium price paid for the put option. This means that he would have gained Rs.2000 minus Rs.400, viz, Rs.1,600 in the option contract. If on the other hand, the spot price has gone up to Rs.43.60 he would not exercise his option but sell in the market and get Rs. 4,36,000 instead of Rs.4,33,000, which he would have got under option. From this gain he would have to deduct the option premium paid for the contract, namely, Rs.400. Either way, he does not lose but may gain, if at all, the loss may be the premium paid for the option.

Option Contract and its Features

1. **Premium or down payment:** The holder of this type of contract must pay a certain amount called the ‘premium’ for having the right to exercise an options trade. In case the holder does not exercise it, s/he loses the premium amount. Usually, the premium is deducted from the total payoff, and the investor receives the balance.
2. **Strike price:** This refers to the rate at which the owner of the option can buy or sell the underlying security if s/he decides to exercise the contract. The strike price is fixed and does not change during the entire period of the validity of the contract. It is important to remember that the strike price is different from the market price. The latter changes during the life of the contract.
3. **Contract size:** The contract size is the deliverable quantity of an underlying asset in an options contract. These quantities are fixed for an asset. If the

contract is for 100 shares, then when a holder exercises one option contract, there will be a buying or selling of 100 shares.

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 option Swaps are primarily over-the-counter contracts between companies or financial institutions. Retail investors do not generally engage in swaps.

Types of Swaps The generic types of swaps, in order of their quantitative importance, are: interest rate swaps, basis swaps, currency swaps, inflation swaps, credit default swaps, commodity swaps and equity swaps. There are also many other types of swaps.

Interest rate swaps The most common type of swap is **an interest rate swap**. Some companies may have comparative advantage in fixed rate markets, while other companies have a comparative advantage in floating rate markets. When companies want to borrow, they look for cheap borrowing, i.e. from the market where they have comparative advantage. However, this may lead to a company borrowing fixed when it wants floating or borrowing floating when it wants fixed. This is where a swap comes in. A swap has the effect of transforming a fixed rate loan into a floating rate loan or vice versa. **Basis swaps** Basis Swap

A basis swap involves exchanging floating interest rates based on different money markets. The principal is not exchanged. The swap effectively limits the interest-rate risk as a result of having differing lending and borrowing rates.

Currency swaps A currency swap involves exchanging principal and fixed rate interest payments on a loan in one currency for principal and fixed rate interest payments on an equal loan in another currency. Just like interest rate swaps, the currency swaps are also motivated by comparative advantage. Currency swaps entail swapping both principal and interest between the parties, with the cashflows in one direction being in a different currency than those in the opposite direction. It is also a very crucial uniform pattern in individuals and customers.

Inflation swaps An inflation-linked swap involves exchanging a fixed rate on a principal for an inflation index expressed in monetary terms. The primary objective is to hedge against inflation and interest-rate risk. **Commodity swaps** A commodity swap is an agreement whereby a floating (or market or spot) price is exchanged for a fixed price over a specified period. The vast majority of commodity swaps involve crude oil.

Credit Default Swap An agreement whereby the payer periodically pays premiums, sometimes also or only a one-off or initial premium, to the protection 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 swaps A 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 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 variations There 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 structures A total 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.
- A constant maturity swap (CMS) is a swap that allows the purchaser to fix the duration of received flows on a swap.
- An amortizing swap is usually an interest rate swap in which the notional principal for the interest payments declines during the life of the swap, perhaps at a rate tied to the prepayment of a mortgage or to an interest rate benchmark such as the LIBOR. It is suitable to those customers of banks who want to manage the interest rate risk involved in predicted funding requirement, or investment programs.
- A zero coupon swap is of use to those entities which have their liabilities denominated in floating rates but at the same time would like to conserve cash for operational purposes.
- A deferred rate swap is particularly attractive to those users of funds that need funds immediately but do not consider the current rates of interest very attractive and feel that the rates may fall in future.
- An accreting swap is used by banks which have agreed to lend increasing sums over time to its customers so that they may fund projects.
- A forward swap is an agreement created through the synthesis of two swaps differing in duration for the purpose of fulfilling the specific time-frame needs of an investor. Also referred to as a forward start swap, delayed start swap, and a deferred start swap.
- A quanto swap is a cash-settled, cross-currency interest rate swap in which one counterparty pays a foreign interest rate to the other, but the notional amount is in domestic currency. The second party may be paying a fixed or floating rate. For example, a swap in which the notional amount is denominated in Canadian dollars, but where the floating rate is set as USD LIBOR, would be considered a quanto

swap. Quanto swaps are known as differential or rate-differential or diff swaps.

- A range accrual swap (or range accrual note) is an agreement to pay a fixed or floating rate while receiving cash flows from a fixed or floating rate which are accrued only on those days where the second rate falls 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.
- **Equity shares:** stocks and shares that carry no fixed interest.
- **Foreign Exchange:** an institution or system for dealing in the currencies of other countries.

5.10 SELF ASSESSMENT QUESTIONS

1. What is Money Market.

2. Discuss the objectives of money market.

5.11 LESSON END EXERCISE

- 1 Discuss the instruments of money market.

2. Difference between money market and capital market

3. Discuss various types of derivatives

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.

EXCHANGE RATE AND CURRENCY MARKETS

Structure:

- 6.1 Introduction**
- 6.2 Objectives**
- 6.3 Concept of Exchange rate**
- 6.4 Significance of exchange rate**
- 6.5 Types of exchange rates**
- 6.6 Exchange rate regimes**
- 6.7 Determinants of exchange rate**
- 6.8 Dynamics on the Forex market**
- 6.9 Summary**
- 6.10 Glossary**
- 6.11 Self Assessment Questions**
- 6.12 Lesson End Exercise**
- 6.13 Suggested Reading**

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 fictitious numbers, a Japan GDP of 8 million Yen would then be worth 800 Dollars. Thus, the exchange rate is a conversion factor, a multiplier or a ratio, depending on the direction of conversion. In a slightly different perspective, the exchange rate is a price. If the exchange rate can freely move, the exchange rate may turn out to

be the fastest moving price in the economy, bringing together all the foreign goods with it.

6.5 Types of exchange rate

It is customary to distinguish nominal exchange rates from real exchange rates. Nominal exchange rates are established on currency financial markets called “forex markets”, which are similar to stock exchange markets. Rates are usually established in continuous quotation, with newspaper reporting daily quotation (as average or finishing quotation in the trade day on a specific market). Central bank may also fix the nominal exchange rate.

1. **Real exchange rates:** Real exchange rates are nominal rate corrected somehow by inflation measures. For instance, if a country A has an inflation rate of 10%, country B an inflation of 5%, and no changes in the nominal exchange rate took place, then country A has now a currency whose real value is $10\% - 5\% = 5\%$ higher than before. In fact, higher prices mean an appreciation of the real exchange rate, other things equal. Another classification of exchange rates is based on the number of currencies taken into account. Bilateral exchange rates clearly relate to two countries’ currencies. They are usually the results of matching of demand and supply on financial markets or in banking transaction. In this latter case, the central bank acts usually as one of the sides of the relationship.
2. **Bilateral exchange rates:** Bilateral exchange rates may be simply computed from triangular relationships: if the exchange rate dollar/yen is 10 000 and the dollar/Angolan kwanza is 100 000 then, as a matter of computation, one yen is worth 10 kwanza. No direct yen/kwanza transaction needs to take place. If, instead, a financial market exists for yen to be exchanged with kwanza, the expectation is that actions by speculators (arbitrage among markets) will bring the parity of 10 kwanza per yen as an 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 $10\% \times 0.6 + 40\% \times 0.4 = 22\%$. 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 increase of international value is a “revaluation”. The most stabile fixed exchange regimes are backed by an international agreement on respective

currency values, often with a formal obligation of loans among central banks in case of necessity.

A “currency crisis” is a rupture of fixed exchange rates with an unwilling devaluation or even the end of that regime in favour of a floating exchange rate. It can dominate the attention of the public, policymakers and entrepreneurs, both in advance and after. For instance, people expecting a crisis can borrow inside the country, convert in a foreign currency, lend that money (e.g. by purchasing bonds). When the crisis comes, they sell the bonds, convert to the national currency, pay back their loans, and gain a hefty profit.

An extreme national engagement to fixed exchange rates is the transformation of the central bank in a mere “currency board” with no autonomous influence on monetary stock. The bank will automatically print or lend money depending on corresponding foreign currency reserves. Thus, exports, imports and capital inflows (e.g. FDI) will largely determine the monetary policy.

Monetary unions phase out the national currencies in favour of one (new or existing). Some further countries can target to join the union and put in place economic and financial policies to that aim, especially if there are explicit conditions for entering into that monetary area. Exiting a monetary union can provoke with large devaluation of the new national currency. Depending on trade elasticities, on foreign debt of the country, on how the exit is managed and on the overall institutional conditions, this can lead to massive internal [poverty](#) or a large export led-growth.

6.7 Determinants of the exchange rates:

- i) Fixed exchange rates are chosen by central banks and they may turn out to be more or less accepted by financial markets. Changes in floating rates or pressures on fixed rates will derive, as for other financial assets, from three broad categories of determinants: variables on the “real” side of the economy;
- ii) Monetary and financial variables determined in cross-linked markets;

- 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 be the difference between domestic and foreign interest rates, thus a reduction in interest rates abroad would have the same effects.

Similarly other fixed-interest financial instruments could be objects of the same dynamics. Accordingly, an increase of domestic interest rates by the central bank is usually considered a way to “defend” the currency. Nonetheless, it may happen that foreigners rather buy shares instead of Treasury bonds. If this were the strongest component of currency demand, then an increase of interest rate may even provoke the opposite results, since an increase of interest rate quite often depresses the stock market, favouring a tide of share sales by foreigners.

In the same “reversed” direction foreign direct investments would work: a restrictive monetary policy usually depresses the growth perspective of the economy. If FDI are mainly attracted by sales perspectives and they constitute a large component of capital flows, then FDI inflow might stop and the currency weaken. Needless to say, those conditions are quite restrictive and not so usually met. A matter of discussion would be whether the relevant interest rate is the nominal or the real one (which, in contrast with the former, keeps into account inflation). Usually foreign investors do not purchase [bread, clothes, and the other items included in the bundle used to compute price level and its dynamics](#): they do not buy anything real in the target economy. So nominal rates are more likely to be taken into account. As a temporary conclusion, interest rates should have an important impact on exchange rate but one has to be careful to check additional conditions.

2. Inflation rate is often considered as a determinant of the exchange rate as well. A high inflation should be accompanied by depreciation. The more so if other countries enjoy lower inflation rates, since it should be the difference between domestic and foreign inflation rates to determine the direction and the scale of exchange rate movements. All this would be implied by a weak version of “one price law” stating that price dynamics of a good are the same worldwide,

after taking into account nominal exchange rates. Thus, here not absolute level but just the percentage differences in price are requested to be equalized. If a hamburger costs in Japan 5% more than a year ago, while in USA it costs 8% more, then the dollar should have been depreciated this year by about $8-5=3\%$. But in order to equalise the price dynamics of different goods, more than one 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 heterogeneously 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.

In extreme cases, local firms producing for the domestic market might go bankrupt. If the reason of appreciation was a soaring world price of main exports (e.g. energy carriers, like oil for many oil producing countries), the composition of the industrial texture would be starkly simplified and concentrated to those exports. This is at odds and works in the opposite direction of the diversification of the economy that is often the stated goal of public strategies in countries depending on too few productions (high export concentration).

A devaluation or depreciation should work in the opposite direction, improving the trade balance thanks to soaring exports and falling imports. If, however, imports have an elasticity to price less than 1, their values in local currency will grow instead of falling. Moreover, if the state, the citizens and / or the enterprises have a debt denominated in a foreign currency, their principal and the interests to be paid soar because of the devaluation. They usually squeeze other expenditures and launch a recessionary impulse throughout the economy. Previous investors in real estate and other assets would be hurt by devaluation, so the perspective of such a dynamics makes investors cautious and might sink FDI.

External debt denominated in foreign currency can, if large enough, provide considerable effects on the positive or negative impact of fluctuation. A devaluation with a large external debt provokes a larger outflows of interest payments (expressed in local currency), possibly squeezing the economy and the public budget, with recessionary effects. For industries where production can be flexibly exported, devaluation offers important opportunities for growth and profitability. Conversely, industries selling exclusively on the domestic market (e.g. the building industry) may see their costs rising while purchasing power of their clients declines

or remains at the same level, which erodes their profits and can even lead to bankruptcies. In other words, devaluation polarises the economy across industries.

Hosting different industries, regions usually exhibit a differentiated degree of international openness: exchange rate fluctuations will have an uneven impact on them. Similarly, the number of job places and the working conditions may be influenced by the degree of international competition and exchange rates levels.

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. Similarly, 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 posit, 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 lead to appreciation in real terms (as the remaining inflation is not compensated by devaluation), which over the years can provoke structural trade deficit and loss of competitiveness (together with foreign 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.

❑ **Long-term trends**

Some geographical monetary areas have enjoyed long periods of stable exchange rate, with moments of consensual realignment after divergence in inflation rates. Many countries strive to keep their currency at a fixed level toward the dollar, the Euro (earlier the German mark) or a basket with multiple currencies. Still, most currency progressively devalue, especially those issued by periphery countries. The US dollar has extremely wide fluctuations with years of “weak” and “strong” dollar.

❑ **Business cycle behaviour**

Too many elements are at work for the exchange rate to exhibit a clearly-defined business cycle behaviour. To the extent that the exchange rate is determined by the trade balance, the exchange rate is counter-cyclical as the latter. At peaks, the trade deficit would depress the exchange rate, forcing it to depreciate. If it is rather the interest rate that turns out to be the main driver of the exchange rate, a possible pro-cyclicality of the interest rate would imply a pro-cyclical exchange rate. In this scenario, recovery and boom are accompanied by rising interest rates and exchange rates. At peaks, we would see very strong currency. Together with domestic demand pressures, this would be the source of a high trade deficit.

If autonomous dynamics in the forex market are the main determinants of the exchange rate, then intense micro-fluctuations and long term tides

would ride the exchange rate, possibly with central bank significant interventions.

6.9 Summary

Exchange rate is the rate at which one currency may be converted into another currency. The exchange rate is used when simply converting one currency to another (such as for the purposes of travel to another country), or for engaging in speculation or trading in the foreign exchange market. There are a wide variety of factors which influence the exchange rate, such as interest rates, inflation, and the state of politics and the economy in each country. It is also known as rate of exchange or foreign exchange rate or currency exchange rate. Exchange depreciation is feasible. By exchange depreciation is meant a decline in the 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 across international borders or territories.
- * **Hedging.** Hedging means reducing or controlling risk. This is done by taking a position in the futures market that is opposite to the one in the physical market with the objective of reducing or limiting risks associated with price changes.
- * **Futures contract.** A 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 upon today (the futures price or strike price) with delivery and payment occurring at a specified future date, the delivery date.
- * **International liquidity.** International liquidity is the ability of a given country to purchase goods and services from another country. It is a combination of a country's readily available supply of foreign currency, and the degree to which its assets may be used as a form of payment or converted to the currency of the country with which it is trading.
- * **Devaluation.** Devaluation in the modern monetary policy is a reduction in the value of a currency with respect to those goods, services or other monetary units with which that currency can be exchanged. 'Devaluation' means official lowering of the value of a country's currency within a fixed exchange rate system, by which the monetary authority formally sets a new fixed rate with respect to a foreign reference currency.

6.11 SELF ASSESSMENT QUESTIONS

Q1. Briefly discuss the concept of Exchange rate?

2. Throw light on the significance of Exchange Rate.

6.12 LESSON END EXERCISE

1. Describe the various determinants of exchange rate

2. Explain the exchange rate regimes

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

DEVALUATION AND DEPRECIATION

STRUCTURE**7.1 Introduction****7.2 Objectives****7.3 Concept of Devaluation and Depreciation****7.4 Devaluation vs. Depreciation****7.5 International Financial Flows****7.6 Summary****7.7 Glossary****7.8 Self Assessment Questions****7.9 Lesson End Exercise****7.10 Suggested Reading****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:

- o 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.
- o The authority devalues the currency by lowering the fixed exchange rate in the international market.
- o It is changed by only the country's authority by comparing the worth of the goods and services in the international market.
- o It helps the economy in the short period.
- o 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:

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

The meaning of Depreciation:

- o 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.)
- o By depreciating the value of currency the problem occurs only for short time but in a long time, it will help an economy to build well and reliable.

- o It also guards against the market crack-ups.
- o The floating exchange rate changes day basis. Floating exchange rate is a rate by which the country determine the value of their own currency in the global market.
- o It happens in the global market on a daily basis because of change in the economic policy or political party in the global market.
- o In the depreciation, the purchasing power of currency falls as compared to another country's currency means country's money has less power to purchase as compared to another currency.

Effects:

- o Exports cheaper
- o Imports expensive
- o Higher inflation
- o Decrease in supply

7.2 Objectives:

After going through this lesson you would able to

- understand the concept of Devaluation
- to know about the concept of Depreciation

7.3 CONCEPT OF DEVALUATION AND DEPRECIATION

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

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.

7.4 DEVALUATION VS. DEPRECIATION

Base	Devaluation of currency	Depreciation of currency
Meaning	Devaluation means to lower the value of country's currency as compared to the another country's value	The meaning of depreciation of the currency is the same as the meaning of devaluation of the currency.
circumstances	It is done by government authority.	It is done by the force of demand and supply in the international market.
Rate	It is done by using fixed exchange rate.	It is done by using floating exchange rate
Effect on economy	It just for short term.	It affects the economy for a longer term
Changes	There is no fixed time for it but it doesn't occur in regularly.	It occurs on a daily basis.

7.5 INTERNATIONAL FINANCIAL FLOWS

Funds flowing into, or out of, a country on account of various types of international transactions are recorded by the monetary authorities of that country in a prescribed statement that is known as the balance of payments. You find an individual maintaining an account of his/her cash receipts and payments. A company prepares a cash-flow statement that shows incoming and outgoing of cash. Similarly, a country records the inflows and outflows of funds in a statement known as the balance of payments. In other words, balance of payments is a statement that records all different forms of funds inflow and outflow and arrives at a conclusion whether there is a net inflow in the country / outflow out of the country influencing, in turn, the foreign exchange reserves possessed by the country. Thus any discussion of the balance of payments embraces the explanation of what the different forms of international financial flows are and how they are recorded in the balance of payments. It also involves the discussion of whether the balance of payments experiences any disequilibrium, and if it is there, what 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 of unilateral transfer. Similarly, a large number of Indians living abroad remit a part of their income to their family members living in India. This is a case of inflow of funds on account of unilateral transfer.

Foreign Investment

Foreign investment may be of two kinds. While one is direct, the other is portfolio. Foreign direct investment (FDI) occurs when a firm moves abroad for the production of goods or provision of services and participates in the management of that company located abroad. On the contrary, foreign portfolio investment (FPI) is not at all concerned with the production of goods and rendering of services. The sole purpose of a foreign portfolio investor is to earn a return through investment in foreign securities without any intention of grabbing the voting power in the company whose securities it purchases. In case of FDI too, an investor invests in the shares of a foreign company, but the sole objective is to enjoy the voting power and thereby a say in the management of the foreign company. Thus, it is primarily the voting right that differentiates between FDI and FPI. Whatever the forms may be, inflow of funds occurs when a foreign

investor makes investment in the country. On the contrary, outflow of funds occurs when the domestic investor invests in a foreign country.

External Assistance and External Commercial Borrowings

External assistance and external commercial borrowings are different in the sense that while the former flows normally from an official institution -bilateral or multilateral, the latter flows from international banks or other private lenders. The rate of interest in the former is usually low along with a longer maturity period. The latter carries market rate of interest and a shorter maturity. Last but not least, external assistance is manifest often in outright grant that does not require repayment of principal/interest payment. Whatever may be the difference between the two, any borrowing from abroad is treated as inflow of funds. Lending abroad, on the other hand, represents outflow of funds. However, repayment of loans is treated just the other way,

Short-term Flow of funds

Normally loans and foreign direct investment are meant for a period exceeding one year. But 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.)

7.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by Devaluation ?

2. What do you mean by Depreciation ?

7.9 LESSON END EXERCISE

- 1 Differentiate between Devaluation and Depreciation

2 What do you mean by international flows ?

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

TYPES OF RISKS; RISK HEDGING AND FUTURES; RISK AND FINANCIAL ASSETS

STRUCTURE

8.1 Introduction

8.2 Objectives

8.3 Concept of Risk and Types of Risks

8.3.1 Types of financial risks

8.4 Risk Hedging

8.4.1 Types of Hedging Strategies

8.4.2 Advantages of Hedging

8.5 Risk hedging and future Contract

8.6 Risk and financial assets

8.7 Summary

8.8 Glossary

8.9 Self assessment Questions

8.10 Lesson End Exercise

8.11 Suggested Readings

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 of 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,

Companies undertake high-cost risks in marketing to launch a new product in order to gain higher sales.

2. **Non- Business Risk:** These types of risks are not under the control of firms. Risks that arise out of political and economic imbalances can be termed as non-business risk.
3. **Financial Risk:** Financial Risk as the term suggests is the risk that involves financial loss to firms. Financial risk generally arises due to instability and losses in the financial market caused by movements in stock prices, currencies, interest rates and more.

8.3.1 TYPES OF FINANCIAL RISKS:

Financial risk is one of the high-priority risk types for every business. Financial risk is caused due to market movements and market movements can include a host of factors. Based on this, financial risk can be classified into various types such as Market Risk, Credit Risk, Liquidity Risk, Operational Risk, and Legal Risk.

Market Risk:

This type of risk arises due to the movement in prices of financial instrument. Market risk can be classified as **Directional Risk** and **Non-Directional Risk**. Directional risk is caused due to movement in stock price, interest rates and more. Non-Directional risk, on the other hand, can be volatility risks.

Credit Risk:

This type of risk arises when one fails to fulfill their obligations towards their counterparties. Credit risk can be classified into **Sovereign Risk** and **Settlement Risk**. Sovereign risk usually arises due to difficult foreign exchange policies. Settlement risk, on the other hand, arises when one party makes the payment while the other party fails to fulfill the obligations.

Liquidity Risk:

This type of risk arises out of an inability to execute transactions. Liquidity risk can be classified into **Asset Liquidity Risk** and **Funding Liquidity Risk**. 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 losses out of legal proceedings, it is a legal risk.

Different Types of Risk

There are 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.

Micro Risk Levels

While the above risk types are the *macro* scale levels of risk, there are also some more important *micro* (small-scale) types of risks that are important when talking about the valuation of a *stock* or *bond*. These include:

- **Business Risk** – The uncertainty of income caused by the nature of a company’s business measured by a ratio of operating earnings (income flows of the firm). This means that the less certain you are about the income flows of a firm, the less certain the income will flow back to you as an investor. The sources of business risk mainly arises from a companies products/services, ownership support, industry environment, market position, management quality etc. An example of business risk could include a rubbish company that typically would experience stable income and growth over time and would have a low business risk compared to a steel company whereby sales and earnings fluctuate according to need for steel products and typically would have a higher business risk.
- **Liquidity Risk** – The uncertainty introduced by the secondary market for a company to meet its future short-term financial obligations. When an investor purchases a security, they expect that at some future period they will be able to sell this security at a profit and redeem this value as cash for consumption – this is the liquidity of an investment, its ability to be redeemable for cash at a future date. Generally, as we move up the asset allocation table – the liquidity risk of an investment increases.
- **Financial Risk** – Financial risk is the risk borne by equity holders (refer Shares section) due to a firms use of debt. If the company raises capital by borrowing money, it must pay back this money at some future date plus the financing charges (interest etc charged for borrowing the money). This increases the degree of uncertainty about the company because it

must have enough income to pay back this amount at some time in the future.

- **Exchange Rate Risk** – The uncertainty of returns for investors that acquire foreign investments and wish to convert them back to their home currency. This is particularly important for investors that have a large amount of over-seas investment and wish to sell and convert their profit to their home 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:

- **Securities Market:** This area includes investments made in shares, equities, indices, and so on. The risk involved in investing in the securities market is known as equity or securities risk.
- **Commodities Market:** This area includes metals, energy products, farming products, and so on. The risk entailed in investing in the commodities market is referred to as the commodity risk.
- **Interest Rate:** This area includes borrowing and lending rates. The risk associated with the interest rates is termed as the interest rate risk.
- **Currencies:** This area comprises foreign currencies and has various associated risks such as volatility and currency risk.

8.4.1 TYPES OF HEDGING STRATEGIES

Hedging strategies are broadly classified as follows:

- 1. Forward Contract:** It is a contract between two parties for buying or selling assets on a specified date, at a particular price. This covers contracts such as forwarding exchange contracts for commodities and currencies.
- 2. Futures Contract:** This is a standard contract between two parties for buying or selling assets at an agreed price and quantity on a specified date. This covers various contracts such as a currency futures contract.
- 3. Money Markets:** These are the markets where short-term buying, selling, lending, and borrowing happen with maturities of less than a

year. This includes various contracts such as covered calls on equities, money market operations for interest, and currencies.

8.4.2 ADVANTAGES OF HEDGING:

- *Hedging limits the losses to a great extent.*
- *Hedging increases liquidity as it facilitates investors to invest in various asset classes.*
- *Hedging requires lower margin outlay and thereby offers a flexible 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-determined 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 current exchange rate prevailing at the time the currencies are being exchanged, while the contract rate is the rate which has been locked at the time the parties agreed to the transaction.

Through this formula, both the parties to the future contract decide whether they have incurred gains or suffered losses. Here also, the buyer hopes that the currency may appreciate while the seller expects that the currency will depreciate.

An important factor in determining the eventual price, is the basis. The basis is calculated by deducting the futures price from the spot price. By successfully predicting the basis of a commodity, the eventual price of a commodity can be calculated at the moment the [hedge](#) is placed.

Long hedging

End-users take a long position when they are hedging their [price](#) risks. By buying a futures contract, they agree to buy a commodity at some point in the future. These contracts are rarely executed, but are mostly offset before their maturity date. Offsetting a position is done by obtaining an equal opposite on the futures market on your current futures position. The profit or loss made on this transaction is then settled with the spot price, where the producer will buy his commodity.

The following example explains the execution of a long hedge.

A producer expects to need a wheat delivery in March. In October he purchases an April Wheat contract to cover his price risk on the spot market in March, when he plans to buy the wheat. He predicts the basis to be – \$ 0,30 which means the April futures price will be 30 cents higher than the March cash price.

the producer can now calculate the expected purchase price for the commodity, using the following formula:

Futures price – Basis + broker commission = Net Purchasing price

Short hedging

Producers of commodities take a short position when hedging their price risks. They sell their product using a futures contract, for a delivery somewhere later in the future. They hedge their price risk similar to long hedgers. They sell a futures contract, which they offset come the maturity date by buying an equal futures contract. The profit or loss made by offsetting the position is then settled with 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 this risk-type. Examples of this type of risk are:

- Tax changes.
- Upward changes in the central bank accommodation rate.
- Sudden change in the economic growth rate.
- Declaration of a war.
- A major change in the exchange rate.

Unsystematic risk is security-specific risk. This risk-type arises from the activities of the issuers of shares, i.e. the companies, and the industry of which they are a part, and may be seen as the major factors that affect the income flows of companies. Analysts generally categorize this risk-type into business risk and financial risk.

Business risk is the uncertainty of income produced by the company itself and/or the industry the company is a part of. Examples of business risk:

- Prolonged labour strike.
- Arrival of serious competition from offshore.
- Harmful management decisions.
- Negative change in product / service quality.

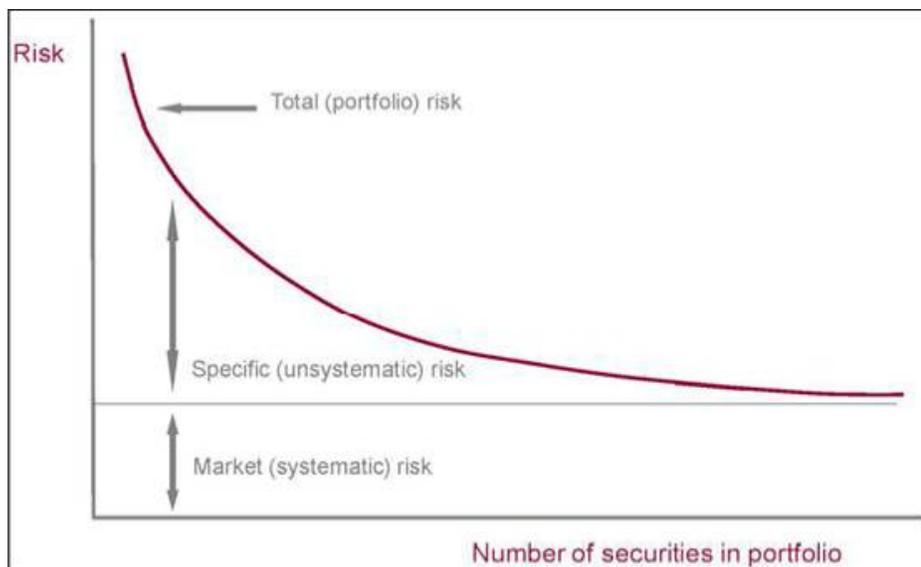
All these factors have an effect on sales variability, and this is one of the main determinants of income / earnings variability.

Financial risk is introduced when debt is utilised as a source of capital, and is used injudiciously by the company. Examples are borrowing at a time when rates are high and are about to fall, borrowing in excess of funding requirements and misuse of the funds so that the funds do not contribute to the income of the company.

Some analysts include liquidity risk as a third type of unsystematic risk. This is the risk of the segment of the share market in which the relevant share is being illiquid so that fair market value cannot be obtained.

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.

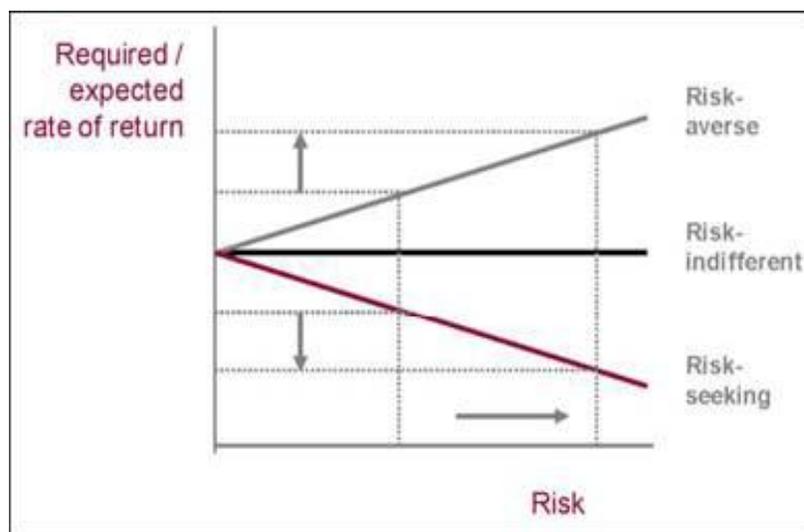


Figure 2: risk profile

8.7 Summary

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
- Financial Risk

Hedging: A hedge is a strategy intended to protect an investment or portfolio against loss. It usually involves buying securities that move in the opposite direction than the asset being protected.

8.8 GLOSSARY

- **Risk:** Any action or activity that leads to loss of any type can be termed as risk.
- **Liquidity-** capable of ready conversion into cash.
- **Volatility-** *Volatility risk* is risk to an investment's value due to unpredictable change

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.

3. Explain the types of hedging and its advantagesAdd some questions

8.11 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

CRITERIA TO EVALUATE ASSETS

Unit-II

STRUCTURE:

- 9.1 Introduction
- 9.2 Objective
- 9.3 Criteria to evaluate assets
- 9.4 Methods of Assets valuation
- 9.5 Importance of Asset valuation
- 9.6 Return on assets
- 9.7 Limitations of Return of Assets
- 9.8 Theories of Level of Interest rate
- 9.9 Summary
- 9.10 Glossary
- 9.11 Self Assessment Questions
- 9.12 Lesson End Exercise
- 9.13 Suggested readings

9.1 INTRODUCTION:

What Is an Asset?

An asset is a resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide a future benefit. Assets are

reported on a company's balance sheet and are bought or created to increase a firm's value or benefit the firm's operations. Examples of assets include: Investments, PPE (Property, Plant, and Equipment), Vehicles, Furniture, Patents (intangible asset), Stock, Cash and cash equivalents.

Current Assets	Noncurrent Assets	Tangible Assets	Intangible Assets	Operating Assets	NonOperating Assets
Inventories	Property	Property	Goodwill	Cash	Goodwill
Trade Receivables	Plant	Plant	Patents	Inventory	Patents
Cash & cash equivalents	Equipment	Equipment	Trademarks	Trade Receivables	Investment Assets
Short term loans &	Patents	Furniture	Copyrights	Plant	
Prepaid Expenses	Trademarks	Computer	Brand	Equipment	
Bills Receivable		Truck		Computer	
				Bills Receivable	

9.2 Objectives:

- After going through this lesson you should be able to;
- Describe the Various criteria to evaluate assets.
 - Discuss different theories related to asset valuation.
 - Discuss the various methods used for valuation of assets

9.3 CRITERIA TO 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 total liabilities are deducted, which is another \$1 million, only \$2.5 million is left, which is the total value of the tangible assets.

9.3.3 Asset Valuation – Valuing Intangible Assets

Intangible assets are assets that take no physical form. They may include patents, logos, franchises, and trademarks.

Say, for example, a multinational company with assets of \$15 billion goes bankrupt one day, and none of its tangible assets are left. It can still have value because of its

intangible assets, such as its logo and patents, that many investors and other companies may be interested in acquiring.

1.3 METHODS OF ASSET VALUATION

Valuation of fixed assets can be done using various methods, which include the following:

1. Cost Method

The cost method is the easiest way of asset valuation. It is done by basing the value on the price for which the asset was bought.

2. Market Value Method

The market value method bases the value of the asset on its market price or its projected price when sold in the open market. In the absence of similar assets in the open market, the replacement value method or the net realizable value method is used.

3. Base Stock Method

The base stock method requires a company to keep a certain level of stocks whose value is assessed based on the value of a base stock.

4. Standard Cost Method

The standard cost method uses expected costs instead of actual costs, often based on the company's past experience. The costs are obtained by recording differences between expected and actual costs.

9.4 IMPORTANCE OF ASSET VALUATION:

Asset valuation is one of the most important things that need to be done by companies 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.

The Basics of Return on Assets—ROA

Businesses (at least the ones that survive) are ultimately about efficiency: squeezing the most out of limited resources. Comparing profits to revenue is a useful operational metric, but comparing them to the resources a company used to earn them cuts to the very feasibility of that company's existence. Return on assets (ROA) is the simplest of such corporate bang-for-the-buck measures.

ROA is calculated by dividing a company's net income by total assets. As a formula, it would be expressed as:

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

Return on Assets = Total Assets Net Income ÷

Higher ROA indicates more asset efficiency.

For example, pretend Spartan Sam and Fancy Fran both start hot dog stands. Sam spends \$1,500 on a bare-bones metal cart, while Fran spends \$15,000 on a zombie apocalypse-themed unit, complete with costume. Let's assume that those were the only assets each deployed. If over some given time period Sam had earned \$150 and Fran had earned \$1,200, Fran would have the more valuable business but Sam would have the more efficient one. Using the above formula, we see Sam's simplified ROA is $\$150/\$1,500 = 10\%$, while Fran's simplified ROA is $\$1,200/\$15,000 = 8\%$.

The Significance of Return on Assets—ROA

Return on assets (ROA), in basic terms, tells you what earnings were generated from invested capital (assets). ROA for public companies can vary substantially and will be highly dependent on the industry. This is why when using ROA as a comparative measure, it is best to compare it against a company's previous ROA numbers or against a similar company's ROA. The ROA figure gives investors an idea of how effective the company is in converting the money it invests into net income. The higher the ROA number, the better, because the company is earning more money on less investment.

Remember total assets is also the sum of its total liabilities and shareholder's equity. Both of these types of financing are used to fund the operations of the company. Since a company's assets are either funded by debt or equity, some analysts and investors disregard the cost of acquiring the asset by adding back interest expense in the formula 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 income are

Return on Assets (ROA)

$$\text{Return on Assets} = \frac{\text{Operating income}}{\text{Total assets}}$$

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9.8 THEORIES OF LEVEL OF INTEREST RATE

1 Classical Theory

2 loanable fund Theory

3 Keynesian Theory

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.

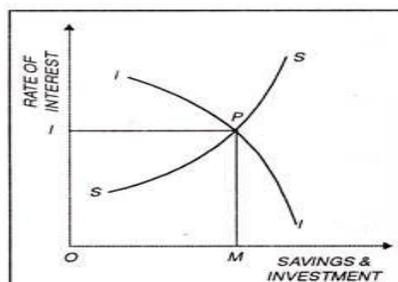
The factors behind the demand for savings and supply of savings were variously interpreted but the idea common to all classical writers was that both the demand and

supply of savings are interest-elastic. Some writers called the interest rate the reward for a saver's abstinence from consuming his income while others called it a charge for the borrower's preference for the present consumption. Supply of savings was supposed to depend upon different considerations by different writers. Some classical authors laid stress on the 'waiting' or 'abstinence' found necessary for saving. They held the rate of interest to be an inducement for the act of saving and the supply of saving. Other classical writers would emphasize time-preference as the primary consideration of savers.

In their view, saving which is used for investment is made available by those who are prepared to postpone their consumption of their present income to some future date, thereby making the purchasing power or the resources available to those who want to invest.

Saving can be obtained by the investors only if they are prepared to pay the savers a rate of interest high enough to overcome their time preference. Obviously, higher is the rate of interest; greater is the number of persons whose rates of time preference are covered. The supply schedule of saving was assumed to be interest-elastic and made to depend only on changes in the rate of interest. As rate of interest rises, the savers are induced to save more; while the abstinence or time-preference of more people is covered, the number of people doing saving also increases.

In this way, as the offered rate of interest rises, volume of saving forthcoming also rises. The supply curve of savings, thus, slopes from left upward to the right, as has been shown in Fig. 7.1 given above.



Demand for savings was the expenditure on the purchase of capital goods which could be used for investment. The act of investment was the expenditure on the purchase of capital goods which could be used

to produce some other goods expected to be sold to earn profit. It was argued by the 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 O_i is the equilibrium rate. In other words, the equilibrium rate of interest is that which equates the cost of borrowing with the marginal productivity of capital on the one hand and on the other induces the marginal saver to save.

His saving is the addition to the volume of saving which makes it equal to the volume of demand for them. At any other rate of interest, the volume of saving induced will be more or less than the amount of investment the producers wish to undertake.

2. loanable fund Theory:

The neo-classical theory of interest or loanable funds theory of interest owes its origin to the Swedish economist Knut Wicksell. Later on, economists like Ohlin, Myrdal, Lindahl, Robertson and J. Viner have considerably contributed to this theory. According to this theory, rate of interest is determined by the demand for and supply of loanable funds. In this regard this theory is more realistic and broader than the classical theory of interest.

Demand for Loanable Funds:

Loanable funds theory differs from the classical theory in the explanation of demand for loanable funds.

According to this theory demand for loanable funds arises for the following three purposes viz.; Investment, hoarding and dissaving:

1. Investment (I):

The main source of demand for loanable funds is the demand for investment. Investment refers to the expenditure for the purchase of making of new capital goods including inventories. The price of obtaining such funds for the purpose of these investments depends on the rate of interest. An entrepreneur while deciding upon the investment is to compare the expected return from an investment with the rate of interest. If the rate of interest is low, the demand for loanable funds for investment purposes will be high and vice-versa. This shows that there is an inverse relationship between the demands for loanable funds for investment to the rate of interest.

2. Hoarding (H):

The demand for loanable funds is also made up by those people who want to hoard it as idle cash balances to satisfy their desire for liquidity. The demand for loanable 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

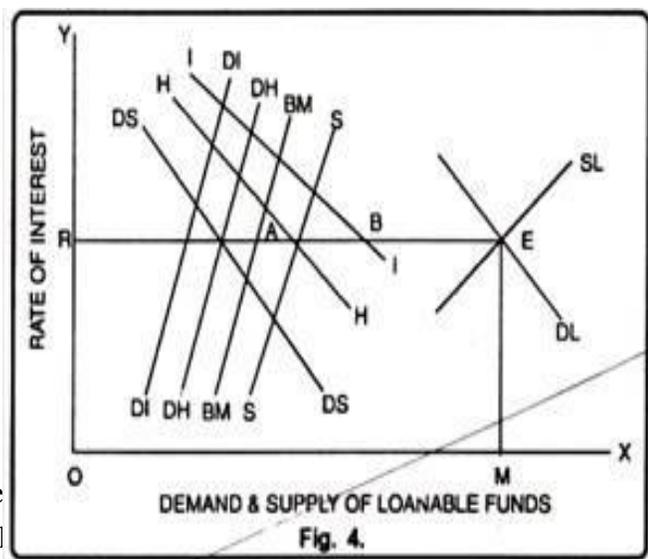
interest rate provides better returns in comparison to present earnings. Thus, high rate of interest leads to higher disinvestment and so on.

4. Bank Money (BM):

Banking system constitutes another source of the supply of loanable funds. The banks advance loans to the businessmen through the process of credit creation. The money created by the banks adds to the supply of loanable funds.

Determination of Rate of Interest:

According to loanable funds theory, equilibrium rate of interest is that which brings equality between the demand for and supply of loanable funds. In other words, equilibrium interest rate is determined at a point where the demand for loanable funds curve intersects the supply curve of loanable funds. It can be shown with the help of a Figure 4.



The rate of interest is determined by the intersection of the demand for loanable funds curve, DL, and the supply of loanable funds curve, SL. Fig. 4 shows that the equilibrium rate of interest is EM; at this rate, the demand for loanable funds is equal to the supply of loanable funds i.e. OM.

Criticism:

Although, loanable funds theory is superior to classical theory, yet, critics have criticised it on the following grounds:

1. Full Employment:

Keynes opined that loanable funds theory is based on the unrealistic assumption of full employment. As such, this theory also suffers from the defects as the classical 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.

3 Keynesian Theory:

Keynesian economics is a theory that says the government should increase demand to boost growth. Keynesians believe consumer demand is the primary driving force in an economy. As a result, the theory supports expansionary fiscal policy. Its main tools are government spending on infrastructure, unemployment benefits, and education. A drawback is that overdoing Keynesian policies increases inflation.

The British economist John Maynard Keynes developed this theory in the 1930s. The Great Depression had defied all prior attempts to end it. President Franklin D. Roosevelt used Keynesian economics to build his famous New Deal program. In his first 100 days in office, FDR increased the debt by \$4 billion to create 16 new agencies and laws. For example, the Works Progress Administration put 8.5 million people to work. The Civil Works Administration created 4 million new construction jobs. Keynes described his premise in "The General Theory of Employment, Interest, and Money." Published in February 1936, it was revolutionary. First, it argued that government spending was a critical factor driving aggregate demand. That meant an increase in spending would increase demand.

Second, Keynes argued that government spending was necessary to maintain full employment.

Keynes advocated deficit spending during the contractionary phase of the business cycle. But in recent years, politicians have used it even during the expansionary phase. President Bush's deficit spending in 2006 and 2007 increased the debt. It also helped create a boom that led to the 2007 financial crisis. President Trump is increasing the debt during stable economic growth. That will also lead to a boom-and-bust cycle.

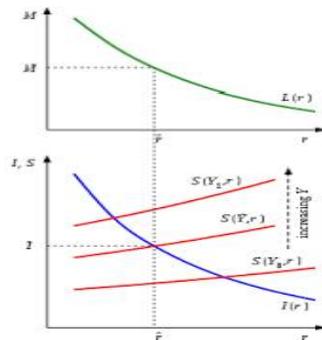
New Keynesian Theory

In the 1970s, rational expectations theorists argued against the Keynesian theory. They said that taxpayers would anticipate the debt caused by deficit spending. Consumers would save today to pay off the future debt. Deficit spending would spur savings, not increase demand or economic growth. The rational expectations theory inspired the New Keynesians. They said that monetary policy is more potent than fiscal policy. If done right, expansionary monetary policy would negate the need for 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. Summary of valuation of assets.

- Asset valuation is the process of determining the fair market value of an asset.
- Asset valuation often consists of both subjective and objective measurements.
- Net asset value is the book value of tangible assets, less intangible assets and liabilities.
- Absolute value models value assets based only on the characteristics of that asset, such as discounted dividend, discounted free cash flow, residential income and discounted asset models.
- Relative valuation ratios, such as the P/E ratio, help investors determine asset valuation by comparing similar assets.

9.9 SUMMARY:

The problem in valuation is not that there are not enough models to value an asset, it is that there are too many. Choosing the right model to use in valuation is as critical to arriving at a reasonable value as understanding how to use the model. This chapter attempts to provide an overview of the valuation models introduced in this book and a general framework that can be used to pick the right model for any task. Choices in valuation models In the broadest possible terms, firms or assets can be valued in one of four ways – asset based valuation approaches where you estimate what the assets owned by a firm are worth currently, discounted cashflow valuation approaches that discount cashflows to arrive at a value of equity or the firm, relative valuation approaches that base value upon multiples and option pricing approaches that use contingent claim valuation. Within each of these approaches, there are further choices that help determine the final value. There are at least two ways in which you can value a firm using asset based valuation techniques. One is liquidation value, where you consider what the market will be willing to pay for assets, if the assets were liquidated today. The other is replacement cost, where you

evaluate how much it would cost you to replicate or replace the assets that a firm has in place today. In the context of discounted cashflow valuation, cashflows to equity can be discounted at the cost of equity to arrive at a value of equity or cashflows to the firm can be discounted at the cost of capital to arrive at the value for the firm. The cashflows to equity themselves can be defined in the strictest sense as dividends or in a more expansive sense as free cashflows to equity. These models can be further categorized on the basis of assumptions about growth into stable growth, two-stage and three-stage models. Finally, the measurement of earnings 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. For 2 other assets, such as real estate, the price can similarly expressed as a function of gross income or per square foot of space. Here, the comparables would be other properties in the same locale with similar characteristics. 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.
- **Keynesian theory:** According to Keynes, the rate of interest is purely “a monetary phenomenon.” Interest is the price paid for borrowed funds. Interest is the reward for parting with liquidity. However, the rate of interest in the Keynesian theory is determined by the demand for money and supply of money.

9.11 SELF ASSESSMENT QUESTIONS

1. How do you evaluate an asset?
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-
2. What is the recognition criteria for assets?

9.12 LESSON END EXERCISE

1. What are the three important elements of asset valuation

2. .How do you identify fixed assets?

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

**Relationship between Long Term and Short Term Rates;
Appropriate Interest Rate Policy**

STRUCTURE**10.1 Introduction****10.2 Objective****10.3 Factors Affecting Market Interest Rates****10.4 Effect of Changes in Interest Rates****10.5 Short-Term and Long-Term Interest Rate****10.6 Relationship between Short Term and Long Term Rates****10.7 Appropriate Interest Rate Policy****10.8 Summary****10.9 Glossary****10.10 Self Assessment Questions****10.11 Lesson end Exercise****10.12 Suggested Readings****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 same direction or to the same extent. Therefore, it is sometimes useful to select one rate to represent the short-term market. It is commonly believed that four factors are dominant in determining interest rate levels. These are state of economy, monetary policy, inflation expectations and federal budget. Three other factors that can be important are:

- i) Saving by individuals,

- ii) International capital flows, and
- iii) Amount of premium required by investors to compensate for interest rate risk.

1. Economic Conditions

Interest rates have a tendency to move up and down with changes in the volume of business activities. In period of rapid economic growth, business firms require large amount of capital to finance increased requirements of in working capital and fixed asset. The business demand for borrowed funds, combined with increase in consumer borrowing put upward pressure on interest rates.

1) Monetary Policy

Monetary policy refers to the policy measures adopted by the Central Bank of the country such as changes in rate of interest (i.e, change in cost of credit) and the availability of credit. The policy regarding the growth of money supply also comes under the purview of monetary policy. Changes in bank rate, open market operations, cash reserve ratio of banks, selective credit controls are the various instruments of monetary policy.

i) Bank Rate

Bank rate is the rate at which the central bank of a country provides loans to the commercial banks. Bank rate is also called the discount rate because in the earlier days, the central bank used to provide finance to the commercial banks by rediscounting their bills of exchange. Through change in the bank rate, the Central Bank can influence the creation of credit by the commercial banks. When the Central Bank raises the cost of borrowing, the bank rate 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 in the rate of inflation.

2) Expected rate of Inflation:

Purchasing power risk arises from unanticipated inflation. It is the risk that the rate of inflation will be greater than the investor expected when the investment was made causing the real rate of return to be lower than expected. Because of these risks, market interest rates and other required returns include an inflation premium.

4) **Government Deficit** Increase in government securities, unless offset by decreases in other borrowing means an increase in the total demand for loanable funds. There is a positive correlation between the amount of government deficit and the money supply.

10.4 EFFECT OF CHANGES IN INTEREST RATES:

The basic argument of interest rate policy is that a rise in the interest rate raises the cost of credit and thus discourages investment as well as consumption financed with loans. On the other hand, lowering of the rate of interest cheapens the cost of credit and thus encourages investment expenditure as well as consumption expenditure. Hence, the interest rate policy can be used as a contra cyclical measure. A change in the short-term rate of interest can be brought about by changing the bank rate, the rate at which the Central Bank of country discounts the first rate short term bills of exchange. It is assumed that a change in the bank rate directly influences the rate of interest charged by the commercial banks on their advances, as well as the other short-term interest rates, such as those charged for money at call, bill discounted, hire purchase finance etc. However, the short-term rate of interest is relevant to investment in inventories. A change in this rate is not likely to influence it significantly, as interest cost constitutes only a small part of the total cost. Similarly, it may not affect the consumption facilitated by purchase, provident fund contributions and insurance premium. : A change in the

short-term rate of interest can effectively change the value of credit taking some factors into consideration. This can be explained by an example of increasing short-term rate of interest with a view to control inflationary situation. It will give rise to following difficulties:

- 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

Short-term interest rates are the rates at which short-term borrowings are effected between financial institutions or the rate at which short-term government paper is issued or traded in the market. Short-term interest rates are generally averages of daily rates, measured as a percentage. Short-term interest rates are based on three-month money market rates where available. Typical standardized names are “money market rate” and “treasury bill rate”.

10.5.2 Long-term interest rates

Long-term interest rates refer to government bonds maturing in ten years. Rates are mainly determined by the price charged by the lender, the risk from the borrower and the fall in the capital value. Long-term interest rates are generally averages of daily rates, measured as a percentage. These interest rates are implied by the prices at which the government bonds are traded on financial markets, not the interest rates at which the loans were issued. In all cases, they refer to bonds whose capital repayment is guaranteed by governments. Long-term interest rates are one of the determinants of business investment. Low long-term interest rates encourage investment in new equipment and high interest rates discourage it. Investment is, in turn, a major source of economic growth.

10.6 RELATIONSHIP BETWEEN SHORT AND LONG TERM RATES

When it comes to interest rates, short-term and long-term are ambiguous phrases. Different financial experts and organizations define the terms differently. For example, the Securities Industry and Financial Markets Association considers bonds with maturities of up to five years to be short term, while the U.S. Department of the Treasury refers to Treasury bills with maturities of 52 weeks or fewer as short-term investments. It might be more useful to refer to shorter-term or longer-term interest rates when comparing investments or loan options.

The relationship between short and longer-term interest rates plays an important role in the conduct of monetary policy. While central banks typically implement

monetary policy by changing the availability and price of credit to the banking system in order to guide market determined short-term rates, longer-term rates are likely to play a more important role in affecting households' and firms' spending 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 comparable shorter-term investments, long-term interest rates are typically higher than short-term interest rates. For example a 30-year U.S. Treasury Bond typically offers a higher interest rate than a five-year U.S. Treasury Note.

10.6.3 Prevailing Rate Changes

The market price of fixed-interest investments, like most bonds, tends to move in the opposite direction of prevailing interest rates. For example, the price of a 4 percent bond would decline if new bonds were issued with a 5 percent interest rate. No one would pay \$1,000 for a 4 percent bond when they could spend the same amount and earn 5 percent on their money. Shorter-term bonds are not affected as greatly as longer-term bonds, since there is less time remaining until maturity, at which time they will be redeemed for full face value, regardless of prevailing rates.

10.7 APPROPRIATE INTEREST RATE POLICY

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). Different countries have different policy interest rates.

Interest rate policy has been considered very crucial for central banks for ensuring smooth functioning of the transmission mechanism of monetary policy. From a stringent administered regime to a virtually complete liberalization, the evolution of interest rate policy in India has been a gradual process. Since 1964, RBI had been fixing all the deposit rates of commercial banks and since 1969 their lending rates. Moreover, the ceiling on call rates had been fixed by Indian Bank Association since 1973. Over the years, an elaborate system of fixing either the maximum or minimum or differential interest rates had evolved in India. The ruling level and structure of interest rates in India was an administered one. Though the interest rates in our country were to a large extent administered, they were

revised from time to time in the context of emerging needs and trends. In this chapter, an attempt has been made to chart out the history of the deregulation of interest rates in India since the Chakravarty Committee Report was submitted to the Reserve Bank of India. This chapter has been divided into 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 weakening the transmission in India were”:

- i. Administered interest rate structure on small saving deposits.
- ii. Structural asymmetry faced by banks in fixing interest rate.
- iii. Practice of giving advances at below Benchmark Prime Lending Rate (BPLR).

“With a view to imparting transparency to the loan process and improving the assessment of monetary policy transmission and promoting competition in the credit market, the Reserve Bank introduced a new system of “base rate” effective from July 1, 2010, which replaced earlier BPLR system”(RBI Annual Report, 2009-10). It is expected that the base rate system will bring about greater flexibility and strengthen both the interest rate and credit channels of monetary transmission. In view of global and financial developments, “the Reserve Bank with an effort to maintain a soft interest rate regime, reduced the policy rates to their historically lowest levels. The repo rate was reduced by 25 basis points from 5.00 per cent to 4.75 per cent with effect from April 21, 2009 while the reverse repo rate was reduced from 3.50 per cent to 3.25 per cent. There were no major changes in policy rates during 2009” (www.rbi.org.in) Furthermore, the thrust of monetary policy during the year 2010-11 had been towards containing inflation. In view of that, the Reserve Bank of India withdrew from its “accommodative policy stance in April 2010 itself. “Though monetary policy was tightened throughout the year, inflation remained sticky on the back of new pressures. In a series of steps, key policy rates were raised. The RBI raised the policy rates six times during the current fiscal year wherein the repo rate under its LAF was increased by 175 basis points raising it to 6.5 per cent and the reverse repo rate was increased by 225 basis points raising it to 5.5 per cent. CRR was at 6 per cent of net demand and time liabilities of banks. Monetary transmission improved considerably in the latter half of 2010-11 after sustained

tight liquidity, and prompted banks to raise deposit and lending rate”(RBI Annual Report, 2010-11).

As per RBI Annual Report (2011-12), “The policy stance continued to be tight up to mid December 2011, but policy rates were kept at a pause mode during the remainder of the year with cuts in cash reserve ratio and open market 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.

10.9 GLOSSARY

- **Annual Percentage Rate (APR):** The cost of credit on a yearly basis, expressed as a percentage.
- **Appraisal:** The act of evaluating and setting the value of a specific piece of personal or real property.
- **Federal Reserve System:** The central bank of the United States. The Fed, as it is commonly called, regulates the U.S. monetary and financial system.
- **Interest:** The term interest is used to describe the cost of using money, a right, share, or title in property.
- **Interest Rate:** The amount paid by a borrower to a lender in exchange for the use of the lender's money for a certain period of time. Interest is paid on loans or on debt instruments, such as notes or bonds, either at regular intervals or as part of a lump sum payment when the issue matures.
- **Lender:** An individual or financial institution that lends money with the expectation that the money will be returned with interest.
- **Maturity:** The date on which the principal balance of a loan, bond, or other financial instrument becomes due and payable.
- **Mortgage:** A debt instrument used in a real estate transaction where the property is the collateral for the loan. A mortgage gives the lender a right to take possession of the property if the borrower fails to pay off the loan.
- **Terms:** The period of time and the interest rate arranged between creditor and debtor to repay a loan.

- **Variable Rate:** Any interest rate or dividend that changes on a periodic basis.

10.10 SELF ASSESSMENT 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?

10.12 SUGGESTED READINGS

- Financial Management - I M Pandey
- Monetary policy and the behavior of interest rates - Stefan Gerlach
- Research paper on banking and interest rates in monetary policy analysis: A quantitative exploration by M Goodfriend & BT McCallum in Journal of Monetary Economics, 2007.
- <https://www.sciencedirect.com>

STRUCTURE

- 11.1 Introduction**
- 11.2 Objectives**
- 11.3 Meaning of Financial Institution**
- 11.4 Financial Institutions in India**
- 11.5 Credit Rating Agencies in India**
- 11.6 Functions of Financial Institutions**
- 11.7 Role of Financial Institutions**
- 11.8 Impact of credit crisis on financial institution**
- 11.9 Summary**
- 11.10 Glossary**
- 11.11 Self Assessment Questions**
- 11.12 Lesson End Excecise**
- 11.13 Suggested Readings**

11.1 INTRODUCTION

A financial institution is responsible for the supply of money to the market through the transfer of funds from investors to the companies in the form of loans, deposits, and investments. The most common types of financial institutions include

commercial banks, investment banks, brokerage firms, insurance companies, and asset management funds. Other types include credit unions and finance firms. Financial institutions are regulated to control the supply of money in the market and protect consumers.

11.2 Objectives

After going through this lesson you should be able to

- know about financial institutions
- know about credit rating agencies in India
- Understand the rate of financial institution

11.3 MEANING OF FINANCIAL INSTITUTION

Bank ABC is a shareholder-owned institution that offers banking and investment services to a wide range of customers. The bank acts as an intermediary between retail and institutional investors, who supply the funds through deposits and retail and institutional investors, who are looking for financing. The bank pays a 2% interest on the deposits it accepts from households and businesses from the interest earned from lending services. In addition, the bank offers fund management and health and life insurance services through its subsidiaries.

Furthermore, Bank ABC operates in the wholesale market, seeking to lend large conglomerates and corporations as well as government agencies. In this context, the bank has a highly-equipped advisory team, which offers corporate finance, forex, capital markets and investment management services.

The bank is regulated for the protection of consumers. Hence, its funds undergo strict scrutiny by the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System. These two Federal agencies are responsible for 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 RATING AGENCIES 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

The two most important credit rating agencies in India are:

- CRISIL
- ICRA

Securities and Exchange Board of India:

The securities and exchange board of India, also referred to as SEBI was founded in the year 1992 in order to protect the interests of the investors and to facilitate the functioning of the market intermediaries. They supervise market conditions, register institutions and indulge in risk management.

Insurance Companies in India:

The insurance companies offer protection against losses. They deal in life insurance, marine insurance, vehicle insurance and so on. The insurance companies collect the little saving of the investors and then reinvest those savings in the market. The insurance companies are collaborating with different foreign insurance companies after the liberalization process. This step has been incorporated to expand the Indian Insurance market and make it competitive.

Specialized Financial Institutions in India:

The specialized financial institutions in India are government undertakings that were set up to provide assistance to the different sectors and thereby cause overall development of the Indian economy. The significant institutions falling under this category includes:

- Board for Industrial & Financial Reconstruction
- Export-Import Bank Of India
- Small Industries Development Bank of India
- National Housing Bank

Brokerage Firms

Brokerages act as arbitrators between buyers & sellers. They mainly assist in securities transactions. A Brokerage company is compensated via commissions after successful completion of transactions. For e.g. when the trade order for 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 and with more flexibility than individuals or corporations can, which makes this function so crucial.

4) Risk Management

Financial institutions manage risk and uncertainty for companies and families. Insurance companies and other portions of the financial sector allow large numbers of people to pool and share the risk, making it easier to handle accidents and other difficulties that occur in business or personal life. If you've ever received a check that covers repairs from a car accident or seen how your health insurance pays for a medical procedure, you've experienced this function of the financial system for yourself.

5) Informing Financial Decisions

If you've ever had to make a large scale monetary decision, you realize how important it is that financial institutions provide key information that makes such decisions easier. Rather than having to wait on a central authority to give you information about factors like interest rates, you can visit your local bank branch or call your investment advisor.

The information that financial institutions provide allows individuals and corporations to make educated and secure decisions in real-time.

6) Maintaining the Market

Financial institutions also make it possible for individuals and other entities to invest in the stock market. Investors can make long-term or short-term ventures into the market for the promise of a greater return.

Institutions like brokers and stock exchanges allow companies to issue stock to have more cash flow based on investors purchasing stock. Often, the stock market drives the pulse of the financial sector as a whole.

7) An Interdependent Financial System

These functions of American financial institutions work in tandem with each other to create a fully interdependent financial system. When each function performs healthily, the other purposes work well, and the monetary system as a whole is 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 cash as you need. Loans have helped launched multi-million dollar businesses

and this speaks to the power of credit facilities. If you are looking to secure a loan for your personal or business needs, you'd be wise to shop around so as to find the agencies with the best rates. Click [here](#) to find out more about what you need to find the best [loan company](#) for your cash advance needs.

3. Offering investment advice.

Most financial institutions have an active investment desk for advising their members on the best ways invest their cash. Investment is one of the best ways of ensuring the financial future for both individuals and businesses but without the right information, people and businesses may lose all their cash by picking un-bankable investment options. Financial institutions are aware of the best investment options for businesses and individuals and they would gladly share this information should you visit their investment desk.

11.8 Impact of credit crisis on financial institution

In an increasingly interdependent financial world, the global financial crisis has had a cascading effect on economies and finances across the nations. The crisis had an impact on Indian economy and finance in a subdued scale and magnitude, when compared to the US and other developed nations.

The crisis is widely viewed as a glaring example of the limitless pursuit of greed and overindulgence at the expense of caution, prudence due diligence and regulation. Wall Street firms broke financial rules and regulations and the people of the world were called upon to bear the burden.

In general, a huge crisis is generated by factors such as overheating of the markets, excessive leveraging of debt, credit booms, miscalculation of risks, rapid outflows of capital from a country, unsustainable macroeconomic policies, off-balance sheet operations by the banks, and so-called imaginative and innovative financial instruments, products, services and unbridled deregulation. The crisis of 2008 was no exception.

Genesis of the crisis

The crisis was an outcome of the interplay between both macroeconomic and microeconomic factors. From a macroeconomic perspective, the crisis has been

attributed to the persistence of global imbalances, an excessively accommodative monetary 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 escaped unhurt with the intervention of the regulator, that is, the Reserve Bank of India (RBI), but it is difficult to ascertain precisely the process. It is likely that a sizeable portion of today's huge Non-Performing Assets (NPA) can be traced back to the projects undertaken before 2013 when a false sense of security was being given with the impression that Indian economy and finance is immune to global shocks.

The present data on NPAs is revealing:

- § Between 2000 to 2010, the growth in NPA was minus 6.20%, while between 2010 to 2015, it was plus 365%. Between 2015 to 2018, it was plus 221%.
- § Between 2009-10 to 2017-18, the addition in NPA is Rs 18,84,507 cr.
- § In 2009, 18 banks have provided Rs 8,80,277 crore towards NPA out of profits.
- § Between 2010 to 2018, banks have written off bad debts amounting to Rs 4,23,428 crore. The current figure of NPA, Rs 8,42,291 crore, is excluding the figure of the write off.
- § Top 12 NPA accounts amount involved is Rs 2,53,729 crore, which is more than 25% of the total NPA.

This revelation of NPA largely came on surface only after Asset Quality Inspection by the RBI at the instance of the then governor of RBI, Raghuram Rajan. It is not an overnight addition in the NPA, which, till this time, were suppressed by resorting to policy prescriptions provided by the same regulator, that is, the RBI, such as Corporate Debt Restructuring, which commenced in 2001, and Strategic Debt Restructuring, which commenced in 2015. Development financial institutions like the ICICI and IDBI were converted into commercial banks. Corporates were left with no other choice than to approach commercial banks for long-term funding for infrastructure and core sector projects, consequent upon a credit crunch in the global market due to the global financial crisis. Thus, it can be fairly concluded that the present crisis in Indian banking has its roots in the global financial crisis.

This impact is not only circumscribed to NPA. Overall, Indian banking is passing 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, instead of recovering NPA so as to strengthen Indian banking. This brazen shift may prove to be disastrous.

11.9 SUMMARY

Financial institutions are regulated to control the supply of money in the market and protect consumers. 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. The bank is regulated for the protection of consumers. Hence, its funds undergo strict scrutiny by the Federal Deposit Insurance Corporation and the Federal Reserve System. 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. 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. In an increasingly interdependent financial world, the global financial crisis has had a cascading effect on economies and finances across the nations. The crisis had an impact on Indian economy and finance in a subdued scale and magnitude, when compared to the US and other developed nations.

11.10 GLOSSARY

- Financial Institution :A financial institution is an intermediary between consumers and the capital or the debt markets providing banking and investment services.

11.11 SELF ASSESSMENT QUESTIONS

1. Discuss various credit rating agencies in India

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2. Explain functions of Financial Institution

11.12 LESSON END EXERCISE

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

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-
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).

**Reserve Bank of India: Functions, Role, Organisation and Management,
Aims and Objectives of Monetary Policy of RBI**

STRUCTURE:

12.1 Introduction

12.2 Objectives

12.3 Reserve Bank of India

12.4 Objectives of RBI

12.5 Historical Development of central bank of India

12.6 Organisation and management

12.7 Difference between commercial banks and central bank

12.8 Monetary Policy

12.8.1 Monetary Function

12.8.2 Monetary terms

12.9 Techniques used by RBI

12.10 Summary

12.11 Glossary

12.12 Self Assessment Questions

12.13 Lesson End Exercise

12.14 Suggested Readings

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 Growth".



12.2 OBJECTIVES

The main objectives of this unit are to:

- Define what 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
- Explain the historical development of central bank of India

12.3 RESERVE BANK OF INDIA

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 In-

dia. It serves as the leader of the banking system and the money market. It regulates money supply and credit in the country. The RBI carries out India's monetary policy and exercises supervision and control over banks and non-banking finance companies in India. RBI was set up in 1935 under the Reserve Bank of India Act, 1934.

Until the Monetary Policy Committee was established in 2016, it also controlled monetary policy in India. It commenced its operations on 1 April 1935 in accordance with the Reserve Bank of India Act, 1934. The original share capital was divided into shares of 100 each fully paid. Following India's independence on 15 August 1947, the RBI was nationalised on 1 January 1949.

It is a member bank of the Asian Clearing Union. The general superintendence and direction of the RBI is entrusted with the 21-member central board of directors: the governor; four deputy governors; two finance ministry representatives (usually the Economic Affairs Secretary and the Financial Services Secretary); ten government-nominated directors to represent important elements of India's economy; and four directors to represent local boards headquartered at Mumbai, Kolkata, Chennai and the capital New Delhi. Each of these local boards consists of five members who represent regional interests, the interests of co-operative and indigenous banks.

The central bank is an independent apex monetary authority which regulates banks and provides important financial services like storing of foreign exchange reserves, control of inflation, monetary policy report till August 2016. A central bank is known by different names in different countries. The functions of a central bank may vary from country to country and are autonomous or body and perform or through another agency vital monetary functions in the country. A central bank is a vital financial apex institution of an economy and the key objects of central banks may differ from country to country still they perform activities and functions with the goal of maintaining economic stability and growth of an economy.

The bank is also active in promoting financial inclusion policy and is a leading member of the Alliance for Financial Inclusion (AFI). The bank is often referred to by the name 'Mint Street'. RBI is also known as banker's bank.

12.4 OBJECTIVES OF RBI

Reserve Bank of India as a central monetary authority of India, like in any other

Central Bank of any country, is empowered to guide, monitor, regulate, control and promote the past, present and future of the financial system of the country.

RBI is performing such functions since 1935 after its inception as empowered by the Reserve Bank of India Act, 1934 and Banking Regulation Act, 1949.

As a Central Bank of the country, the RBI performs a wide range of functions. Among various functions important are:

- Acts as the currency authority
- Controls money supply and credit
- Manages foreign exchange
- Serves as a banker to the government
- Builds up and strengthens the country's financial infrastructure
- Acts as the banker of commercial bank
- Supervises Banks.
- **Financial supervision**

The primary objective of RBI is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions, and non-banking finance companies.

The board is constituted by co-opting four directors from the Central Board as members for a term of two years and is chaired by the governor. The deputy governors of the reserve bank are ex-officio members. One deputy governor, usually the deputy governor in charge of banking regulation and supervision, is nominated as the vice-chairman of the board. The board is required to meet normally once every month. It considers inspection reports and other supervisory issues placed before it by the supervisory departments.

BFS through the Audit Sub-Committee also aims at upgrading the quality of the statutory 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.

- **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.

- **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 settlement time is 9 am to 4:30 pm on weekdays and 9 am to 2 pm on Saturdays.

- **Banker and debt manager to government**

Just as individuals need a bank to carry out their financial transactions effectively and efficiently, governments also need a bank to carry out their financial transactions. The RBI serves this purpose for the Government of India (GoI). As a banker to the GoI, the RBI maintains its accounts, receive payments into and make payments out of these accounts. The RBI also helps the GoI to raise money from the public via issuing bonds and government-approved securities. In Sep 2019, a decision at RBI directors meet was taken to change the RBI financial accounting year to March-April to align itself with the central government calendar instead of the current June-July year.

- **Managing foreign exchange**

The central bank manages to reach different goals of the Foreign Exchange Management Act, 1999. Their objective is to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

With the increasing integration of the Indian economy with the global economy arising from greater trade and capital flows, the foreign exchange market has evolved as a key segment of the Indian financial market and the RBI has an important role to play in regulating and managing this segment. The RBI manages forex and gold reserves of the nation.

On a given day, the foreign exchange rate reflects the demand for and supply of foreign exchange arising from trade and capital transactions. The RBI's Financial Markets Department (FMD) participates in the foreign exchange market by undertaking sales/purchases of foreign currency to ease volatility in periods of excess demand for/supply of foreign currency.

- **Issue of currency**

Other than the Government of India, the Reserve Bank of India is the sole body authorised to issue banknotes in India.

The bank also destroys banknotes when they are not fit for circulation. All the money issued by the central bank is its monetary liability, i.e., the central bank is obliged to 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.

- **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 credit. It is the duty of the RBI to control the credit through the CRR, bank rate and open market operations. As banker's bank, the RBI facilitates the clearing of cheques

between the commercial banks and helps the inter-bank transfer of funds. It can grant financial accommodation to schedule banks. It acts as the lender of the last resort by providing emergency advances to the banks.

- **Regulator of the Banking System**

RBI has the responsibility of regulating the nation's financial system. As a regulator and supervisor of the Indian banking system it ensures financial stability & public confidence in the banking system. RBI uses methods like On-site inspections, off-site surveillance, scrutiny & periodic meetings to supervise new bank licences, setting capital requirements and regulating interest rates in specific areas. RBI is currently focused on implementing norms.

- **Detection of fake currency**

To curb the counterfeit money problem in India, RBI has launched a website to raise awareness among masses about fake banknotes in the market. www.paisaboltahai.rbi.org.in provides information about identifying fake currency.

On 22 January 2014; RBI gave a press release stating that after 31 March 2014, it will completely withdraw from circulation of all banknotes issued prior to 2005. From 1 April 2014, the public will be required to approach banks for exchanging these notes. Banks will provide exchange facility for these notes until further communication. The reserve bank has also clarified that the notes issued before 2005 will continue to be legal tender. This would mean that banks are required to exchange the notes for their customers as well as for non-customers. From 1 July 2014, however, to exchange more than 15 pieces of ₹500 and ₹1000 notes, non-customers will have to furnish proof of identity and residence as well as show aadhar to the bank branch in which he/she wants to exchange the notes.

This move from the reserve bank is expected to unearth black money held in cash. As the new currency notes have added increased security features, they would help in curbing the menace of fake currency.

- **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.

12.5. HISTORICAL DEVELOPMENT OF CENTRAL BANK OF INDIA

The Reserve Bank of India was established following the Reserve Bank of India Act of 1934. Though privately owned initially, it was nationalised in 1949 and since then 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.

- **1961-1968**

As a result of bank crashes, the RBI was requested to establish and monitor a deposit insurance system. Meant to restore the trust in the national bank system, it was initialised on 7 December 1961. The Indian government founded funds to promote the economy, and used the slogan "Developing Banking". The government of India restructured the national bank market and nationalised a lot of institutes. As a result, the RBI had to play the central part in controlling and supporting this public banking sector.

- **1969-1984**

In 1969, the Indira Gandhi-headed government nationalised 14 major commercial

banks. Upon Indira Gandhi's return to power in 1980, a further six banks were nationalised. The regulation of the economy and especially the financial sector was reinforced by the Government of India in the 1970s and 1980s. The central bank became the central player and increased its policies a lot for various tasks like interests, reserve ratio and visible deposits. These measures aimed at better economic development and had a huge effect on the company policy of the institutes. The banks lend money in selected sectors, like agricultural business and small trade companies. The Banking Commission was established on Wednesday, 29 January 1969, to analyse banking costs, effects of legislations and banking procedures, including non banking financial intermediaries and indigenous banking on Government of India economy; with Mr. R.G. Saraiya as the chairman.

The branch was forced to establish two new offices in the country for every newly established office in a town. The oil crises in 1973 resulted in increasing inflation, and the RBI restricted monetary policy to reduce the effects.

- **1985-1990**

A lot of committees analysed the Indian economy between 1985 and 1991. Their results had an effect on the RBI. The Board for Industrial and Financial Reconstruction, the Indira Gandhi Institute of Development Research and the Security & Exchange Board of India investigated the national economy as a whole, and the security and exchange board proposed better methods for more effective markets and the protection of investor interests. The Indian financial market was a leading example for so-called "financial repression" (Mckinnon and Shaw). The Discount and Finance 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 estab-

lish 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.

12.6 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).

The bank is headed by the governor, currently Shaktikanta Das. There are four deputy governors

- B. P. Kanungo,
- N. S. Vishwanathan
- Mahesh Kumar Jain
- Michael Patra.

Two of the four deputy governors are traditionally from RBI ranks and are selected from the bank's executive directors. One is nominated from among the chairpersons of public sector banks and the other is an economist. An Indian Administrative Service officer can also be appointed as deputy governor of RBI and later as the governor of RBI as with the case of Y. Venugopal Reddy and Duvvuri Subbarao. Other persons forming part of the central board of directors of the RBI are Dr. Nachiket Mor, Y. C. Deveshwar, Prof Damodar Acharya, Ajay Tyagi and Anjuly Duggal.

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Reserve Bank of India is operating as a corporate body. It has its common seal and is an on-going concern with perpetual succession.

The organizational structure of RBI is through the Central Board of Directors (CBD). The Transfer of Public Ownership Act provides for the constitution of CBD and Local Board by the Central Government. The CBD has of 20 members (as on date). Besides these members, RBI has one Governor, four Deputy Governors appointed by the Central Government. Their tenure in office is 5 years for Governor and 4 years for Deputy Governors. Also in the organizational structure are Executive Directors.

Presently Mr. Shaktikant Das is the 25rd Governor of Reserve Bank of India, who took over the charge from Dr. Urjit Patel. To start with the first person appointed as the Governor of RBI was Sir Osborne Smith.

The RBI Act provides that CBD conducts one meeting every quarter and at least 6 meetings in a year.

RBI at present has 22 Regional Offices located mostly in the State Capitals / UTs. The jurisdiction of RBI as per the RBI Act of 1934 extends to all the States and Union Territories.

The Local Boards have been formed in four major centers of the country, viz. Mumbai, Kolkata, New Delhi and Chennai.

12.7 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	Financial Profit

	banks and the government of the country.	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

12.8 1.5 Monetary Policy:

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
- Interest Rates management on loans and advances by banks
- Bank Rate Mechanism
- Maintaining proper SLR (Statutory Liquidity Ratio)
- CRR (Cash Reserve Ratio)
- Credit Rationing through Selective Credit Control (now withdrawn)
- Moral Suasion.

12.8.1 Monetary Functions:

Reserve Bank of India performs various functions to manage the monetary system of the country. These functions include:

1. Reserve Bank of India under the RBI Act, Section 22 is solely responsible for the issuance of currency notes excluding rupee one note which issued by Fi-

nance Secretary of the Government of India. RBI regulates the issuance of the notes in India mainly to bring confidence among people of genuineness, quality and credibility of money issued besides bringing in uniformity in issuance of notes. Due to single authority there is effective control on flow of credit in and out of the market.

2. RBI acts as banker to commercial banks.
3. RBI conducts banking and financial operations of the Government of India and advises on various financial and economic issues.

While handling the Government business, RBI maintains government accounts, advises on monetary matters including financial aspects, besides carrying out Government business as and when required.

4. It provides financial accommodation to cooperative banking sector for financing special sectors of the economy like agriculture etc.
5. Bank performs the function of controller of exchange value of rupee vs. US dollar.
6. As a guide and controller of banking and financial sector, RBI appoints CEOs of 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.
16. It regulates the credit flow in the market by using credit control instruments like bank rate, open market operations and power to vary reserve ratios like cash reserve ratio (CRR) and statutory liquidity ratio (SLR). These two ratios are most important tools for maintaining liquidity in the financial system, particularly banking system.
17. Bank Rate, CRR and SLR are some of the quantitative steps that RBI can take from time to time to control flow of money and to control inflation.

12.8.2 Monetary Terms:

1. Statutory Liquidity Ratio (SLR)

- Reserve Bank of India exercises direct control over the liquidity of the banking system. RBI is the only authority to effect changes in the liquidity position of banks based on demand and time liabilities.

- As per Section 5 (f) of the Banking Regulation Act, 1949 'demand liabilities' means those liabilities that are to be met on demand.
- Banks are also required to maintain a portion of their deposit liabilities in the form of liquid assets i.e. bonds etc. This is called Statutory Liquidity Ratio. As on 17.02.2020 the SLR fixed by RBI is 19 per cent.
- Liquid assets to be maintained are in the form of cash, gold and unencumbered approved securities as per section 24 of the Banking Regulation Act, 1949.
- As and when RBI increases the SLR, reduces the funds supply in the market, thus reducing the lendable resources with commercial banks. Vice versa when SLR is reduced it will increase the funds with banks for onward lending.

2. Cash Reserve Ratio (CRR)

- Banks are required to deposit with reserve bank of India an amount equal to the percentage of deposits with respective bank in the ratio prescribed by RBI from time to time. This is called Cash Reserve Ratio (CRR).
- This is mainly done to provide stability to the economy. In simple words CRR is the proportion of funds banks have to deposit with the Reserve Bank of 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 Reverse Repo Rate fixed by RBI is 6.25 per cent.

12.9 TECHNIQUES USED BY RBI

Techniques Used by RBI to Manage and Control Monetary System:

1. Open market Operations : Open market operations refer to the sale and purchase of securities by the Central bank to the commercial banks. A sale of securities by the Central Bank, i.e., the purchase of securities by the commercial banks, results in a fall in the total cash reserves of the latter. 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 flow ing 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.

2. Bank Rate Mechanism : The bank rate, also known as the discount rate, is the rate payable by commercial banks on the loans from or rediscounts of the Central Bank. A change in bank rate affects other market rates of interest. An increase in bank rate leads to an increase in other rates of interest and conversely, a decrease in bank rate results in a fall in other rates of interest.

A deliberate manipulation of the bank rate by the Central Bank to influence the flow of credit created by the commercial banks is known as bank rate policy. It does so by affecting the demand for credit the cost of the credit and the availability of the credit. An increase in bank rate results in an increase in the cost of credit; this is expected to lead to a contraction in demand for credit. In as much as bank credit is an important component of aggregate money supply in the economy, a contraction in demand for credit consequent on an increase in the 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.

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 makes direct appeal to the public and publishes data which will have sobering effect on other banks and the commercial circles.

6. **Liquidity Adjustment Facility**

The Liquidity Adjustment Facility (LAF) is an indirect instrument for monetary control. It controls the flow of money through repo rates and reverse repo rates. The repo rate is actually the rate at which commercial banks and other institutes obtain short-term loans from the Central Bank.

And the reverse repo rate is the rate at which the RBI parks its funds with the commercial banks for short time periods. So the RBI constantly changes these rates to control the flow of money in the market according to the economic situations.

7. **Interest Rate (Repo rate and reverse repo rate) control** : When you borrow money from the bank, the transaction attracts interest on the principal amount. This is referred to as the cost of credit. Similarly, banks also borrow money from RBI during a cash crunch on which they are required to pay inter-

est to the Central Bank. This interest rate is called the repo rate. Technically, repo stands for 'Repurchasing Option' or 'Repurchase Agreement'. It is an agreement in which banks provide eligible securities such as Treasury Bills to the RBI while availing overnight loans. An agreement to repurchase them at a predetermined price will also be in place. Thus, the bank gets the cash and the central bank the security.

Reverse Repo Rate is a mechanism to absorb the liquidity in the market, thus restricting the borrowing power of investors. Reverse Repo Rate is when the RBI borrows money from banks when there is excess liquidity in the market. The banks benefit out of it by receiving interest for their holdings with the central bank. During high levels of inflation in the economy, the RBI increases the reverse repo. It encourages the banks to park more funds with the RBI to earn higher returns on excess funds. Banks are left with lesser funds to extend loans and borrowings to consumers.

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.

12.10 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:

1. Reduce paper-based clearing as a percentage of retail payments: it is expected that the volume of cheque-based payments would be less than 2% of retail electronic transactions by 2021.
2. Accelerated growth in individual retail electronic payment systems: UPI is expected to grow, on an average annualised basis, over 100%, and NEFT at 40%, till December 2021. The number of digital transactions is expected to be 8,707 crore in December 2021.
3. Digital payment transaction turnover vis-à-vis GDP (at market prices-current price) is expected to increase to 10.37 in 2019, 12.29 in 2020 and 14.80 in 2021.
4. Debit card transactions at Point of Sale to increase to 35%, and "continued growth in PPI transactions".
5. Debit card usage at PoS to be at least 44% of total debit card transactions (at PoS + ATM). In value terms it is 15.2 per cent in 2018-19 (5.2 per cent in 2014-15) which is expected to be 22% by end 2021.
6. Card payments/acceptance: Increased deployment of card acceptance infrastructure across the country including at smaller centres with a substantial portion of the infrastructure taking care of processing contactless card payments. It is expected to have 5 million active PoS by end 2021. The total card acceptance infrastructure will be upscaled to six times present levels by end 2021.
7. Reduction in cash in circulation as a percentage of GDP is a goal, but no specific target is being considered by the RBI
8. 50% increase in mobile based payment transactions is expected
9. Reduction in pricing of electronic payment systems by at least 100 basis points,

and a shift from transaction-value-percentage rate to per transaction rate, irrespective of the value of a transaction.

- 10 . Decrease in Technical Declines reported across various payment systems by 10% year-on-year.
- 11 Reduction in Business Declines reported across various payment systems by 5% year-on-year.
- 12 Improvement in Turn Around Time (TAT) for resolution of customer complaints by Payments System Operators.
13. Fraud to Sales (Fraud value / Sales value) x 10000] count for payment systems 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.

12.11 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.
- **FCTR or Foreign currency translation reserve:** In terms of Accounting Standard (AS) 11 FCTR or foreign currency translation reserve arises due to the translation of financial statements of bank's foreign operations. FCTR is reckoned at a discount of 25% for the purpose of determining bank's regulatory capital.
- **Deferred tax assets (DTAs):** The DTAs are associated with accumulated losses and other such assets. Such losses should be deducted in full from CET1 capital.
- **Deferred Tax Liability (DTL)** can be defined as Provision for Future Taxation or an obligation to pay taxes in the future.
- Hybrid securities, often referred to as "hybrids," generally combine both debt and equity characteristics. The instruments in this category fall a number of capital instruments, which combine certain characteristics of equity and certain characteristics of debt.
- Mortgage-backed security (MBS) is a bond type security in which the collateral is provided by a pool of mortgages.

12.12 SELFASSESSMENT QUESTIONS

1. How does the Reserve Bank estimate the demand for banknotes?

2. What is the role of Reserve Bank of India in currency management?

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?

-
-
5. How many Deputy Governors are in the Reserve Bank of India and Name them?
-
-
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12.14 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).

Effectiveness of monetary policy; Credit creation and its Control

STRUCTURE

13.1 Introduction

13.2 Credit Creation

13.2.1 Multiple Credit Creation by the Banking System

13.2.2 Limitations of Credit Creation

13.3 Control Credit Creation

13.3.1 Effectiveness of Credit Control Measures

13.4 Summary

13.5 Glossary

13.6 Self Assessment questions

13.7 Lesson end Exercise

13.8 Suggested End reading

13.1 INTRODUCTION

The effectiveness of monetary policy in influencing income (national) and interest rate.

Quantity theory of money as suggested by the classical authors states that money supply is directly proportional to the level of aggregate demand (assuming velocity of money is constant).

This means that money supply does not affect the demand for money as a fraction of total spending remains stable.

But, this classical notion is not convincing monetary expansion indeed affects demand for money. Once monetary policy is employed interest rates are then influenced. A tight monetary policy means a rise in the interest rate while expansive monetary policy pushes interest rate down. Demand for money is then affected by the interest rate. Or demand for money (both transaction and speculative) is responsive to changes in the rate of interest.

We will now discuss the relation between money supply growth and demand 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 situation of simultaneous equilibrium of both product 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.

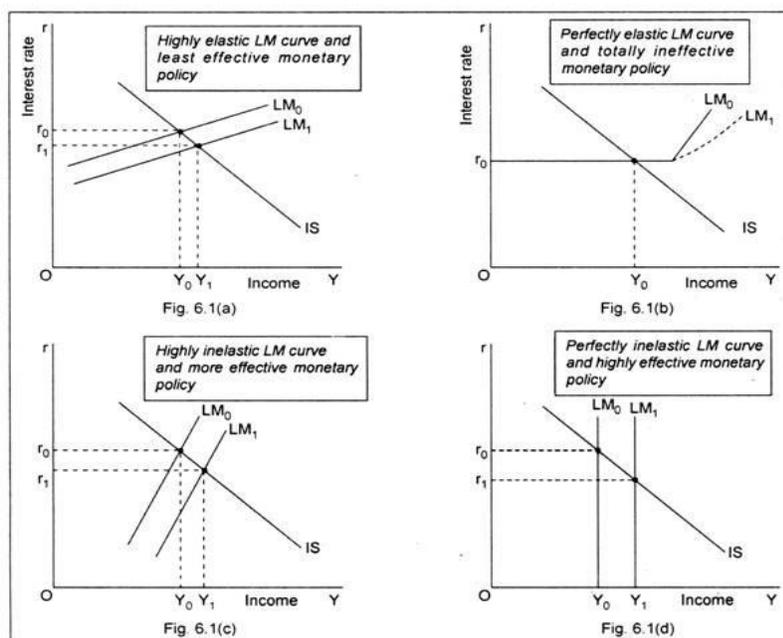


Fig. 6.1: Effectiveness of Monetary Policy

If these elasticities are taken into account, 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 interest 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 interest 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 income, too, rises insignificantly from OY_0 to OY_1 . The fact is that monetary policy is least effective. The reason is: 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 amount making multiplier principle near-inoperative. That is why—national income rises by a very small amount.

Since money demand is highly elastic people hold liquid money for speculative purposes, invest less in securities and economise less on transaction purposes. All these suggest that monetary policy is least effective.

An extreme situation of perfectly elastic money demand has been considered in Fig. 6.1(b) that makes the LM curve perfectly elastic. This is called the Keynesian

range of LM curve or the liquidity trap region. In this region, an increase in money supply does not produce any effect either on interest rate or on income level. This is because at this floor rate of interest, security-holders exchange all their securities for liquid cash and, thus, all liquid cash gets trapped in this region. Any increase in money supply from LM_0 to LM_1 won't make any impact on interest and income. This means that monetary policy is totally ineffective.

In Fig. 6.1(c) since interest elasticity of money demand is lower, an increase in money supply from LM_0 to LM_1 will result in a larger drop in interest rate as compared to Fig. 6.10 (a). As a consequence, multiplier effect will be stronger causing income level to rise by a greater amount.

Here the fall in speculative interest rate does not have much influence on money demand since in this case money demand depends on interest rate very little. An increase in money supply causes transaction balances to go up and speculative balances to go down as interest rate falls. This means monetary policy is highly effective.

An extreme situation of perfectly inelastic money demand may be explained in terms of Fig. 6.1(d). In contrast to the result of Fig. 6.1(b), an increase in money supply now causes a greater fall in interest rate and consequently a larger increase in income. This region is called the classical region. In this region, since interest rate is pretty high, money is demanded for transaction purposes only while speculative balances are nil.

Since no-body holds idle cash, an increase in money supply means fall in interest rate and a rise in income by a very bigger amount. This means monetary policy is highly or most effective in this range of LM curve.

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:

o **Primary Deposits** – A bank accepts cash from the customer and opens a deposit in his name. This is a primary deposit. This does not mean credit creation. These deposits simply convert currency money into deposit money. However, these deposits form the basis for the creation of credit.

o **Secondary or Derivative Deposits** – A bank grants loans and advances and instead of giving cash to the borrower, opens a deposit [account](#) in his name. This is the secondary or derivative deposit. Every loan creates a deposit. The creation of a derivative deposit means the creation of credit.

· **Cash Reserve Ratio (CRR)** – Banks know that all depositors will not withdraw all deposits at the same time. Therefore, they keep a fraction of the total deposits for meeting the cash demand of the depositors and lend the remaining excess deposits. CRR is the [percentage](#) of total deposits which the banks must hold in cash reserves for meeting the depositors’ demand for cash.

· **Excess Reserves** – The reserves over and above the cash reserves are the excess reserves. These reserves are used for loans and credit creation.

· **Credit Multiplier** – Given a certain amount of cash, a bank can create multiple times credit. In the process of multiple credit creation, the total amount of derivative deposits that a bank creates is a multiple of the initial cash reserves.

Credit creation by a single bank

There are two ways of analyzing the credit creation process:

- a. Credit creation by a single bank
- b. Credit creation by the banking system as a whole

In a single bank system, one bank operates all the cash deposits and cheques. The process of creating credit is explained with the hypothetical example below:

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
–	--	--	–
–	---	--	–
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 transfer of cash within the banking system creates primary deposits and increases the possibility for further creation of derivative deposits. Here is an illustration to explain this process better:

As explained above, the initial deposit of Rs. 1,000 with bank A leads to a creation of total deposits of Rs. 5,000.

Limitations of Credit Creation

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

While banks would prefer an unlimited capacity for creating credit to increase profits, there are many limitations. These limitations make the process of creating credit non-profitable. Therefore, a bank continues to create additional credit as long as:

- There is a negligible chance of the loans turning into bad debts
- The interest rate that banks charge on loans and advances is greater than the interest that the bank gives to depositors for the money deposited in the bank.

Hence, we can say that the limitations of credit creation operate through shifts in the balance between liquidity and profitability. The factors that affect the creation of credit are:

- The capacity of banks to create credit.
- The willingness of the banks to create credit
- Also, the demand for credit in the market.

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

Control Credit Creation

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:

(i) Bank Rate:

The bank rate, also known as the discount rate, is the rate payable by commercial banks on the loans from or rediscounts of the Central Bank. A change in bank rate affects other market rates of interest. An increase in bank rate leads to an increase in other rates of interest and conversely, a decrease in bank rate results in a fall in other rates of interest.

A deliberate manipulation of the bank rate by the Central Bank to influence the flow of credit created by the commercial banks is known as bank rate policy. It does so by affecting the demand for credit the cost of the credit and the availability of the credit.

An increase in bank rate results in an increase in the cost of credit; this is expected to lead to a contraction in demand for credit. In as much as bank credit is an important component of aggregate money supply in the economy, a contraction in demand for credit consequent on an increase in the 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.

(ii) Open Market Operations:

Open market operations refer to the sale and purchase of securities by the Central bank to the commercial banks. A sale of securities by the Central Bank, i.e., the purchase of securities by the commercial banks, results in a fall in the total cash reserves of the latter.

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 Statutory Liquidity Ratio (SLR) and the Cash Reserve Ratio (CRR).

The statutory liquidity ratio refers to that proportion of aggregate deposits which the commercial banks are required to keep with themselves in a liquid form. The commercial banks generally make use of this money to purchase the government securities. Thus, the statutory liquidity ratio, on the one hand is used to siphon off the excess liquidity of the banking system, and on the other it is used to mobilise revenue for the government.

The Reserve Bank of India is empowered to raise this ratio up to 40 per cent of aggregate deposits of commercial banks. Presently, this ratio stands at 25 per cent.

The cash reserve ratio refers to that proportion of the aggregate deposits which the commercial banks are required to keep with the Reserve Bank of India. Presently, this ratio stands at 9 percent.

II. Qualitative Method:

The qualitative or selective methods of credit control are adopted by the Central Bank in its pursuit of economic stabilisation and as part of credit management.

(i) Margin Requirements:

Changes in margin requirements are designed to influence the flow of credit against specific commodities. The commercial banks generally advance loans to their customers against some security or securities offered by the borrower and acceptable to banks.

More generally, the commercial banks do not lend up to the full amount of the security but lend an amount less than its value. The margin requirements against specific securities are determined by the Central Bank. A change in margin requirements will influence the flow of credit.

A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security.

(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 developing economies, on the contrary, economic conditions are such as to limit the effectiveness of the credit control measures.

13.4 SUMMARY

The effectiveness monetary policy in influencing income (national) and interest rate. Quantity theory of money as suggested by the classical authors states that money supply is directly proportional to the level of aggregate demand (assuming velocity of money is constant). This means that money supply does not affect the demand for money demand as a fraction of

total spending remains stable. But, this classical notion is not convincing monetary expansion indeed affects demand for money. Once monetary policy is employed interest rates are then influenced. A tight monetary policy means a rise in the interest rate while expansive monetary policy pushes interest rate down.

13.5 GLOSSARY

Credit Creation: 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. State and explain the various quantitative and qualitative methods of credit control generally adopted by central banks.

13.6 SELF ASSESSMENT QUESTIONS

1. State and explain the various quantitative and qualitative methods of credit control generally adopted by central banks.

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

13.7 LESSON END EXERCISE

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.
- * Mithani, D. M. (1998), "Money, Banking, International Trade and Public Finance", 11th Edition, Himalaya Publishing House, Mumbai.

PROFITABILITY AND EFFICIENCY OF BANKS

STRUCTURE

- 14.1 Introduction**
- 14.2 Objective**
- 14.3 Profitability in Banking Sector**
- 14.4 Efficiency of the Banking**
- 14.5 Summary**
- 14.6 Glossary**
- 14.7 Self Assessment Questions**
- 14.8 Lesson End Exercise**
- 14.9 Suggested Readings**

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 create a relatively high volume of income-generating assets and liabilities the same as the one that can create a relatively high level of income from service and intermediation operations with the given level of inputs.

14.5 SUMMARY

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. 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.

14.6 GLOSSARY

Profitability: Profitability are income and expenditure which significantly shown in financial statements during annual period.

Efficiency: 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.

14.7 SELF ASSESSMENT QUESTIONS

1. What is bank? What are the functions of a modern bank?

2. Discuss the role of commercial banking in the economic development of a country.

14.8 LESSON END EXERCISE

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.
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COMMERCIAL BANKS AND REGIONAL RURAL BANKS

**Commercial Banks: Nature, Types, Functions, Banking Innovation;
Regional Rural Banks: Functions and Purpose**

STRUCTURE

15.1 Introduction

15.2 Objectives

15.3 Nature of Commercial Bank

15.4 Objectives of commercial banks

15.5 Functions of commercial banks

15.5.1 Creation by Commercial Banks

15.5.2 Process of credit creation

15.6 Types of commercial banks

15.7 Challenges in commercial banking

15.8 Banking Innovation

15.9 Regional Rural Banks of India

15.10 Function and Purpose of Regional Rural Banks

15.11 Features of Regional Rural Banks

15.12 List of Regional Rural Banks

- 15.13 Progress of Regional Rural Banks in India**
- 15.14 Functional Superiority of Regional Rural Banks**
- 15.15 Summary**
- 15.16 Glossary**
- 15.17 Self Assessment Questions**
- 15.18 Lesson End Exercise**
- 15.19 Suggested Readings**

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, are 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
- Small entrepreneurs
- Small and marginal farmers
- Mobilize deposits from rural households

Role for RRB: -

RRB has following major role in implementation of central and state government sponsored various programme of poverty alleviation as-

- Swarnajayanti Gram Swarozgar Yojana(SGSRY)
- Prime minister Rozgar guarantee Yojana
- Antyabasai
- Old Age pension
- Midday Meal
- Indira Awas Yojana
- Payment to Aganbadi
- Scholarship to Students
- Labor payment for NAREGA laborers

NABARD is the main regulatory authority of all Regional rural Banks in India.

The structure of RRBs: - RRB's has mainly three shareholders namely-

- i. Government of India - 50% share
- ii. Sponsor Bank - 35% share
- iii. State Government - 15% share

Organizational structure varies from banks to banks, depending upon the nature and size of business done by the Branch. RRB's office has three to seven departments.

Following is the decision making hierarchy of officials in RRB's.

- i. Board of Directors
- 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 NATURE OF 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 is one of the characteristics of creating a medium of exchange through Checks, Hundi, Pay Orders, Traveler Checks, and Certificates etc. As a result, the customers of the bank do not have the risk of carrying cash. This is the biggest opportunity for the customers of the commercial bank. So the creation of the medium of exchange characteristic is more popular.
- The bank helps in building the necessary capital for the country by collecting human money and scattered savings from different areas of the country and which was later invested in profitable and developing sectors. So the collection of saving and formation of capital is another best characteristic of the commercial bank.
- It is a special feature of commercial banks. The depositor may seek the refund of his deposit at any time. With the request of the bank, the bank will always keep the liquidity necessary for the bank to meet the depositor's demand. They keep a part of the deposit money from depositor as liquidity, and the rest is invested in different sectors. All these activities are called maintain liquidity characteristic of the commercial bank.
- Invest is the king of making money more. Commercial banks save apart from savings collected as liquidity and the remaining money is invested in a

lucrative sector and short-term lending. From the reserved liquidity, the bank fulfills the daily claims of the depositors. Thus, the commercial banks are benefited through investment and lending. And according to the management for investment and sanction of loan, the commercial bank has been benefited.

➤ As banks are formed with the permission of the central bank, it has to compulsorily maintain good relations with the central bank for its own sake. For this reason, under special circumstances, it usually operates as a bank-listed bank. And a good relationship with the central bank is the key to growth popularity easily. As a result, the relationship with the central bank features is the most popular characteristics of the commercial bank.

15.4 OBJECTIVES OF COMMERCIAL BANKS

Commercial banks play such an important role in the economic development of a country that modern industrial economy cannot exist without them. They 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.

15.5 FUNCTIONS 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.

Deposits are of three types as under:

a) Current account deposits:

Such deposits are payable on demand and are, therefore, called demand deposits. These can be withdrawn by the depositors any number of times depending upon the balance in the account. The bank does not pay any Interest on these deposits but provides cheque facilities. These accounts are generally maintained by businessmen and Industrialists who receive and make business payments of large amounts through cheques.

b) Fixed deposits (Time deposits):

Fixed deposits have a fixed period of maturity and are referred to as time deposits. These are deposits for a fixed term, i.e., period of time ranging from a few days to a few years. These are neither payable on demand nor they enjoy cheque facilities.

They can be withdrawn only after the maturity of the specified fixed period. They carry higher rate of interest. They are not treated as a part of money supply

Recurring deposit in which a regular deposit of an agreed sum is made is also a variant of fixed deposits.

c) Savings account deposits:

These are deposits whose main objective is to save. Savings account is most suitable for individual households. They combine the features of both current account and fixed deposits. They are payable on demand and also withdrawable by cheque. But bank gives this facility with some restrictions, e.g., a bank may allow four or five cheques in a month. Interest paid on savings account deposits is lesser than that of fixed deposit.

There are two traditional forms of deposits:

(i) Deposits which can be withdrawn on demand by depositors are called demand deposits, e.g., current account deposits are called **demand deposits** because they are payable on demand but saving account deposits do not qualify because of certain conditions on withdrawal. No interest is paid on them. Term deposits, 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.

(B) Secondary Functions:

Apart from the above-mentioned two primary (major) functions, commercial banks perform the following secondary functions also:

3. Discounting bills of exchange or bundles:

A bill of exchange represents a promise to pay a fixed amount of money at a specific point of time in future. It can also be encashed earlier through discounting process of a commercial bank. Alternatively, a bill of exchange is a document acknowledging an amount of money owed in consideration of goods received. It is a paper asset signed by the debtor and the creditor for a fixed amount payable on a fixed date. It works like this.

Suppose, A buys goods from B, he may not pay B immediately but instead give B a bill of exchange stating the amount of money owed and the time when A will settle the debt. Suppose, B wants the money immediately, he will present the bill of exchange (Hundi) to the bank for discounting. The bank will deduct the

commission and pay to B the present value of the bill. When the bill matures after specified period, the bank will get payment from A.

4. Overdraft facility:

An overdraft is an advance given by allowing a customer keeping current account to overdraw his current account up to an agreed limit. It is a facility to a depositor for overdrawing the amount than the balance amount in his account.

In other words, depositors of current account make arrangement with the banks that in case a cheque has been drawn by them which are not covered by the deposit, then the bank should grant overdraft and honour the cheque. The security for overdraft is generally financial assets like shares, debentures, life insurance policies of the account holder, etc.

Difference between Overdraft facility and Loan:

(i) Overdraft is made without security in current account but loans are given against security.

(ii) In the case of loan, the borrower has to pay interest on full amount sanctioned 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:

The banks provide many general utility services, some of which are as under:

- (i) Traveller's cheques .The banks issue traveler's cheques and gift cheques.
- (ii) Locker facility. The customers can keep their ornaments and important documents in lockers for safe custody.
- (iii) Underwriting securities issued by government, public or private bodies.
- (iv) Purchase and sale of foreign exchange (currency).

15.5.1 Credit (Money) Creation by Commercial Banks (A10; D10, 10C, 11, 11C):

RBI produces money while commercial banks increase the supply of money by creating credit which is also treated as money creation. Commercial banks create credit in the form of secondary deposits.

Total deposits of a bank is of two types:

(i) Primary deposits (initial cash deposits by the public) and (ii) Secondary deposits (deposits that arise due to loans given by the banks which are assumed to be redeposited in the bank.) Money creation by commercial banks is determined by two factors namely (i) Primary deposits i.e. initial cash deposits and (ii) Legal Reserve Ratio (LRR), i.e., minimum ratio of deposits which is legally compulsory for the commercial banks to keep as cash in liquid form. Broadly when a bank receives cash deposits from the public, it keeps a fraction of deposits as cash reserve (LRR) and uses the remaining amount for giving loans. In the process of lending money, banks are able to create credit through secondary deposits many times more than initial deposits (primary deposits).

15.5.2-Process of (credit)-creation:

Suppose a man, say X, deposits Rs 2,000 with a bank and the LRR is 10%, which means the bank keeps only the minimum required Rs 200 as cash reserve (LRR). The bank can use the remaining amount Rs 1800 (= 2000 – 200) for giving loan to someone. (Mind, loan is never given in cash but it is redeposited in the bank as demand deposit in favour of borrower.) The bank lends Rs 1800 to, 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 $1/\text{LRR}$.

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., $10/100$ or 0.1, then money multiplier = $1/0.1 = 10$.

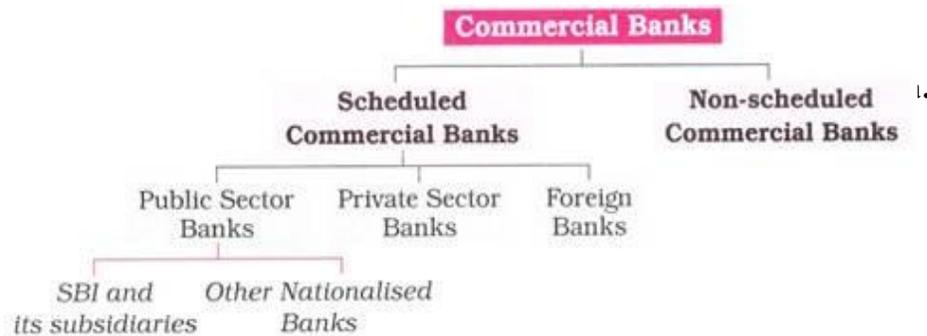
Smaller the LRR, larger would be the size of money multiplier credited to his account. He is simply given the cheque book to draw cheques when he needs money. Again, 20% of Sohan's deposit which is considered a safe limit is kept for him by the bank and the balance Rs640 (= 80% of 800) is advanced to,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

The bank is able to lend money and charge interest without parting with cash because the bank loan simply creates a deposit (or credit) for the borrower. If the bank succeeds in creating credit of, say, Rs 15,000, it means that the bank has created credit 15 times of the primary deposit of Rs 1,000. This is what is meant by credit creation.

Similarly, the bank creates credit when it buys securities and pays the seller with its own cheque. The cheque is deposited in some bank and a deposit (credit) is created for the seller of securities. This is also called credit creation. As a result of credit creation, money supply in the economy becomes higher. It is because of this credit creation power of commercial banks (or banking system) that they are called factories of credit or manufacturer of money.

15.6

The



Scheduled Banks:

Commercial banks are classified in two broad categories—scheduled banks and non-scheduled banks.

Scheduled banks are those banks which are included in Second Schedule of Reserve Bank of India. A scheduled bank must have a paid-up capital and reserves of at least Rs 5 lakh. RBI provides special facilities including credit to scheduled banks. Some of important scheduled banks are State Bank of India 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.

15.7 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-term success.” Improving the legacy architecture that powers commercial payments means looking beyond the customer experience. Maintaining and constantly bolting middle-ware onto legacy architecture is costly and time consuming for IT staff. Some estimates say banks spend as much as 75% of their IT budget on maintaining legacy systems. Without the added internal costs and time spent making updates to dated tech, banks could shift their focus to becoming more flexible to adapt to future needs.

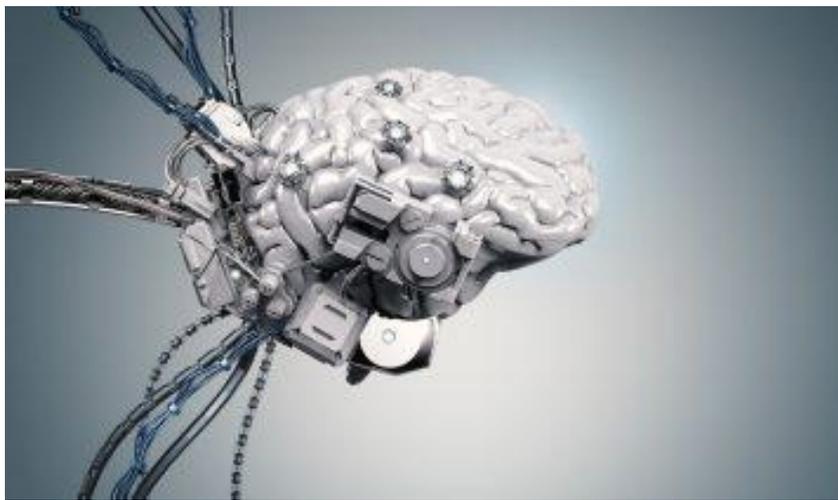
15.8 BANKING INNOVATION

- 1. Biometrics and security:** When adopting new payment methodologies, banks must strike a balance between ease-of-use, ease-of-access, and security. We’ve already seen that consumer payment methods using

biometric authentication becoming mainstream and it won't be long before corporate clients expect the same.

Extending this functionality into corporate cards has the potential to make commercial payments more seamless and secure. Mobile wallets that defer to personal attributes to make secure payments on cards offer a potential route forward.

2. Artificial Intelligence



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 way², 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.

Fintechs have dominated the API landscape by creating apps that have challenged and often surpassed solutions made by the banking industry.

To keep pace, banks now need to either invest heavily to develop this technology themselves or partner with fintechs in a bid to be more effective and efficient.³ By working together and taking advantage of APIs, banks and fintech firms can enhance the customer experience much more than either entity could do on its own.

4. e_Payables – Crossing over from the Consumer to the Commercial World

The use of different payment types is partly a response to the consumerisation of our financial experience. Corporate clients can't understand why payments should still be a laborious process of raising invoices and purchase orders, requesting printed cheques or bank transfers and creating lengthy payment terms.

Instead, the immediacy of a card – real, virtual or embedded in an app – ties all the above elements together. It gives unsurpassed traceability and is easy to add to financial management software.

Historically, paying by using a card has been seen as a debt generator. However, using payment cards as a substitute for invoice terms makes them a useful tool both to enhance a company's working capital positions and to improve traceability; security and the level of control that can be placed on business spend.

5. Expense Management Systems (EMS)

An Expense Management Systems (EMS) is just one of many tools that can be brought together into a single financial view, helping businesses gain greater control over expenditure. Unlike written expense policies and separate transactional management software, an EMS embeds expense policies into the technology, allowing real-time reconciliation and approvals to take place.

15.9 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.

The regional rural banks are maintaining its special charter if their of operation is very much limited to a definite region, grant direct loan to rural people at concessional rates and receive subsidies and concessions from the Reserve Bank and the sponsoring bank.

15.10 FUNCTION AND PURPOSE OF REGIONAL RURAL BANKS

The RRBs Act has made various provisions regarding the incorporation, regulation and working of RRBs. According to this Act, the RRBs are to be set-up mainly

with a view to develop rural economy by providing credit facilities for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas.

Such facility is provided particularly to the small and marginal farmers, agricultural labourers, artisans, and small entrepreneurs and for other related matters.

The objectives of RRBs can be summarized as follows:

- (i) To provide cheap and liberal credit facilities to small and marginal farmers, agri-culture labourers, artisans, small entrepreneurs and other weaker sections.
- (ii) To save the rural poor from the moneylenders.
- (iii) To act as a catalyst element and thereby accelerate the economic growth in the particular region.
- (iv) To cultivate the banking habits among the rural people and mobilize savings for the economic development of rural areas.
- (v) To increase employment opportunities by encouraging trade and commerce in rural areas.
- (vi) To encourage entrepreneurship in rural areas.
- (vii) To cater to the needs of the backward areas which are not covered by the other efforts of the Government?
- (viii) To develop underdeveloped regions and thereby strive to remove economic disparity between regions.

15.11 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 entrepreneurs 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 sponsoring 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-dues) grow too much and establish an adequate liaison system with various development and marketing agencies at the local level.

Special Features of Regional Rural Banks:

- ❖ The area of operation of each rural bank has been limited to a specified region comprising one or more districts in any anything
- ❖ The lending rates of these banks cannot be higher than the prevailing lending rates of co-operative credit societies in any particular state; and
- ❖ The salary structure of the employees of these banks has been fixed in consonance with the salary structure of the employees of the state government and local authorities of comparable level and status in the bank's area of operation.
- ❖ The area of operation of a rural bank is limited to a specified region which comprises of one or more districts.
- ❖ These banks cannot have a lending rate which is higher than the prevailing lending rate of cooperative credit societies in any particular state.
- ❖ The salary structure of the employees of these banks is fixed in consonance with the salary structure of the employees of the state government, local authorities of comparable level and status in the area.
- ❖ They are public sector banks. The paid-up capital of each bank is Rs. 25 lakhs. 50 percent of the capital is contributed by the Central Government. The concerned state government contributes 15 percent. 35 percent is contributed by the sponsoring public-sector commercial banks.
- ❖ Providing banking facilities to rural and semi-urban areas.
- ❖ Carrying out government operations like disbursement of wages of [MGNREGA](#) workers, distribution of pensions etc.
- ❖ Providing Para-Banking facilities like locker facilities, debit and credit cards, mobile banking, internet banking, UPI etc.

15.12 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

12	Chaitanya Godavari Grameena Bank	Andhra Bank	Andhra Pradesh
13	Chhattisgarh Rajya Gramin Bank	State Bank of India	Chhattisgarh
14	Dena Gujarat Gramin Bank	Dena Bank	Gujarat
15	Ellaqui Dehati Bank	State Bank of India	Jammu & Kashmir
16	Gramin Bank of Aayavart	Bank of India	Uttar Pradesh
17	Himachal Pradesh Gramin Bank	Punjab National Bank	Himachal Pradesh
18	J&K Grameen Bank	J&K Bank Ltd.	Jammu & Kashmir
19	Jharkhand Gramin Bank	Bank of India	Jharkhand
20	Karnataka Vikas Grameena Bank	Syndicate Bank	Karnataka
21	Kashi Gomti Samyut Gramin Bank	Union Bank of India	Uttar Pradesh
22	Kaveri Grameena Bank	State Bank of India	Karnataka
23	Kerala Gramin Bank	Canara Bank	Kerala
24	Langpi Dehangi Rural Bank	State Bank of India	Assam
25	Madhyanchal Gramin Bank	State Bank of India	Madhya Pradesh
26	Madhya Bihar Gramin Bank	7 Punjab National Bank	Bihar
27	Maharashtra Gramin Bank	Bank of Maharashtra	Maharashtra

25	Madhyanchal Gramin Bank	State Bank of India	Madhya Pradesh
26	Madhya Bihar Gramin Bank	Punjab National Bank	Bihar
27	Maharashtra Gramin Bank	Bank of Maharashtra	Maharashtra
28	Malwa Gramin Bank	State Bank of India	Punjab
29	Manipur Rural Bank	United Bank of India	Manipur
30	Meghalaya Rural Bank	State Bank of India	Meghalaya
31	Mizoram Rural Bank	State Bank of India	Mizoram
32	Nagaland Rural Bank	State Bank of India	Nagaland
33	Narmada Jhabua Gramin Bank	Bank of India	Madhya Pradesh
34	Odisha Gramya Bank	Indian Overseas Bank	Odisha
35	Pallavan Grama Bank	Indian Bank	Tamil Nadu
36	Pandyan Grama Bank	Indian Overseas Bank	Tamil Nadu
37	PaschimBanga Gramin Bank	UCO Bank	West Bengal

38	Pragathi Krishna Gramin Bank	Canara Bank	Karnataka
39	Prathama Bank	Syndicate Bank	Uttar Pradesh
40	Puduvai Bharthiar Grama Bank	Indian Bank	Puducherry
41	Punjab Gramin Bank	Punjab National Bank	Punjab
42	Purvanchal Bank	State Bank of India	Uttar Pradesh
43	Rajasthan Marudhara Gramin Bank	State Bank of India	Rajasthan
44	Saptagiri Grameena Bank	Indian Bank	Andhra Pradesh
45	Sava Haryana Gramin Bank	Punjab National Bank	Haryana
46	Sava UP Gramin Bank	Punjab National Bank	Uttar Pradesh
47	Saurashtra Gramin Bank	State Bank of India	Gujarat
48	Sutlej Gramin Bank	Punjab and Sird Bank	Punjab

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

15.13 PROGRESS OF REGIONAL RURAL BANKS IN INDIA

In the mean time, the regional rural banks have extended their network throughout the country to a considerable extent. Initially, there were 196 regional rural banks operating in 28 states with nearly 14,700 branches. Till June 1996, these RRBs have been lending annually nearly Rs 1500 crore to the rural people and more than 90 per cent of the loan has been advanced to weaker sections.

As on September, 1990, the RRBs had advanced jointly to the tune of Rs 3,560 crore in the form of short-term crop loans, term loans for agricultural activities, for rural artisans, cottage and village industries, retail trade, self-employment projects and consumption loans etc.

Among all the states, Uttar Pradesh is the state where larger number of RRB branches has already been opened. Recently, after amalgamation, the number of RRBs has been reduced to 92.

During the last 30 years, RRBs have been participating actively in various programmes designed for providing credit assistance to identified beneficiaries included under the new 20 Point Programme, IRDP and other programmes designed for scheduled castes and tribes. RRBs are also advancing loans to weaker sections and physically handicapped persons under differential rate of industrial (DIR) schemes.

At the end of June 2014, there were 92 amalgamated RRBs, covering 518 districts of the country with a network of 18,291 branches. Out of all these branches of RRBs, 4,042 are the rural branches as on June 30, 2014 which constitute about 21.4 per cent of the total branches of RRBs.

The loans and advances stood at Rs 7,852.7 crore as at the end of September 1996. Again, Rs 15,423 crore were mobilised as deposits by RRBs at the end of September 1996. Consequent upon the permission of the Reserve Bank of India to determine their own lending rate with effect from 26 August 1996, most of the RRBs have been charging interest rates on their loans varying between 13.5 to 19.5 per cent per annum.

In recent years, under the softer interest regime, interest rates on loans advanced by RRBs have also declined considerably. Again, total amount of credit advanced 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.

15.13.1 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.

15.13.2 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.

15.14 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 by the share of deposits contributed by these branch offices of RRBs in different states. The share of deposits of these branches of RRBs in December, 1991 in a state like Uttar Pradesh was 25.7 per cent in comparison to that of only 12.4 per cent for other Scheduled Commercial Banks.

This achievement is noteworthy if we consider that the number of branches of RRBs (1,193) was even lower than that of other scheduled commercial banks (1,361). Moreover, the share of deposits of RRBs in Haryana was also higher than other scheduled commercial banks which had comparatively double the number of branches.

Another important matter that has also been noticed is that most of the branches of RRBs are opened in unbanked centres and thus the deposits mobilised by them are fresh deposits and are not diverted from the deposits per branch of RRBs established before 1980 is uniformly higher in almost all the states of the country. In respect of credit operations, RRBs were successful in identifying the target groups and also in meeting their credit requirements.

15.14.1 Unsatisfactory Performance of Regional Rural Banks

The Regional Rural Banks (RRBs) have been experiencing an unsatisfactory performance since last few years. Therefore, the RRBs have now become a serious problem for the Indian Banking sector. They are now far from fulfilling purpose for which they were set up some two decades ago.

These RRBs have been incurring heavy losses year after year. In 1990-91, the RRBs incurred a total loss of Rs 92.87 crore, followed by Rs 258.66 crore during 1991-92. In 1993-94, 173 out of the country's 196 RRBs incurred losses to the tune of Rs 310 crore.

As per the latest data available with the National Bank for Agriculture and Rural Development (NABARD), the total accumulated losses of all Regional Rural

Banks, operating in the country are estimated at Rs 2,176 crore as on 31st March, 1996.

It is, therefore, not surprising that these banks, established for the purpose of providing an impetus to rural growth have dismally failed to boost agro-based rural economy. One of the major contributory factors responsible for the mounting 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. A provision of Rs 5 crore for the purpose was made by the government during 1993-94.

The issue capital of the RRBs is shared by the Central Government, all the state governments and various sponsoring banks. At the end of March, 1992 the total credit support extended to the banks amounted to Rs 4090.86 crore. As on the same date the banks had mobilised Rs 5868 crore from 345 lakh accounts. During 1991-92, the RRBs disbursed only Rs 1,107 crore among 23 lakh rural people drawn from the weaker sections of the society.

To revitalize the banks a sum of Rs 402 crore was released in 1991-92 by the state owned National Bank for Agriculture and Rural Development (NABARD). The weak condition of RRBs has been reflected from the fact that many have completely wiped out their equity and reserves and in some, the losses are even eating into deposits.

This is an unsustainable situation and long term structural measures are necessary if these banks are to be rehabilitated.

Attributing high establishment and operational cost, low level of business and restricted area of operation as the main causes for the loss, the RBI had initiated certain measures to enable RRBs to diversify their operations.

In line with the government's focused strategy for improving the viability of the Regional Rural Banks in the country as many as 136 RRBs have been provided financial support to the tune of Rs 573 crore for their comprehensive revamping. By according priority to revival of viable RRBs instead of tackling the problem in a generalized manner, it is expected to bring down considerably the losses of RRBs and make them stand on their own feet.

The RRBs have been advised to prepare bank specific development action plans to enable them to adopt a systematic approach for their turn around. Besides, the RRBs have been permitted by the RBI to deploy a part of their surplus non-statutory liquidity Ratio fund in the credit portfolio of their sponsor banks.

The RBI has fully deregulated the interest rates that can be charged to the ultimate borrowers by the RRBs. Now there is even a move to merge all the 92 RRBs to 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.

15.15 SUMMARY

Major portion of commercial banking in India is undertaken in the public sector. Within the public sector, the State Bank of India and its subsidiaries constitute State Bank Group 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.

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. 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 and small entrepreneurs in order to develop agriculture, trade, commerce, industry and other usual productive activities in different rural areas of the country.

15.16 GLOSSARY

- **Annual Percentage Rate (APR)** - The yearly rate that is charged for borrowing, which represents the annual cost of funds over the term of the loan.
- **Annual Percentage Yield (APY)**- The amount of interest earned on a deposit account during a one-year period. This includes interest earned on the amount in the account and compounded interest for the year.
- **Automated Clearing House (ACH)**- An electronic network in the United States that allows financial institutions to transfer funds. ACH is used for credit transfers like direct deposit, payroll for businesses and vendor payments. It makes transferring money simple and efficient, saving business owners and individuals time.
- **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 you pay 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 disbursement 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 between the foreman and the subscribers relating to the chit;
- **"chit amount"** means the sum-total of the subscriptions payable by all the subscribers for any installment of a chit without any deduction of discount or otherwise;
- **"discount"** means the sum of money or the quantity of grain which a prized subscriber is, under the terms of the chit agreement, required to forego and which is set apart under the said agreement to meet the expenses of running the chit or for distribution among the subscribers or for both;
- **"dividend"** means the share of the subscriber in the amount of discount available under the chit agreement for rateable distribution among the subscribers at each installment of the chit;
- **"draw"** means the manner specified in the chit agreement for the purpose of ascertaining the prized subscriber of any installment of the chit;

15.17 SELF ASSESSMENT QUESTIONS

1. State The Sources And Application Of Funds Of Commercial Banks?

2. Describe The Nature Of Commercial Banks?

3. Give The Functions Of Commercial Banks?

15.18 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?

15.19 SUGGESTED READINGS

- Bhole, L.M. (2000): Financial Institutions and Markets. Tata Mc Graw Hills, New Delhi.
- Machiraju, H . R. (.I 998) : Indian Financial System, Vi kas I Publications, Delhi.
- Sundharam, K.D.S. and Varshney, P.N. (2000) - Banking , ; and financial System, Sultan Chand & Sons, Delhi.
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DEVELOPMENT AND INVESTMENT BANKING

Unit-IV

STRUCTURE:

- 16.1 Introduction**
- 16.2 Objectives**
- 16.3 Objectives of Development Banks**
- 16.4 Development Banks in India**
- 16.5 Role of development banks in the Indian economy**
- 16.6 Functions of Development banks**
- 16.7 Development Financial Institutions**
- 16.8 Summary**
- 16.9 Glossary**
- 16.10 Self Assessment Questions**
- 16.11 Lesson End Exercise**
- 16.12 Suggested reading**

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.
- Discuss the origin of development banks in India.
- Explain the working of all India level development banks.

16.3 OBJECTIVES OF DEVELOPMENT BANKS:

- The main objectives of the development banks are
- To promote industrial growth,
- To develop backward areas,
- To create more employment opportunities,
- To generate more exports and encourage import substitution,
- To encourage modernization and improvement in technology,
- To promote more self employment projects,
- To revive sick units,
- To improve the management of large industries by providing training,
- To remove regional disparities or regional imbalance,
- To promote science and technology in new areas by providing risk capital,
- To improve capital market in the country.

16.4 DEVELOPMENT BANKS IN INDIA



Development banking was started after the World War II. It provided finance to reconstruct the buildings and industries which were destroyed in the war.

In India, development banking was started immediately after independence.

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 IN THE INDIAN ECONOMY

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,

inducing investors and entrepreneurs, sealing the leakages of material and human resources by careful allocation thereof, undertaking development activities, including promotion of industrial units to fill the gaps in the industrial structure and by ensuring that no healthy projects suffer for want of finance and/or technical services. Hence, the DFIs have to perform financial and development functions on finance functions, there is a provision of adequate term finance and in development functions there include providing of foreign currency loans, underwriting of shares and debentures of industrial concerns, direct subscription to equity and preference share capital, guaranteeing of deferred payments, conducting techno-economic surveys, market and investment research and rendering of technical and administrative guidance to the entrepreneurs.

3. Rupee Loans:

Rupee loans constitute more than 90 per cent of the total assistance sanctioned and disbursed. This speaks eloquently on DFI's obsession with term loans to the neglect of other forms of assistance which are equally important. Term loans unsupplemented by other forms of assistance had naturally put the borrowers, most of whom are small entrepreneurs, on to a heavy burden of debt-servicing. Since term finance is just one of the inputs but not everything for the entrepreneurs, they had to search for other sources and their abortive efforts to secure other forms of assistance led to sickness in industrial units in many cases.

4. Foreign Currency Loans:

Foreign currency loans are meant for setting up of new industrial projects as also for expansion, diversification, modernization or renovation of existing units in cases where a portion of the loan was for financing import of equipment from abroad and/or technical know-how, in special cases.

5. Subscription to Debentures and Guarantees:

Regarding guarantees, it is well-known that when an entrepreneur purchases some machinery or fixed assets or capital goods on credit, the supplier usually asks him to furnish some guarantee to ensure payment of installments by the purchaser at regular intervals. In such a case, DFIs can act as guarantors for

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

and development functions are as important to institutions as the financing role. The promotional activities like carrying out industrial potential surveys, identification of potential entrepreneurs, conducting entrepreneurship development programs and providing technical consultancy services have contributed in a significant manner to the process of industrialization and effective utilization of industrial finance by industry. IDBI has created a special technical assistance fund to support its various promotional activities. Over the years, the scope of promotional activities has expanded to include programs for up gradation of skill of State level development banks and other industrial promotion agencies, conducting special studies on important issues concerning industrial development, encouraging voluntary agencies in implementing their programs for the uplift of rural areas, village an cottage industries, artisans and other weaker sections of the society.

16.6 FUNCTIONS OF DEVELOPMENT BANKS

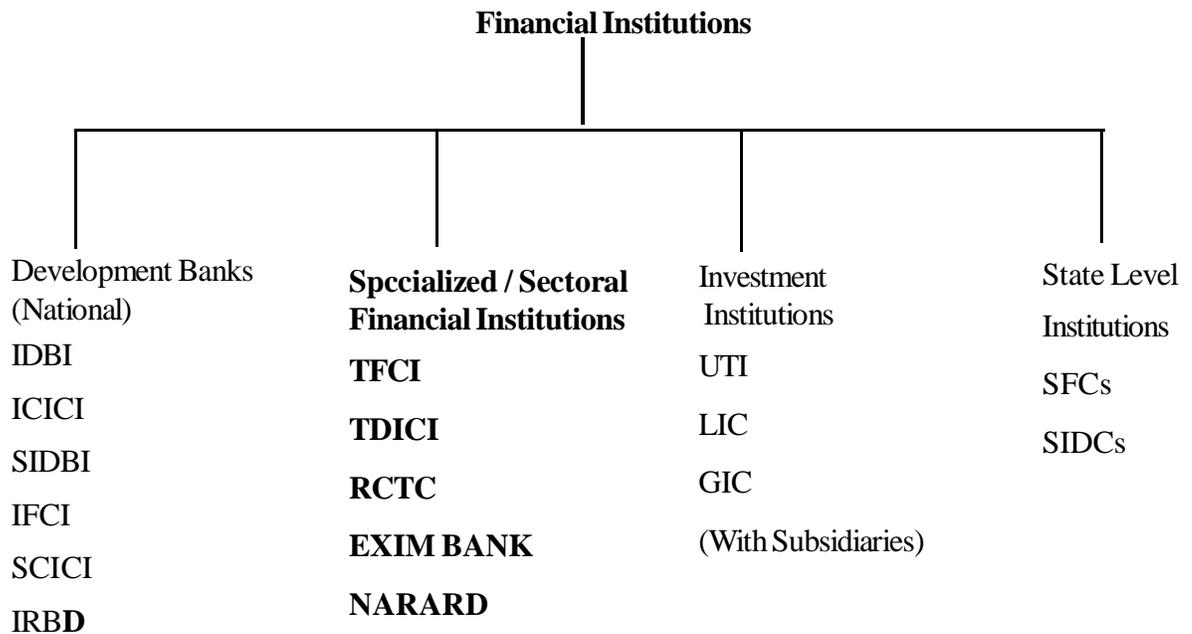
- They promote and develop small-scale industries (SSI) in India.
- To finance the development of the housing sector in India.
- To facilitate the development of large-scale industries (LSI) in India.
- They help in the development of the agricultural sector and rural India.
- To enhance the foreign trade of India.
- They help to review (cure) sick industrial units.
- To encourage the development of Indian entrepreneurs.
- To promote economic activities in backward regions of the country.
- They contribute to the growth of capital markets.

16.7 DEVELOPMENT FINANCIAL INSTITUTIONS

A development Financial Institution (DFI) is defined as an “ an institution endorsed or supported by Government of India primarily to provide development / Project finance to one or more sectors or sub-sectors of the economy. The institution differentiates itself by a thoughtful balance between commercial norms of 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).



DFI can be classified in four categories of institutions as per their function:

- 1 National Development Banks e.g. IDBI, SIDBI, ICICI, IRBI, IDFC
- 2 Sector specific financial institutions e.g. TFCI, EXIM Bank, NABARD, HDFC, NBH
3. Investment Institutions e.g. LIC, GIC, and UTI
- 4, State level Institutions e.g, State Finance corporation and SIDCs

The role of DFIs was to recognize the gaps in institutions and markets in our financial sector and act as a gap filler which was made due to incapability of commercial banks to finance big infrastructure projects for long term and support them to attain growth and financial steadiness. Therefore, govt. of India set up specialized DFIs in India to fulfil long term project financing requirements of industry and agriculture. The financial institutions in India were set up under the full control of both Central and State Governments. Government used these institutions for the achievements in planning and development of the nation as a whole

The following are some of the major institutions set up after 1974:

1981: NABARD

1982: EXIM Bank

1986: Shipping Credit and Investment Company

: 1982: EXIM Bank

1986: Shipping Credit and Investment Company of India (SCICI)

1987: Indian Renewable Energy Development Agency (IREDA)

a. NABARD:

It is the apex banking institution to provide finance for Agriculture and rural development. National Bank for Agriculture and Rural Development (NABARD) was established on July 12, 1982 with the paid up capital of Rs. 100 cr. by 50: 50 contribution of government of India and Reserve bank of 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 2013 registering an increase of 14.6 per cent, over the previous year.

3. Rural Infrastructure Development Fund (RIDF)

Through the Rural Infrastructure Development Fund (RIDF) 16,292.26 crore was disbursed during 2012-13. A cumulative amount of 1,62,083 crore has been sanctioned for 5.08 lakh projects as on 31 March 2013 covering irrigation, rural roads and bridges, health and education, soil conservation, drinking water schemes, flood protection, forest management etc.

New Business Initiatives:

1. NABARD Infrastructure Development Assistance (NIDA):

NABARD has set up NIDA, a new line of credit support for funding of rural infrastructure projects. The sanctions under NIDA during the year 2012-13 was 2,818.46 crore and disbursement was 859.70 crore.

2. Direct refinance assistance to CCBs for short term multipurpose credit:

Direct refinance assistance to CCBs was conceived and additional line of finance for CCBs in the light of recommendations of the “Task Force on Revival of Short Term Rural Cooperative Credit Structure, which enables the latter to raise financial resources other than from StCBs. During 2012-13, refinance assistance aggregating 3,385 crore was sanctioned to 42 CCBs and disbursement stood at 2,363.45 crore.

B. IFCI

IFCI, previously Industrial Finance Corporation of India, is a Non-Banking Finance Company in the public sector. Established in 1948 as a statutory corporation, IFCI is currently a company listed on BSE and NSE. IFCI has seven subsidiaries and one associate. It provides financial support for the diversified growth of Industries across the spectrum. The financing activities cover various kinds of projects such as airports, roads, telecom, power, real estate, manufacturing, services sector and such other allied industries. During its 70 years of existence, mega-projects like Adani Mundra Ports, GMR Goa International Airport, Salasar Highways, NRSS Transmission, Raichur Power 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.

C. 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 Corporation of India (LIC) has got a technical go-ahead from Insurance Regulatory and Development Authority of India (IRDAI) to increase stake in

IDBI Bank up to 51%. LIC completed acquisition of 51% controlling stake on January 21, 2019 making it the majority shareholder of the IDBI Bank. Reserve Bank of India has clarified vide a Press Release dated March 14, 2019, that IDBI Bank stands re-categorized as a Private Sector Bank for regulatory purposes with effect from January 21, 2019.

The bank has an aggregate balance sheet size of INR 3.74 trillion as on 31 March 2016. It has 3,683 ATMs, 1892 branches, including one overseas branch in Dubai, 58 e-lounges and 1407 centers as of 1 February 2020.

D. IDFC

IDFC was incorporated on 30 January, 1997 with its registered office in Chennai and started operations on June 9, 1997. In 1998 the company registered with the Reserve Bank of India (RBI) as a non-banking financial company and in 1999 it formally became a Public Financial Institution.

To conform with RBI guidelines, IDFC founded a non-operative financial holding company IDFC Financial Holding Company Limited in 2014 to manage its five subsidiaries IDFC Bank, IDFC MF, IDFC Alternatives & IDFC Securities. IDFC is the holding company for NOFHC IDFC Projects Ltd and IDFC Foundation. IDFC Bank started operations in 19 October 2015 with 23 branches in Madhya Pradesh, Delhi, Mumbai, Hyderabad, Bengaluru, Pune, Chennai, Ahmedabad and Kolkata. IDFC bank has launched its 100th branch in Honnali, Karnataka in October 2017. In December 2018, IDFC merged with Capital First Ltd., an NBFC, and renamed itself as IDFC FIRST Bank. Capital First shareholders to get 139 IDFC Bank shares for every 10 shares held.

E. EXIM

Export–Import Bank of India is a finance institution in India, established in 1982 under Export-Import Bank of India Act 1981. Since its inception, Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of 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.

F. 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.¹ 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.”

16.9 GLOSSARY

- 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).

- Agricultural Development Banks: It includes, for example, National Bank for Agriculture & Rural Development (NABARD).
- Export-Import Development Banks: It includes, for example, Export-Import Bank of India (EXIM Bank).
- Housing Development Banks: It includes, for example, the National Housing Bank (NHB).

16.10 SELF ASSESSMENT QUESTIONS

1. What is a Development Bank ?

2. What is the structure of developments Bank in India ?

16.11 LESSON END EXERCISE

1. Short Information on Different development Bank

2. Difference between a Development bank & a Commercial bank

16. 12 SUGGESTED READINGS

- Bhole, L.M. (2000): Financial Institutions and Markets. Tata Mc Graw Hills, New Delhi.
- Machiraju, H . R. (.I 998) : Indian Financial System, Vi kas I Publications, Delhi.
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INTERNATIONAL FINANCIAL INSTITUTIONS

STRUCTURE

17.1 Introduction

17.2 Objectives

17.3 World Bank

17.3.1 Lending Operations

17.4 International Development Association (IDA)

17.4.1 Working of IDA

17.5 International Finance Corporation

17.5.1 Working of IFC

17.6 Asian Development Bank

17.6.1 Functions of ADB

17.6.2 Shareholders

17.6.3 Operations of ADB

17.7 Summary

17.8 Glossary

17.9 Self Assessment Questions

17.10 Lesson End Exercise

17.11 Suggested Readings

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.

The World Bank (IBRD) is an inter-governmental institution, corporate in form, whose capital stock is entirely owned by its member-governments. Initially, only nations that were members of the IMF could be members of the World Bank; this restriction on membership was subsequently relaxed.

17.3.1 Lending Operations:

Loans are granted to member countries only after the Bank is fully satisfied about the economic position of the borrowing country as well as the soundness of the specified projects for which assistance is sought. In granting loans, the Bank is prepared to take reasonable risks but insists that funds obtained from it should be used for purposes which are constructive and practical. The Bank has powers of supervision and control to ensure that funds are used for the purposes for which the loan is granted. Normally, the Bank makes medium or long-term loans, the term being related to the estimated useful life of the equipment or plant being financed.

The Bank makes or facilitates loans in any one or more out of its own following ways:

- (a) By making or participating in direct loans out of its own funds; or
- (b) Out of the funds raised in the market of a member, or otherwise borrowed by the Bank; or
- (c) By guaranteeing, in whole or in part, loans made by private investors through the investment channels. The total outstanding amount of the loans made or guaranteed by the Bank is not to exceed 100 per cent of its total unimpaired subscribed capital resources and surplus. The interest rate charged by the Bank on its loans is the estimated cost to the Bank of borrowing money for a comparable term in the market and is uniform without distinction among borrowers. In addition to the rate of interest, the Bank charges on all loans a commission of 1 per cent for the purpose of creating a special reserve against losses and ½ per cent for administrative expenses.

17.4 INTERNATIONAL DEVELOPMENT ASSOCIATION (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

from conventional loans and these would be repayable mostly in the currency lent rather than in the currency of the borrower. Since IDA charges nominal rates of interest on its loans, it has also been nicknamed the “Soft-Loan Window.” IDA has granted a number of credits to India for her development schemes. The grant of credits for development projects given by IDA to India has been in the nature of a continuous flow. But for the funds that have been made available by IDA to India, our development pace would have been considerably slower. In fine, it may be said that the IDA is expected to make a distinct contribution to the economic development of backward nations, furthering their development projects and supplementing the activities of the World Bank. Moreover, unlike the World Bank loans which are meant to cover only the foreign exchange costs, the IDA loans can be utilised to finance both foreign exchange and local currency costs.

17.5 INTERNATIONAL FINANCE CORPORATION (IFC)

The IFC was established in 1956. There are 133 countries that are members of the IFC and it is

legally and financially separate from the IBRD, although IBRD provides some administrative and other services to the IFC. The IFC’s main responsibilities are (i) To provide risk capital in the form of equity and long-term loans for productive private enterprises in association with private investors and management; (ii) To encourage the development of local capital markets by

carrying out standby and underwriting arrangements; and (iii) To stimulate the international flow

of capital by providing financial and technical assistance to privately controlled finance companies. Loans are made to private firms in the developing member countries and are usually for a period of seven to twelve years. The key feature of the IFC is that its loans are made to private enterprises and its investments are made in conjunction with private business. In addition to funds contributed by IFC, funds are also contributed to the same projects by local and foreign

investors. IFC investments are for the establishment new enterprises as well as for the expansion

and modernization of existing ones. They cover a wide range 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 Commission for Asia and Far East (UNECAFE) estimated that Asia and the Pacific region had an annual deficit of US \$ one billion. The ADB was formed to fill this gap. The inaugural meeting was held in Tokyo and the newly named bank was installed in Manila (Philippines). The first President was Mr. Watanabe and during his initial years the bank conducted regional surveys to develop a fuller understanding of the social and economic conditions of the Developing Member Countries (DMC). In 1974, the Asian Development Fund

was established to streamline the bank's means of financing. During 1972-76, the Bank's commitment to the DMCs increased from \$316 million to 776 million. In the late 70s, the bank

recognised the need to develop additional strategy to reduce poverty in the region, so they evolved the concept of multi-project loans which was a cost-effective means for funding projects

too small for the Bank's involvement. In 1978, the Asian Development Fund was increased to 2.15 billion. 1986 was a significant year for the Bank because the Peoples Republic of China joined the Bank and India received her first loan of \$100 million to the ICICI (Investment Credit and Investment Corporation of India) for one lending to Private Sector enterprises. In 1993,

annual lending commitments rose to \$5 billion and the cumulative total by 1991 was \$37.6 billion for 1039 projects. On the borrowing front, in 1991, the Bank offered Dragon Bonds which was a US \$ 300 million offering in the capital markets of Hong Kong, Singapore and Taipei. The present President is Mr. Tadao Chino, who was Japan's former Vice Minister of Finance for

International Affairs, before he took over in January 1999. Bank Profile Over the past 41 years, the bank's membership has grown from 31 to 57, of which 41 are from within the region and 16 from outside the region. The Bank gives special attention to the needs of the smaller or less developed countries and priority to regional, sub-regional and national projects and programmes.

17.6.1 Functions of ADB:

- To extend loans and equity investments for the economic and social development 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 of 31 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.

17.7 Summary

The World Bank and the International Monetary Fund (IMF) are collectively known as the Bretton Woods Institutions (BWIs), after the village in New Hampshire, USA, where they were founded by delegates of 44 nations in July 1944. The World Bank Group and the International Monetary Fund (IMF) are twin intergovernmental pillars supporting the structure of the world's economic and financial order. The "World Bank" (thereafter, the Bank) refers to the International Bank for Reconstruction and Development (IBRD), and its affiliates are the International Development Agency (IDA) and International Finance Corporation (IFC). It began its operations in 1946-47, in order to finance rebuilding economies of countries devastated by the Second World War. Lending for productive projects or to finance reform programmes, which will lead to economic growth in its less developed member countries, is now the bank's main objective. IDA was established in 1959 and began operations in 1960. Its purpose is to finance projects or reform programmes in countries that are not able to service loans from the IBRD. IFC was established in 1956 and became a specialised agency of the UN in 1957. Its special purpose is to promote growth of the private sector and to assist productive private enterprises within its developing member countries, where such enterprises can advance economic development. The Asian Development Bank (ADB) is a regional development bank established on 22 August 1966 to facilitate economic development of countries in Asia. The bank admits the members of the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP, formerly known as the United Nations Economic Commission for Asia and the Far East) and non-regional developed countries. From 31 members at its establishment, ADB now has 67 members - of which 48 are from within Asia and the Pacific and 19 outside. ADB was modeled closely on the World Bank, and has a similar weighted voting system where votes are distributed in proportion with member's capital subscriptions.

17.8 Glossary

- * **Economic development:** Economic development generally refers to the sustained, concerted actions of policymakers and communities that promote the standard of living and economic health of a specific area. Economic development can also be referred to as the quantitative and qualitative changes in the economy.
- * **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 SELF ASSESSMENT QUESTIONS

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

2. Discuss the usefulness of the I.B.R.D. in facilitating and promoting long-term investment.

17.10 LESSON END EXERCISE

1. Write notes on:

a. International Finance Corporation (IFC)

b. International Development Association (IDA)

c. Asian Development Bank (ADB)

17.11 SUGGESTED READINGS

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

NON BANKING FINANCIAL INSTITUTIONS

STRUCTURE

18.1 Introduction

18.2 Objectives

18.3 Types of NBFCs

18.4 Features of NBFCs

18.5 Role of Growth of Investment companies

18.6 Role of NBFIs in the financial system

18.7 Registration of NBFC

18.8 Supervision of NBFCs

18.9 A brief history of NBFIs

18.10 Growth of NBFC in India

18.11 Non-Banking Financial Intermediaries and Developed Countries

18.11.1 Non-Banking Financial Intermediaries and Underdeveloped Countries

18.12 Summary

18.13 Glossary

18.14 Self Assessment Questions

18.15 Lesson End Exercise

18.16 Suggested Readings

18.1 INTRODUCTION

Non-Banking Financial Companies are rising fast as an integral part of the Indian financial system. A non-banking financial institution (NBFI) or non-bank financial company (NBFC) does not have a full banking license but facilitate bank-related financial services like investment, contractual savings, and market brokering and risk pooling. They play a big role in strengthening the economy and have been able to carve out a place for themselves in meeting the credit needs of both wholesale and retail customers.

18.2 OBJECTIVES

After going through this lesson you would be able to;

18.3 TYPES OF 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 whereby the lessor grants the lessee the right to use an asset in return for periodical lease-rent payments.

There are two types of leasses (i) operating lease, and (ii) financial or capital lease. The operating lease is a short-term lease which can be cancelled. Financial lease is a non-concealable contractual commitment.

(2) Hire Purchase Finance Company is a company which carries on as its principle business, hire purchase transactions or the financing of such transactions. The sources of hire-purchase finance are

(i) Hire purchase Finance Companies.

(ii) Retails and Wholesale Traders.

(iii) Bank and Financial Institutions.

Hire-purchase finance or credit is a system under which term loans for purchase of goods, producer goods or consumer goods and services are advanced which have to be liquidated under an installment plan. The period of credit is generally one to three years. The hire purchase credits available for a wide range of products and services. Hire-purchase finance companies are the public or private limited companies or partnership firms engaged in giving credit for acquiring durable goods.

(3) Housing Finance Company is a company which carries on as its principle business, the financing of the acquisition or construction of houses including the acquisition or development of plots of lands for construction of houses. These companies are supervised by National Housing Bank, which refinances housing loans by scheduled commercial banks, co-operative banks, housing finance companies and the apex co-operative housing finance societies.

(4) Investment Company means any company which carries on as its principle business the acquisition of securities. These types of companies are investment holding companies formed by business houses. As such they provide finance mainly to companies associated with these business houses.

As compare to open-end investment companies or mutual funds/units trust, these investment companies are close end companies having a fixed amount of share capital. Almost all 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 unhealthy features of the operations of these companies; (i) Negative NOF (Net Owned Fund), (ii) Understatement of their deposit liability, (iii)

Forfeiture of deposits, (iv) Levy of service charges on the depositors (v) Payment of high rates of commission, etc.

To remove these features, RBI has extended prudential norms to these companies, introduced compulsory registration requirement, specified minimum rates of interest payable on their deposits under different schemes. Under the RBI (Amendment) Act, 1997, the RBI directly inspects and monitoring the activities of these companies.

18.4 FEATURES OF NBFC

Categorization of Companies:

For the purpose of the new regulations, NBFCs have been divided into three broad categories as indicated below:

- (a) NBFCs accepting public deposits.
- (b) NBFCs not accepting public deposits are engaged in loan, investment, hire purchase finance and equipment leasing activities.
- (c) NBFCs not accepting public deposits and has acquired shares/securities in their own group/ holding/subsidiary companies of not less than 90 percent of their total assets and are not trading in these shares/securities.

While NBFCs accepting public deposits will be subjected to all the provisions of the Directors, those which do not accept public deposits will be supervised in a limited manner.

Some of the key regulations for acceptance of deposits by the NBFCs are:-

- They are allowed to accept or renew public deposits for a minimum period of 12 months and a maximum period of 60 months.
- They cannot accept deposits repayable on demand.
- They cannot offer interest rates higher than the ceiling rate prescribed by RBI from time to time.

- 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.

Investment companies are categorized into three types: closed-end funds, mutual funds (or open-end funds) and unit investment trusts (UITs). Each of these three investment companies must register under the Securities Act of 1933 and the Investment Company Act of 1940. Units or shares in closed-end funds are typically offered at a discount to their net asset value (NAV) and are traded on stock exchanges. Investors who want to sell shares will sell them to other investors on the secondary market at a price determined by market forces and participants, making them not redeemable. Since investment companies with a closed-end structure issue only a fixed number of shares, back-and-forth trading of the shares in the market has no impact on the portfolio.

Mutual funds have a floating number of issued shares and sell or redeem their shares at their current net asset value by selling them back to the fund or the broker acting for the fund. As investors move their money in and out of the fund, the fund expands and contracts, respectively. Open-ended funds are often restricted to investing in liquid assets, given that the investment managers have to plan in a way that the fund is able to meet the demands for investors who may want their money back at any time.

Like mutual funds, unit investment trusts are also redeemable, as units held by the trust can be sold back to the investment company.

Investment companies make profits by buying and selling shares, property, bonds, cash, other funds and other assets. The portfolio that is created using the pool of funds is usually diversified and managed by an expert fund manager, who can choose to invest in specific markets, industries or even unlisted businesses that are at early stages in their development. In return, clients gain access to a wide array of investment products that they normally would not have been able to access. The success of the fund depends on how effective the manager's strategy is. In addition, investors should be able to save on trading costs since the investment company is able to gain economies of scale in operations.

Role and growth of an investment company

Investing for the future has never been more important than it is today. The recent financial storm has left many people shaken, and many more wondering if investing

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 its shareholders. Depending on the type—close-end or open-end—and

the structure of the investment company, investors can redeem their shares for cash from the company, sell the shares to another firm or individual, or receive capital distributions when assets held by the investment company are sold.

18.6 ROLE OF NBF I IN THE FINANCIAL SYSTEM

- NBFIs act as a supplement to banks by providing infrastructure to distribute excess resources to individuals and companies with deficits.
- NBFIs also serve the additional purpose of introducing competition in financial services.
- Unlike banks who may offer a packaged deal on a set of financial services, NBFIs offer customized services to suit the specific needs of clients. NBFIs specializing in one particular sector develop an informational advantage.
- From loans and credit facilities to private education funding and retirement planning, from trading in money markets to underwriting stocks and shares, and Term Finance Certificates, NBFCs offer almost all banking services. They provide wealth management services like managing stocks and shares portfolios, discounting services like discounting of instruments and give advice on merger and acquisition activities.
- The number of NBFCs has increased greatly in the last several years due to venture capital companies, retail and industrial companies have entered the lending business. NBFCs also often support property investments in property besides preparing feasibility, market or industry studies for companies.
- NBFCs are usually not allowed to take deposits from the general public and have to find options for funding their operations.
- NBFCs do not provide cheque books nor do they provide a saving account and current account. They are only authorized to take fixed deposit or time deposits.

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 implemented.

Flow of credit from banks to NBFCs:

- (i) Bank credit to NBFCs for their advances against commercial vehicles has been brought under the ambit of priority sector advances.
- (ii) The ceiling on bank lending to NBFCs registered with the Reserve Bank has been removed with effect from May 1999.

RBI Directions to NBFCs:

Reserve Bank of India announced a set of measures to protect the interest of depositors and provide more effective supervision over NBFCs on January 2, 1998. The regulations stipulate on the NBFCs, an upper limit both on public deposits to be accepted, on the rate of interest to deposits, in order to restrain them from offering incentives and mobilize excessive deposits.

The disclosure requirements have been strengthened and responsibilities cast on the Board of Directors and auditors of the companies to ensure proper conformation deposit regulations and prudential norms prescribed by RBI.

18.9 A BRIEF HISTORY OF NFBI

- NBFCs started humbly in India in the 1960s as an alternative for savers and investors whose financial needs were not sufficiently met by the existing banking system. The NBFCs initially operated on a limited scale without making much impact on the financial industry. They invited fixed deposits from investors and worked out leasing deals for big industrial firms.
- In the first stages of development, the Companies Act regulated financing. However, the unique and complex nature of operations and with financial companies acting as financial intermediaries, there was a call for a separate regulatory mechanism.
- Hence, Chapter III B was included in the Reserve Bank of India Act, 1934, which assigned the Bank with limited authorities to regulate deposit-taking companies. Since then the RBI has initiated measures to regulate the NBFC sector.

- The RBI accepted and implemented that hire purchase and leasing 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.

18.10 GROWTH OF NBFC IN INDIA

Non-banking Financial Companies (NBFC) sector in India has undergone a significant transformation over the past few years and plays a significant role in the growth of the Indian financial system. NBFC in India sector is playing a critical role in the development of Core infrastructure, transport, employment generation, wealth creation, economic development of the weaker sections in India. Non Banking Financial Companies have outperformed banks in the Mortgage Industry, by leveraging technology in credit deployment. Technology

has made NBFC's expand into underserved segments, where the banks don't serve. NBFC's have carved niche business areas for themselves by understanding customers & building customized products, which the commercial banks fail to.

The total Credit market of NBFC's is going up from 13% FY16 to 16% FY17 to 20% FY18. The average growth of NBFC's will be 4-6% every FY.

Following are the major factors that led to the growth of NBFC's in India

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 base.

Robust Risk Management:

Given their focus on lending to the sub-prime customer segment, and regulatory disadvantage (SARFEASI, DRT, and capital adequacy requirements) in comparison to commercial bank lenders, NBFCs are ensuring enhanced governance through a proactive, robust and agile risk management model.

18.11 NON-BANKING FINANCIAL INTERMEDIARIES AND DEVELOPED COUNTRIES

A summary of the important statutory provisions regulating the activities of Non-banking Financial Intermediaries in ten foreign countries is given below.

- **Australia:** The Australian Financial system includes a wide range of financial intermediaries. The NBFIs include building societies, unit trusts, life

assurance off-ices, pastoral finance companies, instalment credit companies, development finance institutions and credit unions. The Financial Corporation Act, 1974 requires a wide range of financial corporations whose assets exceed \$1 million to register with the Reserve Bank and to provide certain information about their activities. These NBFIs whose assets exceed \$5 million are subject to regulation of assets ratios, lending and interest rates. The collection of information from NBFIs is a policy objective in Australia so that the regulations can be tailored to suit the requirements of particular types of financial institutions. Importance is also given to the need for consulting NBFIs and seeking their co-operation for voluntary restraint.

- **Canada:** In Canada, there are institutions other than banks which accept deposits from and make loans to the public. Some of these institutions such as trust companies, loan companies, money-lenders and credit unions operate under certain special federal or provincial government laws. Others, such as finance and investment companies are incorporated under the general federal or provincial company legislation. The deposits with all the provincial trust and loan companies are insured with the Canada 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 Commission of Control of Banks in France may strike out the name of a company from the list for non-adherence to the advices issued by the Commission.

- **Japan:** In a broader sense, NBFIs in Japan include financial institutions such as mutual loan and savings banks, credit associations, credit cooperatives and financial institutions for agriculture, in addition to the insurance companies and government institutions including financial agencies and the postal savings system. Monetary policy in Japan was traditionally centred on commercial banks. However, certain monetary measures have recently been extended to NBFIs. The reserve deposit requirements which are limited only to banks have since 1963 been extended to mutual loan and savings banks and credit associations holding deposits of over 20 billion. In 1969, the Central Co-operative Bank for Agriculture and Forestry was also brought under control.

18.11.1 Non-Banking Financial Intermediaries and Underdeveloped Countries :-

Non-Banking Financial Intermediaries play a special role in underdeveloped countries. In India, the capital market is unorganised and underdeveloped. Majority of the people in India are poor and they are unable to save. Those who save, invest their savings in gold, jewellery, real estate, speculation, foreign exchange and conspicuous consumption. Under these circumstances, NBFIs undertake the task of encouraging the personal savings among the middle-income group of the people. ²⁹ Further, as the economy develops, the non-monetized sector is gradually transformed into the monetized sector. With the increase in the rate of monetization of the economy, the banking habit of people also grow. In such a situation, the commercial banks alone are not sufficient to mobilise the

savings and put them into productive channels. So the role of NBFIs becomes all the more important in mobilising and investing these savings for capital formation and economic development. The major function of financial intermediaries is to transfer the savings of surplus units to deficit units; hence, they can play a useful role in the economy of the country. To the extent that they help in monetising the economy and transferring unproductive financial assets into productive assets they contribute to the country's economic development. In fact, the nature and diversity of financial institutions themselves have become measures of economic development of a country.

18.12 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 1988-89, fertilizer industry was sanctioned maximum funds, followed by textile industry. GICI has not provided any concessional financial assistance to backward areas. However, GICI has helped in building up a good network of general insurance facilities. The UTI is an investment trust set up in 1964. Its main objective is to channelize the surplus funds of the community into productive use so as to achieve growth and diversification of Indian economy. The investment policy of the UTI aims at striking a reasonable balance between securities and return on investment. Unlike the LIC and commercial banks, the UTI is not constrained to invest any proportion of its funds in government and other approved securities. The UTI has come up with many schemes over time to tap resources from every segment of society. Its investible funds have crossed Rs. 10,000 crore in 1989, It has been observed that the UTI has preferred to invest its funds in developed areas. A criticism of the UTI is that a major part of investible funds have flowed into urban areas. For the UTI, there is definitely a need and scope for developing new schemes to mobilize rural savings and to identify rural ' industries to get financial assistance. Further there is also scope to reduce expenditure of the UTI and raise dividend to unit holders

18.13 GLOSSARY

A non-bank financial institution (NBFI) is an organization that provides financial services, but is not a licensed bank and is not allowed to accept deposits from customers. The types of services offered by a NBFI typically fall into the following categories:

- **Risk Pooling Institutions:** organizations such as insurance companies that spread financial risk among a large number of entities.

- **Institutional Investors:** organizations such as pension funds and mutual funds that trade securities in volumes that qualify for lower commissions.
- **Other Non-Bank Financial Institutions:** organizations that provide financial services such as leasing of assets, market makers (who provide liquidity), management companies, financial advisors, and securities brokers.

18.14 SELF ASSESSMENT 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?

18.15 LESSON END EXERCISE

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

2. What are systemically important NBFIs?

3. What are the different types/categories of NBFIs registered with RBI?

18.16 SUGGESTED READINGS

- Bhole, L.M. (2000): Financial Institutions and Markets. Tata Mc Graw Hills, New Delhi.
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LEASING AND HIRE PURCHASE

STRUCTURE

- 19.1 Introduction
- 19.2 Objectives
- 19.3 Leasing: Definition and Main Features Benefits of Leasing
- 19.4 Types of Leasing
- 19.5 Main Clauses in the Lease Agreement
- 19.6 To Buy or Lease: A Crucial Decision
- 19.7 Hire Purchase
- 19.8 Choice between Leasing and Hire Purchase
- 19.9 Summary
- 19.10 Glossary
- 19.11 Self Assessment Questions
- 19.12 Lesson End Exercise
- 19.13 Suggested Readings

19.1 INTRODUCTION

Financing of Capital assets of a firm requires long-term funds of substantial magnitude. Several sources have been tapped to raise such funds, e.g. equity, debt instruments and development finance in the form of term loans. All these sources have their distinctive advantages and disadvantages to the borrowers and the lenders or investors. Raising long-term funds for acquiring capital assets through debt instruments or long-term debts, imposes several obligations on the borrowers, who have to bear some degree of risk also. Hence, alternative means for acquiring the capital assets without raising funds immediately have been devised. Leasing and hire purchase of capital assets are two such methods through which the need for raising the funds can be avoided. These are the substitutes for raising finance. We shall deal in this unit these two means of acquiring capital assets for use in a firm.

19.2 Objectives

After studying this Chapter, you should be able to:

- Understand the concepts and distinguishing features of leasing and hire purchase;
- Explain different types of leasing;
- Understand standard clauses in a lease agreement; and
- To study the difference between lease and hire purchase.

19.3 LEASING: DEFINITION AND MAIN FEATURES

A lease is a contract whereby the owner of an asset (the lessor) grants to another person (the lessee) exclusive right to use the asset for an agreed period of time, in return for the payment of a rent (called lease rental). Capital assets like land buildings, equipments, machinery, vehicles are the usual assets which are generally acquired on lease basis. The lessor remains the owner of the asset, but the possession and economic use of the asset is vested in the lessee.

As there is no separate statute in India to govern the contracts of leasing, which is akin to a contract of bailment, the provisions of the Indian Contract Act apply to it.

According to Section 146 of the Indian Contract Act, 1872 bailment is “the delivery of goods by one person to another person for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them.” The person delivering the goods is called the bailor and the person to whom they are delivered is called the bailee.

Since an equipment lease transaction falls in the category of a bailment contract, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (unless expressly specified otherwise in the lease agreement) as given in the Indian Contract Act. Briefly, these may be stated as follows:

1. The lessor has the duty to deliver the asset to the lessee, to legally authorize 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 and its supplier and enters into a lease arrangement with a leasing company. He furnishes certain particulars, such as his name, address, details about his business, name and address of the guarantor, if any, description of the equipment (model, make, size, specification etc.), the name and address of the supplier.

The lessor examines the lease proposal and evaluates the credit-worthiness of the applicant, his past performance in the business and his capacity to pay the periodical rentals, taking into account the profitability and projected cash flows of his business and his reputation, etc.

Benefits of Leasing

Several benefits are derived by the lessee by acquiring the assets on lease basis, as compared to buying the same. The benefits are as follows:

- a) **Convenience in case of short-term need:** If the capital asset is needed for a short period only, say a year or two, leasing is a very convenient and appropriate method of acquiring. It dispenses with the formalities and expenses incurred in purchasing the asset and selling it soon after the need is over.
- b) **No Risk of Technological Obsolescence:** In case of owning the asset, the firm bears the risk of the asset becoming obsolete. In the present age of

technological innovations, risks in owning an asset with outdated and old technology cannot be ignored. With such equipments, the firm cannot compete with its competitors and will incur heavy losses. Leasing provides a shield against all these hazards by shifting the risk of obsolescence of equipment to the lessor. This is true of operating leases which are for short duration and cancellable at the option of the lessee. The lessee can cancel an old lease agreement and enter into a new one in case a technologically superior product is available in the market. It is true that lease rentals for such equipments tend to be higher, but this disadvantage is more than off-set by the benefits the lessee derives by passing on the risk of obsolescence to the lessor.

- c) **Efficient Maintenance Services:** Under operating or full service lease, the 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:

Firm A				
Equity Capital	100		Fixed Assets	200
Debts	200		Current Assets	100
Total	300		Total	300

Debt Equity Ratio = 2:1

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

Debt Equity Ratio = 1:1

The debt-equity ratio of firm A increases from 1:1 to 2:1, while that of firm B remains unaffected. In its balance sheet the leased asset is shown as an off balance sheet item. Higher debt-equity ratio of Firm A will adversely affect its further debt taking capacity, while firm B can take further debt easily to acquire other assets or to meet its working capital needs. If the firm has got surplus cash with it, it can employ it fruitfully elsewhere.

- f) Benefit of Tax Shield:** The lessee claims lease rentals as tax deductible expenses every year during the lease period. Thus, his tax liability is reduced to that extent.

In case he buys the asset with borrowed funds, he can claim (i) depreciation, and (ii) interest on borrowed funds as tax deductible expenses. To the extent the lease rental exceeds the depreciation and interest burden, his deductible expenses are larger and his tax liability is lower. The net burden, in such cases, is neutralised by the benefits derived by the lessee as enumerated above.

In the books of the lessor, lease rentals received are taxable, under the head 'Profits and Gains from Business or Professions', after deducting: (i) depreciation on the assets, and (ii) interest on the borrowed funds, if any.

19.4 TYPES OF LEASES:

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. Operating 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 of the lessor.

2. Financial Lease

In case of a financial lease, the lessor remains the owner of the leased asset during the lease period, but does not undertake its necessary maintenance. The rental received by the lessor fully amortises the cost of the equipment and earns a profit for him. These leases are non-cancellable. Ultimately, the ownership of the leased asset may be transferred to the lessee at an agreed price. The lessor thus acts as a financier only and earns a return on his investment in the leased asset by way of rentals. Financial leases are for the major part of the useful life of the asset.

3. Sale and Lease Back

This is another type of lease arrangement wherein the lessee who already owns the assets, sells the same to the lessor, and thereafter takes the same asset from him on lease basis. This is called 'Sale and Lease Back arrangement'. Under this arrangement, the lessee immediately recovers the value of his already owned assets from the lessor. Thereafter, the lessee makes payment of the lease rentals periodically as usual. Such a lease arrangement enhances the liquid resources of the lessee immediately, which can be utilised otherwise to meet his working capital requirements or to purchase another asset on cash payment basis. This type of lease is an alternative to a mortgage of the assets.

4. Leveraged Lease

In case of an ordinary lease, the lessor purchases the asset with an appropriate mix of debt and equity. But the creditor (i.e., supplier of the debt funds) does not have recourse to the lessee. In other words, in case the lessor defaults in making repayment of the debt, the creditor cannot claim the same from the lessee. He will have recourse to the lessor only.

Leveraged lease is just opposite to the above. In such case, the creditor remains entitled to have recourse to the lessee, i.e., he can recover his claims from the lessee also. The lease rental is assigned to the creditor. The lessee is required to pay the lease rental directly to the creditor of the lessor. Generally this transaction is undertaken through a trustee, who receives the lease rental and appropriates it as debt service component to the creditor and the balance amount to the 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.

19.5 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.
- 5) **Delivery and Re-delivery:** This clause mentions when and how the leased equipment would be delivered to the lessee and how it will be delivered back to the lessor on the completion of the lease period.
- 6) **Right to Use:** This clause allows the lessee to make proper and lawful use of the equipment.
- 7) **Repairs and Maintenance:** Usually this clause states that the lessee shall maintain and repair the equipment and keep it in good and working condition. The cost of such maintenance shall be borne by the lessee.
- 8) **Alterations/Additions to Equipment:** This clause states that the lessee shall not make any alterations or additions to the equipment or remove it from the premises without the written consent of the lessor.
- 9) **Right to Inspect Equipment:** This clause gives the lessor the right to enter the premises of the lessee and to inspect the equipment as and when he desires.
- 10) **Damage to Equipment:** It is usual to stipulate that the lessee will bear all risks, losses, damages, theft or destruction of the equipment as long as it is in his custody.

11) Prohibition of Sub-leasing: This clause prohibits the lessee from sub-leasing the equipment or selling it to any party.

12) Default by Lessee and Remedies: It is usual to include a clause indicating the specific events of default by the assessee and the remedies available to the lessor in such cases. The remedies may be:

- a) to declare that all unpaid rentals are due and payable immediately and to sue the lessee for the recovery of the same,
- b) to terminate the lease agreement, and
- c) to seize the equipment given on lease.

13) Insurance: This clause requires the lessee to take out a fire insurance policy in respect of the equipment in the joint names of the lessee and the lessor (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.

19.6 TO BUY OR LEASE: A CRUCIAL DECISION

Lessee's Point of View

A firm going to acquire a capital asset has to make a crucial decision regarding buying it or acquiring it on lease basis. In the former case, the firm shall have to raise funds through debt or equity, if it does not possess surplus funds with itself. The decision of the firm will rest on the evaluation of both the proposals and comparative costs involved therein. The following steps are involved in such an evaluation:

1. The decision of the firm to acquire a particular asset is basically a capital budgeting decision and must be taken by the firm very carefully by any of the 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:

$$\text{Lease rental payment} \times (1 - \text{tax rate})$$
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 debts as the discount rate for this purpose.

10. Select the alternative with lower present value of cash outflows. Thus, the decision criterion is:
- i if PV of cash outflows under leasing alternative is greater than PV of cash outflows under buying alternative — buy the asset.
 - ii if PV of cash outflows under buying alternative is greater than the PV of cash outflows under leasing alternative — lease the asset.

Example 1

A Limited company is contemplating to have an access to a machine for a period of 5 years. The company can have the use of machine for the stipulated period through leasing arrangement or the requisite amount can be borrowed at 14% to buy the machine. The firm is in the 50% tax bracket.

In the case of leasing, the firm would be required to pay at the end-of-year lease rent of Rs.1,20,000 for 5 years. All maintenance, insurance and other costs are to be borne by the lessee.

In the case of purchase of the machine (which costs Rs.3,43,300), the firm would have 14% five-year loan to be paid in 5 equal annual installments, each installment becoming due at the end of each year. The machine would be depreciated on a straight line basis, with no salvage value.

Advise the company which option it should go for, assuming lease rents are paid (a) at the end of the year (b) in advance.

Solution

The analysis is presented in Tables 1 to 3 (year-end lease rental payments) and Table 4 (advance lease payments).

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 Loan 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
*Determination of loan installment					
5	1,00,000	87,706	12,294	87,706	-

$$\frac{\text{Amount of loan}}{\text{PV factor of annuity of Rs. for 5 years at 14\% rate of interest}} = \frac{\text{Rs.3,43,300}}{3.433} = \text{Rs. 1,00,000}$$

Table 3: Present Value of After-Tax Cash Outflows under Buying (Borrowing) alternative

Year-End	Loan installment (Rs.)	Tax advantage on interest payment I (0.5) (Rs.)	Tax advantage on depreciation Rs. 68,660 (0.5) (Rs.)	Net Cash outflows (Col. 2-Col.3+4) (Rs.)	PV factor at after-tax cost of debt 7% (Rs.)	PV of buying alternative (Rs.)
1	2	3	4	5	6	7
1	1,00,000	24,031	34,330	41,639	0.935	38,932
2	1,00,000	20,395	34,330	45,275	0.873	39,525
3	1,00,000	16,250	34,330	49,420	0.816	40,327
4	1,00,000	11,526	34,330	54,144	0.763	41,312
5	1,00,000	6,147	34,330	59,523	0.713	42,440
Total						2,02,536

Year-End	Lease Payment (Rs.)	Tax Shield (Rs.)	Cash outflows after taxes (Rs.)	PV factor at 7% (Rs.)	Total PV (Rs.)
1	2	3	4	5	6
0	1,20,000	-	1,20,000	1,000	1,20,000
1-4	1,20,000	60,000	60,000	3,387	2,03,220
5	-	60,000	-60,000	0.713	-42,780
					2,80,440

The operational implication of advance payment for tax purposes is that it qualifies for tax shield only in the year for which payment applies. For instance, Rs.1,20,000 payment at the beginning of the period ($t = 0$) represents a pre-paid expense and is not deductible for tax purposes until year 1. Similarly, the other 4 payments are not deductible until the following year. The schedule of cash flows under leasing alternative when the payment is made in advance is shown in Table 4.

19.7 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).

A hire purchase transaction is to be distinguished from an installment payment sale. In the latter case, the ownership in the asset is passed on to the user (buyer) on payment of the first installment itself. Moreover, the buyer does not enjoy the right of termination of the agreement before making payment of all the installments.

Leasing and Hire Purchase

In case of hire purchase, ownership of the asset passes on to the user (hirer) after payment of all the installments, but in case of a lease, the lessee is entitled to use the asset; ownership remains vested in the lessor. The hirer (user) can charge depreciation on the asset, while in case of lease; only the lessor can do so. The hirer remains liable to maintain the asset, but in case of operating lease the lessor has to bear the maintenance cost also. Moreover, the hirer can charge depreciation on the hired assets and other charges, while the hiree can claim interest on borrowed capital only. But in case of a lease, the lessor is allowed to claim depreciation, while the lessee can claim the rentals and maintenance expenses as deductible expenses from income. Lease is for the full value of the equipment, while in case of hire purchase, a cash down payment is generally required.

Split of Hire Purchase Installments between Interest and Principal Repayment

To illustrate how the hire-purchase installments are split between interest and principal 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:

$$\begin{array}{l} \text{1st year:} \quad \frac{36+35+34+\dots+25}{36+35+34+\dots+1} = \frac{366}{666} \\ \text{2nd year:} \quad \frac{24+23+22+\dots+13}{36+35+34+\dots+1} = \frac{222}{666} \\ \text{3rd year:} \quad \frac{12+11+10+\dots+1}{36+35+34+\dots+1} = \frac{78}{666} \end{array}$$

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

$$\text{1st year:} \quad x Rs. 4,50,000 = Rs. 247,297$$

$$\text{2nd year:} \quad x Rs. 4,50,000 = Rs. 1,50,000$$

$$\text{3rd year:} \quad x Rs. 4,50,000 = Rs. 52,703$$

Given these interest allocations, the annual hire-purchase installments would be split as follows:

Year	Hire Purchase (Rs.)	Interest installment (Rs.)	Principle repayment (Rs.)
1	4,83,333	2,47,297	2,36,036
2	4,83,333	1,50,000	3,33,333
3	4,83,333	52,703	4,30,630

19.8 CHOICE BETWEEN LEASING AND HIRE PURCHASE

Before discussing the procedure for choosing between leasing and hire purchase options, the following differences between them, from the point of view of the lessee (hirer), may be noted:

S. No	Leasing	Hire Purchase
1.	Depreciation and investment allowance cannot be claimed by the lessee.	Depreciation and investment allowance can be claimed by the hirer.
2.	The entire lease rental is a tax-deductible expense	Only the interest component of the hire purchase installment is tax-deductible
3.	The lessee, not being the owner of the asset, does not enjoy the salvage value	The hire, being the owner of the asset, enjoys the salvage value of the asset

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.
- ⇒ Hire: Each installment paid by hire purchaser is treated as hire. It includes part of cash price (principal) and interest rate.
- ⇒ Hire Purchase Charges: The difference between hire purchase price and cash price.
- ⇒ Net Hire Purchase Charges: It is the difference between net hire purchase price and cash price.
- ⇒ Net Cash Price: It is the total cash price less deposit, if any.
- ⇒ Net Hire Purchase Price: The total amount of hire purchase price s reduced by:
 - ⇒ Delivery Expenses
 - ⇒ Insurance Charges, if any, and
 - ⇒ Registration Fees of Agreement etc.

19.11 SELF ASSESSMENT QUESTIONS

1. What is leasing?

2. What are the main clauses which are usually incorporated in a lease agreement?

3. Define 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

STRUCTURE

20.1 Introduction

20.2 Objective

20.3 Housing Finance In India

20.4 History of Merchant Banks

20.4.1 Functions of Merchant Banks

20.4.2 Difference between an Investment Bank and a Merchant Bank

20.5 Venture Capital Funds

20.5.1 Types of Venture Capital Funds

20.5.2 Functions of Venture Capital

20.5.3 Features of Venture Capital

20.5.4 Benefits of Venture Capital

20.6 Summary

20.7 Glossary

20.8 Self Assessment Question

20.9 Lesson end exercise

20.10 Suggested Reading

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”

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

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.”

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

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

“Put simply, housing finance is what allows for the production and consumption of housing. It refers to the money we use to build and maintain the nation’s housing stock. But it also refers to the money we need to pay for it, in the form of rents, mortgage loans and repayments.”

(2009) Peter King, Understanding Housing Finance – Meeting Needs and Making Choices, p.3.

20.2 Objective

After going through this lesson you should be able to

- know about Housing Finance in India
- Understand Merchant Banking
- Know about Venture capital funds

20.3 HOUSING FINANCE IN INDIA

The responsibility of providing housing finance largely rested with the Government of India till the mid-eighties. The setting up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India (RBI) in 1988 as the apex institution marked the beginning of the emergence of housing

finance as a fund based financial service in the country. It has grown in volume and depth with the entry of a number of specialized financial institutions/ companies.

1. Housing Finance System:

The implementation of housing finance policies pre-supposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance system to individuals for house construction, there was no well established finance system till the mid 80s in as much as it had not been integrated with the main financial system of the country. The setting up of the National Housing Bank (NHB) a fully owned subsidiary of the Reserve Bank of India (RBI) and as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in India. The system has also been characterized by 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 (LIG) 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 its mission to promote an effective and cost effective housing finance system in the country, the NHB frames guidelines for housing finance institutions to ensure their growth on sound lines. The NHB provides loans and financial assistance to scheduled banks and housing finance institutions or to any authority established by or under any Central, State or Provincial Act. Being the chief regulatory body, NHB regulates the activities of housing finance companies based on regulatory and supervisory authority derived under the NHB Act. As per the amendments to certain provisions of the Act, NHB is empowered to grant certificate of registration to companies for commencing/carrying on the business of a housing finance institution. NHB also raises resources for the housing sector towards increasing new housing stock and provides refinance to a large set of retail lending institutions. These include scheduled commercial banks, specialized housing finance institutions, apex co-operative housing finance societies and agriculture and rural development banks. Besides the lending operations, NHB's dedicated training division conducts regular training programmes in areas relating to housing and housing finance for development of management capabilities of officials working in the sector.

LIC Housing Finance Limited (LICHFL):

LIC Housing Finance Limited (LICHFL) as a subsidiary of LIC was incorporated on June 19th 1989, to accelerate the development of housing. LIC Housing Finance Ltd is the second largest Housing Finance Company in India. LIC Housing Finance provides long term finance of individuals and corporate for the purchase, construction, repair and renovation of new/existing flats/houses. The Company is the only one of its kind that offers a Life Insurance Policy as collateral security to back its loans. LICHFL provides finance on existing property of business/ personal needs. The company has been growing steadily over the last one decade both in terms of business and profits.

6) Housing Development Finance Corporation (HDFC):

The Housing Development Finance Corporation (HDFC) was formally promoted and incorporated on October 17, 1977 under the Chairmanship 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 funds through an [initial public offering](#) (IPO) by providing [mezzanine financing](#), bridge financing, equity financing, and corporate credit products. They also issue and sell securities on behalf of corporations through [private placements](#) to refined investors who require less regulatory disclosure. Large merchant banks place equity privately with other financial institutions by acquiring a considerable share of ownership from companies with a significant potential for high growth rate to seal the gap between venture capital and public stock.

20.4 HISTORY OF MERCHANT BANKS

The history of merchant banks can be traced back to Italy in the late Medieval times as well in France in the 17th and 18th centuries. Merchant banks began operating as organized [money markets](#) consisting of merchants financing the transactions of other merchants. French merchant Marchand Banquier invested all his profits by integrating the banking business into his merchant activities and became a merchant banker.

In the United Kingdom, merchant banks started in the early 18th century. The oldest merchant bank in the United Kingdom is Barings Bank, which was established by a German-originated family of bankers and merchants. It was founded in 1762 and was the second oldest merchant bank in the world after Berenberg Bank. The bank was, at one time, referred to as the sixth great European power after Germany, Russia, United Kingdom, Austria, and France after it helped finance the US government during the 1812 War.

The growth of trade and industries in the 19th century led to the emergence of merchant banks in the United States. The first merchant banks in the United States were JP Morgan & Co and Citi Bank. The industry was mainly dominated by German-Jewish immigrant bankers and Yankee houses with close ties to expatriate Americans who settled in London as merchant bankers. However, with the growth of the financial world, corporations overshadowed family-owned businesses in the banking business. The corporations included merchant banking as one of their areas of interest, a characteristic that banks hold until today.

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 from venture capitalists and other large investors. Merchant banks offer such companies creative credit products such as bridge financing, equity financing, and mezzanine financing. They place equity with other financial institutions and take ownership of small but promising companies.

[Investment banks](#), on the other hand, focus on underwriting and selling securities through initial public offerings (IPO) and share offerings. Unlike merchant banks that focus on small companies with potential for growth, investment's bank clientele comprises large companies with enough resources to finance the sale of securities to the public. Investment banks advise their clients on [mergers and acquisitions](#), buyouts, and capital restructuring, among other services.

Traditional merchant banks mainly focus on international financing activities including trade finance, foreign corporate investing, and foreign real estate investment. Some of these activities may be shared with investment banks, but there are other functions like issuing letters of credit and international funds transfer that are predominantly carried out by merchant banks. Investment banks focus on raising funds for corporations and governments and issuing debt or equity on the market. This is a transition from their traditional roles of underwriting and selling securities. Investment banks also help in mergers and acquisitions as well as buying and selling large companies.

20.5 VENTURE CAPITAL FUNDS

A Venture Capital Fund, also known as VCF, is a type of an investment fund which investors provide to homegrown or foreign startups that might have a long-term growth potential in the near future. This type of financing is generally undertaken by strong investors, investment banks or high net worth individuals.

It is often risky for investors who allocate funds to seed a startup, but the returns over the long term in case of a successful business are lucrative. SEBI (Securities and Exchange Board of India) is the prominent government body which has set up guidelines regarding venture capital investment and stake-holding.

20.5.1 Types of Venture Capital Funds

Every startup has different stages of business operations which require 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 startup in developing a business plan. The business plan focuses upon market opportunity, the product, the development and financial needs.
- Apart from developing a business plan and providing resources to do the same, venture capitalists also evaluate the merits/demerits of the technological innovation. This allows for better ways to meet the business objectives and efficient management of the technological innovation.

- Venture capitalist also have a large network of other ventures across different industry. This is essential for a small business when it comes to professional networking.
- Apart from providing financial aid, Venture capitalists are actively involved in supplying a broad spectrum of specialist services - technical, commercial, managerial, financial and entrepreneurial.

20.5.3 Features of Venture Capital

- The most prominent feature of VCFs is that they provide seed funding and expansion-stage financing.
- The nature of VC funding is such that the investment in a particular startup usually involves purchasing an equity stake by the venture capitalists.
- VCFs bring with them the knowledge and experts of the investors which will help the small businesses scale up and grow economically.
- VCFs help in developing new products & services and acquire latest technologies that will help the company to grow further.
- VCFs offer networking opportunities. With influential and wealthy investors promoting the company, the company will scale up in no time.
- Venture capitalists hold the authority to influence the decisions of the enterprises they are investing in.
- Venture capitalists invest in multiple young startups across industrial sectors with a belief that at least one firm will achieve massive growth and reward them with a large payout. This brings about risk diversification

20.5.4 Benefits of Venture 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 offers the same services as an [investment bank](#), however, it typically services smaller clients and makes direct equity investments in them. A Venture Capital

Fund, also known as VCF, is a type of an investment fund which investors provide to homegrown or foreign startups that might have a long-term growth potential in the near future. This type of financing is generally undertaken by strong investors, investment banks or high net worth individuals.

20.7 GLOSSARY

Merchant Bank: A Merchant bank is a firm or financial institution that invests equity capital directly in businesses and often provides those businesses with advisory services.

Venture Capital Fund: A Venture Capital Fund, also known as VCF, is a type of an investment fund which investors provide to homegrown or foreign startups that might have a long-term growth potential in the near future.

20.8 SELF ASSESSMENT QUESTION

1. What is merchant banking? Explain the role of merchant bankers in the capital market

2. What is investment banking? Explain the characteristic features of Indian investment companies.

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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20.10 SUGGESTED READING

- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
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