Bachelor of Commerce

BC - 305

INDIAN FINANCIAL SYSTEM

Directorate of Distance Education
Guru Jambheshwar University of Science & Technology
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Introduction to Financial System and Economic Development

STRUCTURE:

1.0 Learning Objectives

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

- Know the meaning of economy and economic development.
- Know the functions of financial system.
- Understand the organisation of financial system.

1.1 Circular Flow of Economy

An economy is a system for coordinating society's productive activities. As we can see from the following figure that every economy is composed of four sectors. These are households, markets for goods and services, firms, and factor markets.

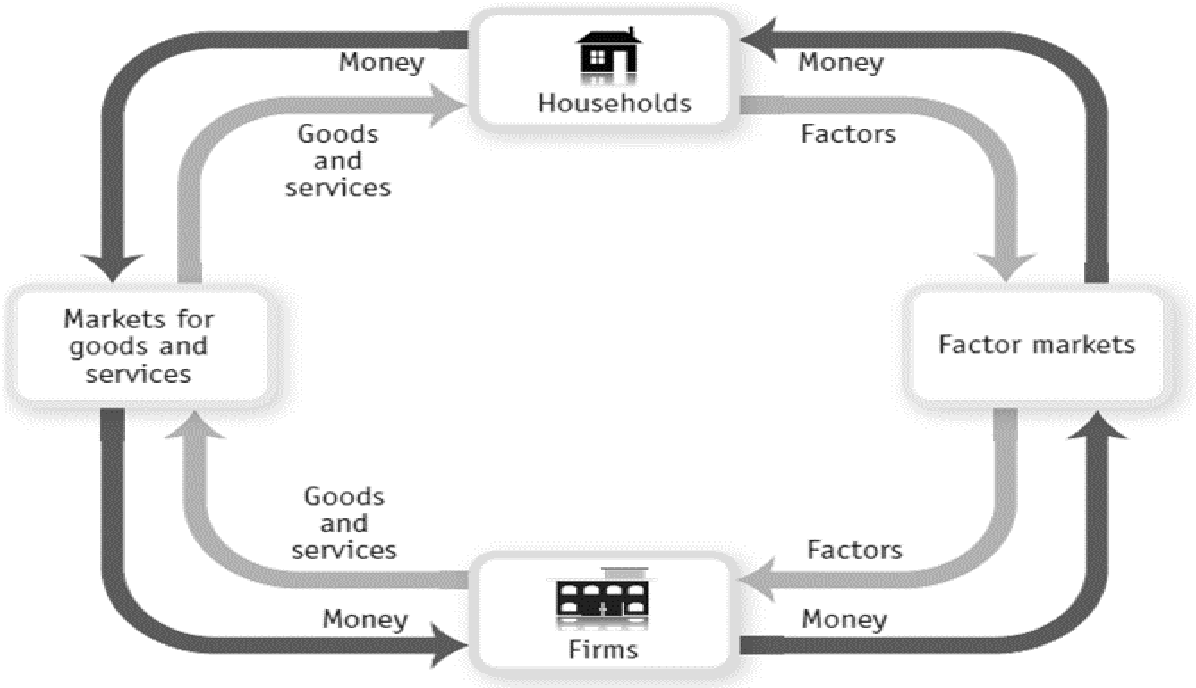

Figure 1: Circular Flow of Economy

Initially, households render their services via factor markets to the firms which produce goods and services. For these services, the firms pay the households wages and salaries as remuneration for their services. The firms then sell their products via markets for goods and services to the households in exchange of funds. Every economy in the world works in this manner and this process is known as circular flow of economy.

1.2 Economic Development

Government, companies, bankers and economists keep track of the flows of money between sectors with the national income and product accounts, or national accounts. Gross Domestic Product, or GDP, measures the value of all final goods and services produced in the economy. It does not include the value of intermediate goods and services. It can be calculated in three ways: add up the value added by all producers; add up all spending on domestically produced final goods and services; or add up all the income paid by domestic firms to factors of production.

Economic development is measured as changes (growth) in real GDP per capita in order to eliminate the effects of changes in the price level and changes in population size. Levels of real GDP per capita vary greatly around the world. The key determinants of long-run economic development are rising productivity, which is output per worker, rising capital formation and technological progress.

The large differences in countries' economic developments are largely due to differences in their rates of accumulation of physical and human capital as well as differences in technological progress. Although inflows of foreign savings from abroad help, a prime factor is differences in domestic savings and investment spending rates, since most countries that have high investment spending in physical capital finance it by high domestic savings. Technological progress is largely a result of research and development, or R&D. Governments can enhance economic growth by developing a well-functioning financial system that channels savings into investment spending, education, and R&D.

1.3 Financial System

A system is a set of interrelated parts working together to achieve some purpose. With reference to the financial system, it implies a set of complex and closely-connected or intermixed institutions, agents, practices, markets, claims, and so on in an economy. Conceptually, the term financial system includes a complex of institutions and mechanisms which affect the generation of savings and their transfer to those who will invest. In other words, financial systems may be said to be made up of all those channels through which savings become available for investment.

1.4 Functions

Financial systems are of crucial significance to capital formation. That adequate capital formation is indispensable to speedy economic development is universally recognised in academic literature. The main function of financial systems 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.

The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. The effective mobilisation of savings, the efficiency of the financial organisation/system and the channelization of these savings into the most desirable and productive forms of investment are all inter-connected and have a great bearing on the contribution of capital formation to economic development.

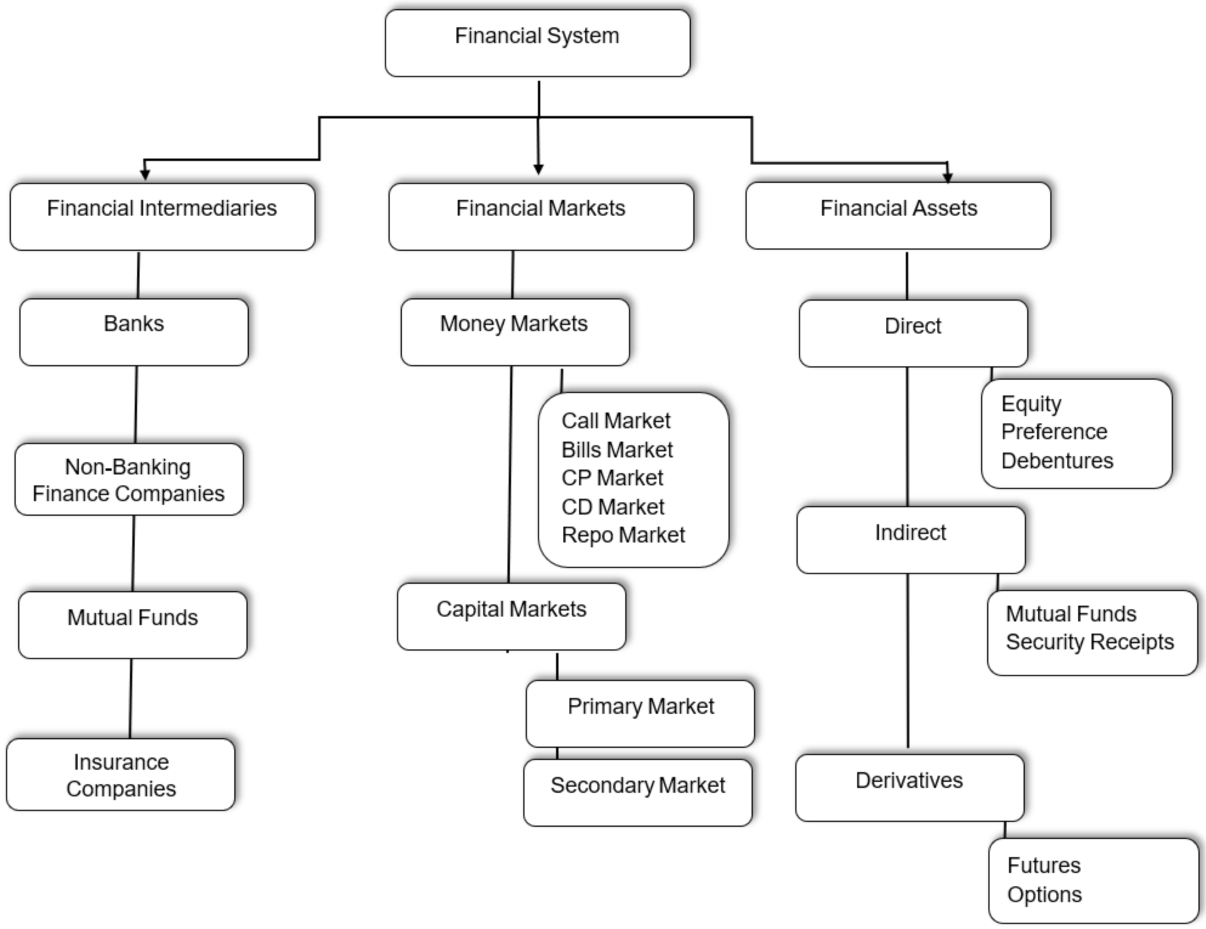

Figure 2: Organisation of Financial System

1.5 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 investments representing expenditure on durable assets. The relationship between savings and investments varies considerably among economic units. Goldsmith1 has designated the various economic units into three categories:

- Saving-surplus units, that is, those units whose savings are in excess of investments,
- Economic units whose investments exceed their savings referred to as Savings-deficit units and
- Neutral units in whose case savings are equal to investments.

If capital formation is to take place, the savings of the savings-surplus units must be transferred to the savings-deficit units. There is, in other words, a need for institutional arrangement to facilitate the transfer of resources. 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 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 requisite technical and market information and temperament to use it, while the activity of savings is largely diffused between innumerable individuals who lack the skill, capacity and personal characteristics for active investment. Hence, the transferred process is crucial to facilitate 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.

1.6 Organisation of Financial System

The organisation/structure of the financial system consists of (i) financial intermediaries, (ii) financial markets and (iii) financial assets/instruments. Exhibit 1.1 portrays the organisation of the financial system.

1.6.1 Financial Intermediaries

If you look carefully our experience with the money, you will find that at some points we aresavers and therefore we are investors.But at some other points, we are borrowers. For example, when you put your money away in a bank or in a mutual fund or in the equity shares of a company, you are a saver who is investing. On the other hand, when you take a mortgage loan, a motor car loan, etc., you become a borrower.

In exactly the same way, companies borrow and companies also invest their surplus cash. Every governments also borrow and when they have surplus cash which is very rare they would invest it in the financial system. So, whether you are a government, whether you are a company, or whether you are an individual, you’re both a saver and therefore an investor and a borrower almost at the same time.

Now, where do you go to save, invest, and borrow? Financial intermediaries bring the savers and the borrowers together. An important component of the financial system is a range of financial intermediaries which collect savings from others and use these funds to purchase ownership or debt claims. Financial intermediaries issue to savers the claims/securities whose features may be different from those claims/securities that financial intermediaries buy and hold. In simple words,financial intermediaries, in the savings-investment process, stand between the final borrowers and final lenders.

Now, what's the role of a financial intermediary? Essentially, it is to intermediate funds from savers to borrowers in the most risk-free manner. Therefore, whatever money you have, you can take it and put it in a financial intermediary. And when you want to borrow, the intermediary will be in a position to lend to you. These institutions, therefore, engage in what we call denomination intermediation. That means taking money from savers in all forms; small, big, large, and lending it to borrowers in amounts that borrowers would need. Risk-free manner is an important operating phrase. Financial intermediaries absorb almost all of the risks that go with financial intermediation. For example, if you go and put your money in a bank and let us say they lend it to a Mr Ramesh and that Mr Ramesh goes insolvent and does not pay back the amount he has borrowed from the bank. It is still binding on that bank to make sure that your money is given to you when it is due to you. In other words, the bank will have to absorb all the risks and that is what we mean by the intermediate funds in a risk-free manner.

Services

The services/economies provided by the financial intermediaries that tailor financial assets to the desires of savers-investors are: Convenience, Lower risk, Expert management and Economies of scale.

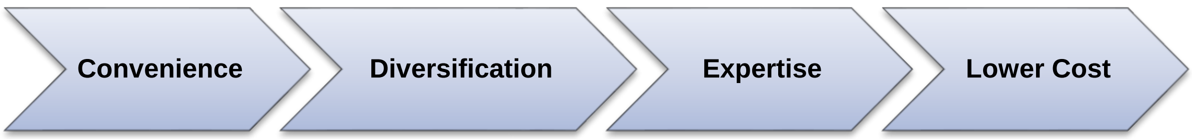

Figure 3: Services of Financial Intermediaries

Convenience: Financial intermediaries convert securities into more convenient vehicle for the mobilisation of savings, particularly of small savers. Firstly, they change the denomination/terms of the securities/credit to suit the requirements of individual savers/borrowers by offering securities of varying sizes. Both savers and borrowers get flexibility in dealing with a financial intermediary as compared to dealing with a various parties. Secondly, intermediaries transform a primary security of a certain maturity into an indirect security of a different maturity. They create liquidity by issuing more liquid securities to savers than the securities they buy.

Diversification: Financial intermediaries'offers risk diversification to small investors.It helps investors in reducing the risk of capital depreciation and poor dividends. Small investors with limited capital can achieve better diversification by purchasing indirect securities than what they could do by direct purchase of securities in the securities market. A mutual fund is a best example of diversification.

Professionalism: Majority of small and medium investors lack the required skills, training and experience to deal with financial products and markets. Financial intermediaries provide the benefits of their experience and skillsin managing the savings of these investors. They offers a whole range of service from security selection to wealth management to the investors. Thus, in effect, financial intermediaries place the small investors in the same position in the matter of expert management as large institutional investors.

Lower Cost: Financial intermediaries issue indirect securities to lenders and channel their funds to the ultimate borrowers at lower cost. Becausethe main operation of financial intermediaries is tobuy/sell primary securities in large quantities in financial markets.Individual investors cannot operate at this large scale as financial intermediaries can. Therefore, economies of scale are available intermediaries rather than to a borrower/lender. Financial intermediaries play animportant role in mobilisation of savings for economic development and make the financial systems/organisations more efficient.

Types of Financial Intermediaries

Types of financial intermediaries are Banks, Non-banking Finance Companies, Mutual Funds and Insurance Companies which operates in almost every economy.

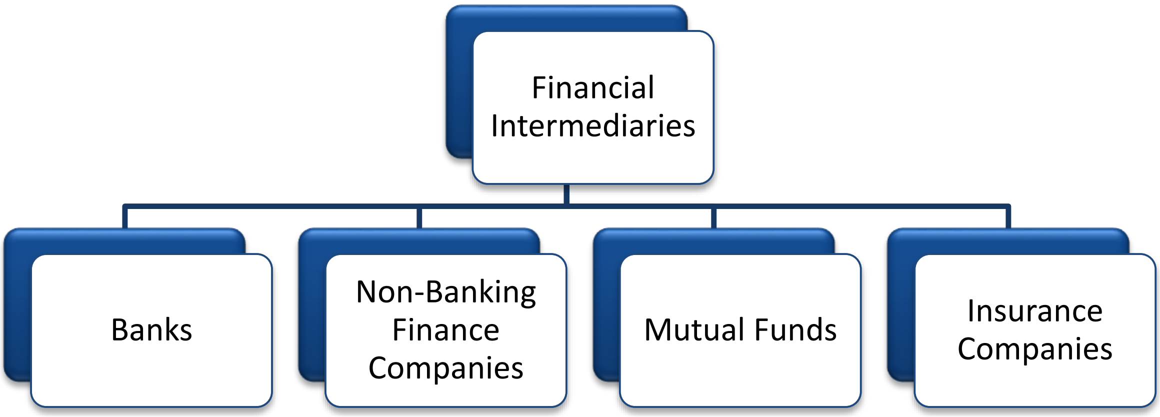

Figure 4: Types of Financial Intermediaries

1.6.1.1 Banks

If we go back to four to five decades ago, the only place that savers could go to invest their money was in a bank. And the only place that borrowers could go to borrow was a bank. Therefore, banks are the biggest financial intermediaries even to this day.Banks collect savings primarily in the form of deposits and finance short-term and long-term capital requirements of corporates, individuals and other entities.Banks today are important not just from the point of view of economic growth, but also financial stability. In emerging economies, banks are special for three important reasons. First, they take a leading role in developing other financial intermediaries and markets. Second, due to the absence of well-developed equity and bond markets, the corporate sector depends heavily on banks to meet its financing needs. Finally, in emerging markets such as India, banks cater to the needs of a vast number of savers from the household sector, who prefer assured income and liquidity and safety of funds, because of their inadequate capacity to manage financial risks.

1.6.1.2 Non-banking finance companies (NBFC)

NBFC become a source of incremental finance. At times, they finance businesses which do not meet strict banking norms. NBFCs do not have access to cheap bank deposits from the public (in the form of savings account, current account etc.), although they can accept fixed deposits. Their cost of funds being higher than banks, their lending too tends to be at a higher rate. Yet borrowers access these funds, either because they are unable to mobilise funds from banks, or to fund their requirements beyond what they can mobilise from banks. NBFCs are particularly active in consumer finance and personal finance.NBFCs are categorised into following diverse entities based on their primary activity:

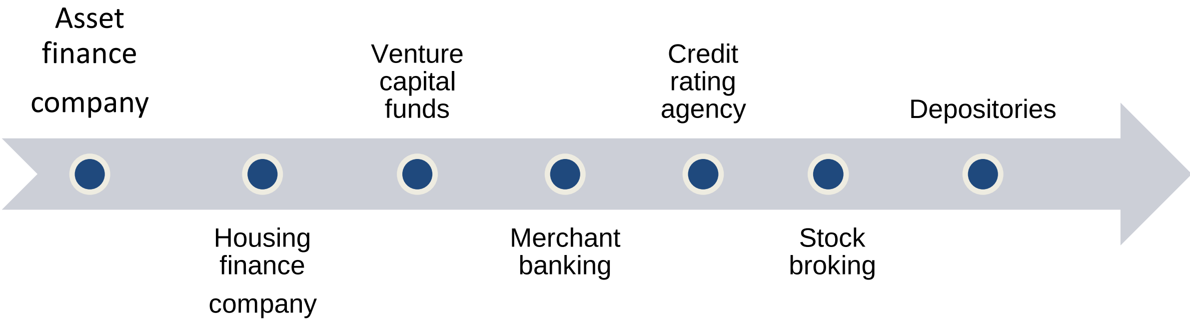

Figure 5: Types of Non-banking Finance Companies

1.6.1.3 Mutual Funds

A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments and other securities. Mutual funds have a fund manager who invests the money on behalf of the investors by buying / selling stocks, bonds etc.A mutual fund is formed in the form of a trust which has a sponsor, trustees, asset management company and custodian. The trust is established by the sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of the SEBI regulations by the mutual fund. The AMC manages the funds by making investment in various types of securities. The custodian holds the securities of the various schemes of the mutual fund in its safe custody. Mutual funds offers convenience in terms of lower denomination of investment and liquidity, lower risk through diversification, expert management and reduced transaction cost due to economies of scale.

1.6.1.4 Insurance Companies

Insurance companies generally invest the insurance premium paid policyholders and in exchange promise them to pay a specified sum on maturity of the insurance policy or upon the happening of a certain event. They differ from other financial intermediaries, because their main function is to provide protection to their investors against unforeseen risks. Insurance companies generallyhave animportant position among all the intermediaries. Because, large number of small investorsinvest in these companies. The need of insurance is affected by various factorssuch as the creation of an emergency fund to guardfrom financial misfortune, building a good investment and accumulation of a fund by the time of retirement from active work.

On the basis of above discussion, the objective of financial intermediaries and banks is to intermediate funds from savers to borrowers in the most risk-free manner. There is a difference between indirect finance as practiced by the financial intermediaries and direct finance as practiced by entities in the financial markets.In the former case, that means indirect finance engaged in by banks and financial intermediaries, the risk is carried almost entirely by the bank or the financial intermediary whereas, in the case of direct finance, that is financial markets, the risk is carried entirely by the saver or the investor. As an example, if you buy the shares of a company and that company's goes insolvent, you run the risk of losing your entire investments and you have nobody except yourself to blame for that. On the other hand, if you put your money in a bank and the bank lends it to some company and that goes insolvent there is a very good chance that you will still get your money back. Thanks to a deposit guarantee or some form of insurance that your bank or the financial intermediary would have subscribed to on your behalf, to ensure the safety of your money.

1.6.2 Financial Markets

Financial markets are markets, both real and virtual, where financial instruments of varying maturities are traded. Instruments traded in the financial markets include overnight instruments such as call money and fed funds.Short-term instruments with maturities up to one year such; as treasury bills, commercial paper, etc.Long-term instruments with maturities up to 30 years such as government securities and corporate bonds. Perpetual instruments such as equity shares. They are broadly classified into short-term markets and long-term markets.

1.6.2.1 Money Markets/Short-term markets

These markets include

- Call Money Markets
- Treasury Bills Market
- Repo Market
- Commercial Paper Market
- Certificate of Deposits Markets; and so on.

The one thing important about the short-term markets is the maturity for instruments traded in the short-term market vary from overnight to a maximum of 180 days, in some cases up to one year

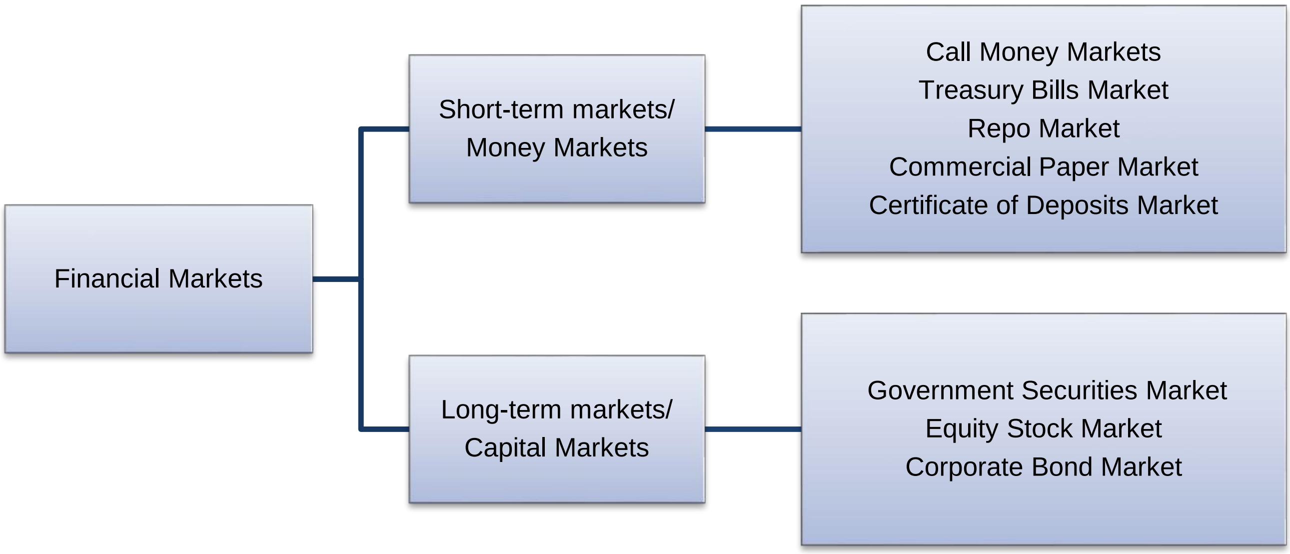

Figure 6: Types Financial Markets

1.6.2.2 Capital Markets/Long-term market

These marketsprimarily refers to

- Government Securities Market,
- Equity Stock Market
- Corporate Bond Market.

In the long-term markets, the maturities for instruments traded vary from one year to perpetuity, in other words, they don't have a maturity date. Short-term markets almost universally are also commonly referred to as Money Markets. Long-term markets are commonly referred to as Capital Markets.Financial resources raised in these markets are often used by firms to fund their long-term capital investment and by governments to fund their fiscal deficit, as well as long-term investments in infrastructure development, so on and so forth. Do bear in mind that short term or long term in the context of financial markets and instruments refers to the maturity period of the instruments issued. They do not refer to the holding period by the investor. For example, an investor could buy a corporate bond of 15 years maturity which is a long-term instrument and sell it at the end of 90 days, i.e. in a short period and he books his trading profit or loss. In this case the instrument is a long-term and hence, part of the long-term market but the holding period is in the short term. Financial markets facilitate price discovery. And by that we mean, markets determine prices and yields for interest bearing instruments, price for equity shares, etc; based on factors such as projected cash flows and risk profile of the issuer Interest rate expectations Liquidity, News-flows, etc. in a free and transparent manner across markets.The financial markets has two interdependent and inseparable segments, the new issues (primary market) and the stock (secondary) market.

1.6.2.3 Primary Market

The primary market provides the channel for sale of new securities. Primary market provides opportunity to issuers of securities; government as well as corporates, to raise resources to meet their requirements of investment and/or discharge some obligation. They may issue the securities at face value, or at a discount/premium and these securities may take a variety of forms such as equity, debt etc. They may issue the securities in domestic market and/or international market. The primary market issuance is done either through public issues or private placement. A public issue does not limit any entity in investing while in private placement, the issuance is done to select people. In terms of the Companies Act, 1956, an issue becomes public if it results in allotment to more than 50 persons. This means an issue resulting in allotment to less than 50 persons is private placement. There are two major types of issuers who issue securities. The corporate entities issue mainly debt and equity instruments (shares, debentures, etc.), while the governments (central and state governments) issue debt securities (dated securities, treasury bills). The price signals, which subsume all information about the issuer and his business including associated risk, generated in the secondary market, help the primary market in allocation of funds.

1.6.2.4 Secondary Market

Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. The secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risk and return. They also sell securities for cash to meet their liquidity needs. The secondary market has further two components, namely the over-the-counter (OTC) market and the exchange-traded market. OTC markets are essentially informal markets where trades are negotiated. Most of the trades in government securities are in the OTC market. The exchanges do not provide facility for spot trades in a strict sense. Closest to spot market is the cash market where settlement takes place after some time. Trades taking place over a trading cycle, i.e. a day under rolling settlement, are settled together after a certain time (currently 2 working days). Tradesexecuted on the

Stock Exchange are cleared and settled bya clearing corporation which provides novation and settlement guarantee. Nearly 100% ofthe trades settled by delivery are settled in demat form.

Overall, transfer of resources from those with idle resources to others who have a productive need for them is perhaps most efficiently achieved through the financial markets. Stated formally, financial markets provide channels for reallocation of savings to investments and entrepreneurship and thereby decouple these two activities. As a result, the savers and investors are not constrained by their individual abilities, but by the economy’s abilities to invest and save respectively, which inevitably enhances savings and investment in the economy.

1.6.3 Financial Instruments

The financial intermediaries and savers and borrowers generally trade in the financial assets/instruments (securities). Therefore, these instruments also become a part of financial system. These securities are basically claims on a stream of income and/or assets of any economic organisation and usually held as a store of value and for the anticipated return. The financial assets fall into three broad categories: (i) Direct (ii) Indirect and (iii) Derivatives.

1.6.3.1 Direct Securities

These securities/instruments are issued by non-financial economic units such as companies to meet their long-term and short-term capital requirements. The major types of direct instruments are equity shares, preference shares and debentures.

1.6.3.1.1 Equity/Ordinary Shares

Investors owning equity shares of a company are owners of the company. They are issued equity shares of the company, as evidence of such ownership. Equity investors are not entitled to any fixed return or repayment of capital. However, they are entitled to the benefits that arise out of the performance of the company. If the business fails, they may lose the entire investment. Of all the financiers, they take the most risk.

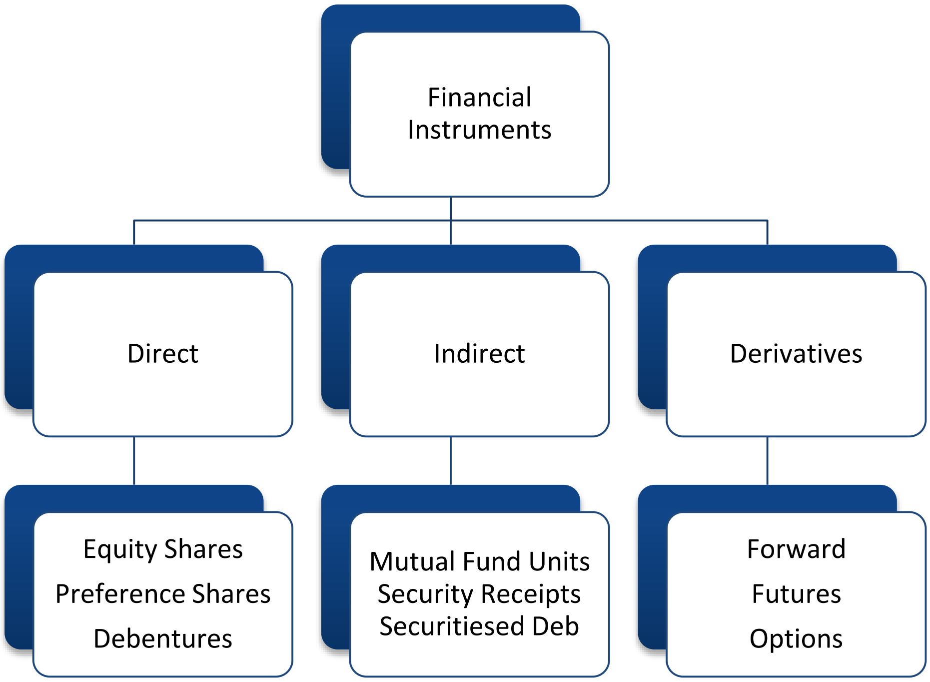

Figure 7: Financial Instruments

1.6.3.1.2 Debentures

Investors in the debt of a company are not owners of the company – they are more in the nature of lenders to the company. They are issued debentures or other debt securities, as evidence of the moneys invested. Investors in debt securities are entitled to be paid an interest and repaid their capital as per terms agreed at the time of investment. The debt capital is to be serviced, irrespective of whether or not the company is profitable. Debt, which is repayable within a short time period of 1 year, is called money market. Money market is thus a segment of the debt market. A company can issue perpetual or redeemable debentures. 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 nonconvertible or convertible into equity shares.

1.6.3.1.3 Preference Shares

A preference share is a hybrid security and takes the features of both equity and debentures. Investors in preference capital of a company are considered to be owners of the company, as per the Companies Act, 1956. They are issued preference shares of the company, as evidence of such ownership. However, their ownership rights are much lesser than those of equity investors. Preference investors take more risk than debt investors, but less risk than equity. Like debt, they are entitled to a fixed return – but this is payable only out of the profits of the company. If, in a year, the company does not have adequate profits, the dividend will not be payable (in the case of non-cumulative preference shares) or be payable in future years (in the case of cumulative preference shares). Besides the fixed return, they may also be entitled to additional returns, depending on profits of the company (in the case of participating preference shares). Preference shares, which are not entitled to such additional share on the profits of the company, are called non-participating preference shares.

1.6.3.2 Indirect Securities

The indirect financial assets are coined from the underlying primary security and bearing their own utilities. They are better suited to the requirements of investors, particularly small investors. They are equally attractive to borrowers in that they can sell their primary securities to financial intermediaries on more satisfactory terms than selling them directly to ultimate lenders (investors). The main consideration underlying the attractiveness of indirect securities is that the pooling of funds by a financial intermediary leads to a number of indirect and derived benefits that add greatly to the efficiency and effectiveness of this type of financial marketing.Indirect securities are financial assets issued by financial intermediaries, such as units of mutual funds, policies of insurance companies, deposits of banks, security receipts issued by securitisation and asset reconstruction companies, securitised debt instruments issued by special purpose vehicles (SPVs) and so on.Some of these are benefits that arise from division of labour and efficiencies of size and scale as similar to those observed in many other economic processes. But another type of benefit is uniquely financial and is largely statistical in nature. This relates to the variety of services and economics that are provided by the financial intermediaries, namely, convenience, lower risk and expert management.

Derivatives

One of the most significant events in the securities markets has been the development and expansion of financial derivatives. The term "derivatives" is used to refer to financial instruments which derive their value from some underlying assets. The underlying assets could be equities (shares), debt (bonds, T-bills, and notes), currencies, and even indices of these various assets, such as the Nifty 50 Index. Derivatives derive their names from their respective underlying asset. Thus if a derivative's underlying asset is equity, it is called equity derivative and so on. Derivatives can be traded either on a regulated exchange, such as the NSE or off the exchanges, i.e., directly between the different parties, which is called "over-the-counter" (OTC) trading. (In India only exchange traded equity derivatives are permitted under the law.) The basic purpose of derivatives is to transfer the price risk (inherent in fluctuations of the asset prices) from one party to another; they facilitate the allocation of risk to those who are willing to take it. In so doing, derivatives help mitigate the risk arising from the future uncertainty of prices. For example, on November 1, 2009 a rice farmer may wish to sell his harvest at a future date (say January 1, 2010) for a pre-determined fixed price to eliminate the risk of change in prices by that date. Such a transaction is an example of a derivatives contract. The price of this derivative is driven by the spot price of rice which is the "underlying". There are various types of derivatives traded on exchanges. The three basic forms of derivatives are Forwards, Futures, and Options.

1.6.3.2.1 Forward Contracts

These are promises to deliver an asset at a pre- determined date in future at a predetermined price. Forwards are highly popular on currencies and interest rates. The contracts are traded over the counter (i.e. outside the stock exchanges, directly between the two parties) and are customized according to the needs of the parties. Since these contracts do not fall under the purview of rules and regulations of an exchange, they generally suffer from counterparty risk i.e. the risk that one of the parties to the contract may not fulfil his or her obligation.

1.6.3.2.2 Futures Contracts

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in future at a certain price. These are basically exchange traded, standardized contracts. The exchange stands guarantee to all transactions and counterparty risk is largely eliminated. The buyers of futures contracts are considered having a long position whereas the sellers are considered to be having a short position. It should be noted that this is similar to any asset market where anybody who buys is long and the one who sells in short. Futures contracts are available on variety of commodities, currencies, interest rates, stocks and other tradable assets. They are highly popular on stock indices, interest rates and foreign exchange.

1.6.3.2.3 Option Contracts

Options give the buyer (holder) a right but not an obligation to buy or sell an asset in future. Options are of two types - calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date. One can buy and sell each of the contracts. When one buys an option he is said to be having a long position and when one sells he is said to be having a short position.

1.8 Summary

- Governments can enhance economic growth by developing a well-functioning financial system that channels savings into investment spending, education, and R&D.
- Financial systems may be said to be made up of all those channels through which savings become available for investment.
- 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 structure of the financial system consists of financial intermediaries, financial markets and financial assets/instruments.
- An important component of the financial system is a range of financial intermediaries which collect savings from others and use these funds to purchase ownership or debt claims.Types of financial intermediaries are Banks, Non-banking Finance Companies, Mutual Funds and Insurance Companies which operates in almost every economy.
- Financial markets are markets, both real and virtual, where financial instruments of varying maturities are traded. Instruments traded in the financial markets include short-term instruments with maturities up to one year such; as treasury bills, commercial paper, etc. and long-term instruments with maturities up to 30 years such as government securities, corporate bonds and perpetual instruments such as equity shares.
- Financial assets are basically claims on a stream of income and/or assets of any economic organisation and usually held as a store of value and for the anticipated return. The financial assets fall into direct securities, indirect securities and derivative instruments.

1.9 Keywords

Economy: A system for coordinating society's productive activities.

Economic Development: Measurement of changes (growth) in real GDP per capita.

Saving-surplus Units: Those units whose savings are in excess of investments.

Economic Units: Whose investments exceed their savings referred to as Savings-deficit units.

Neutral units: in whose case savings are equal to investments.

Non-banking finance companies:are a source of for businesses which do not meet strict banking norms.

Direct Securities: are issued by non-financial economic units such as companies to meet their long-term and short-term capital requirements.

Indirect Securities:are generated from the underlying primary security.

Futures Contracts: A futures contract is an agreement between two parties to buy or sell an asset at a certain time in future at a certain price.

Option Contracts: Options give the buyer (holder) a right but not an obligation to buy or sell an asset in future.

1.10 Check Your Progress

1. Which of the following are functions of a financial system?
    a. The operation of a payments system.
    b. Providing the means of portfolio adjustment.
    c. Helping to reduce unemployment.
    d. Channelling funds between lenders and borrowers.
    e. Helping speculators to bet on price movements.
2. Financial system consists of
    a. Financial assets
    b. Financial markets
    c. Financial intermediaries
    d. All of the above
3. Which of the following are deposit-taking institutions (DTIs)?
    a. Building societies.
    b. Insurance companies.
    c. Investment trust companies.
    d. Pension funds.
    e. Retail banks.

4. Saving in an economy are done by
    a. Households
    b. Government
    c. Business firms
    d. All of these
5. Which of the following is a financial asset
    a. Plant
    b. Buildings
    c. Shares
    d. Land

1.10 Self-assessment Test

1. What is a financial system? Discuss the components of a formal financial system.
2. Discuss the types of financial markets and their inter-relationship.
3. What are the characteristics and functions of financial markets?
4. 'A market-based financial system is preferable over a bank-based system.' Comment critically.
5. 'A financial system is a well-integrated system whose parts interact with each other.' Explain.

1.11 Answers to Check Your Progress

Question 1	Answer	(d)
Question 2	Answer	(d)
Question 3	Answer	(e)
Question 4	Answer	(d)
Question 5	Answer	(c)

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Course: **Indian Financial System**	
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Overview of Indian Financial System

STRUCTURE:

2.0 Learning Objectives

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

- Understand the meaning and components of financial system.
- Know the banking structure and types of banks.
- Know the functions of NBFCs.
- Understand the financial markets.

2.1 Introduction

The period from the mid-1960s to the early 1990s was characterized by government controlled interest rates, industrial licensing and controls, dominant public sector, and limited competition. This led to the emergence of an economy characterised by uneconomic and inefficient production systems with high costs. This inefficient allocation and use of resources resulted in high capital-output ratios. Despite a rise in saving rates, there was greater dependence on assistance from abroad to meet urgent situations.

The Indian government, therefore, initiated deregulation in the 1980s by relaxing the entry barriers, removing restrictive clauses in the Monopolies and Restrictive Trade Practices (MRTP) Act, allowing expansion of capacities, encouraging modernization of industries, reducing import restrictions, raising the yield on long-term government securities, and taking measures to help the growth of the money market. These measures resulted in a relatively high growth in the second half of the 1980s, but its pace could not be sustained. Further, the government initiated economic reforms in June 1991 to provide an environment of sustainable growth and stability.

The deregulation of industry, liberalization of foreign exchange markets and convertibility of currency require an efficient financial system. Hence, the steps to improve the financial system were an integral part of the economic reforms initiated in 1991. The improved financial system is expected to increase the efficiency of resource mobilization and allocation in the real economy, which, in turn, would induce a higher rate of economic growth.

In the 1990s, there was a paradigm shift in development from a state-dominated to a market-determined strategy. This shift was a result of the government's failure in achieving a higher growth rate. On the one hand, the government could not generate resources for investment or public services; on the other, there was an erosion in public savings. Thus, a failure of the government's restrictive and regulating policies and a need to adopt a market-determined strategy of development were the causes for undertaking reforms in the financial system. These reforms aimed at improving operational and allocative efficiency of the financial system. Further, they targeted at increasing competitive efficiency in the operation of the system, making it healthy and profitable and imparting to it an operational flexibility and autonomy for working efficiently. The reforms primarily aimed at structural transformation in the financial system to improve efficiency, stability, and integration of various components of the financial system. Some of the structural changes initiated are free pricing of financial assets, relaxation of quantitative restrictions, and removal of barriers to entry, new methods and instruments of trading, and greater participation and improvement in clearing, settlement, and disclosure practices.

Now, India's financial sector is integrating with that of the rest of the world. The interest rates have been freed, the statutory provisions have been reduced and prudential norms have been strengthened for players in the financial sector. Reforms have altered the organization structure, ownership pattern, and domain of operations of financial institutions and infused greater competition. Presently the Indian financial system is composed of banks, non-banking financial companies and financial markets.

2.2 Banks

Banks have played a critical role in the economic development of some developed countries such as Japan and Germany and most of the emerging economies including India. Banks today are important not just from the point of view of economic growth, but also financial stability. In emerging economies, banks are special for three important reasons. First, they take a leading role in developing other financial intermediaries and markets. Second, due to the absence of well-developed equity and bond markets, the corporate sector depends heavily on banks to meet its financing needs. Finally, in emerging markets such as India, banks cater to the needs of a vast number of savers from the household sector, who prefer assured income and liquidity and safety of funds, because of their inadequate capacity to manage financial risks. Forms of banking have changed over the years and evolved with the needs of the economy. The transformation of the banking system has been brought about by deregulation, technological innovation and globalization. While banks have been expanding into areas which were traditionally out of bounds for them, non-bank intermediaries have begun to perform many of the functions of banks. Banks thus compete not only among themselves, but also with nonbank financial intermediaries, and over the years, this competition has only grown in intensity. Globally, this has forced the banks to introduce innovative products, seek newer sources of income and diversify into non-traditional activities.

In India, the definition of the business of banking has been given in the Banking Regulation Act, (BR Act), 1949. According to Section 5(c) of the BR Act, 'a banking company is a company which transacts the business of banking in India.' Further, Section 5(b) of the BR Act defines banking as, 'accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable, by cheque, draft, and order or otherwise.' This definition points to the three primary activities of a commercial bank which distinguish it from the other financial institutions. These are: (i) maintaining deposit accounts including current accounts, (ii) issue and pay cheques, and (iii) collect cheques for the bank's customers.

2.3 Evolution of Commercial Banks in India

The commercial banking industry in India started in 1786 with the establishment of the Bank of Bengal in Calcutta. The Indian Government at the time established three Presidency banks, viz., the Bank of Bengal (established in 1809), the Bank of Bombay (established in 1840) and the Bank of Madras (established in 1843). In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, which took up the role of a commercial bank, a bankers' bank and a banker to the Government. The Imperial Bank of India was established with mainly European shareholders. It was only with the establishment of Reserve Bank of India (RBI) as the central bank of the country in 1935, that the quasi-central banking role of the Imperial Bank of India came to an end.

In 1860, the concept of limited liability was introduced in Indian banking, resulting in the establishment of joint-stock banks. In 1865, the Allahabad Bank was established with purely Indian shareholders. Punjab National Bank came into being in 1895. Between 1906 and 1913, other banks like Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. After independence, the Government of India started taking steps to encourage the spread of banking in India. In order to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a state-partnered and state-sponsored bank taking over the Imperial Bank of India and integrating with it, the former state-owned and state-associate banks. Accordingly, State Bank of India (SBI) was constituted in 1955. Subsequently in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former state-associate banks as its subsidiaries. To better align the banking system to the needs of planning and economic policy, it was considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalized. This was an important milestone in the history of Indian banking. This was followed by the nationalisation of another six private banks in 1980. With the nationalization of these banks, the major segment of the banking sector came under the control of the Government. The nationalisation of banks imparted major impetus to branch expansion in un-banked rural and semi-urban areas, which in turn resulted in huge deposit mobilization, thereby giving boost to the overall savings rate of the economy. It also resulted in scaling up of lending to agriculture and its allied sectors. However, this arrangement also saw some weaknesses like reduced bank profitability, weak capital bases, and banks getting burdened with large non-performing assets. To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system.

One important feature of the reforms of the 1990s was that the entry of new private sector banks was permitted. Following this decision, new banks such as ICICI Bank, HDFC Bank, IDBI Bank and UTI Bank were set up. Commercial banks in India have traditionally focused on meeting the short-term financial needs of industry, trade and agriculture. However, given the increasing sophistication and diversification of the Indian economy, the range of services extended by commercial banks has increased significantly, leading to an overlap with the functions performed by other financial institutions. Further, the share of long-term financing (in total bank financing) to meet capital goods and project-financing needs of industry has also increased over the years.

2.4 Banking Structure in India

2.4.1 Banking Regulator

The Reserve Bank of India (RBI) is the central banking and monetary authority of India, and also acts as the regulator and supervisor of commercial banks.

2.4.2 Scheduled Banks in India

Scheduled banks comprise scheduled commercial banks and scheduled co-operative banks. Scheduled commercial banks form the bedrock of the Indian financial system, currently accounting for more than three-fourths of all financial institutions' assets. SCBs are present throughout India, and their branches, having grown more than four-fold in the last 40 years now number more than 80,500 across the country.

2.4.3 Public Sector Banks

Public sector banks are those in which the majority stake is held by the Government of India (GoI). Public sector banks together make up the largest category in the Indian banking system. There are currently 27 public sector banks in India. They include the SBI and its 6 associate banks (such as State Bank of Indore, State Bank of Bikaner and Jaipur etc), 19 nationalised banks (such as Allahabad Bank, Canara Bank etc) and IDBI Bank Ltd. Public sector banks have taken the lead role in branch expansion, particularly in the rural areas. Public sector banks account for bulk of the branches in India. In the rural areas, the presence of the public sector banks is overwhelming; in 2009, 96 percent of the rural bank branches belonged to the public sector. The private sectorbanks and foreign banks have limited presence in the rural areas.

2.4.4 Regional Rural Banks

Regional Rural Banks (RRBs) were established during 1976-1987 with a view to develop therural economy. Each RRB is owned jointly by the Central Government, concerned State Government and a sponsoring public sector commercial bank. RRBs provide credit to smallfarmers, artisans, small entrepreneurs and agricultural labourers. Over the years, theGovernment has introduced a number of measures of improve viability and profitability ofRRBs, one of them being the amalgamation of the RRBs of the same sponsored bank within aState. This process of consolidation has resulted in a steep decline in the total number of RRBsto 86 as on March 31, 2009, as compared to 196 at the end of March 2005.

2.4.5 Private Sector Banks

In this type of banks, the majority of share capital is held by private individuals and corporates.Not all private sector banks were nationalized in in 1969, and 1980. The private banks whichwere not nationalized are collectively known as the old private sector banks and include bankssuch as The Jammu and Kashmir Bank Ltd., Lord Krishna Bank Ltd etc. Entry of private sectorbanks was however prohibited during the post-nationalisation period. In July 1993, as part ofthe banking reform process and as a measure to induce competition in the banking sector, RBIpermitted the private sector to enter into the banking system. This resulted in the creation ofa new set of private sector banks, which are collectively known as the new private sectorbanks. As at end March, 2009 there were 7 new private sector banks and 15 old private sectorbanks operating in India.

2.4.6 Foreign Banks

Foreign banks have their registered and head offices in a foreign country but operate theirbranches in India. The RBI permits these banks to operate either through branches; or throughwholly-owned subsidiaries. The primary activity of most foreign banks in India has been inthe corporate segment. However, some of the larger foreign banks have also made consumerfinancinga significant part of their portfolios. These banks offer products such as automobilefinance, home loans, credit cards, household consumer finance etc. Foreign banks in India arerequired to adhere to all banking regulations, including priority-sector lending norms asapplicable to domestic banks. In addition to the entry of the new private banks in the mid-90s, the increased presence of foreign banks in India has also contributed to boost competitionin the banking sector.

2.4.7 Co-operative Banks

Co-operative banks cater to the financing needs of agriculture, retail trade, small industry and self-employed businessman in urban, semi-urban and rural areas of India. A distinctive feature of the co-operative credit structure in India is its heterogeneity. The structure differs across urban and rural areas, across states and loan maturities. Urban areas are served by urban cooperative banks (UCBs), whose operations are either limited to one state or stretch across states. The rural co-operative banks comprise State co-operative banks, district central cooperative banks, SCARDBs and PCARDBs. The co-operative banking sector is the oldest segment of the Indian banking system. The network of UCBs in India consisted of 1721 banks as at end-March 2009, while the number of rural co-operative banks was 1119 as at end-March 2008.10 Owing to their widespread geographical penetration, cooperative banks have the potential to become an important instrument for large-scale financial inclusion, provided they are financially strengthened.11 The RBI and the National Agriculture and Rural Development Bank (NABARD) have taken a number of measures in recent years to improve financial soundness of co-operative banks.

2.5 Non-Banking Finance Companies (NBFCs)

India has many thousands of non-banking financial companies, predominantly from the private sector. NBFCs are required to register with RBI in terms of the Reserve Bank of India (Amendment) Act, 1997. An NBFC is a company engaged in the business of loans and advances, acquisition of shares/bonds/debentures/securities issued by the Government or local authority or other similar marketable securities, leasing, hire-purchase, insurance business, venture capital, merchant banking, broking and housing finance. It is mandatory that every NBFC should be registered with the RBI to commence/carry on anybusiness. It should have a minimum net owned fund of 25 lakh. The NBFCs registered with the RBI are

i. Equipment leasing,
ii. hire-purchase,
iii. Loan and
iv. Investment companies.

The other types of NBFCs are regulated by other regulators. They could be further classified into those accepting deposits and those not accepting deposits. The registered NBFCs are required to invest in unencumbered approved securities worth at least 5 per cent of theiroutstanding deposits. Every NBFC must create a reserve fund by transferring at least 20 percent of its net profits before declaring any dividend. The RBI can regulate/prohibit solicitation ofdeposits from public. It can give directions to NBFCs relating to (a) prudential norms for incomerecognition, accounting standards, provisioning on capital adequacy and (b) deployment offunds. It can also issue directions for providing information relating to deposits/for conduct ofbusiness. For contraventions/defaults by an NBFC, the RBI can impose penalty. It can alsocancel the registration of an NBFC.All NBFCs together currently account for around nine percent of assets of the total financial system. Housing-finance companies form a distinct sub-group of the NBFCs. As a result of some recent government incentives for investing in the housing sector, these companies' business has grown substantially. Housing Development Finance Corporation Limited (HDFC), which is in the private sector and the Government-controlled Housing and Urban Development Corporation Limited (HUDCO) are the two premier housing-finance companies. These companies are major players in the mortgage business, and provide stiff competition to commercial banks in the disbursal of housing loans.

2.5.1 Mutual Funds

A mutual fund pools the savings, particularly of the relatively small investors, and invests them in a well-diversified portfolio of sound investment. It issues units (securities) to unit holders (investors) according to the quantum of money invested by them. The profits/losses are shared by the unit holders in proportion of their investments. According to the SEBI, mutual funds are funds established in the form of a Trust to raise money through the sale of units to the public under various schemes for investing in securities including money market instruments or gold/gold related instruments or real estate assets.A mutual is set up in the form of a trust which has (i) a sponsor, (ii) trustees, (iii) an asset management company (AMC) and (iv) custodians. The sponsors set up the trust as promoters. The trustees hold the property in trust for the benefit of the unit holders. They are vested with general powers of superintendence and direction over the AMC and they monitor their performance and compliance with the SEBI regulations. The AMC manages the funds. The custodian holds the securities of the fund in its custody. The main elements of the regulatory mechanism for mutual funds in India in terms of the SEBI regulations are: (i) registration of mutual funds, (ii) constitution and management of mutual funds, (iii) constitution and management of AMCs/custodians, (iv) mutual fund schemes, (v) investment objectives/valuation policies, (vi) real estate mutual fund schemes, (vii) inspection and audit, (viii) general obligations, and (ix) action in case of default.

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank of India. Unit Trust of India (UTI) was established in 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs. 6,700 crores of assets under management. 1987 marked the entry of non-UTI, public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990.

At the end of 1993, the mutual fund industry had assets under management of Rs. 47,004 crores. With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996. The number of mutual fund houses went on increasing, with many foreign mutual

Year	Unit Trust of India	Bank-sponsored Mutual Funds	Financial Institution-sponsored Mutual Funds	Private Sector Mutual Funds	Total
2000-01	322	249	1273	9292	11136
2001-02	-7284	863	406	16134	10119
2002-03	-9434	1033	861	12122	4582
2003-04	1050	4526	787	41510	47873
2004-05	-2467	706	-3384	7933	2788
2005-06	3424	5365	2112	41581	52482
2006-07	7326	3033	4226	79477	94062
2007-08	10678	7597	2178	138224	158677
2008-09	-4112	4489	5954	-30538	-24208
2009-10	15653	9855	4871	47968	78347
2010-11	-16636	1304	-16988	-16281	-48600
2011-12	-3179	389	-3098	-39525	-45413
2012-13	4629	6708	2241	65284	78862
2013-14	401	4845	2572	46761	54579
2014-15	-1278	-1148	-994	106300	102880
2015-16	15416	27421	1388	87533	131758
2016-17	20146	42577	6406	274289	343418
2017-18	-1261	41890	-2675	234272	272226
2018-19	-2496	53657	-1454	61083	107609

funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1, 21,805crores. The Unit Trust of India with Rs. 44,541 crores of assets under management was way ahead of other mutual funds. In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs. 29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.The second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs. 76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth.

2.5.2 Insurance Organisations

Any class of insurance business can be carried out only by a public company, a cooperative society, an insurance cooperative society, or a body corporate other than a private company. After the enactment of the IRDA Act, only Indian insurance companies are eligible to carry out any class of insurance business (i.e., life/general/fire/marine and miscellaneous), Indian companies are defined as those in which the aggregate holding of equity by a foreign company does not exceed 26 per cent of the paid-up equity capital.

The Insurance Act provides the broad framework for the insurance sector in the country. Some of the important aspects of the framework contained in the Act are: eligibility, registration, accounts and balance sheet, actuarial report and abstract; investment of assets; insurance business in rural/social sector; investigation; power to issue directions; registration of principal/ chief/special agent(s); issue of license to intermediary/insurance penalties; power to call for information; power of Government to make rules; powers of IRDA to make regulations.

To carry on their business, insurance companies should be registered with the IRDA. It would register an applicant on being satisfied that its financial condition and the general character of its management are sound, the volume of its business, capital structure and earnings prospects would be adequate, the interest of the public would be served, and it has complied with all the other requirements. The minimum paid up capital of an insurance company should be 100 crore (for life/general business) and 250 crore (for reinsurance business). The registration would be renewed annually. Promoters cannot hold more than 26 per cent of the paid-up capital of an insurance company. Every insurer should also keep a specified deposit with the RBI which would be deemed to be a part of its assets. The assets of insurers should be invested in the following manner: 25 per cent in Government securities (including deposits with the RBI); at least 25 per cent in Government/other approved securities; and the balance in approved and other investments. Upto 15 per cent of the controlled fund of the insurers can be invested in other investments. Upto 25 per cent of the assets of general insurance companies can be invested in other investments. No funds of policyholders can be invested outside India.

The duty of the IRDA is to regulate, promote and ensure the orderly growth of the insurance and reinsurance business. Its powers and functions include: Issue/renewal/ cancellation/suspension of registration of insurance companies; protection of policyholder’s interests; specifying the requisite qualifications/practical training for intermediaries/agents; specifying the code of conduct for surveyors/loss assessors; promoting efficiency in the conduct of insurance business; promoting/regulating professional organisations; calling for information, undertaking inspection, conducting inquiries/investigations of insurers/intermediaries/other organisations; regulating investments of funds/maintenance of margin of solvency and so on. The IRDA would be bound by the directions of the Government on questions of policy

In India, insurance has a deep-rooted history. It finds mention in the writings of Manu (Manusmrithi), Yagnavalkya (Dharmasastra) and Kautilya (Arthasastra). The writings talk in terms of pooling of resources that could be re-distributed in times of calamities such as fire, floods, epidemics and famine. This was probably a pre-cursor to modern day insurance. Ancient Indian history has preserved the earliest traces of insurance in the form of marine trade loans and carriers’ contracts. Insurance in India has evolved over time heavily drawing from other countries, England in particular. 1818 saw the advent of life insurance business in India with the establishment of the Oriental Life Insurance Company in Calcutta. This Company however failed in 1834. In 1829, the Madras Equitable had begun transacting life insurance business in the Madras Presidency. 1870 saw the enactment of the British Insurance Act and in the last three decades of the nineteenth century, the Bombay Mutual (1871), Oriental (1874) and Empire of India (1897) were started in the Bombay Residency. This era, however, was dominated by foreign insurance offices which did good business in India, namely Albert Life Assurance, Royal Insurance, Liverpool and London Globe Insurance and the Indian offices were up for hard competition from the foreign companies. In 1914, the Government of India started publishing returns of Insurance Companies in India. The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate life business. In 1928, the Indian Insurance Companies Act was enacted to enable the Government to collect statistical information about both life and non-life business transacted in India by Indian and foreign insurers including provident insurance societies. In 1938, with a view to protecting the interest of the Insurance public, the earlier legislation was consolidated and amended by the Insurance Act, 1938 with comprehensive provisions for effective control over the activities of insurers.

The Insurance Amendment Act of 1950 abolished Principal Agencies. However, there were a large number of insurance companies and the level of competition was high. There were also allegations of unfair trade practices. The Government of India, therefore, decided to nationalize insurance business. An Ordinance was issued on 19th January, 1956 nationalising the Life Insurance sector and Life Insurance Corporation came into existence in the same year. The LIC absorbed 154 Indian, 16 non-Indian insurers as also 75 provident societies—245 Indian and foreign insurers in all. The LIC had monopoly till the late 90s when the Insurance sector was reopened to the private sector. The history of general insurance dates back to the Industrial Revolution in the west and the consequent growth of sea-faring trade and commerce in the 17th century. It came to India as a legacy of British occupation. General Insurance in India has its roots in the establishment of Triton Insurance Company Ltd., in the year 1850 in Calcutta by the British. In 1907, the Indian Mercantile Insurance Ltd, was set up. This was the first company to transact all classes of general insurance business. 1957 saw the formation of the General Insurance Council, a wing of the Insurance Association of India. The General Insurance Council framed a code of conduct for ensuring fair conduct and sound business practices. In 1968, the Insurance Act was amended to regulate investments and set minimum solvency margins. The Tariff Advisory Committee was also set up then. In 1972 with the passing of the General Insurance Business (Nationalisation) Act, general insurance business was nationalized with effect from 1st January, 1973. 107 insurers were amalgamated and grouped into four companies, namely National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd and the United India Insurance Company Ltd. The General Insurance Corporation of India was incorporated as a company in 1971 and it commence business on January 1sst 1973. This millennium has seen insurance come a full circle in a journey extending to nearly 200 years. The process of re-opening of the sector had begun in the early 1990s and the last decade and more has seen it been opened up substantially. In 1993, the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector. The objective was to complement the reforms initiated in the financial sector. The committee submitted its report in 1994 wherein, among other things, it recommended that the private sector be permitted to enter the insurance industry. They stated that foreign companies be allowed to enter by floating Indian companies, preferably a joint venture with Indian partners. Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the insurance industry. The IRDA was incorporated as a statutory body in

April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premiums, while ensuring the financial security of the insurance market. The IRDA opened up the market in August 2000 with the invitation for application for registrations. Foreign companies were allowed ownership of up to 26%. The Authority has the power to frame regulations under Section 114A of the Insurance Act, 1938 and has from 2000 onwards framed various regulations ranging from registration of companies for carrying on insurance business to protection of policyholders' interests. In December, 2000, the subsidiaries of the General Insurance Corporation of India were restructured as independent companies and at the same time GIC was converted into a national re-insurer. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002. Today there are 31 general insurance companies including the ECGC and Agriculture Insurance Corporation of India and 24 life insurance companies operating in the country. The insurance sector is a colossal one and is growing at a speedy rate of 15-20%. Together with banking services, insurance services add about 7% to the country's GDP. A well-developed and evolved insurance sector is a boon for economic development as it provides long- term funds for infrastructure development at the same time strengthening the risk-taking ability of the country.

2.6 Financial Markets

Money market is a market for overnight to short-term funds (i.e., upto 1 year) and for short-term money and financial assets that are close substitutes for money, that is, financial assets that can be quickly converted into cash (money) with minimum transaction cost and without loss in value. These broad objectives/functions of the money market are three-fold: (i) It acts as an equilibrating mechanism for evening out short-term surpluses and deficiencies of funds, (ii) It is the focal point of RBI intervention for influencing liquidity in the economy and (iii) It provides reasonable access to the users of short-term funds to meet their requirements at realistic/ reasonable cost or to temporarily deploy their excess funds for earning returns. The organisation of the money market in India till the mid-eighties, suffered from three deficiencies: an arrow base in terms of limited participants, paucity of instruments and controlled interest rates. The present organisation comprises of a number of instruments (interrelated sub-markets) and intermediaries. The sub-markets are: call/notice market, T-bills market, commercial bills market, CPs market and CDs market.

The money market intermediaries are primary dealers (PDs) and money market mutual funds. The objectives of PDs are: strengthening the infrastructure in the Government securities market including the money market, improving the secondary market trading system and making an effective conduit for conducting OMOs. Subsidiaries of banks/TIIs, companies engaged primarily in the securities business and subsidiaries/JVs by entities incorporated abroad, approved by the FIPB, with a minimum of NOFs of ` 50 crore can be registered with the RBI as PDs. To enable them to effectively fulfil their obligations, the RBI extends facilities such as access to SGL account; permission to borrow and lend in the money market including the call market and to obtain all money market instruments; access to LAF; favoured access to OMOs; and access to liquidity support through repos and reverse repos. An MMMF is a conduit through which small investors can participate in the money market to earn the market-related yield. They are, however, a marginal player in the Indian money market.

The industrial securities market consists of the new issue (NIM)/primary market and the secondary/ stock exchange market. The two parts of the market have some differences as well as some similarities. The difference between the NIM and stock exchanges pertain to the types of securities dealt with, the nature of financing and organisation. The NIM deals in new securities, which are offered to the investing public for the first time. The stock market is a market for old securities, which have been issued already and granted a stock exchange quotation. The NIM provides additional funds to the issuing companies, directly. The contribution of the stock exchange to corporate financing is indirect as, the issuing company is not involved inthe transaction. Organisationally, stock exchanges have a physical existence and are located in a particular geographical area. An NIM has no physical/geographical existence and is recognised only by the services it renders at the time of flotation of new securities. The similarities between the two parts of the securities market relate to listing, control and economic interdependence. The securities issued in the NIM are invariably listed on the stock exchange, enabling investors to dispose them off. It encourages holding of new securities and widens the primary market. The stock exchanges exercise considerable control over the NIM in terms of compliance with listing requirements, to ensure fair dealings. One aspect of the economic interdependence between the two segments of the market is that the activity in the NIM and the prices of securities in the stock exchange are broadly related. Similarly, prices of new issues are influenced by the price movements in the stock markets. Stock exchanges discharge three vital functions in the orderly growth of capital formation: it creates a nexus between savings and investments, it acts as a market place and it facilitates continuous price formation. As a nexus, the stock exchanges arrange for the preliminary distribution of new issues. Their members act as brokers and underwriters. As a market place, they guarantee saleability of securities to investors who have already invested and surety of purchase to those who desire to invest. The collective judgement of many players in the market brings about changes in security prices in small graduation, thereby evening out wide swings in the price and ensuring continuous price formation. The main function of the NIM is to facilitate the transfer of resources from the savers to the entrepreneurs. Its general function is split, up operationally into a triple service function: origination, underwriting and distribution. Origination refers to the investigation and analysis and processing of new issue proposals. One aspect is the preliminary investigation, entailing a careful study of the technical, economic, financial and legal aspects of the issuer to ensure that the issue is a sound one. To improve the quality of the capital issue, the sponsor also renders services of an advisory natures such as type and price, timing and magnitude of issues, methods of flotation and so on. Underwriting is a form of institutional guarantee that the issue would be sold by eliminating the risk arising from uncertainty of public response. The sale of securities to the ultimate investors is known as distribution. The methods of flotation of issues are: prospectus/public issue, book building, offer for sale, placements and rights issues. Under the prospectus/public issue method, issuing companies offer directly to the general public, through a prospectus, a fixed number of shares, at a stated (par/premium) price. To ensure success, issues are generally underwritten. It is, however, an expensive method and is, therefore, suitable only for larger issues. The book building method is a volume and price discovery method. The investors quote the number of securities and the price at which they wish to acquire them. The Offer for sale method involves offering/sale of shares by the existing holders (promoters) to dilute their holdings in existing companies. Under the placement method, the entire block of securities is offered to a select group of investors. It is an inexpensive method and the success of an issue does not depend upon public response. Securities can be sold through this method even at times when conditions in the market may not be favourable. The existing shareholders are offered the right to subscribe to new shares in proportion to the number of shares held in the issuing company in rights issues. This method can be used only by existing companies.

2.7 Check Your Progress

1. The main function of the financial system is
   (a) to mobilise savings and to channelise them into productive investment
   (b) to perform various transformation services
   (c) to ensure efficient functioning of the payment mechanisms
   (d) all of these

2. Finance may broadly be defined as monetary resources comprising debt and ownership funds
   (a) of the state
   (b) of the company
   (c) of the persons
   (d) of all three
3. Rudimentary finance refers to
   (a) the financial system of a less developed economy
   (b) the absence of financial instruments
   (c) the absence of financial markets
   (d) all of these
4. The major participants in the Indian money market are
   (a) Reserve Bank of India
   (b) Commercial banks
   (c) Development financial institutions
   (d) only (a) and (b)
5. The sub-markets in the Indian money market are
   (a) call (money) market
   (b) bill market
   (c) market for commercial papers and certificate of deposits
   (d) all of these

2.8 Summary

- The role of the financial system was limited in the state-dominated environment. Banks were the dominant financial institutions for accumulation of savings and financing of trade and industrial activities. The financial system had a limited role in capital accumulation.
- A failure of the government's restrictive and regulating policies and a need to adopt a market-determined strategy of development were the causes for undertaking reforms in the financial system.
- The government initiated economic reforms in June 1991 to provide an environment of sustainable growth and stability.

- The basic priority in the early reforms period was to remove structural rigidities and inefficiencies in the financial system.
- Commercial banks in India have traditionally focused on meeting the short-term financial needs of industry, trade and agriculture. However, given the increasing sophistication and diversification of the Indian economy, the range of services extended by commercial banks has increased significantly, leading to an overlap with the functions performed by other financial institutions.
- India has many thousands of non-banking financial companies, predominantly from the private sector. NBFCs are required to register with RBI in terms of the Reserve Bank of India (Amendment) Act, 1997. All NBFCs together currently account for around nine percent of assets of the total financial system.
- The organisation of the money market in India till the mid-eighties, suffered from three deficiencies: an arrow base in terms of limited participants, paucity of instruments and controlled interest rates. The present organisation comprises of a number of instruments (interrelated sub-markets) and intermediaries.
- The industrial securities market consists of the new issue (NIM)/primary market and the secondary/ stock exchange market. The NIM deals in new securities, which are offered to the investing public for the first time. The stock market is a market for old securities, which have been issued already and granted a stock exchange quotation.

2.9 Keywords

- **Public sector banks:** PS banks are those in which the majority stake is held by the Government of India (GoI).
- **Regional Rural Banks:** RRB is owned jointly by the Central Government, concerned State Government and a sponsoring public sector commercial bank.
- **Private Sector Banks:** In this type of banks, the majority of share capital is held by private individuals and corporates.
- **Foreign Banks:** Foreign banks have their registered and head offices in a foreign country but operate their branches in India.
- **Co-operative Banks:** Co-operative banks cater to the financing needs of agriculture, retail trade, small industry and self-employed businessmen in urban, semi-urban and rural areas of India.

- **Non-banking finance companies:**are a source of for businesses which do not meet strict banking norms.
- **Mutual Funds:** A mutual fund pools the savings, particularly of the relatively small investors, and invests them in a well-diversified portfolio of sound investment.

2.10 Self-assessment Test

1. Briefly y describes the banking structure in India.
2. Write a note on the principles of commercial banking.
3. What is capital market? Briefly describe the organisation of capital market of an economy.
4. Distinguish between organised and unorganised capital market.
5. Distinguish between money market and capital market.
6. Discuss the inter-relationship between money market and capital market of an economy.

2.11 Answers to Check Your Progress

Question 1	Answer	(d)
Question 2	Answer	(d)
Question 3	Answer	(d)
Question 4	Answer	(d)
Question 5	Answer	(d)

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Course: **Indian Financial System**	
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Organization of Financial Markets and Financial Instruments in India

STRUCTURE:

3.0 Learning Objectives

After going through this lesson, the learner should be able to:

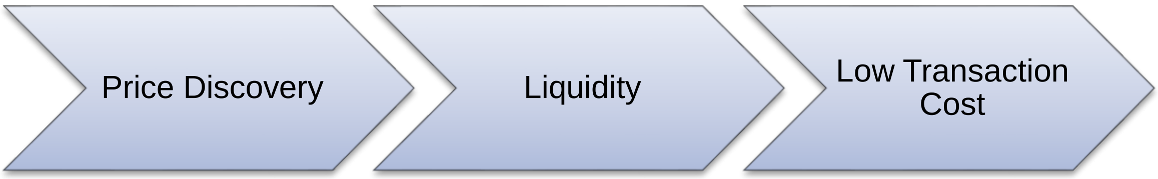
- Know the functions of financial markets.
- Understand the short-term and long-term financial instruments.
- Understand the regulatory framework.

3.1 Introduction

A financial market is a market for creation and exchange of financial assets. If you buy or sell financial assets, you will participate in financial markets in some way or the other. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. The corporations, financial institutions, individuals and governments trade in financial products in these markets either directly or through brokers and dealers on organised exchanges of off-exchanges. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are interlinked by the laws, contracts, covenants and communication networks.

3.1.1 Functions of Financial Markets

Financial markets play a pivotal role in allocating resources in an economy by performing three important functions:



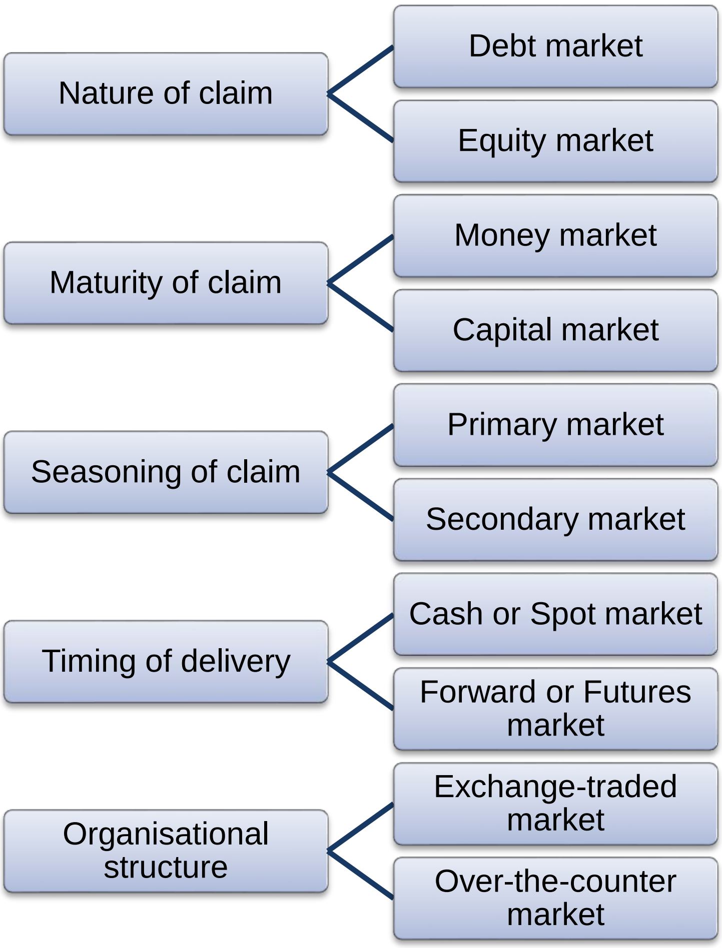
- Financial markets facilitate price discovery. The continual interaction among numerous buyers and sellers who throng financial markets helps in establishing the prices of financial assets. Well-organised financial markets seem to be remarkably efficient in price discovery. That is why financial economists say: "If you want to know what the value of a financial asset is, simply look at its price in the financialmarkets.
- Financial markets provide liquidity to financial assets. Investors can readily sell their financial assets through the mechanism of financial markets. In the absence of financial markets which provide such liquidity, the motivation of investors to hold financial assets will be considerably

diminished. Thanks to negotiability and transferability of securities through the financial markets, it is possible for companies (and other entities) to raise long-term funds from investors with short-term and medium-term horizons. While one investor is substituted by another when a security is transacted, the company is assured of long-term availability of funds.

- Financial markets considerably reduce the cost of transacting. The two major costs associated with transacting are search costs and information costs. Search costs comprise explicit costs such as the expenses incurred on advertising when one wants to buy or sell an asset and implicit costs such as the effort and time one has to put in to locate a customer. Information costs refer to costs incurred in evaluating the investment merits of financial assets.

3.1.2 Classification of Financial Markets

There are different ways of classifying financial markets.

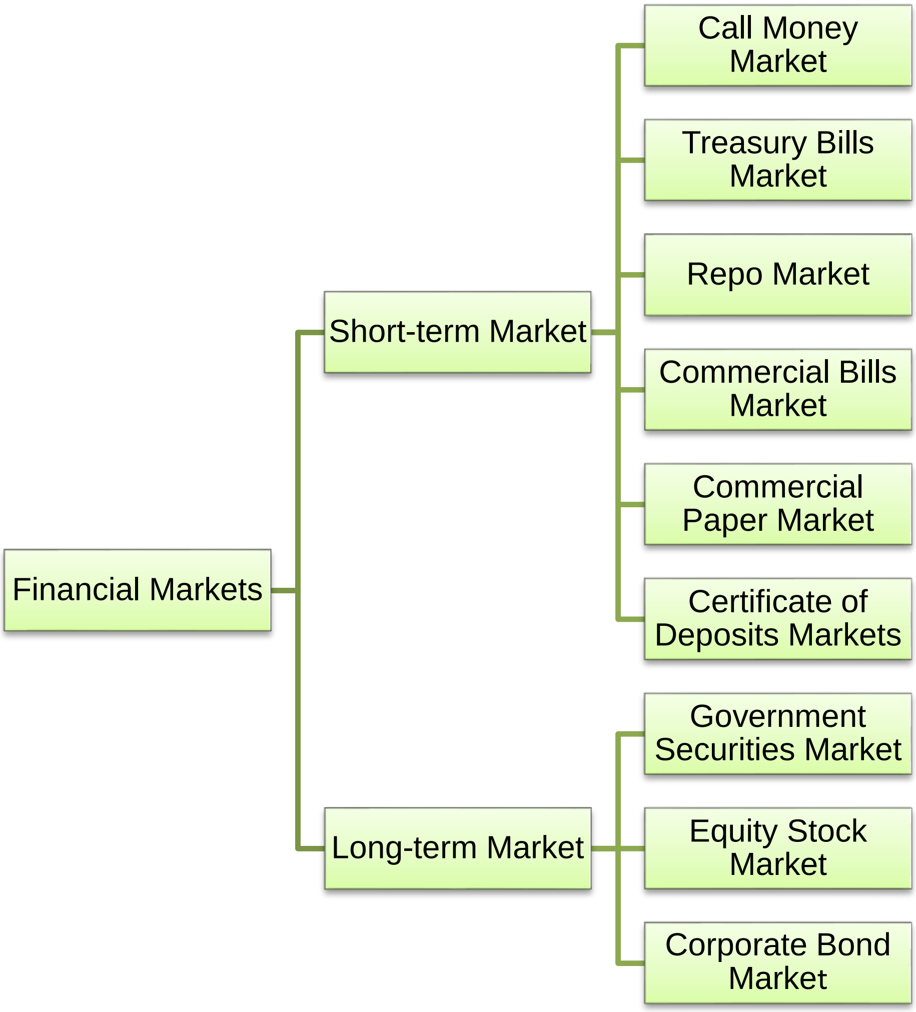


- One way is to classify financial markets by the type of financial claim. The debt market is the financial market for fixed claims (debt instruments) and the equity market is the financial market for residual claims (equity instruments).
- A second way is to classify financial markets by the maturity of claims. The market for short-term financial claims is referred to as the money market and the market for long-term financial claims is called the capital market. Traditionally, the cut off between short-term and long-term financial claims has been one year - though this dividing line is arbitrary, it is widely accepted. Since short-term financial claims are almost invariably debt claims, the money market is the market for short-term debt instruments. The capital market is the market for long-term debt instruments and equity instruments.
- A third way to classify financial markets is based on whether the claims represent new issues or outstanding issues. The market where issuers sell new claims is referred to as the primary market and the market where investors trade outstanding securities is called the secondary market.
- A fourth way to classify financial markets is by the timing of delivery. A cash or spot market is one where the delivery occurs immediately and a forward or futures market is one where the delivery occurs at a pre-determined time in future.
- A fifth way to classify financial markets is by the nature of its organisational structure. An exchange-traded market is characterised by a centralised organisation with standardised procedures. An over-the-counter market is a decentralised market with customised procedures.

In this chapter, we consider the simplest classification of financial markets i.e. the short-term market and the long-term market.

3.2 The Short-term Market

While the securities market generally caters to the investors with a long-term investment horizon, the money market provides investment avenues of short-term tenor. Money market transactions are generally used for funding the transactions in other markets including Government Securities market and meeting short-term liquidity mismatches. By definition, money market is for a maximum tenor of one year. Within the one year, depending upon the tenors, money market is classified into:



- Overnight market - The tenor of transactions is one working day.
- Notice money market – The tenor of the transactions is from 2 days to 14 days.
- Term money market – The tenor of the transactions is from 15 days to one year.

Money market instruments include call money, repos, T- Bills, Cash Management Bills Commercial Paper, Certificate of Deposit and Collateralized Borrowing and Lending Obligations (CBLO).

3.2.1 Treasury Bills (T-bills)

Treasury bills or T-bills, which are money market instruments, are short-term debt instruments issued by the Government of India and are presently issued in three tenors, namely, 91 day, 182 day and 364 day. Treasury bills are zero coupon securities and pay no interest. Instead, theseare issued at a discount and redeemed at the face value at maturity. For example, a 91 day Treasury bill of ₹100/- (face value) may be issued at say ₹ 98.20, that is, at a discount of say, ₹1.80 and would be redeemed at the face value of ₹100/-. The return to the investors is the difference between the maturity value or the face value (that is ₹100) and the issue price (for calculation of yield on Treasury Bills please see answer to question no. 26).

3.2.2 Cash Management Bills (CMBs)

In 2010, Government of India, in consultation with RBI introduced a new short-term instrument, known as Cash Management Bills (CMBs), to meet the temporary mismatches in the cash flow of the Government of India. The CMBs have the generic character of T-bills but issued for maturities less than 91 days.

3.2.3 Call money market

Call money market is a market for uncollateralized lending and borrowing of funds. This market is predominantly overnight and is open for participation only to scheduled commercial banks and the primary dealers.

3.2.4 Repo market

Repo or ready forward contact is an instrument for borrowing funds by selling securities with an agreement to repurchase the said securities on a mutually agreed future date at an agreed price, which includes interest for the funds borrowed. The reverse of the repo transaction is called 'reverse repo' which is lending of funds against buying of securities with an agreement to resell the said securities on a mutually agreed future date at an agreed price which includes interest for the funds lent. It can be seen from the definition above that there are two legs to the same transaction in a repo/ reverse repo. The duration between the two legs is called the 'repo period'. Predominantly, repos are undertaken on overnight basis, i.e., for one day period. Settlement of repo transactions happens along with the outright trades in G-Secs. The consideration amount in the first leg of the repo transactions is the amount borrowed by the seller of the security. On this, interest at the agreed 'repo rate' is calculated and paid along with the consideration amount of the second leg of the transaction when the borrower buys back the security. The overall effect of the repo transaction would be borrowing of funds backed by the collateral of G-Secs. The repo market is regulated by the Reserve Bank of India. All the above mentioned repo market transactions should be traded/reported on the electronic platform called the Clearcorp Repo Order Matching System (CROMS). As part of the measures to develop the corporate debt market, RBI has permitted select entities (scheduled commercial banks excluding RRBs and LABs, PDs, all-India FIs, NBFCs, mutual funds, housing finance companies, insurance companies) to undertake repo in corporate debt securities. This is similar to repo in G-Secs except that corporate debt securities are used as collateral for borrowing funds. Only listed corporate debt securities that are rated 'AA' or above by the rating agencies are eligible to be used for repo. Commercial paper, certificate of deposit, non-convertible debentures of original maturity less than one year are not eligible for this purpose. These transactions take place in the OTC market and are required to be reported on FIMMDA platform within 15 minutes of the trade for dissemination of trade information. They are also to be reported on the clearing house of any of the exchanges for the purpose of clearing and settlement.

3.2.5 Tri-party Repo

"Tri-Party Repo" means a repo contract where a third entity (apart from the borrower and lender), called a Tri-Party Agent, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction. Funds borrowed under repo including tri-party repo in government securities shall be exempted from CRR/SLR computation and the security acquired under repo shall be eligible for SLR provided the security is primarily eligible for SLR as per the provisions of the Act under which it is required to be maintained. Tri Party Repo Dealing System (TREPS) facilitates, borrowing and lending of funds, in Triparty Repo arrangement. CCIL is the Central Counterparty to all trades from TREPS and also perform the role and responsibilities of Triparty Repo Agent. All the repo eligible entities are entitled to participate in Triparty Repo. The entity type admitted include, Public Sector Banks, Private Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, Bank cum Primary Dealers, NBFCs, Corporates, Provident/ Pension Funds, Payment Banks, Small Finance Banks, etc.

TREPS Dealing System is an anonymous order matching System provided by CCDS (Clearcorp Dealing Systems (India) Ltd) to enable Members to borrow and lend funds. It also disseminates online information regarding deals concluded, volumes, rate etc., and such other notifications as relevant to borrowing and lending under Triparty Repo by the members. The borrowing and/ or lending can be done for settlement type T+0 and T+1.

3.2.6 Commercial Paper (CP)

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note and held in a dematerialized form through any of the depositories approved by and registered with SEBI. A CP is issued in minimum denomination of ₹5 lakh and multiples thereof and shall be issued at a discount to face value.No issuer shall have the issue of CP underwritten or co-accepted and options (call/put) are not permitted on a CP. Companies, including NBFCs and AIFIs, other entities like co-operative societies, government entities, trusts, limited liability partnerships and any other body corporate having presence in India with net worth of ₹100 cr. or higher and any other entities specifically permitted by RBI are eligible to issue Commercial Papers subject to conditions specified by RBI. All residents, and non-residents permitted to invest in CPs under Foreign Exchange Management Act (FEMA), 1999 are eligible to invest in CPs; however, no person can invest in CPs issued by related parties either in the primary or secondary market. Investment by regulated financial sector entities will be subject to such conditions as the concerned regulator may impose.

3.2.7 Certificate of Deposit (CD)

Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time. Banks can issue CDs for maturities from 7 days to one year whereas eligible FIs can issue for maturities from 1 year to 3 years.

3.3 The Long-Term Market

These markets primarily refers to Government Securities Market, Equity Stock Market and Corporate Bond Market. In the long-term markets, the maturities for instruments traded vary from one year to perpetuity, in other words, they don't have a maturity date.

3.3.1 Government Securities Market

A Government Security (G-Sec) is a tradable instrument issued by the Central Government or the State Governments. It acknowledges the Government’s debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments. Dated G-Secs are securities which carry a fixed or floating coupon (interest rate) which is paid on the face value, on half-yearly basis. Generally, the tenor of dated securities ranges from 5 years to 40 years.

Instruments

- Fixed Rate Bonds – These are bonds on which the coupon rate is fixed for the entire life (i.e. till maturity) of the bond. Most Government bonds in India are issued as fixed rate bonds.
- Floating Rate Bonds (FRB) – FRBs are securities which do not have a fixed coupon rate. Instead it has a variable coupon rate which is re-set at pre-announced intervals (say, every six months or one year). FRBs were first issued in September 1995 in India.
- Capital Indexed Bonds – These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the Principal amount of the investors from inflation. A 5 year Capital Indexed Bond, was first issued in December 1997 which matured in 2002.
- Inflation Indexed Bonds (IIBs) - IIBs are bonds wherein both coupon flows and Principal amounts are protected against inflation. The inflation index used in IIBs may be Whole Sale Price Index (WPI) or Consumer Price Index (CPI). Globally, IIBs were first issued in 1981 in UK. In India, Government of India through RBI issued IIBs (linked to WPI) in June 2013. Since then, they were issued on monthly basis (on last Tuesday of each month) till December 2013. Based on the success of these IIBs, Government of India in consultation with RBI issued the IIBs (CPI based) exclusively for the retail customers in December 2013.
- Bonds with Call/ Put Options – Bonds can also be issued with features of optionality wherein the **issuer** can have the option to buy-back (call option) or the **investor** can have the option to sell the bond (put option) to the issuer during the currency of the bond. It may be noted that such bond may have put only or call only or both options. The first G-Sec with both call and put option viz. 6.72% GS 2012 was issued on July 18, 2002 for a maturity of 10 years maturing on July 18, 2012. The optionality on the bond could be exercised after completion of five years tenure from the date of issuance on any coupon date falling thereafter. The Government has the right to buy-back the bond (call option) at par value (equal to the face value) while the investor had the right to sell the bond (put option) to the Government at par value on any of the half-yearly coupon dates starting from July 18, 2007.
- Special Securities - Under the market borrowing program, the Government of India also issues, from time to time, special securities to entities like Oil Marketing Companies, Fertilizer Companies, the Food Corporation of India, etc. (popularly called oil bonds, fertiliser bonds and food bonds respectively) as compensation to these companies in lieu of cash subsidies These

securities are usually long dated securities and carry a marginally higher coupon over the yield of the dated securities of comparable maturity.

- STRIPS – Separate Trading of Registered Interest and Principal of Securities. - STRIPS are the securities created by way of separating the cash flows associated with a regular G-Sec i.e. each semi-annual coupon payment and the final principal payment to be received from the issuer, into separate securities. They are essentially Zero Coupon Bonds (ZCBs). However, they are created out of existing securities only and unlike other securities, are not issued through auctions. Stripped securities represent future cash flows (periodic interest and principal repayment) of an underlying coupon bearing bond. Being G-Secs, STRIPS are eligible for SLR. All fixed coupon securities issued by Government of India, irrespective of the year of maturity, are eligible for Stripping/Reconstitution, provided that the securities are reckoned as eligible investment for the purpose of Statutory Liquidity Ratio (SLR) and the securities are transferable.
- *Sovereign Gold Bond (SGB):* SGBs are unique instruments, prices of which are linked to commodity price viz Gold. SGBs are also budgeted in lieu of market borrowing. The calendar of issuance is published indicating tranche description, date of subscription and date of issuance. The Bonds shall be denominated in units of one gram of gold and multiples thereof. Minimum investment in the Bonds shall be one gram with a maximum limit of subscription per fiscal year of 4 kg for individuals, 4 kg for Hindu Undivided Family (HUF) and 20 kg for trusts and similar entities notified by the Government from time to time, provided that (a) in case of joint holding, the above limits shall be applicable to the first applicant only; (b) annual ceiling will include bonds subscribed under different tranches during initial issuance by Government and those purchased from the secondary market; and (c) the ceiling on investment will not include the holdings as collateral by banks and other Financial Institutions. The Bonds shall be repayable on the expiration of eight years from the date of issue of the Bonds. Pre-mature redemption of the Bond is permitted after fifth year of the date of issue of the Bonds and such repayments shall be made on the next interest payment date. The bonds under SGB Scheme may be held by a person resident in India, being an individual, in his capacity as an individual, or on behalf of minor child, or jointly with any other individual. The bonds may also be held by a Trust, HUFs, Charitable Institution and University. Nominal Value of the bonds shall be fixed in Indian Rupees on the basis of simple average of closing price of gold of 999 purity published by the India Bullion and Jewelers Association Limited for the last three business days of the week

preceding the subscription period. The issue price of the Gold Bonds will be ` 50 per gram less than the nominal value to those investors applying online and the payment against the application is made through digital mode. The Bonds shall bear interest at the rate of 2.50 percent (fixed rate) per annum on the nominal value. Interest shall be paid in half-yearly rests and the last interest shall be payable on maturity along with the principal. The redemption price shall be fixed in Indian Rupees and the redemption price shall be based on simple average of closing price of gold of 999 purity of previous 3 business days from the date of repayment, published by the India Bullion and Jewelers Association Limited. SGBs acquired by the banks through the process of invoking lien/hypothecation/pledge alone shall be counted towards Statutory Liquidity Ratio. The above subscription limits, interest rate discount etc. are as per the current scheme and are liable to change going forward.

- 7.75% Savings (Taxable) Bonds, 2018: Government of India has decided to issue 7.75% Savings (Taxable) Bonds, 2018 with effect from January 10, 2018. These bonds may be held by (i) an individual, not being a Non-Resident Indian-in his or her individual capacity, or in individual capacity on joint basis, or in individual capacity on any one or survivor basis, or on behalf of a minor as father/mother/legal guardian and (ii) a Hindu Undivided Family. There is no maximum limit for investment in these bonds. Interest on these Bonds will be taxable under the Income Tax Act, 1961 as applicable according to the relevant tax status of the Bond holders. These Bonds will be exempt from wealth-tax under the Wealth Tax Act, 1957. These Bonds will be issued at par for a minimum amount of ₹1,000 (face value) and in multiples thereof.
- State Development Loans:State Governments also raise loans from the market which are called SDLs. SDLs are dated securities issued through normal auction similar to the auctions conducted for dated securities issued by the Central Government. Interest is serviced at half-yearly intervals and the principal is repaid on the maturity date. Like dated securities issued by the Central Government, SDLs issued by the State Governments also qualify for SLR. State Governments have also issued special securities under “UjjwalDiscom Assurance Yojna (UDAY) Scheme for Operational and Financial Turnaround of Power Distribution Companies (DISCOMs)” notified by Ministry of Power

Advantages of Govt. Security Market

Holding of cash in excess of the day-to-day needs (idle funds) does not give any return. Investment in gold has attendant problems in regard to appraising its purity, valuation, warehousing and safe custody, etc. In comparison, investing in G-Secs has the following advantages:

- Besides providing a return in the form of coupons (interest), G-Secs offer the maximum safety as they carry the Sovereign's commitment for payment of interest and repayment of principal.
- They can be held in book entry, i.e., dematerialized/ scripless form, thus, obviating the need for safekeeping. They can also be held in physical form.
- G-Secs are available in a wide range of maturities from 91 days to as long as 40 years to suit the duration of varied liability structure of various institutions.
- G-Secscan be sold easily in the secondary market to meet cash requirements.
- G-Secscan also be used as collateral to borrow funds in the repo market.
- Securities such as State Development Loans (SDLs) and Special Securities (Oil bonds, UDAY bonds etc) provide attractive yields.
- The settlement system for trading in G-Secs, which is based on Delivery versus Payment (DvP), is a very simple, safe and efficient system of settlement. The DvP mechanism ensures transfer of securities by the seller of securities simultaneously with transfer of funds from the buyer of the securities, thereby mitigating the settlement risk.
- G-Sec prices are readily available due to a liquid and active secondary market and a transparent price dissemination mechanism.

Issuance Process

- G-Secsare issued through auctions conducted by RBI. Auctions are conducted on the electronic platform called the E-Kuber, the Core Banking Solution (CBS) platform of RBI. Commercial banks, scheduled UCBs, Primary Dealers, insurance companies and provident funds, who maintain funds account (current account) and securities accounts (Subsidiary General Ledger (SGL) account) with RBI, are members of this electronic platform. All members of E-Kuber can place their bids in the auction through this electronic platform. The results of the auction are published by RBI at stipulated time. All non-E-Kuber members can participate in the primary auction through scheduled commercial banks or PDs (called as Primary Members-PMs). The proprietary transactions in G-Secs undertaken by PMs are settled through SGL account maintained by them with RBI.

- The RBI, in consultation with the Government of India, issues an indicative half-yearly auction calendar which contains information about the amount of borrowing, the range of the tenor of securities and the period during which auctions will be held.
- A Notification and a Press Communique giving exact particulars of the securities, viz., name, amount, types of issue and procedure of auction are issued by the Government of India about a week prior to the actual date of auction.
- Auction for dated securities is conducted on Friday for settlement on T+1 basis (i.e. securities are issued on next working day i.e. Monday). The investors are thus given adequate time to plan for the purchase of G-Secs through such auctions
- The Reserve Bank of India conducts auctions usually every Wednesday to issue T-bills of 91day, 182 day and 364 day tenors. Settlement for the T-bills auctioned is made on T+1 day i.e. on the working day following the trade day. The Reserve Bank of India announces the issue details of T-bills through a press release on its website every week. Like T-bills, Cash Management Bills (CMBs) are also issued at a discount and redeemed at face value on maturity. The tenor, notified amount and date of issue of the CMBs depend upon the temporary cash requirement of the Government. The tenors of CMBs is generally less than 91 days. The announcement of their auction is made by Reserve Bank of India through a Press Release on its website.

3.3.2 Equity Market

Stock exchange refers to a market where securities are traded after being initially offered to the public in the primary market. Majority of the trading is done in the stock market. The stock/secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risk and return. These participants also sell securities for cash to meet their liquidity needs. The secondary market has further two components, namely the over-the-counter (OTC) market and the exchange-traded market. OTC markets are essentially informal markets where trades are negotiated. Most of the trades in government securities are in the OTC market. All the spot trades where securities are traded for immediate delivery and payment take place in the OTC market. The exchanges do not provide facility for spot trades in a strict sense. Closest to spot market is the cash market where settlement takes place after some time. Trades taking place over a trading cycle, i.e. a day under rolling settlement, are settled together after a certain time (currently 2 working days). Nearly 100% of the trades settled by delivery are settled indemat form.

The origin of the equity stock market in India goes back to the end of the eighteenth century when long-term negotiable securities were first issued. However, for all practical purposes, the real beginning occurred in the middle of the nineteenth century after the enactment of the Companies Act in 1850, which introduced the feature of limited liability and generated investor interest in corporate securities. An important early event in the development of the stock market in India was the formation of the Native Share and Stock Brokers' Association at Bombay in 1875, the precursor of the present day Bombay Stock Exchange. This was followed by the formation of associations/ exchanges in Ahmedabad (1894), Calcutta (1908), and Madras (1937). In addition, a large number of ephemeral exchanges emerged mainly in buoyant periods only to recede into oblivion during depressing times subsequently. The most important development in the Indian stock market was the establishment of the National Stock Exchange (NSE) in 1994. Within a short period, it emerged as the largest stock exchange in the country surging ahead of the Bombay Stock Exchange (BSE) which was historically the dominant stock exchange in India. At present, NSE and BSE account for almost 100 percent of the total turnover on the Indian stock market, thanks to three factors: advent of automated trading and the nationwide reach of NSE and BSE; introduction of a common rolling settlement system; and abolition of regional listing requirement. The past few years in many ways have been remarkable for securities market in India. It has grown exponentially as measured in terms of amount raised from the market, number of stock exchanges and other intermediaries, the number of listed stocks, market capitalisation, trading volumes and turnover on stock exchanges, and investor population. Along with this growth, the profiles of the investors, issuers and intermediaries have changed significantly. The market has witnessed fundamental institutional changes resulting in drastic reduction in transaction costs and significant improvements in efficiency, transparency and safety.

Reforms in the securities market, particularly the establishment and empowerment of SEBI, market determined allocation of resources, screen based nation-wide trading, dematerialisation and electronic transfer of securities, rolling settlement and ban on deferral products, sophisticated risk management and derivatives trading, have greatly improved the regulatory framework and efficiency of trading and settlement. Indian market is now comparable to many developed markets in terms of a number of qualitative parameters.

3.3.3 Derivatives Market

Trading in derivatives of securities commenced in June 2000 with the enactment of enabling legislation in early 2000. Derivatives are formally defined to include: (a) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security, and (b) a contract which derives its value from the prices, or index of prices, or underlying securities. Derivatives trading in India are legal and valid only if such contracts are traded on a recognised stock exchange, thus precluding OTC derivatives. Derivatives trading commenced in India in June 2000 after SEBI granted the approval to this effect in May 2000. SEBI permitted the derivative segment of two stock exchanges, i.e. NSE and BSE, and their clearing house/corporation to commence trading and settlement in approved derivative contracts. To begin with, SEBI approved trading in index futures contracts based on S&P CNX Nifty Index and BSE-30 (Sensex) Index. This was followed by approval for trading in options based on these two indices and options on individual securities. The derivatives trading on the NSE commenced with S&P CNX Nifty Index futures on June 12, 2000. The trading in S&P CNX Nifty Index options commenced on June 4, 2001 and trading in options on individual securities commenced on July 2, 2001. Single stock futures were launched on November 9, 2001. In June 2003, SEBI-RBI approved the trading on interest rate derivative instruments. The Mini derivative Futures & Options contract on S&P CNX Nifty was introduced for trading on January 1, 2008 while the long term option contracts on S&P CNX Nifty were introduced for trading on March 3, 2008.

3.3.4 Corporate Bond market

The corporate bond market has been in existence in India for a long time. However, despite a long history, the size of the public issue segment of the corporate bond market in India has remained quite insignificant. The lack of market infrastructure and comprehensive regulatory framework coupled with low issuance leading to low liquidity in the secondary market, narrow investor base, inadequate credit assessment skills, high cost of issuance, lack of transparency in trades and underdevelopment of securitization of products are some of the major factors that hindered the growth of the private corporate debt market. The market for long term corporate debt has two large segments:

- Bonds issued by public sector units, including public financial institutions,
- Bonds issued by the private corporate sector

In order to facilitate development of a vibrant primary market for corporate bonds in India, Securities and Exchange Board of India (SEBI) has notified Regulations for Issue and Listing of Debt Securities to provide for simplified regulatory framework for issuance and listing of non-convertible debt securities (excluding bonds issued by Governments) issued by any company, public sector undertaking or statutory corporations.

- These regulations apply to public issue of debt securities and listing of debt securities issued through public issue or on private placement basis on a recognized stock exchange.
- The draft offer document needs to be filed with the designated stock exchange through a SEBI registered merchant banker who shall be responsible for due diligence exercise in the issue process and the draft offer document shall be placed on the websites of the stock exchanges for a period of seven working days inviting comments.
- While listing of securities issued to the public is mandatory, the issuers may also list their debt securities issued on private placement basis subject to compliance of simplified regulatory requirements as provided in the Regulations.
- NBFCs are exempted from mandatory listing. However, they may list their privately placed debt securities subject to compliance with the simplified requirements and Listing Agreement.
- An issuer proposing to issue debt securities to the public through the on-line system of the designated stock exchange should comply with the relevant applicable requirements as may be specified by SEBI.
- The issuer may decide the amount of minimum subscription which it seeks to raise by issue of debt securities and disclose the same in the offer document. In the event of non-receipt of minimum subscription all application moneys received in the public issue shall be refunded forthwith to the applicants.
- An issuer desirous of making an offer of debt securities to the public has to make an application for listing to one or more recognized stock exchanges in terms of sub-section (1) of section 73 of the Companies Act, 1956 (1 of1956).
- The debt securities issued to the public or on a private placement basis, which are listed in recognized stock exchanges, shall be traded and such trades shall be cleared and settled in recognized stock exchanges subject to conditions specified by SEBI.

- In case of trades of debt securities which have been made over the counter, such trades shall be reported on a recognized stock exchange having a nationwide trading terminal or such other platform as maybe specified by the Board.3)
- The debt securities shall carry a credit rating of not less than investment grade from a Credit Rating Agency registered with the Board.
- The company shall appoint a debenture trustee registered with SEBI in respect of the issue of the debt securities.
- The debt securities shall be issued and traded in demat form.

3.4 Regulatory Framework

The five main legislations governing the securities market are: (a) the SEBI Act, 1992 which established SEBI to protect investors and develop and regulate securities market; (b) the Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities, and disclosures to be made in public issues; (c)the Securities Contracts (Regulation) Act, 1956, which provides for regulation of transactions in securities through control over stock exchanges; (d) the Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities; and (e)the Prevention of Money Laundering Act, 2002 which prevents money laundering and provides for confiscation of property derived from or involved in money laundering.

3.4.1 Capital Issues (Control) Act, 1947

The Act had its origin during the war in 1943 when the objective was to channel resources to support the war effort. It was retained with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channelled into proper lines, i.e. for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors. Under the Act, any firm wishing to issue securities had to obtain approval from the Central Government, which also determined the amount, type and price of the issue. As a part of the liberalisation process, the Act was repealed in 1992 paving way for market determined allocation of resources.

3.4.2 SEBI Act, 1992

The SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made there under. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

3.4.3 Securities Contracts (Regulation) Act, 1956

It provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities takes place on a specified recognised stock exchange. The stock exchanges determine their own listing regulations which have to conform to the minimum listing criteria set out in the Rules.

3.4.4 Depositories Act, 1996

The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with.

3.4.5 Companies Act, 1956

It deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standard of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, payment of interest and dividends, supply of annual report and other information.

3.4.6 Prevention of Money Laundering Act, 2002

The primary objective of the Act is to prevent money laundering and to provide for confiscation of property derived from or involved in money laundering. The term money-laundering is defined as whoever acquires, owns, possessor transfers any proceeds of crime; or knowingly enters into any transaction which is related18to proceeds of crime either directly or indirectly or conceals or aids in the concealment of the proceeds or gains of crime within India or outside India commits the offence of money laundering. Besides providing punishment for the offence of money-laundering, the Act also provides other measures for prevention of Money Laundering. The Act also casts an obligation on the intermediaries, banking companies etc to furnish information, of such prescribed transactions to the Financial Intelligence Unit- India, to appoint a principal officer, to maintain certain records etc.

The Government has framed rules under the SCRA, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, and for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars which need to be complied with by market participants. The SROs like stock exchanges have also laid down their rules and regulations. The absence of conditions of perfect competition in the securities market makes the role of regulator extremely important. The regulator ensures that the market participants behave in a desired manner so that securities market continues to be a major source of finance for corporate and government and the interest of investors are protected. The responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI) and SEBI. The orders of SEBI under the securities laws are appellable before a Securities Appellate Tribunal (SAT) most of the powers under the SCRA are exercisable by DEA while a few others by SEBI. The powers of the DEA under the SCRA are also con-currently exercised by SEBI. The powers in respect of the contracts for sale and purchase of securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities are exercised concurrently by RBI. The SEBI Act and the Depositories Act are mostly administered by SEBI. The rules under the securities laws are framed by government and regulations by SEBI. All these are administered by SEBI. The powers under the Companies Act relating to issue and transfer of securities and non-payment of dividend are administered by SEBI in case of listed public companies and public companies proposing to get their securities listed. The SROs ensure compliance with their own rules as well as with the rules relevant for them under the securities laws.

3.5 Check Your Progress

1. Which one of the following is not a component of Indian capital market?
   (a) Government securities market
   (b) Treasury bill market
   (c) Industrial securities market
   (d) Derivatives market
2. The major function of financial markets is
   (a) to provide finance
   (b) to mobilise and allocate savings
   (c) to provide investment information
   (d) all of these
3. One major reform in recent years in the capital market of India is
   (a) statutory status to SEBI
   (b) bringing merchant banks under SEBI regulation
   (c) simplification of issue procedures
   (d) all of these
4. Primary market is also called
   (a) New Issue Market
   (b) Initial Public Offer (IPO) Market
   (c) Both (a) and (b) are correct
   (d) Both (a) and (b) are incorrect
5. The secondary security market is also known as
   (a) stock market
   (b) stock exchange
   (c) both (a) and (b)
   (d) neither (a) nor (b)

3.6 Summary

- A financial market is a market for creation and exchange of financial assets. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. Financial markets facilitate price discovery, provide liquidity to financial assets and considerably reduce the cost of transacting. We can classify financial markets by the maturity of claims. The market for short-term financial claims also referred to as the money market and the market for long-term financial claims is called capital market. The capital market is the market for long-term debt instruments and equity instruments.
- Treasury bills or T-bills, which are money market instruments, are short -term debt instruments issued by the Government of India and presently issued in three tenors, namely, 91 day, 182 day and 364 day.
- Call money market is a market for uncollateralized lending and borrowing of funds.
- Repo or ready forward contact is an instrument for borrowing funds by selling securities with an agreement to repurchase the said securities on a mutually agreed future date at an agreed price, which includes interest for the funds borrowed. The reverse of the repo transaction is called 'reverse repo' which is lending of funds against buying of securities with an agreement to resell the said securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.
- Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note and held in a dematerialized form through any of the depositories approved by and registered with SEBI.
- Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note, for funds deposited at a bank or other eligible financial institution for a specified time.
- A Government Security (G-Sec) is a tradable instrument issued by the Central Government or the State Governments. In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs).
- G-Secsare issued through auctions conducted by RBI. Auctions are conducted on the electronic platform called the E-Kuber, the Core Banking Solution (CBS) platform of RBI. Commercial

banks, scheduled UCBs, Primary Dealers, insurance companies and provident funds, who maintain funds account (current account) and securities accounts (Subsidiary General Ledger (SGL) account) with RBI, are members of this electronic platform.

- Stock exchange refers to a market where securities are traded after being initially offered to the public in the primary market. Majority of the trading is done in the stock market. The stock/secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risk and return.
- Reforms in the securities market, particularly the establishment and empowerment of SEBI, market determined allocation of resources, screen based nation-wide trading, dematerialisation and electronic transfer of securities, rolling settlement and ban on deferral products, sophisticated risk management and derivatives trading, have greatly improved the regulatory framework and efficiency of trading and settlement. Indian market is now comparable to many developed markets in terms of a number of qualitative parameters.
- The market for long term corporate debt has two large segments viz. bonds issued by public sector units, including public financial institutions and bonds issued by the private corporate sector.
- The five main legislations governing the securities market are the SEBI Act, 1992, the Companies Act, 1956, the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1996, the Prevention of Money Laundering Act, 2002.

3.7 Keywords

- **Repo:** Repo or ready forward contact is an instrument for borrowing funds by selling securities with an agreement to repurchase the said securities on a mutually agreed future date at an agreed price, which includes interest for the funds borrowed.
- **Floating Rate Bonds:** FRBs are securities which do not have a fixed coupon rate. Instead it has a variable coupon rate which is re-set at pre-announced intervals (say, every six months or one year).
- **Capital Indexed Bonds**: These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the Principal amount of the investors from inflation.
- **Inflation Indexed Bonds**: IIBs are bonds wherein both coupon flows and Principal amounts are protected against inflation.

- **Sovereign Gold Bonds:** SGBs are unique instruments, prices of which are linked to commodity price viz Gold.
- **Over-the-counter (OTC) market**: OTC markets are essentially informal markets where trades are negotiated.

3.8 Self-assessment Test

1. Briefly describe the structure of Indian financial markets.
2. Discuss the major functions of financial markets in India.
3. Write a brief description of the major reforms in Indian financial markets in recent years.
4. Discuss the role of financial markets in economic development of India.

3.9 Answers to Check Your Progress

Question 1	Answer	(b)
Question 2	Answer	(d)
Question 3	Answer	(d)
Question 4	Answer	(c)
Question 5	Answer	(c)

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Course: **Indian Financial System**	
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Money Market: Meaning, Constituents, Functions and Recent Developments in Indian Money Market

STRUCTURE:

4.0 Learning Objectives

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

- Know the features of functions of money market.

- Understand the Treasury Bills markets, CD markets, CP markets.
- Understand about the primary dealers and money market mutual funds.

4.1 Introduction

The money market is a market for overnight to short-term funds, and for short-term money and financial assets that are close substitutes for money. "Short-term", in the Indian context, generally means a period up to one year. "Close substitute for money" denotes any financial asset that can be quickly converted into money with minimum transaction cost and without loss in value. In simple words, money market refers to that segment of the financial system that enables the raising of short-term funds for meeting the temporary shortages of cash and obligations, and the temporary deployment of excess funds for earning returns. The major participants in the market are the commercial banks, the other financial intermediaries, large corporates and Reserve Bank of India (RBI). RBI plays an important role and holds a strategic position in the Indian money market. By varying liquidity in the market through various instruments, it influences the availability and cost of credit. In fact, a developed money market contributes to an effective monetary policy. An effective money market requires the development of appropriate institutions, instruments and operating procedures that facilitate the widening and deepening of the market and the allocation of operating procedures with the minimum transactions cost and minimum delays. The broad objectives/functions of the money market are to provide:

- An equilibrating mechanism investing short-term fundsin case of surplus and raising funds in case of need.
- An important mechanism to central bank (RBI) for influencing liquidity in the economy.
- An easy and quick access to short-term funds at reasonable price/cost.

4.2 Features of Money Market

The money market has different operational features when we compare it with the capital market. These features are as follows:

- Money market instruments are issued only for shortduration (normally upto one year), but capital market instruments are for longer durations/periods.
- Money market is arecognised source of working capital for corporate sector, but the focus of the capital market is onlong-term funds requirements.
- Money market is a wholesale market and there are a large number of participants.

- The volume of trading in financial assets in money market is very large, which requires professional operators.
- The trading in the money market is conducted on the telephone, followed by written confirmation from both the borrowers and the lenders.
- The transactions are on a 'same day settlement' basis. Due to greater flexibility in the regulatory framework, there is a greater scope for innovative dealings.
- Money market consists of a number of interrelated sub-markets such as the call market, the commercial bill market, the Treasury Bills Market, the commercial paper market, the certificates of deposit market and so on.

4.3 Functions of Money Market

The RBI is the most important constituent of the money market organisation. The functions of money market are as under:

- To ensure that liquidity and short-term interest rates are maintained at levels consistent with the monetary.
- To ensure an adequate flow of credit to the productive sectors of the economy.
- To help in maintain a stable foreign exchange market.

4.4 Organisation of Money Market

The money market in India until the mid-eighties suffered from serious deficiencies/lacuna. Since the early 1990s, the money market has undergone a significant transformation in terms of instruments, participants and technological infrastructure. Various reform measures have resulted in a relatively deep, liquid and vibrant money market. The transformation has been facilitated by the Reserve Bank's policy initiatives as also by a shift in the monetary policy operating procedures from administered and direct to indirect market-based instruments of monetary management. The changes in the money market structure and monetary policy operating procedures in India have been broadly in step with the international experience and best practices.

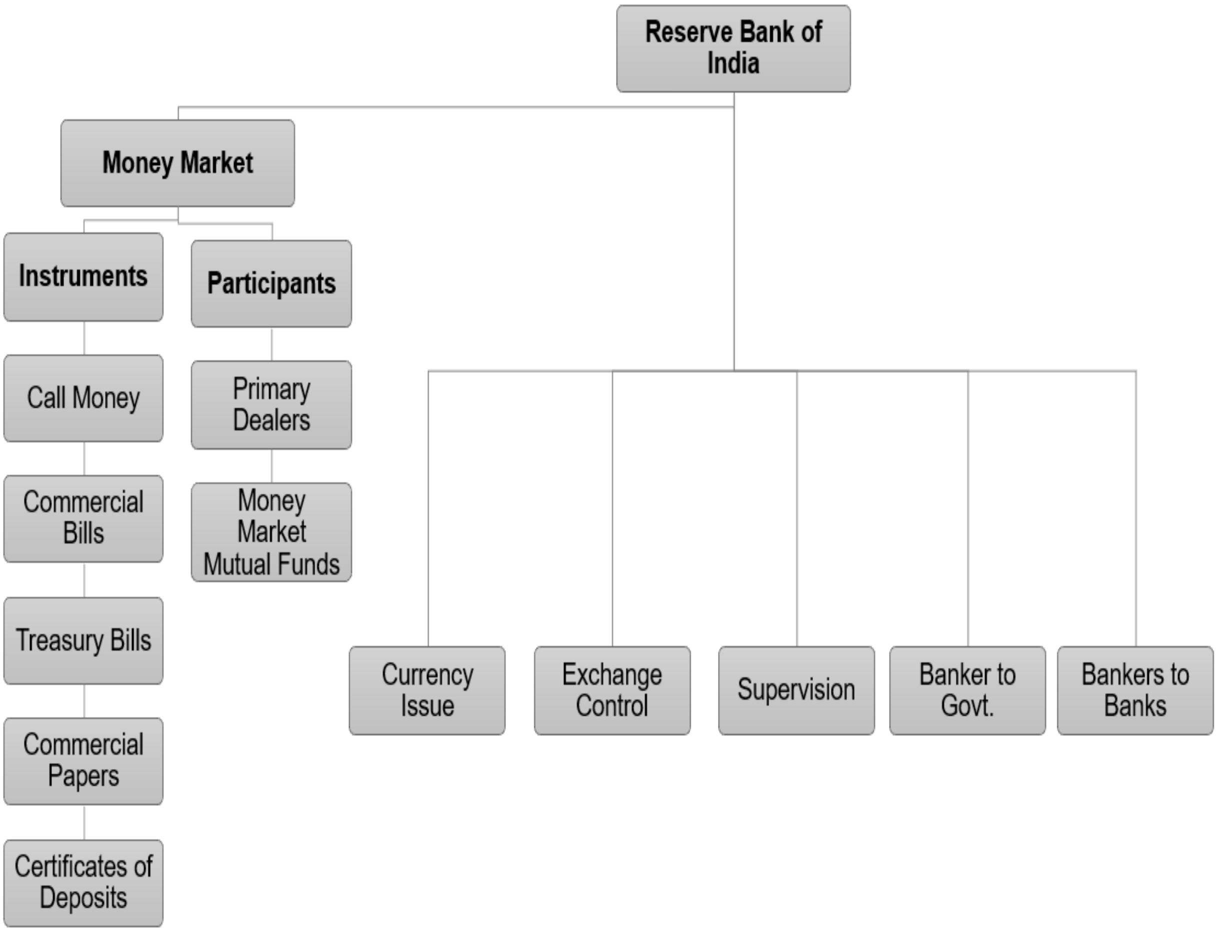

Figure 1: Money Market Organisation

The present organisation of the money market in India covers the many segments such asRole of Reserve Bank of India (RBI), main instruments/markets and the intermediaries. The instruments traded in the money market and the sub-markets are Call/notice market; Treasury bills (T-bills) market; Commercial bills market; Commercial papers (CPs) market; and Certificate of Deposits (CDs) market. The money market intermediaries are Primary Dealers (PDs) and Money Market Mutual Funds (MMMFs).

4.4.1 Reserve Bank of India (RBI)

The RBI is like a brain behind the money market and the main regulator of the banking system. The functions/roles of the RBI comprise of note issuing authority (issue of currency), Government banker, bankers' bank, supervisory authority, promoter of the financial system and regulator of money and credit (monetary authority).

4.4.2 Treasury Bills (T-Bills) Market

A T-bill is an instrument of short-term borrowing by the Government of India. It is a particular kind of finance bill (i.e. a bill that does not arise from any genuine transaction in goods) or a promissory note issued by the RBI on behalf of the Government. T-bills are issued to raise short-term funds to bridge seasonal/temporary gaps between receipts (revenue and capital) and expenditure of the Government of India. The main features of T-bills are: (i) These are negotiable securities; (ii) Theseare issued at discount and are repaid at par on maturity. The difference (discount) between the price at which they are sold and their redemption value is the effective return on T-bills; (iii) High liquidity on account of short tenure (i.e. 91-day and 364-days) and inter-bank repos, (iv) Absence of default risk due to Government guarantee and RBI's willingness to always purchase/discount them, negligible capital depreciation; (v) Assured yield; (vi) Low transaction cost; (vii) Eligibility for inclusion in SLR; and (viii) Purchases/sales effected through the SGL (Subsidiary General Ledger) Account with the RBI.

The development of T-bill market is at the heart of the growth of the money market. The T- bills play a vital role in the cash management of the Government. Being a risk-free instrument, their yields at various maturities serve as a benchmark and help in pricing different floating rates instruments in the market. The T-bill market is RBI's preferred tool for intervention to influence liquidity and short-term interest rates. Its development is a pre-requisite for effective OMOs.

Until 1988, the only kind of Treasury bill that was available was the 91-day bill, issued on tap; at a fixed rate of 4.5%, (the rates on these bills remained unchanged at 4.5% since 1974!). 182-day T-bills were introduced in 1987, and the auction process for T-bills was started. 364-day T-bills were introduced in April 1992, and in July 1997, the 14-day T-bills were also introduced. RBI had suspended the issue of 182-day T- bills from April 1992, and revived their issuance since May 1999. RBI did away with 14-day and 182-day Treasury Bills from May 2001. It was decided in consultation with the Central Government to re-introduce, 182-day TBs from April 2005. All T-bills are now sold through an auction process according to a fixed auction calendar, announced by the RBI. Ad hoc treasury bills, which enabled the automatic monetisation of central government budget deficits, have been eliminated in 1997. All T-bill issuances now represent market borrowings of the central government.

T-bills are sold through an auction process announced by the RBI at a discount to its face value. RBI issues a calendar of T-bill auctions (Table 4.1). It also announces the exact dates of auction, the amount to be auctioned and payment dates. T-bills are available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000. Banks and PDs are major bidders in the T-bill market. Both discriminatory and uniform price auction methods are used in issuance of T-bills. Currently, the auctions of all T-bills are multiple/discriminatory price auctions, where the successful bidders have to pay the prices they have actually bid for in the market. Non-competitive bids, where bidders need not quote the rate of yield at which they desire to buy these T-bills, are also allowed from provident funds and other investors. RBI allots bids to the non-competitive bidders at the weighted average yield arrived at based on the yields quoted by accepted competitive bids at the auction. Allocations to non-competitive bidders are outside the amount notified for sale. Non-competitive bidders therefore do not face any uncertainty in purchasing the desired amount of T-bills from the auctions. Pursuant to the enactment of FRBM Act with effect from April 1, 2006, RBI has prohibited from participating in the primary market. Auction of all the Treasury Bills are based on multiple price auction method at present. The notified amounts of the auction is decided every year at the beginning of financial year (Rs.500 crore each for91-day and 182-day Treasury Bills and Rs.1, 000crore for 364-day Treasury Bills for the year 2008-09) in consultation with GOI. RBI issues a Press Release detailing the notified amount and indicative calendar in the beginning of the financial year. The auction for MSS amount varies depending on prevailing market condition. Based on the requirement of GOI and prevailing market condition, the RBI has discretion to change the notified amount. In addition, it is discretion of the RBI to accept, reject or partially accept the notified amount depending on prevailing market condition.

T-bills are issued at a discount and redeemed at par. The implicit yield in the T-bill is the rate at which the issue price (which is the cut-off price in the auction) has to be compounded, for the number of days to maturity, to equal the maturity value.

Yield, given price, is computed using the formula:

= ((100-Price)*365)/ (Price * No of days to maturity)

Similarly, price can be computed, given yield, using the formula:

= 100/(1+(yield% * (No of days to maturity/365))

For example, a 182-day T-bill, auctioned on January 18, at a price of Rs. 95.510 would have an implicit yield of 9.4280% computed as follows:

= ((100-95.510)*365)/(95.510*182)

9.428% is the rate at which Rs. 95.510 will grow over 182 days, to yield Rs. 100 on maturity. Treasury bill cut-off yields in the auction represent the default-free money market rates in the economy, and are important benchmark rates.

4.4.3 Commercial Bills Market

Commercial bill is a short-term, negotiable and self-liquidating instrument with low risk. It is a written instrument containing an unconditional order signed by the maker, directing to pay a certain amount of money only to a particular person or to the bearer of the instrument. The seller (drawer) draws bills of exchange on the buyer (drawee) for the value of the goods delivered by him. Such bills are called trade bills. Commercial banks can be inland or foreign. Inland bills are drawn/payable in India or drawn upon any person resident in India. Foreign bills are (i) drawn/payable outside India, (ii) drawn on a party/payable in India or drawn in India/payable outside India. A related classification is export and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by overseas exporters. When trade bills are accepted by commercial banks, they are called commercial bills. If the seller gives some time for payment, the bill is payable at a future date (usance bill). During the currency of the bill, if the seller is in need of funds, he may approach his bank for discounting the bill (discounted bill). One of the methods used by banks for providing credit to customers is by discounting commercial bills at a negotiated discount rate. The bank receives the maturity proceeds (face value) of discounted bills from the drawee. Meanwhile, if the bank is in need of funds, it can rediscount the bills already discounted in the Commercial Bill Discount Market.

Bill rediscounting is an important segment of the money market and the bill, as an instrument, provides short-term liquidity to the banks in need of funds. The commercial bill market in India is based on the suggestions of the Narasimham Study Group in 1970. Based on its recommendations, the Bill Markets Scheme (1970) replaced the 1952 Scheme. In the initial stages of the development of the bill rediscounting market, the RBI provided significant support, but over the years it gradually withdrew its support as financial institutions such as banks, LIC, UTI, GIC and its subsidiaries, ICICI, IRBI and ECGC were permitted to rediscount bills of exchange presented by banks. However, these institutions were not permitted to raise funds by a further round of rediscounting. The rate of discount was governed by directive from the RBI until 1989. The cost of funds raised by banks through the bills rediscounting scheme was lower than the effective cost of inter-bank deposits or loans of over 60 days, as the latter was subjected to re- serve requirements. As a result, bill rediscounting emerged as a satisfactory source of funds for banks that sought funds through the money market. Yet, despite the various measures taken by the RBI to develop bill finance, the instrument did not become popular.

During the post-1991 period, to augment the facilities for rediscounting and make resources available for the purpose, the RBI progressively enlarged the number of eligible institutions for rediscounting of bills to include, besides scheduled commercial banks, all-India financial institutions like the, UTI, IDBI, LIC, GIC and its subsidiaries. ICICI, IRBI (HBI), IFCI, ECGC, NABARD, NHB, Exim Bank, SCICIC, HDFC mutual funds and state and urban cooperative banks.

In addition, the discount/rediscount rates were modified to encourage the borrowers to switch over to the bill rediscounting market. The prescribed ceiling in the rediscount rate was freed in so far as the banks/financial institutions rediscounted the bills with the DFHI. In other words, the DFHI was permitted to fix its own bid/offer discount rates for the bills. The bill rediscounting rates were totally freed from May 1, 1989.

Another step in the direction of activating the bill market was the abolition of stamp duty. The endorsement/delivery of the bills at the time of rediscounting was also done away with. To facilitate further rediscounting of bills, banks were permitted to draw derivative usance promissory notes for a suitable amount with a maturity period up to 90 days, on the strength of the underlying bonafide commercial/trade bills discounted by them. The stamp duty on these bills was remitted by the Government as the underlying bills were stamped in the normal course. Since the physical lodgement of bills was done away with, multiple rediscounting was facilitated and greater liquidity was imparted to bills. RBI also promoted a drawee bill scheme to secure prompt payment to small-scale units. The development of bill finance/culture not only facilitates an efficient payment system but also ensures the liquidity of the assets/funds of the banks. This segment of the money market in India, however, is not developed to the extent desirable or as compared to its counterparts in other money markets. The factors hindering the development of bill finance/culture are:

- Reluctance on the part of the users to move towards bill culture owning to the element of strict financial discipline.
- Lack of an active secondary market.
- Administrative problems relating to the physical scrutiny of invoices, physical presentation of bills for payment, endorsements/re-endorsement at the time of rediscounting.
- Absence of specialised credit information agencies.
- System of cash credit which is more convenient and cheaper than bill financing as the procedure for discounting/rediscounting are complex and time-Consuming.
- Misuse of the bill market in the early 1990's by banks and finance companies.
- Small size of the foreign trade.

- Absence of specialised discounting institutions.

4.4.4 Commercial Papers (CPs) Market

Following the recommendations of the Vaghul Committee in March 1989, the RBI permitted the issue of CPs within the framework of its guidelines, which were modified from time to time to enhance their suitability as money market instruments. The CP is a short-term unsecured negotiable instrument consisting of usance primary notes with a fixed maturity, thus, indicating the short-term obligation of an issuer. It is generally issued by companies as a means of raising short-term debt and, by a process of securitisation, inter- mediation of the bank is eliminated. The PDs and all-India financial institutions can also issue CPs. It is issued on a discount to face value basis but it can also be issued in interest-bearing form. The issuer promises the buyer a fixed amount at a future date but pledges no assets. His liquidity and earning power are the only guarantee. In other words, the CP is not tied to any specific self-liquidating trade transaction in contrast to the commercial bills that arise out of specific trade/commercial transaction. A CP can be issued by a company directly to the investor or through bank/merchant banks (dealers). When the companies directly deal with the investors, rather than use a securities dealer as an intermediary, the CP is called a direct paper. Such companies/borrowers announce the current rates of CPs of various maturities. Investors can then select those maturities that closely approximate their holding period and acquire the security/ paper directly from the issuer. When CPs are issued by security dealer/dealers on behalf of their corporate customers, they are called dealer papers. They buy at a price less the commission and sell at the highest possible level. It is generally backed by a revolving underwriting facility from banks to ensure continuous availability of funds on each roll-over of the CP. Moreover, unlike commercial bills, maturities within the range can be tailored to specific requirements.

Advantages

A CP, as a short-term financial instrument, has several advantages both to the issuer and the investor. It is a simple instrument as it hardly involves any documentation between the issuer and the investor. It is additionally flexible in terms of maturities of the underlying promissory note, which can be tailored to match the cash flow of the issuer. Further, a well rated company can diversify its sources of finance from banks to the short-term money market at a cheaper cost. This is particularly relevant in a system, such as in India, in which reserve requirements on banks are in vogue in the form of SLR and CRR, which raise the effective cost of bank lending. Also, the CP provides investors with returns higher than what they obtain from the banking system. In addition, companies that are able to raise funds through

CPs become better known in the financial world and are thereby placed in a more favourable position for raising long-term capital. Thus, there is an in-built incentive for companies to remain financially strong. Unlike bank credit which is secured by a first charge on the current assets, CP is unsecured. There are no limitations on the end-use of funds raised through CPs, and as negotiable/transferable instruments, they are highly liquid. Finally, in the Indian context, the creation of a commercial paper market has resulted in a part of the inter-corporate funds flowing into this market, which is under the control of the monetary authorities.

Framework of Indian CP Market Commercial paper (CP) is a unsecured money market instrument issued in the form of a promissory note. As a privately placed instrument, CP was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide additional instrument to investors. Subsequently, primary/satellite dealers and all-India financial institutions (FIs) were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. The issue of CP is governed by the directions/guidelines issued by the RBI from time to time. These guidelines provide the broad framework of the CPs market in India. The main elements of the present framework of the Indian CP market, prescribed by the RBI, are outlined below.

Eligibility for Issue of CP Companies, primary dealers (PDs) and financial institutions (FIs) that have been permitted to raise short-term resources under the umbrella limit fixed by the RBI are eligible to issue CP. A company would be eligible to issue CP provided: (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than `4 crore;(b)company has been sanctioned working capital limit by bank(s) or FIs; and (c) the borrowal account of the company is classified as a standard asset by the financing bank(s)/institution(s). Working capital limit means the aggregate limits including those by way of purchase/discount of bills sanctioned by banks/FIs for meeting the working capital requirements.

Rating Requirements All eligible participants/issuers should obtain the credit rating for issuance of the CP from any one of the SEBI-registered credit rating agencies. The minimum credit rating should be A-3 as per the standardised rating symbols/definitions provided by the SEBI. The issuers should ensure at the time of issuance of the CP that the rating obtained is current and has not fallen due for review.

Tenor CP can be issued for maturities between a minimum of 7 days and a maximum up to one year from the date of issue. The maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.

Issue of CP Credit Enhancement Limits, CP can be issued as a “stand alone” product. It would not be obligatory for banks/FIs to provide stand-by facility. Banks/FIs may, based on their commercial judgement, subject to the prudential norms applicable to them, with the specific approval of their respective Board of Directors, choose to provide stand-by assistance/credit, backstop facility by way of credit enhancement for a CP issue. Non-bank entities (including corporates) may provide unconditional/irrevocable guarantee for credit enhancement for CP issue provided: (i) the issuer fulfils the eligibility criteria for issuance of CP, (ii) the guarantor has a credit rating at least one notch higher than the issuer by an approved agency, and (iii) the offer document properly discloses the net worth of the guarantor company, the names of companies to which the guarantor has issued similar guarantees, the extent of guarantee offered and the condition under which the guarantee would be invoked. The aggregate amount of a CP from an issuer should be within the limit as approved by its Board of Directors or the quantum indicated by the credit rating agency for the specified rating, whichever is lower. Banks and FIs will, however, have the flexibility to fix working capital limits duly taking into account the resource pattern of companies’ financing including CPs. An FI can issue a CP within the overall umbrella limit fixed by the RBI. The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. The CP may be issued on a single date or in parts on different dates provided that in the latter case, each CP should have the same maturity date. Every issue of CP, including renewal, should be treated as a fresh issue.

Investment in CP Individuals, banks, other corporate bodies registered or incorporated in India and unincorporated bodies, NRIs and FIIs would be eligible to invest in CP. However, FPIs would be eligible to invest subject to (i) conditions set by the SEBI, and (ii) compliance with the provisions of the FEMA/Foreign Exchange Deposit Regulations and Foreign Exchange Management (Transfer/Issue of Security by a Person Resident Outside) Regulations.

Mode of IssuanceCP can be issued either in the form of a promissory note or in a dematerialised form through any depository approved by and registered with the SEBI. However, RBI-regulated entities are required to make fresh investments and hold CPs only in dematerialised form. The CPs should be issued in denominations of `5 lakh and multiples. The amount invested by a single investor should not be less than `5 lakh (face value). It will be issued at a discount to face value as may be determined by the issuer. No issuer should have the issue of a CP underwritten or co-accepted. Options (call/put) are not permitted on CPs.

Investment/Redemption The investor in CP (primary subscriber) should pay the discounted value of the CP to the account of the issuer through the IPA. When CP is held in demat form, the holder of the CP will have to get it redeemed and receive payment from the IPA.

Procedure for Issuance Every issuer must appoint an IPA for issuance of a CP. He should disclose to the potential investors its financial position as per the standard market practice. After the exchange of deal confirmation between the investor and the issuer, the issuer should arrange for crediting the CP to the investor's account with a depository through the IPA. The investors should be given a copy of the IPA certificate to the effect that the issuer has a valid agreement with the IPA and documents are in order.

Trading and Settlement All OTC trades in CP should be reported within 15 minutes of the trade to the Financial Markets Trade Reporting and Confirmation Platform (F-TRAC) of Clearcorp Dealing System (India) Ltd (CDSL). The requirement of exchange of physical confirmation of trades matched on F-TRAC is waived subject to the participants (i) entering into one-time bilateral agreement for eliminating the exchange of confirmation or multilateral agreement drafted by the FIMMDA, (ii) adhering to the applicable laws such as stamp duty and (iii) ensuring adherence to a sound risk management framework and complying with all the regulatory/legal requirements/ practices in this regard. They should be settled through the clearing house of the NSE/BSE. The settlement cycle for OTC trades in CPs should be T+0/T+1.

Buyback of CP Issuers may with the approval of their Board of Directors, buy-back CPs from the investors before maturity through the secondary market at prevailing market price. The buy-back cannot be before a minimum period of seven days from the issue date and the issuer should intimate the IPA of the buy-back undertaken.

Duties/Obligations The duties/obligations of the issuer, the issuing and the paying agent (IPA) and credit rating agency (CRA) are set out below:(a) Issuer They should ensure that the guidelines and procedures laid down for the CP issuance are strictly adhered to.(b)Issuing and Paying Agent (IPA) The IPA should ensure that the issuer has the minimum credit rating as stipulated by the RBI and the amount mobilised through issuance of CP is within the quantum indicated by the CRA for the specified rating or as approved by its Board of Directors, whichever is lower. It has to verify all the documents submitted by the issuer, namely, copy of the Board resolution, signatures of authorised executants (when CP in physical form) and issue a certificate that the documents are in order. It should also certify that it has a valid agreement with the issuer. The certified copies of original documents verified by the IPA should be held in its custody. All banks acting as IPAs should report the details of issuance of CPs on the Online Returns Filing System (ORFS) module of the RBI within two days from the date of issuance. They should immediately report, on occurrence, full particulars of default in repayment of CP in the prescribed format to the RBI. They should similarly report all instances of buy-back undertaken by the issuers. (c) Credit Rating Agency (CRA) The code of conduct prescribed by the SEBI for CRAs for undertaking rating of capital market instruments would be applicable to them for rating a CP. Further, the CRA would have the discretion to determine the validity period of the rating depending upon its perception about the strength of the issuer. Accordingly, the CRA should at the time of rating, clearly indicate the date when the rating is due for review. They would have to closely monitor the rating assigned to the issuers vis-à-vis their track record at regular intervals and make their revision in the ratings public through their publications and website.

Documentation Procedure Standardised procedures/documentation for CPs are prescribed by the Fixed Income Money Market and Derivatives Association of India (FIMMDA) in consonance with international best practices. Issuers/IPAs should follow the guidelines issued by the FIMMDA with the RBI's approval.

Non-applicability of Certain Other Directions Nothing contained in the RBI NBFCs Directions, would apply to any NBFC insofar as it relates to the acceptance of deposits by issuance of CP, in accordance with these guidelines. effective cost/Interest yield As CPs are issued at discount and redeemed at their face value, their effective pre-tax interest yield

where net amount realised = face value – discount – issuing and paying agent (IPA) charges, that is, stamp duty, rating charges, dealing bank fee and fee for stand by facility.

Assuming face value of a CP to be `5,00,000, maturity period to be 90 days, net amount realised

= `4,80,000, discount and other charges associated with the issue of CP = 1.5 per cent, the pre-tax effective cost of CP

The participants in the market are corporate bodies, banks, mutual funds, the UTI, LIC, GIC and so on, which have surplus funds and are on a lookout for opportunities for short-term in- vestments. The PDs also operate both in the primary and secondary markets for CPs by quoting its bid and offering prices. Although the CP market has become fairly popular now, a secondary market is yet to develop and when fully developed, it would impart strength and vitality to the money market. Investors, with temporary surplus, would be able to get attractive yields for their short-term funds and borrowers would be able to raise resources at market-related rates. The development of a secondary market with the active participation of the PDs will improve the liquidity of CPs.

4.4.5 Call Money Market

The call/notice money market forms an important segment of the Indian Money Market. Call and notice money market refers to the market for short-term funds ranging from overnight funds to funds for a maximum tenor of 14 days. Under Call money market, funds are transacted on overnight basis and under notice money market, funds are transacted for the period of 2 days to 14 days.

Participants in call/notice money market currently include banks (excluding RRBs) and Primary dealers both as borrowers and lenders. Non-Bank institutions are not permitted in the call/notice money market with effect from August 6, 2005. The regulators has prescribed limits on the banks and primary dealers operation in the call/notice money market.

An electronic screen-based negotiated quote-driven system for all dealings in call/notice and term money market has been operationalised with effect from September 18, 2006. This system has been developed by Clearing Corporation of India Ltd. on behalf of the Reserve Bank of India.

This system provides an electronic dealing platform with features like Direct one to one negotiation, real time quote and trade information, preferred counterparty setup, online exposure limit monitoring, dealing facilitated for T+0 settlement type for Call Money and dealing facilitated for T+0 and T+1 settlement type for Notice and Term Money.

Information on previous dealt rates, ongoing bids/offers on real time basis imparts greater transparency and facilitates better rate discovery in the call money market. The system has also helped to improve the ease of transactions and increased operational efficiency. However, participation on this platform is optional and currently both the electronic platform and the telephonic market are co-existing.

Call markets represent the most active segment of the debt markets. Though the demand for funds in the call market is mainly governed by the banks' need for resources to meet their statutory reserve requirements, it also offers to some participants a regular funding source for building up short-term assets. However, the demand for funds for reserve requirements dominates any other demand in the market.

Following the recommendations of the Reserve Banks Internal Working Group (1997) and the Narasimhan Committee (1998), steps were taken to reform the call money market by transforming it into a pure interbank market in a phased manner. The non-banks exit was implemented in four stages beginning May 2001 whereby limits on lending by non-banks were progressively reduced along with the operationalisation of negotiated dealing system (NDS) and CCIL until their complete withdrawal in August 2005. In order to create avenues for deployment of funds by non-banks following their phased exit from the call money market, several new instruments were created such as market repos and CBLO.Currently, the participants in the call/notice money market currently include banks (excluding RRBs) and Primary Dealers (PDs) both as borrowers and lenders.

Short-term liquidity conditions impact the call rates the most. On the supply side the call rates are influenced by factors such as: deposit mobilisation of banks, capital flows, and banks' reserve requirements; and on the demand side, call rates are influenced by tax outflows, government borrowing programme, seasonal fluctuations in credit off take. The external situation and the behaviour of exchange rates also have an influence on call rates, as most players in this market run integrated treasuries that hold short- term positions in both rupee and forex markets, deploying and borrowing funds through call markets.

During normal times, call rates hover in a range between the repo rate and the reverse repo rate. The repo rate represents an avenue for parking short-term funds, and during periods of easy liquidity, call rates are only slightly above the repo rates. During periods of tight liquidity, call rates move towards the reverse repo rate.

4.4.6 Certificate of Deposits (CDs) Market

A CD is a document of title to a time deposit and can be distinguished from a conventional time deposit in respect of its free negotiability and, hence, marketability. In other words, CDs are a marketable receipt of funds deposited in a bank for a fixed period at a specified rate of interest. They are bearer documents/instruments and are readily negotiable. They are attractive to the bankers and the investors in the sense that the former is not required to encash the deposit prematurely, while the latter can sell the CDs in the secondary market before its maturity and thereby the instrument has liquidity/ready marketability. Based on the recommendations of the Vaghul Committee, the RBI formulated a scheme in June 1989 for the issue of CDs by scheduled banks (excluding RRBs). The RBI guidelines pro- vide the framework for its operations. In order to broad base the primary market, and also to develop an active secondary market, modifications have been introduced from time to time in the limit for issue of CDs, minimum size, denomination and so on.

- **Guidelines** A CD is a negotiable money market instrument, issued in a demat form or as a usance promissory note against funds deposited at a bank/other eligible financial institutions (FIs) for a specified time.
- **Eligibility** The CDs can be issued by (i) commercial banks [excluding the RRBs/Local Area Banks (LABs)] and (ii) select all-India FIs permitted by the RBI to raise resources by way of term money/deposits, certificate of deposits, CPs and inter-corporate deposits within the umbrella limit fixed by it.
- **Aggregate Amount** Banks have freedom to issue CDs depending on their funding requirements. An FI may issue CDs within the overall umbrella limit fixed by the RBI, time to time.
- **Minimum Size of Issue and Denominations**The minimum amount of a CD should be 1 lakh, that is, the minimum deposit that could be accepted from a single subscriber should not be less than1 lakh and in multiples of 1 lakh.
- **Investors** The CDs can be issued to individuals/corporations/companies/(including banks/PDs) trusts/funds/associations and so on. The NRIs may also subscribe to CDs on a non-repatriable basis only. Thesecannot be endorsed to another NRI in the secondary market.
- **Maturity** The maturity period of a CD issued by a bank should be between 7 days (minimum) and one year (maximum). The FIs can issue CDs with maturity of 1-3 years.
- **Discount/Coupon Rate**The CDs may be issued at a discount on face value. They can also be issued on floating rate basis provided the methodology of the compiling the floating rate is objective, transparent and market-based. The issuer is free to determine the discount/coupon rate. The interest rate on the floating rate CDs should be set periodically according to the predetermined formula that indicates the spread over a transparent benchmark. The investors should be clearly informed of the same.
- **Reserve Requirements** Banks have to maintain the appropriate SLR and CRR on the issue price of the CDs.
- **Transferability** The physical CDs can be freely transferred by endorsement and delivery. The dematerlized CDs can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs.
- **Trade in CDs**The trading procedure applicable to the CPs (discussed earlier) is also applicable to the CDs.

- **Settlement** All OTC traders in CDs must be cleared and settled through the authorised clearinghouses of the stock exchanges, that is, NSCCL/ICCL/CCL.
- **Loans/Buy-backs** Loans against CDs and buy-back of CDs by the issuers before maturity are not permitted.
- **Format** The CDs should be issued only in demat form. Issuance of CDs in physical form, if any, on the insistence of the investors should be separately reported to the RBI. The issuance of CD would attract stamp duty. There would be no grace period for repayment.
- **Security** Since physical CDs are freely transferable by endorsement and delivery, they should be printed on good quality security paper and necessary precautions should be taken to guard against tampering with the document. They should be signed by two/more authorised signatories.
- **Payment of Certificate**: Since CDs are transferable, the physical certificate may be presented for payment to the last holder. Since the question of liability on account of any defect in the chain of endorsements may arise, banks should be cautious and make payments only by a crossed cheque. The holders of the dematted CD should approach their respective Depository Participants (DPs) and give transfer/delivery instructions to transfer the demat security represented by informational securities identification number (ISIN) to the CD Redemption Account maintained by the issuer. The holder should also communicate to the issuer by a letter/fax a copy of the delivery instruction given to the DP and intimate the place at which the payment is requested to facilitate prompt payment. Upon receipt of the demat credit of CDs in the CD Redemption Account, the issuer on maturity date would arrange to pay to the holder/transferor by way of bankers' cheque/high value cheque.
- **Duplicate Certificate** Duplicate certificates can be issued in case of loss of physical certificates only in physical form after compliance with the following: (i) a notice in at least one local newspaper of loss of CD certificate, (ii) lapse of 15 days from the date of notice and (iii) execution of an indemnity bond by the investor to the satisfaction of the issuer of the CD. The duplicate certificates should be only in physical form and fresh stamping would not be required.

4.4.7 Primary Dealers

In accordance with the announcement of the monetary policy, on May 14, 1994 to introduce a system of Primary Dealers (PDs)

- To strengthen the infrastructure in the Government securities market, including the money market, in order to make it vibrant, liquid and broad based;
- To ensure the development of underwriting and market capabilities for Government securities outside the RBI so that the latter will gradually shed these functions;
- To improve the secondary market trading system, which would contribute to price discovery, enhance liquidity and turnover and encourage voluntary holding of Government securities amongst a wider investor base; and
- To make PDs an effective conduit for conducting open market operations (OMOs).

The following classes of institutions are eligible to apply for primary dealership:

- Subsidiaries of scheduled commercial bank(s) and all-India financial institution(s) dedicated predominantly to the securities business and in particular to the Government securities market.
- Companies incorporated under the Companies Act, 1956 and engaged predominantly in the securities business and in particular to the Government securities market.
- Subsidiaries/joint ventures set up by entities incorporated abroad under the approval of the Foreign Investment Promotion Board (FIPB).

The applicant should have owned funds (NOFs) of a minimum of `50 crore, consisting of paid-up equity capital, free reserves, balance in share premium account and capital reserves representing a surplus arising out of sale proceeds of assets but not reserves created by the revaluation of assets, less accumulated loss balance, deferred revenue expenditure and other intangible assets. The decision to enlist PDs would be taken by the RBI based on its perception of market needs, suitability of the applicant and the likely value addition to the system.

The PDs are expected to play an active role in the Government securities market, both in its primary and secondary segments. A PD is required to have a standing arrangement with the RBI, based on the execution of an undertaking and an authorisation letter issued by the RBI covering, inter alia, the following aspects:

- A PD has to commit to aggregatively bid for Government of India dated securities on an annual basis of not less than a specified amount and auction T-bills for specified percentage of each auction. The agreed minimum amount/percentage of bids has to be separately indicated for dated securities as well as T-bills.

- A PD is required to achieve a minimum success ratio of 40 per cent for dated securities and T-bills.
- The PDs are collectively offered to underwrite upto 100 per cent of the notified amount in respect of all issues where the amounts are notified. A PD can offer to underwrite an amount not exceeding five times of its net owned funds. The amount so arrived at should not exceed 30 per cent of the notified amount of the issue. If two/more issues are floated at the same time, the 30 per cent limit applies to the amounts of both the issues taken together. In the case of devolvement, allotment of securities is made at the competitive cut-off price/yield decided at the auction or at par in 'the case of predetermined coupon flotation. Obligations under items (i) to (iii) above are confined only to Central Government dated securities and obligations under item (i) to (ii) to T-bills.
- The T-bills issues are not underwritten. Instead, PDs are required to commit to submit minimum bids at each auction. Their commitment to participate in T-bills subscription works out as follows: (a) a each PD individually commits, at the beginning of the year, to submit a minimum bid as a fixed percentage of the notified auction, (b) the minimum percentage of bids for each PD is determined by the RBI through negotiations so that the entire issue is collectively apportioned among all PDs and (c) in determining the minimum bidding commitment, the RBI takes into account the offer made by the PD, its net owned funds and track record. The percentage of minimum bidding commitment determined by the RBI remains unchanged for the entire financial year or till furnishing of undertaking on bidding commitment for the next financial year, whichever is later.
- A PD offers a firm two-way quote either through the Negotiated Dealing System (NDS) or the over-the-counter telephone market or through a recognised stock exchange in India a deal in the secondary market for Government securities and takes principal positions.
- A PD has to maintain the prescribed minimum capital standards at all points of time.
- A PD should achieve a sizeable portfolio in Government securities before the end of the first year of operation after authorisation.
- The annual turnover of a PD in a financial year cannot be less than five times of the
- Average month-end stocks in Government dated securities and 10 times of the average month-end stocks in T-bills. Of the total, the turnover in respect of outright transactions cannot be less

than three times in respect of Government dated securities and six times for T-bills. The turnover is calculated as under: Total purchase and sales during the year divided by average of month-end stocks during the year. Purchases are inclusive of primary market purchases and sales are inclusive of redemption on maturities. The target should be achieved by the end of the first year of operations, after authorisation by the RBI.

- A PD has to maintain physical infrastructure in terms of office, computing equipment, communication facilities like telex, fax, telephone etc. and skilled manpower for efficient participation in primary issues, trading in the secondary market and to provide advice and education to investors.
- A PD should have an efficient control system for the fair conduct of business, settlement of trades and maintenance of accounts. The Guidelines on Securities Transaction to be followed by DPs, issued from time to time, should be strictly adhered to.
- A PD must provide access to the RBI to all records, books, information and documents as may be required.
- A PD is subject to all prudential and regulatory guidelines of the RBI.
- A PD must submit periodic returns as prescribed by the RBI.
- A PD's investment in G-Secs and T-bills on a daily basis should at least be equal to its net call borrowing plus net RBI borrowings plus net owned funds of ` 50 crore.

The RBI extends these following facilities to PDs to enable them to effectively fulfil their obligations:

- Access to current account facility and Subsidiary General Ledger (SGL) Account facility (for Government securities).
- Permission to borrow and lend in the money market, including call money market, and to obtain all money market instruments.
- Access to liquidity support through Repos operations with the RBI in Central Government dated securities and Auction Treasury Bills upto the limit fixed by the RBI. The scheme is separately notified every year. The limit is fixed at 16.67 per cent and 10 per cent respectively of commitments made by a PD for tendering aggregative bids on an annual basis in Government of India dated securities and T-bills. Special discretionary access may be considered when market conditions warrant it.
- Access to Liquidity Adjustment Facility (LAF) of the RBI.

- Favoured access to open market operations by the RBI.

4.4.8 Money Market Mutual Funds

The sophistication and versatility of the money market is reflected in the diversity of money market instruments to suit the varied needs of market participants. The money market instruments outlined earlier in the chapter deals with wholesale transactions involving large amount and are suitable for large corporate and institutional investors. To enable small investors to participate in the money market, a money market mutual fund (MMMF) works as a conduit through which they can earn the market related yield. In April 1991, the RBI outlined a broad framework for setting up these institutions. As a follow-up, in September 1991, a Task Force was appointed to work out the operating guidelines for the setting up of MMMFs. Following the recommendations of the Task Force, in April 1992, the RBI announced detailed guidelines in this regard. Despite the lapse of three years since the guidelines were issued, MMMFs continued to be consciously absent in the money market in India. View a view to imparting greater liquidity and depth to the money market and in order to make the scheme more flexible and attractive to banks and financial institutions, certain modifications to the existing scheme were introduced in December 1995.

In its credit policy, announced on October 29, 1999, the RBI stipulated that from the angle of consistent policy, with regard to investor protection, MMMFs would be brought under the umbrella of the SEBI regulations like other mutual funds. Once the SEBI regulatory framework for MMMFs was in place, the RBI would withdraw its guidelines. However, banks/FIs desirous of setting up MMMFs would have to take necessary clearance from the RBI before approaching the SEBI for registration. The SEBI Mutual Fund Regulations (discussed in a subsequent chapter) are since 2000 applicable to money market mutual funds also.

However, the growth in MMMFs has been less than expected. The size of the MMMF schemes floated by three sponsors is rather small. The MMMFs would hopefully grow when the Indian money market would grow in volume and acquire depth.

4.5 Check Your Progress

1. A commercial paper, an instrument in Indian money market is of a minimum amount of
   (a) 5 lakh
   (b) 10 lakh
   (c) 15 lakh

(d) 25 lakh

2. Treasury bills are sold through
   (a) auctions
   (b) the public debt office of the RBI
   (c) both (a) and (b)
   (d) neither (a) nor (b)
3. Which of the following is not an instrument of money market?
   (a) Treasury bill
   (b) commercial bill
   (c) share
   (d) commercial papers
4. In the context of transactions of securities, PDs are
   (a) Private Dealers
   (b) Public Dealers
   (c) Primary Dealers
   (d) None of these
5. In India, treasury bills are claims against the
   (a) Central Government of India
   (b) State Bank of India
   (c) Reserve Bank of India
   (d) Nationalised Banks of India

4.6 Summary

- The money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than one year.
- A money market provides a balancing mechanism to even out the demand for and supply of short-term funds, a focal point for central bank intervention for influencing liquidity and general level of interest rates in the economy, and reasonable access to
- Suppliers and users of short-term funds to fulfil their borrowings and investment requirements at an efficient market clearing price.

- The instruments traded in the Indian money market are treasury bills (T-bills), call/notice money market—call (overnight) and short notice (up to 14 days), commercial papers (CPs), certificates of deposits (CDs), commercial bills (CBs), and collateralized borrowing and lending obligations (CBLOs).
- A commercial paper is an unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading creditworthy and highly rated corporates to meet their working capital requirements.
- Commercial bill is a short-term, negotiable, and self-liquidating instrument with low risk. It enhances the liability to make payment on a fixed date when goods are bought on credit. In India, the bill market did not develop due to (i) the cash-credit system of credit delivery where the onus of cash management rests with banks and (ii) an absence of an active secondary market.
- Certificates of deposit are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. CDs are issued by banks during periods of tight liquidity, at relatively high interest rates.
- The Reserve Bank seeks to influence monetary conditions through management of liquidity by operating in varied instruments. These instruments can be categorized as direct and indirect market-based instruments.
- The management of liquidity is essentially through direct instruments such as varying cash reserve requirements, limits on refinance, administered interest rates, and qualitative and quantitative restrictions on credit. The Reserve Bank also influences monetary conditions through market-based, indirect instruments such as open market operations and refinance (standing facilities)/discount (market- based discount windows)/repo windows.

4.7 Keywords

- **T-bill:** Itis an instrument of short-term borrowing by the Government of India**.**
- **CD:** Itis a document of title to a time deposit and can be distinguished from a conventional time deposit in respect of its free negotiability and, hence, marketability.
- **Call and notice money market:** It refers to the market for short-term funds ranging from overnight funds to funds for a maximum tenor of 14 days.

- **Commercial bill**: It is a short-term, negotiable and self-liquidating instrument with low risk. It is a written instrument containing an unconditional order signed by the maker, directing to pay a certain amount of money only to a particular person or to the bearer of the instrument

4.8 Self-assessment Test

1. Discuss the main instruments of a money market.
2. Briefly describe the structure of Indian money market.
3. Describe the composition of money market in India.
4. Discuss the features, merits and limitations of call money market in India.
5. What is a Treasury bill? Write a short note on Treasury bill market in India.
6. What is commercial bill market? Mention the merits and limitations of commercial bill market in India.

4.9 Answers to Check Your Progress

Question 1	Answer	(d)
Question 2	Answer	(a)
Question 3	Answer	(c)
Question 4	Answer	(c)
Question 5	Answer	(a)

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Capital Market: Primary and Secondary Market, Recent Development in Indian Capital Market

STRUCTURE:

5.0 Learning Objectives

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

- Know the primary market process.
- Know the secondary market process.
- Understand reforms in Indian securities markets.

5.1 Introduction

Business, trade and commerce need finance for their working capital needs, as well as to set up new projects. The finance can come from Governments, multi-lateral funding agencies, domestic financial institutions, banks, capital market etc.

The capital market has the following major components:

5.1.1 Equity Capital

Investors owning equity shares of a company are owners of the company and issued equity shares of the company, as evidence of such ownership. Equity investors are not entitled to any fixed return or repayment of capital. However, they are entitled to the benefits that arise out of the performance of the company. If the business fails, they may lose the entire investment. Outof all the financiers, they take the highest risk.

5.1.2 Debt Capital

Investors in the debt of a company are not owners of the company – they are more in the nature of lenders to the company. They are issued debentures or other debt securities, as evidence of the moneys invested.

Investors in debt securities are entitled for interest payment and repaid their capital as per terms agreed at the time of investment. The debt capital is to be serviced, irrespective of whether or not the company is profitable. Debt, which is repayable within a short time period of 1 year, is called money market. Money market is thus a segment of the debt market. The inter-bank money market for very short tenors of 1 to 3 days is called call money market. Slightly longer money market for tenors of 4 to 15 days is called notice money market.

5.1.3 Preference Capital

Investors in preference capital of a company are consideredowners of the company, as per the Companies Act, 1956. They are issued preference shares of the company, as evidence of such ownership. However, their ownership rights are much lesser than those of equity shareholders arebutPreference shareholders take more risk than debt investors, but less risk than equity do. Like debt, they are entitled to a fixed return – but this is payable only out of the profits of the company. If, in a year, the company does not have adequate profits, the dividend will not be payable (in the case of non-cumulative preference shares) or be payable in future years (in the case of cumulative preference shares).

Besides the fixed return, they may also be entitled to additional returns, depending on profits of the company (in the case of participating preference shares). Preference shares, which are not entitled to such additional share on the profits of the company, are called non-participating preference shares.

Equity shares, debentures, preference shares etc. are called securities. Parties that invest in these securities are calledinvestors. The companies that need the money issue securities to the investors. Therefore, the companies are called issuers. The capital market performs a useful role in bringing issuers and investors together, thus ensuring flow of funds to businesses, trade and commerce.

5.2 Capital Market Segments

5.2.1 Primary Market

Primary market provides an opportunity to the issuers of securities, both Government and corporations, to raise funds through issue of securities. The securities may be issued in the domestic or international markets, at face value, or at a discount (i.e. below their face value) or at a premium (i.e. above their face value), .The primary market issuance is done either through a public issue or private placement. Under the Companies Act, 1956, an issue is referred to as public, if it results in allotment of securities to 50 investors or more. However, when the issuer makes an issue of securities to a select group of persons not exceeding 49, and if it is neither a rights issue (i.e. issued only to existing investors) nor a public issue (i.e. made available to any member of the general public to invest in), itis called a private placement. When a company makes a public issue of its equity shares for the first time, it is called an initial public offer (IPO) and subsequent issues are follow-on public offers (FPO).

5.2.2 Secondary Market

Secondary market refers to a market, where securities that are already issued by the Government or corporations, are traded between buyers and sellers of those securities. The securities traded in the secondary market could be in the nature of equity, debt, derivatives etc.As clear from the above, the primary market transactions directly affect the issuing company's balance sheet (i.e. the financial statement of its assets and liabilities as on any date). For instance, if the company issues equity shares, the equity share capital in its balance- sheet will increase. On the other hand, secondary market transactions in those equity shares have no impact on the issuing company's balance sheet. The ownership of the shares will move from the seller to the buyer – but the issuing company's balance sheet is not affected.

5.3 Institutions & Intermediaries

Capital market activities create the need for different kinds of institutions. A brief on these institutions follows:

- **Stock Exchange:** The National Stock Exchange (NSE) is India's premier stock exchange. A critical role is to offer a platform for secondary market trades. NSE provides trading in four different segments- Wholesale Debt Market, Capital Market, Futures and Options and Currency Derivatives Segment.
- **Clearing Corporation:** Once trades are executed, the clearing and settlement is handled by the clearing corporation, which may operate as an independent entity or a subsidiary of the exchange. The National Securities Clearing Corporation Ltd. (NSCCL), a wholly owned subsidiary of NSE, is responsible for clearing and settlement of trades executed at the NSE. As part of its role, NSCCL provides financial guarantee for all the settlements. This takes care of any counter- party risk. Further, NSCCL helps in managing the risk in the market through an effective margining system. CRISIL has assigned its highest corporate credit rating of 'AAA' to the National Securities Clearing Corporation Ltd (NSCCL). 'AAA' rating indicates highest degree of strength with regard to honoring debt obligations. The rating also factors in NSCCL's rigorous risk management controls and adequate settlement guarantee cover. Clearing corporations are regulated by SEBI.
- **Merchant Bankers / Investment Bankers:** Issuing companies mobilise money from investors through issue of securities in the primary market. Merchant bankers assist companies in handling the issue. Merchant Bankers are regulated by SEBI.
- **Underwriters:** The success of a public issue many a times depends on the prevailing sentiment in the markets. Companies and their merchant bankers prefer the certainty that the expected funds will be mobilized. This certainty is brought in by appointing Underwriters. Every underwriter commits to bring in an agreed amount as part of the issue. Thus, if the targeted money is not mobilized in the issue, the underwriters bring in the funds to bail out the issue. Underwriters are regulated by SEBI.
- **Registrar & Transfer Agents (RTA):** The RTA keeps a record of the share-holders and their share-holding in the company. In a public issue, RTA is responsible for allotting shares to applicants on the basis of allotment formula that is finalized between the company, its merchant banker and the stock exchange. The RTA also assists companies in executing various corporate actions such as dividend payments, rights issues (issue of new shares at an agreed price to existing investors) and bonus issues (issue of new shares, free, to existing investors).RTAs are regulated by SEBI.

- **Depository:** Although a company issues securities as part of its resource mobilization exercise, the investor is rarely given a physical certificate. It is normal practice for investors to have a depository account, into which their investments are credited; when they sell any part of their portfolio, the corresponding investments are reduced from their depository account. Thus, a depository account serves the same purpose for securities, as a bank account serves for money. NSE, along with some other institutions, promoted India's first depository, National Securities Depository Ltd (NSDL). Central Depository Services (India) Ltd is the other depository that operates in the country. The depositories have made instantaneous electronic transfer of securities possible. Demat (Dematerialised) settlement has eliminated the bad deliveries and associated problems which existed in the physical settlement of securities transactions in the country. To prevent physical certificates from sneaking into circulation, it has been made mandatory for all newly issued securities to be compulsorily traded in dematerialised form. Now, the public listed companies making IPO of any security for Rs.10 crore or more have to make the IPO only in dematerialised form.Depositories are regulated by SEBI.
- **Mutual Funds:** Mutual Funds are vehicles to mobilise funds from investors, through various schemes. The funds are then invested in line with the scheme guidelines, for the benefit of investors. Mutual Funds in India are regulated by SEBI.
- **Venture Capital Funds & Private Equity Funds:** Businesses need to reach a certain size, before they are in a position to mobilize funds from the public at large. Their resource requirements until then can be met through Venture Capital Funds and Private Equity Funds. The Venture Capital funds invest at a very early stage in a company, and are prepared to take the risk of the venture failing. Private Equity funds tend to invest at a later stage, after the business has demonstrated some progress in executing its business model. At times, the difference between these two categories of funds is lost in the market. Venture Capital Funds need to register with SEBI. Foreign venture capital investors are also regulated by RBI.
- **Foreign Institutional Investors (FII):** Institutional investors are organizations who invest their own funds or pool sums of money from investors and invest those sums in investible assets such as equity, debt, government securities, commodities etc. FIIs are institutional investors from or registered in a country outside of the one in which they are currently investing. FIIs invest their proprietary (own) funds or pool money and invest on behalf of "broad based" funds, corporates, foreign individuals etc. FIIs are entitled to operate as such, based on their registration with SEBI

and the RBI. Detailed eligibility and operating guidelines exist for FIIs (can be found on SEBI and RBI websites).Investments by FIIs enjoy full capital account convertibility. They can invest in a company under portfolio investment route upto 24% of the paid up capital of the company. This can be increased up to the sectoral cap / statutory ceiling, as applicable to the Indian companies concerned, by passing a resolution of its Board of Directors followed by a special resolution to that effect by the company at its general body. FIIs are regulated by both SEBI and RBI.

- **Insurance Companies:** Life insurance policies that are taken to cover the lives of individuals are typically of long tenors. Often they extend over several decades. Insurance companies invest the funds available with them in the primary and secondary markets. Life insurance companies thus become a source of long term funds in the capital market.Insurance companies are regulated by Insurance Regulatory & Development Authority (IRDA). For their operations in the capital market, they also need to comply with the capital market regulations of SEBI.
- **Pension Funds:** People look towards pension to give them a regular stream of income during their retirement years. The regulatory framework in the area is still evolving. Anyone can buy an annuity product from an insurance company, by paying a lump sum amount. Companies too can buy such contracts from insurance companies, on behalf of employees. The annuity payments from the insurance company under the contract fulfils the need for the regular stream of income for a retired employee. These operations of insurance companies are regulated by IRDA. New Pension Scheme (NPS) is a pension scheme regulated by the Pension Fund Regulatory and Development Authority (PFRDA). The NPS provides for regular contributions by individuals or employers of individuals towards a pension plan. The contributions accumulate during the earning years of the individual. Towards retirement, the accumulations are to be used to buy an annuity from an insurance company.Like insurance, pension funds are a source of long-term funds for the capital market. As seen above, different aspects of pension are regulated by PFRDA and IRDA. Pension funds also need to comply with the capital-market related regulations of SEBI while investing in the markets

5.4 Primary and Secondary Market Process

5.4.1 Primary Market Process

An entrepreneur having an idea looks for people who will provide the seed capital to help him take the initial idea forward. Family, relatives, friends, colleagues and former colleagues are typical seed capital investors, also called angels. They invest based on their comfort with and confidence in the entrepreneur. Seed capital investors need the clarity that their investment can be completely written off, if, for any reason, the entrepreneurial idea does not work out.

Assuming the idea progresses well, the entrepreneur soon needs larger sums of money than is possible to collect from his immediate circle of family, friends and associates. He needs venture capital. Venture capital investors are long-term investors who are prepared to take the risk that the entrepreneurial project can fail. However, if it succeeds, they reap profits, because their investment happens at a low business valuation.

Once the pilot is ready and there is greater clarity on the efficacy of the business model, the entrepreneur is confident that his idea will work. He now starts thinking of scaling up. In such a situation, where project risks are less, private equity capital can be attracted. Private equity investors invest at higher business valuations than the venture capital investors, and invest with a shorter time horizon. They tend to expect an opportunity to sell their investments in about 2 years through a sale either to some strategic investor or as part of the IPO of the company.

Strategic investors are investors who invest in a company because it fits their business strategy. For example, an automobile company's investment in one of its auto ancillary suppliers. Financial investors invest in a company because they see value in it. Angel investors, venture capital investors and private equity investors are examples of financial investors. They will sell of their shares at some stage. Thus, their behaviour pattern is different from strategic investors, who are driven by the strategic fit, rather than potential gain on sale of the shares.

An entrepreneur looking for pure funding and the benefit of the investor's connections will go for financial investors. If he wants some kind of technical or commercial capabilities too, he may look for a strategic investor.

IPO Process: Initial Public Offerings (IPOs) are covered by the Securities & Exchange Board of India (Issue of Capital & Disclosure Requirements) Regulations, 2009. Companies appoint investment bankers (also called merchant bankers) to assist them in the IPO process. The investment banker works with the company over several months, preparing the company for the IPO and then handling the IPO. The responsibilities include conducting the due diligence on various disclosures in the prospectus; liaise with SEBI and co-ordinate on all other aspects of the issue.

It is quite common to have a team of investment bankers as issue managers, especially for large issues. The issue managers sign an inter se agreement that sets out each investment banker's role and responsibility. Among them, one is the lead – also called Book Running Lead Manager. Others are co-Leads, and may also be called Book Running Lead Managers.

Besides the investment banker, the company appoints some other agencies. These are:

- Syndicate Members – Brokers registered with SEBI are appointed to procure bids (applications) from investors for the IPO.
- Underwriters – Investment Bankers, stockbrokers and other SEBI-registered underwriters are appointed to ensure that the issue amount is mobilized.
- Each underwriter indicates an amount that he is underwriting. If the issue does not receive adequate subscriptions from investors, then the shortfall is to be met by the underwriters (who have brought in fewer applications than the amount underwritten by them).
- Legal adviser – Solicitors, to advise on all legal aspects of the issue, to ensure that all legalities are complied with and to review the Prospectus of the issue
- Credit Rating Agency – to grade the IPO.An independent and unbiased grading of the IPO is compulsory
- Depository – to demat the shares of the company.Though investors have the option of asking for physical shares, it is compulsory for companies coming out with an IPO to offer demat facility
- Registrar & Transfer Agent (RTA) – to process investors' applications and handle the allotment and refunds.The company, Depository and RTA enter into a tripartite agreement for their respective responsibilities. It is pertinent to note that while the RTA operationalizes the allotment (based on which investors know how many shares they have been allotted), the relevant shares will need to be dematerialized with the depository, who will credit the demat shares to the investor's account (maintained with his depository participant).
- Bankers to the issue – to collect forms and relevant payment instruments.Deciding on the Resource Mobilisation Program, Capital Structure, Business Valuation and Dilution Level. This is a key area where the investment banker advises the company and its promoters. The resources mobilized should be adequate for the company's medium term plans.Capital structure needs to be appropriate for the company, given its business exigencies, risks and long term plans.Higher the business valuation, lesser would be the dilution required (i.e. stake that needs to be offered to

the public) for meeting the resource mobilization target.For example, if the company is valued at Rs. 2,000 crores, and it wants to come to the market for Rs. 200 crores, then only about 10% of the share capital needs to be offered to the public. But, for the same requirement of funds, if the business valuation is only Rs. 1,000 crores, then about 20% of the share capital will need to be offered to the public.Higher the dilution, lesser the equity control that the promoter would have over the company.Higher the business valuation, lesser the profits than investors in the IPO will earn, when they sell their shares in the stock exchange. Therefore, too high a business valuation would make it difficult for the investment banker to sell the issue.

SEBI has laid down strict regulations regarding eligibility of companies to tap the IPO market and reservations for various classes of investors. Similarly, there are various requirements that the company has to fulfil on an ongoing basis, once its shares are listed.The investment banker hand-holds the company over several months, in order to ensure that the company can stand the public scrutiny that is incidental to the IPO process and listing.

As regards pricing, two options are available:

- Fixed price issue – here the investor knows at the time of investment, the exact price at which the shares are being offered. Therefore, the investor only indicates the number of shares in his application.If the applications for shares are more than the issue size, then a basis of allotment is decided in consultation with the stock exchange. Accordingly, the investor may be allotted all the shares he applied for, or some of the shares he applied for, or none of the shares he applied for.
- Book built issue – here the investors know a price band, say Rs. 100 to Rs. 120, at the time of investment. The lower end of the band is called floor; the higher end is the cap. The cap cannot be more than 1.2 times the floor.Within this price band, investors have to bid for the shares i.e. indicate the number of shares that they are prepared to buy at various prices.The issue book is built as a compilation of such bids received from investors. Depending on the depth of bids received, the investment banker together with the company will decide the cut-off price. The process is called price discovery process.All bids to buy the shares below the cut-off price are rejected. Allotment for other bids is done as per a basis of allotment that is finalized along with the stock exchange.

The prospectus is a key document that has details of the company, its background, promoters, directors and management, company's financials, plans, objects of the issue etc. The prospectus is prepared by the lead manager and reviewed by the legal adviser before it is submitted to SEBI for vetting.

In a book-built issue, the prospectus evolves through three forms:

- Draft Red Herring Prospectus (DRHP) – This has all the statutory details other than the price of the issue and issue period. It is submitted to SEBI for vetting
- Red Herring Prospectus (RHP) – The price band and the issue period are added to the prospectus that has been vetted by SEBI. This is submitted to the ROC.
- Prospectus – The final price (instead of price band) is incorporated in the RHP after the issue is closed and price discovery process is completed.

The company also needs to sign a listing agreement with the stock exchanges where it proposes to list its shares. These are mentioned in the prospectus.

Around the issue opening date, the investment bankers arrange conferences for brokers and the press. The conferences are not only publicity events, but also a forum for the brokers / press to meet the company's management and seek clarifications on their plans.

Based on the advertising and publicity campaign, and the efforts of syndicate members, investors apply in the IPO. Applications / bids are accepted until the issue closure date.Applications are tabulated by the RTA, who also reconciles the balances with the bankers to the issue.The company and the lead managers decide on the allotment price. The basis of allotment is decided in consultation with the lead stock exchange.The RTA operationalizes the allotment, based on the basis finalized with the stock exchange. Accordingly,A list of allottees and the number of shares allotted to each, is prepared and sent to the depository, who credits the shares to each allottee'sdemat account with his respective depository participant.For applications made under ASBA, the registrar processes requests for banks to release blocked amounts as per the allotments made on those applications.

For other applications where partial allotments are made, the registrar processes refund instructions.The lead manager intimates SEBI and the Stock Exchanges regarding completion of the various formalities.The stock exchange sets a date for commencement of trading. The first day of trading has become a ceremonial affair, where the company's management or any of its brand ambassadors rings the opening bell in the exchange. With this, trading in the company's shares commences.

Until the IPO stage, there is no transparent price for the company’s shares. Once the IPO is concluded and the shares start trading in the stock exchange, the price of its shares can be watched in the market.

The price of its share multiplied by the total number of shares issued i.e. market capitalization is an indicator of the value of the company in the stock exchange.

Listing gives companies a certain visibility and brand positioning. Besides, companies which are traded in the stock exchange are perceived as large companies with transparent business operations adhering to corporate governance standards. They also tend to be better supervised by the regulators, and closely monitored by investors and the market, in general.

The ultimate aspiration of most entrepreneurs is therefore to take their company public. But, the path from idea to IPO can be a long one with its own twists and turns. Besides business skills of the entrepreneurial team, grit and luck too have a role, in taking the company to the public.

5.4.2 Secondary Market Process

Secondary market is the place for sale and purchase of existing securities. It enables an investor to adjust his holdings of securities in response to changes in his assessment about risk and return. It also enables him to sell securities for cash to meet his liquidity needs. It essentially comprises of the stock exchanges, which provide platform for trading of securities and a host of intermediaries who assist in trading of securities and clearing and settlement of trades. The securities are traded, cleared and settled as per prescribed regulatory framework under the supervision of the Exchanges and SEBI.

- **Stock Exchange:** The stock exchanges are the exclusive centres for trading of securities. Listing of companies on a Stock Exchange is mandatory to provide an opportunity to investors to invest in the securities of local companies. The trading volumes on exchanges have been witnessing phenomenal growth for last few years. For example, the National Stock Exchange (NSE) is India’s premier stock exchange. A critical role is to offer a platform for secondary market trades. NSE provides trading in four different segments- Wholesale Debt Market, Capital Market, Futures and Options and Currency Derivatives Segment.
- **Wholesale Debt Market (WDM) Segment:** This segment commenced its operations in June 1994. It provides the trading platform for wide range of debt securities, which includes State and Central Government securities, T-Bills, PSU Bonds, Corporate debentures, Commercial Papers, Certificate of Deposits etc.

- **Capital Market (CM) Segment:** This segment commenced its operations in November 1995. It offers a fully automated screen based trading system, known as the National Exchange for Automated Trading (NEAT) system. Various types of securities e.g. equity shares, warrants, debentures etc. are traded on this system.
- **Futures & Options (F&O) Segment:** This segment provides trading in derivatives instruments like index futures, index options, stock options, and stock futures, and commenced its operations at NSE in June 2000.
- **Currency Derivatives Segment (CDS) Segment:** This segment commenced its operations on August 29, 2008, with the launch of currency futures trading in US Dollar-Indian Rupee (USD-INR). 'Interest rate futures' was another product made available for trading on this segment with effect from August 31, 2009.
- **Membership**: There are no entry/exit barriers to the membership of any stock exchange. Anybody can become a member by complying with the prescribed eligibility criteria and exit by surrendering membership without any hidden cost. The members are admitted to different segments of the Exchange subject to the provisions of the Securities Contracts (Regulation) Act, 1956, the SEBI Act, 1992, the rules, circulars, notifications, guidelines, etc. issued hereunder and the byelaws, rules and regulations of the Exchange. Members can trade on stock exchanges on behalf of their clients.

5.4.3 Listing of securities

Listing means admission of securities of an issuer to trading privileges on a stock exchange through a formal agreement. The prime objective of admission to dealings on the Exchange is to provide liquidity and marketability to securities, as also to provide a mechanism for effective management of trading.

As per SEBI directive, an unlisted company may make an initial public offering (IPO) of equity shares or any other security, which may be converted into or exchanged with equity shares at a later date, only if it meets all the following conditions:

a) The company should have net tangible assets of at least Rs. 3 crore in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets;
b) The company should have a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years;

c) The company should have a net worth of at least Rs. 1 crore in each of the preceding 3 full years (of 12 months each);

d) In case the company has changed its name within the last one year, at least 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and

e) The aggregate of the proposed issue and all previous issues made in the same financialyear in terms of size (i.e. offer through offer document + firm allotment + promoters'contribution through the offer document), does not exceed five (5) times its pre-issue networth as per the audited balance sheet of the last financial year.

5.4.4 Trading

Trading in secondary market happens through placing of orders by the investors and their matching with a counter order in the trading system. Orders refer to instructions provided by a customer to a brokerage firm, for buying or selling a security with specific conditions. These conditions may be related to the price of the security (limit order or market order or stop loss orders) or related to time (a day order or immediate or cancel order). Advances in technology have led to most secondary markets of the world becoming electronic exchanges. Disaggregated traders across regions simply log in the exchange, and use their trading terminals to key in orders for transaction in securities. We outline some of the most popular orders below:

- ***Limit Price/Order:*** In these orders, the price for the order has to be specified while entering the order into the system. The order is executed only at the quoted price or at a better price (a price lower than the limit price in case of a purchase order and a price higher than the limit price in case of a sale order).
- ***Market Price/Order****:* Here the constraint is the time of execution and not the price. It gets executed at the best price obtainable at the time of entering the order. The system immediately executes the order, if there is a pending order of the opposite type against which the order can match. The matching is done automatically at the best available price (which is called as the market price). If it is a sale order, the order is matched against the best bid (buy) price and if it is a purchase order, the order is matched against the best ask (sell) price. The best bid price is the order with the highest buy price and the best ask price is the order with the lowest sell price.

- ***Stop Loss (SL) Price/Order:*** Stop-loss orders which are entered into the trading system, get activated only when the market price of the relevant security reaches a threshold price. When the market reaches the threshold or pre-determined price, the stop loss order is triggered and enters into the system as a market/limit order and is executed at the market price / limit order price or better price. Until the threshold price is reached in the market the stop loss order does not enter the market and continues to remain in the order book. A sell order in the stop loss book gets triggered when the last traded price in the normal market reaches or falls below the trigger price of the order. A buy order in the stop loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order. The trigger price should be less than the limit price in case of a purchase order and vice versa.
- ***Day Order (Day):*** A Day order is valid for the day on which it is entered. The order, if not matched, gets cancelled automatically at the end of the trading day. At the National Stock Exchange (NSE) all orders are Day orders. That is the orders are matched during the day and all unmatched orders are flushed out of the system at the end of the trading day.
- ***Immediate or Cancel order (IOC):*** An IOC order allows the investor to buy or sell a security as soon as the order is released into the market, failing which the order is removed from the system. Partial match is possible for the order and the unmatched portion of the order is cancelled immediately.
- ***Matching of orders:*** When the orders are received, they are time-stamped and then immediately processed for potential match. The best buy order is then matched with the best sell order. For this purpose, the best buy order is the one with highest price offered, also called the highest bid, and the best sell order is the one with lowest price also called the lowest ask (i.e., orders are looked at from the point of view of the opposite party). If a match is found then the order is executed and a trade happens. An order can also be executed against multiple pending orders, which will result in more than one trade per order. If an order cannot be matched with pending orders, the order is stored in the pending orders book till a match is found or till the end of the day whichever is earlier. The matching of orders at NSE is done on a price-time priority i.e., in the following sequence:
    - Best Price
    - Within Price, by time priority

- Orders lying unmatched in the trading system are 'passive' orders and orders that come in to match the existing orders are called 'active' orders. Orders are always matched at the passive order price. Given their nature, market orders are instantly executed, as compared to limit orders, which remain in the trading system until their market prices are reached. The set of such orders across stocks at any point in time in the exchange, is called the Limit Order Book (LOB) of the exchange. The top five bids/asks (limit orders all) for any security are usually visible to market participants and constitute the Market by Price (MBP) of the security.

5.4.5 Reforms in Indian Securities Markets

Over a period, the Indian securities market has undergone remarkable changes and grown exponentially, particularly in terms of resource mobilisation, intermediaries, the number of listed stocks, market capitalisation, turnover and investor population. The following paragraphs list the principal reform measures undertaken since 1992.Creation of Market Regulator

- Securities and Exchange Board of India (SEBI), the securities market regulator in India, was established under SEBI Act 1992, with the main objective and responsibility for protecting the interests of investors in securities;promoting the development of the securities market; andregulating the securities market.
- **Screen Based Trading:** Prior to setting up of NSE, the trading on stock exchanges in India was based on an open outcry system. The system was inefficient and time consuming because of its inability to provide immediate matching or recording of trades. In order to provide efficiency, liquidity and transparency, NSE introduced a nation-wide on-line fully automated screen based trading system (SBTS) on the CM segment on November 3, 1994.
- **Reduction of Trading Cycle:** Earlier, the trading cycle for stocks, based on type of securities, used to vary between 14 days to 30 days and the settlement involved another fortnight. The Exchanges, however, continued to have different weekly trading cycles, which enabled shifting of positions from one Exchange to another. It was made mandatory for all Exchanges to follow a uniform weekly trading cycle in respect of scrips not under rolling settlement.In December 2001, all scrips were moved to rolling settlement and the settlement period was reduced progressively from T+5 to T+3 days. From April 2003 onwards, T+2 days settlement cycle is being followed.

- **Equity Derivatives Trading:** In order to assist market participants in managing risks better through hedging, speculation and arbitrage, the Securities Contract (Regulations) Act, 1956 was amended in 1995 to lift the ban on options in securities. Trading in derivatives, however, took off in 2000 with the launch of index futures after suitable legal and regulatory framework was put in place. The market presently offers index futures, index options, single stock futures and single stock options.
- **Demutualisation:** Historically, stock exchanges were owned, controlled and managed by a set of brokers. They set the rules and regulations which they were expected to follow. This led to a conflict of interest. In case of disputes, integrity of the stock exchange suffered. NSE, however, was set up with a pure demutualised governance structure i.e. ownership, management and trading rights were distributed between three different sets of entities. NSE's ownership vested in the hands of banks, insurance companies, financial institutions, its management was drawn from professionals and brokers were offered trading rights on the exchange. This separation of ownership, management and trading rights eliminated conflict of interest and provided transparency in operations. Currently, all the stock exchanges in India have a demutualised set up.
- **Dematerialisation:** As discussed earlier, the old settlement system was inefficient due to the time lag for settlement. Another source of inefficiency and risk was the need for physical movement of physical securities. Physical securities could be stolen, forged, mutilated, lost in transit etc. To obviate these problems, the Depositories Act, 1996 was passed to provide for the establishment of depositories in securities with the objective of ensuring transferability of securities with speed, efficiency and accuracy. Thus, the two depositories viz. NSDL and CDSL, discussed earlier, came up. Securities are held in the depository in an electronic form eliminating physical paper. Securities are also transferred from one party to another electronically.
- **Clearing Corporation:** The anonymous electronic order book ushered in by the NSE did not permit members to assess credit risk of the counter-party and thus necessitated some innovation in this area. To address this concern, NSE set up the first clearing corporation, viz. National Securities Clearing Corporation Ltd. (NSCCL), which commenced its operations in April 1996. It carries out the clearing and settlement of the trades executed in the equities and derivatives segments of the NSE. It is the first clearing corporation in the country to establish the Settlement Guarantee Fund (SGF) in June 1996. It guarantees all financial settlements of trades executed on

the NSE. It has been managing clearing and settlement functions since its inception without a single failure or clubbing of settlements. Today NSCCL settles trades under the T+2 rolling settlement.

- **Investor Protection:** In order to protect the interest of investors and promote awareness, the Central Government (Ministry of Corporate Affairs) established the Investor Education and Protection Fund (IEPF) in October 2001. With similar objectives, the Exchanges and SEBI also maintain investor protection funds to take care of investor claims.
- SEBI and the stock exchanges have also set up investor grievance cells for redressal of investor grievances. All these agencies and investor associations also organise investor education and awareness programmes.
- **Globalisation:** Indian companies have been permitted to raise resources overseas through issue of ADRs, GDRs, FCCBs and ECBs. Further, FIIs have been permitted to invest in all types of securities, including government securities and tap the domestic market, upto limits as seen earlier.
- RBI has permitted two-way fungibility for ADRs / GDRs, which means that the investors (foreign institutional or domestic) who hold ADRs / GDRs can cancel them with the depository and sell the underlying shares in the market.
- **Direct Market Access:** In April 2008, SEBI allowed the direct market access (DMA) facility to the institutional investors. DMA allows brokers to offer their respective clients, direct access to the Exchange trading system through the broker's infrastructure without manual intervention by the broker.
- **Securities Lending & Borrowing Scheme (SLBS**): In April 2008, the Securities Lending & Borrowing mechanism was allowed. Normally, market participants cannot take short positions directly in the securities, because under rolling settlement, the securities will need to be delivered in T+2 days. The SLBS offers a mechanism for market participants who take short positions to borrow the securities to meet the settlement needs of the exchange. The borrower of the security will pay the lender of the security for the period that the security has been borrowed. It thus becomes an additional source of income (besides dividend) for investors who own the securities.

- **Currency Futures:** On August 29, 2008, NSE launched trading in currency future contracts in the USD-INR pair (i.e. on US Dollars) for the first time in India. Subsequently, contracts in the GBP-INR, EUR-INR and JPY-INR (i.e. on the UK's Pound-Sterling, Euro and Japanese Yen) were added.
- **Application Supported by Blocked Amount (ASBA):** ASBA is a major primary market reform. It enables investors to apply for IPOs / FPOs and rights issues without making a payment. Instead, the amount is blocked in the investors' own bank account. On allotment, an amount proportionate to the shares allotted goes out from the bank account; the balance amount is unblocked and available for use by the investor. Thus, the investor is saved the head ache of waiting for refund of moneys after allotment.
- **Issue of Capital & Disclosure Requirements (ICDR) Regulations, 2009:** In August 2009, the SEBI came out with the Issue of Capital and Disclosure Requirements (ICDR) Regulations 2009, replacing the Disclosure and Investor Protection (DIP) Guidelines 2000. ICDR governs all disclosure norms regarding issue of securities.

5.5 Check Your Progress

1. A rise in Sensex indicates
   (a) A buoyancy (bullish) condition in the stock market
   (b) A sluggish (bearish) condition in the stock market
   (c) A highly unstable condition in the stock market
   (d) A tremendous speculative condition in the stock market
2. Underwriting means
   (a) commitment to purchase the whole or a part of unsold securities issued by a company
   (b) issue of securities below their prices
   (c) writing off the bad debts of a company
   (d) None of these
3. Secondary market is also called
   (a) stock market
   (b) stock exchange
   (c) share market
   (d) all of these

4. Primary market is also called
    (a) bond market
    (b) share market
    (c) new issue market
    (d) none of these
5. Equity shares are also known as
    (a) ordinary shares
    (b) preference shares
    (c) bonus shares
    (d) rights shares

5.6 Summary

- Parties that invest in the securities are the investors. The companies that need the money issue securities to the investors. Therefore, the companies are called issuers. The capital market performs a useful role in bringing issuers and investors together, thus ensuring flow of funds to businesses, trade and commerce
- Primary market provides an opportunity to the issuers of securities, both Government and corporations, to raise funds through issue of securities.
- Capital market activities create the need for different kinds of institutions.
- Initial Public Offerings (IPOs) are covered by the Securities & Exchange Board of India (Issue of Capital & Disclosure Requirements) Regulations, 2009. Companies appoint investment bankers (also called merchant bankers) to assist them in the IPO process.
- The prospectus is a key document that has details of the company, its background, promoters, directors and management, company's financials, plans, objects of the issue etc.
- Until the IPO stage, there is no transparent price for the company's shares. Once the IPO is concluded and the shares start trading in the stock exchange, the price of its shares can be watched in the market.
- Secondary market is the place for sale and purchase of existing securities. It enables an investor to adjust his holdings of securities in response to changes in his assessment about risk and return. It comprises of the stock exchanges which provide platform for trading of

securities and a host of intermediaries. The securities are traded, cleared and settled as per prescribed regulatory framework of the Exchanges and SEBI.

- Trading in secondary market happens through placing of orders by the investors and their matching with a counter order in the trading system.
- Over a period, the Indian securities market has undergone remarkable changes and grown exponentially, particularly in terms of resource mobilisation, intermediaries, the number of listed stocks, market capitalisation, turnover and investor population.

5.7 Keywords

- **Primary Market:** Primary market provides an opportunity to the issuers of securities to raise funds through issue of securities.
- **Secondary Market:** Secondary market refers to a market, where securities that are already issued are traded between buyers and sellers of those securities.
- **Clearing Corporation:** Once trades are executed, their clearing and settlement are handled by the clearing corporation
- **Registrar & Transfer Agents (RTA)**: The RTA keeps a record of the share-holders and their share-holding in the company.
- **Syndicate Members**: Brokers registered with SEBI are appointed to procure bids (applications) from investors for the IPO.
- **Underwriters:** Investment Bankers, stock brokers and other SEBI-registered underwriters are appointed to ensure that the issue amount is mobilized.
- **Fixed price issue:** here the investor knows at the time of investment, the exact price at which the shares are being offered.
- **Book built issue**: here the investors know a price band, say Rs. 100 to Rs. 120, at the time of investment. The lower end of the band is called floor; the higher end is the cap. The cap cannot be more than 1.2 times the floor.
- **Draft Red Herring Prospectus (DRHP)**: This has all the statutory details other than the price of the issue and issue period. It is submitted to SEBI for vetting
- **Limit Price/Order:** In these orders, the price for the order has to be specified while entering the order into the system. The order gets executed only at the quoted price or at a better price

- **Market Price/Order**: It gets executed at the best price obtainable at the time of entering the order. The system immediately executes the order, if there is a pending order of the opposite type against which the order can match.
- **Stop Loss (SL) Price/Order:** Stop-loss orders which are entered into the trading system, get activated only when the market price of the relevant security reaches a threshold price
- **Day Order (Day):** A Day order is valid for the day on which it is entered. The order, if not matched, gets cancelled automatically at the end of the trading day.

5.8 Self-assessment Test

1. Describe the main features of Indian capital market and indicate their implication.
2. What is security market? Describe the security market of India bringing out its various sub-categories.
3. Discuss the various methods of trading securities in Indian capital market.
4. Discuss the major functions of Securities and Exchange Board of India
5. Briefly mention the major reforms introduced in the Indian capital market in recent years.
6. Write a short essay on recent trends in Indian capital market.

5.9 Answers to Check Your Progress

Question 1	Answer	(a)
Question 2	Answer	(a)
Question 3	Answer	(d)
Question 4	Answer	(c)
Question 5	Answer	(a)

5.10 References/Suggested Readings

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Course: **Indian Financial System**	
Course Code: **BC 305**	Author: **Dr. Kapil Choudhary**
Lesson No: **6**	Vetter: **Dr. Suresh K. Mittal**

Depository System

STRUCTURE:

6.0 Learning Objectives

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

- Know the meaning and functions of depository system.

- Know the advantages and disadvantages of depository system.
- Understand the legal framework of depository system.

6.1 Introduction

Prior to the setting up of NSE, trading on stock exchanges in India took place without the use of information technology for immediate matching or recording of trades. The practice of physical trading imposed limits on trading volumes as well as the speed with which the new information is incorporated into prices. The unscrupulous operators used this information asymmetry to manipulate the market. The information asymmetry helped brokers to perpetrate a manipulative practice known as "gala". Gala is a practice of extracting highest price of the day for "buy" transaction irrespective of the actual price at which the purchase was actually done and give lowest price of the day for "sell" transactions irrespective of the price at which sale was made.

The clients did not have any method of verifying the actual price. The electronic and now fully online trading introduced by the NSE has made such manipulation difficult. It has also improved liquidity and made the entire operation more transparent and efficient.

The NSE has set up a clearing corporation to provide legal counterparty guarantee to each trade thereby eliminating counterparty risk. The National Securities Clearing Corporation Ltd. (NSCCL) commenced operations in April 1996. Counterparty risk is guaranteed through fine-tuned risk management systems and an innovative method of on-line position monitoring and automatic disablement. Principle of "novation" is implemented by NSE capital market segment.

Under this principle, NSCCL is the counterparty for every transaction and, therefore, default risk is minimised. To support the assured settlement, a "settlement guarantee fund" has been created. A large settlement guarantee fund provides a cushion for any residual risk. Therefore, despite the fact that the daily traded volumes on the NSE run into thousands of crores of rupees, credit risk no longer poses any problem in the marketplace.

The erstwhile settlement system on Indian stock exchanges was also inefficient and increased risk, due to the time that elapsed before trades were settled. The transfer was by physical movement of papers. There had to be a physical delivery of securities -a process fraught with delays and resultant risks. The second aspect of the settlement relates to transfer of shares in favour of the purchaser by the company. The system of transfer of ownership was grossly inefficient as every transfer involves physical movement of paper securities to the issuer for registration, with the change of ownership being evidenced by an endorsement on the security certificate. In many cases, the process of transfer would take much longer than the two months stipulated in the Companies Act, and a significant proportion of transactions would end up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant. In addition, the issuer has the right to refuse the transfer of a security. All this added to costs and delays in settlement, restricted liquidity and made investor grievance redressal time consuming and, at times, intractable.

To obviate these problems, the Depositories Act, 1996 was passed. It provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It does so by

- making securities of public limited companies freely transferable, subject to certain exceptions;
- dematerialising the securities in the depository mode;
- providing for maintenance of ownership records in a book entry form.

In order to streamline both the stages of settlement process, the Act envisages transfer ownership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with. Two depositories, viz., NSDL and CDSL, have come up to provide instantaneous electronic transfer of securities. In any stock exchange, trades or transactions have to be settled by either squaring up the carrying forward positions or settling by payment of net cash or net delivery of securities. This account settlement period, if it is long leads to several price distortions and allows for market manipulation. It increases the chances of speculation resulting in volatility, which hurts the small investors. With the application of IT in the securities market - screen-based trading and trading through the Internet - it has been possible to reduce this settlement period.

6.1.1 Depositories

The depositories are important intermediaries in the securities market that is scrip-less or moving towards such a state. In India, the Depositories Act defines a depository to mean, "Acompany formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992." The principal function of a depository is to dematerialise securities and enable their transactions in book-entry form.

Dematerialisation of securities occurs when securities issued in physical form are destroyed and an equivalent number of securities are credited into the beneficiary owner's account. In a depository system, the investors stand to gain by way of lower costs and lower risks of theft or forgery, etc. They also benefit in terms of efficiency of the process. However, the implementation of the system has to be secure and well governed. All the players have to be conversant with the rules and regulations as well as with the technology for processing. The intermediaries in this system have to play strictly by the rules.

A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. A depository cannot directly open accounts and provide services to clients. Any person willing to avail of the services of the depository can do so by entering into an agreement with the depository through any of its Depository Participants.

6.1.2 Depository Participants

A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act, 1996. In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the provisions of the SEBI Act. As per the provisions of this Act, a DP can offer depository related services only after obtaining a certificate of registration from SEBI.

SEBI (D&P) Regulations, 1996 prescribe a minimum net worth ofRs. 50 lakh for the applicants who are stockbrokers or non-banking finance companies (NBFCs), for granting a certificate of registration to act as a DP. For R & T Agents a minimum net worth of Rs. 10 crore is prescribed in addition to a grant of certificate of registration by SEBI. If a stockbroker seeks to act as a DPin more than one depository, he should comply with the specified net worth criterion separately for each such depository. If an NBFC seeks to act as a DP on behalf of any other person, it needs to have a networth of Rs. 50 cr. in addition to the networth specified by any other authority.No minimum net worth criterion has been prescribed for other categories of DPs. However, depositories can fix a higher net worth criterion for their DPs. NSDL stipulates a minimum net worth of Rs. 100 lakh to be eligible to become a DP as againstRs. 50 lakh prescribed by SEBI (D&P) Regulations, except for R & T agents and NBFCs, as mentioned above.

6.1.3 The Depository System

The Depositories Act, 1996, defines a depository to mean, "A company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992.

The principal function of a depository is to dematerialise securities and enable their transactions in book-entry form. The securities are transferred by debiting the transferor's depository account and crediting the transferee's depository account.

A depository is very much like a bank in many of its operations. We can draw an analogy between the two in order to get a better understanding of the depository system.

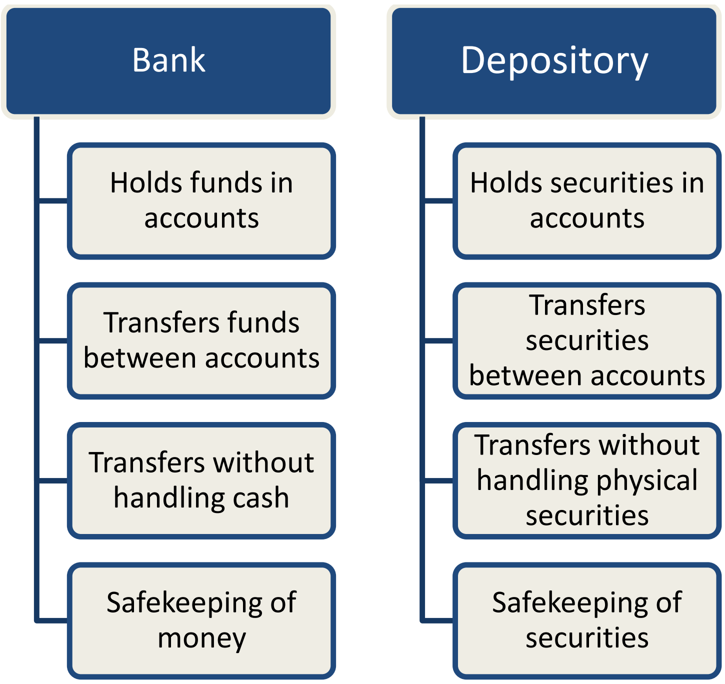

Figure 1: Similarity between Bank and Depository

In a bank, the medium of exchange is money, whereas a depository deals in securities. In a bank, money is given for safekeeping. In a depository, securities are kept for safety. Banks hold and transfer funds; depositories perform the same function with securities. Banks can transfer funds from one account to another without handling cash; a depository can do the same with physical securities. Just as in a bank an account is opened to avail of the banking services, an account has to be opened with a DP for holding scrips in the depository segment.

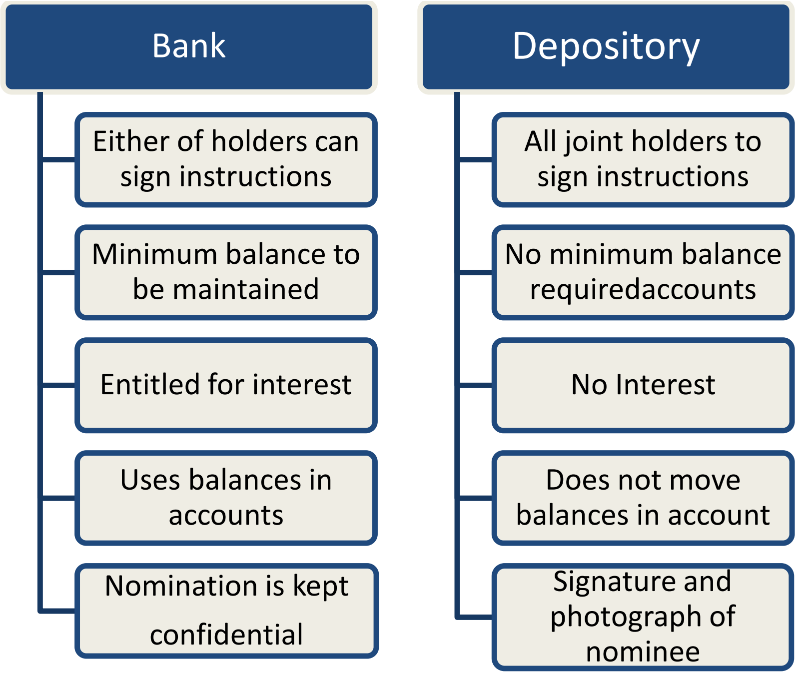

Figure 2: Difference between Bank and Depository

In case of transactions in a bank account, any one of the joint holders can sign the instructions (cheques), whereas in the depository, all joint holders are required to sign all the instructions. Minimum funds balance prescribed by the bank has to be maintained in the bank account; no minimum balance of securities is required to be maintained in a depository account. A bank uses the funds held in a bank account for lending purposes. The securities maintained in a depository account by an investor can be moved from the account only on basis of a proper authorisation from the account holder. A depository cannot use the client's security balances. Nomination is kept confidential in case of bank accounts. The photograph and signature of the nominee is required to be affixed on the nomination form for registering the nomination for a depository account.

6.1.4 Legal Framework

The operations of the depositories are primarily governed by the Depositories Act, 1996, Securities and Exchange Board of India (Depositories & Participants) Regulations, 1996, Bye-Laws approved by SEBI, and Business Rules framed in accordance with the Regulations and Bye-Laws. The Depositories Act passed by Parliament received the President's assent on August 10, 1996. It was notified in a Gazette on August 12 of the same year. The Act enables the setting up of multiple depositories in the country. This was to see that there is competition in the service and there is more than one depository in operation. At present, two depositories are registered with SEBI - The National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL).

Only a company registered under the Companies Act, 1956 and sponsored by the specified category of institutions can set up a depository in India. Before commencing operations, depositories should obtain a certificate of registration and a certificate of commencement of business from SEBI.

Any of the following may promote a depository:

- A public financial Institution as defined in section 4A of the Companies Act, 1956;
- A bank included in the Second Schedule to the Reserve Bank of India Act, 1934;
- A foreign bank operating in India with the approval of the Reserve Bank of India;
- A recognised stock exchange;
- An institution engaged in providing financial services where not less than 75% of the equity is held jointly or severally by these institutions;
- A custodian of securities approved by Government of India, and
- A foreign financial services institution approved by Government of India.

The promoters of a depository are also known as sponsors. A depository company must have a minimum net worth of Rs. 100 crore. The sponsor(s) of the depository have to hold at least 51% of the equity capital of the depository company. Participants of that depository, if any, can hold the balance of the equity capital. However, no single participant can hold, at any point of time, more than 5% of the equity capital. No foreign entity, individually or collectively either as a sponsor or as a DP, or as a sponsor and DP together, can hold more than 20% of the equity capital of the depository.

As per the provisions of the SEBI Act, a depository can deal in securities only afterobtaining a certificate of registration from SEBI. The sponsors of the proposed depository should apply to SEBI for a certificate of registration in the prescribed form. On being satisfied with the eligibility parameters of a company to act as a depository, SEBI may grant a certificate of registration subject to certain conditions.

Commencement of Business – A depository that has obtained registration as stated above, can function only if it obtains a certificate of commencement of business from SEBI. A depository must apply for and obtain a certificate of commencement of business from SEBI within one year from the date of receiving the certificate of registration from SEBI.

SEBI grants a certificate of commencement of business if it is satisfied that the depository has adequate systems and safeguards to prevent manipulation of records and transactions. SEBI takes into account all matters relevant to the efficient and orderly functioning of the depository. It particularly examines whether:

1. The depository has a net worth of not less than Rs. 100 crore;
2. The Bye-Laws of the depository have been approved by SEBI;
3. The automatic data processing systems of the depository have been protected against unauthorised access, alteration, destruction, disclosure or dissemination of records and data;
4. The network, through which continuous electronic means of communication are established between the depository, participants, issuers and issuers' agents, is secure against unauthorised entry or access;
5. The depository has established standard transmission and encryption formats for electroniccommunication of data between the depository, participants, issuers and issuers' agents;
6. The physical or electronic access to the premises, facilities, automatic data processing systems, data storage sites and facilities including back-up sites, and to the electronic data communication network connecting the DPs, issuers and issuers' agents is controlled, monitored and recorded;
7. The depository has a detailed operational manual explaining all aspects of its functioning, including the interface and method of transmission of information between the depository, issuers, issuers' agents, DPs and beneficial owners;
8. The depository has established adequate procedures and facilities to ensure that its records are protected against loss or destruction and arrangements have been made for maintaining back-up facilities at a location different from that of the depository;
9. The depository has made adequate arrangements including insurance for indemnifying the beneficial owners for any loss that may be caused to such beneficial owners by the wrongful act, negligence or default of the depository or its participants or of any employee of the depository or participant; and
10. The granting of certificate of commencement of business is in the interest of investors in securities market.

If either the issuer (a company which has issued securities) or the investor opts to hold his securities in a demat form, the issuer entersinto an agreement with the depository to enable the investors to dematerialise their securities. No such agreement is necessary where:

i. Depository, is the issuer of securities, or;
ii. The State or Central Government is the issuer of government securities.

Where the issuer has appointed a registrar to the issue or share transfer, the depository enters into a tripartite agreement with the Issuer and Registrar & Transfer (R&T) Agent, as the case may be, for the securities declared eligible for dematerialisation. At present, NSDL is discharging the responsibility of R&T Agent for the securities issued by State and Central Governments.

6.1.5 Rights and Obligations of Depositories

Depositories have the rights and obligations conferred upon them under the Depositories Act, the regulations made under the Depositories Act, Bye-Laws approved by SEBI, and the agreements made with the participants, issuers and their R&T agents.Every depository must have adequate mechanisms for reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards. It should conduct an annual inspection of these procedures and forward a copy of the inspection report to SEBI. The depository is also required to ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that the records are not lost, destroyed or tampered with. In the event of loss or destruction, sufficient back up of records should be available at a different place. Adequate measures should be taken, including insurance, to protect the interests of the beneficial owners against any risks.

Every depository is required to extend all such co-operation to the beneficial owners, issuers, issuers' agents, custodians of securities, other depositories and clearing organisations, as is necessary for the effective, prompt and accurate clearance and settlement of securities transactions and conduct of business. The depository should indemnify beneficial owners of securities for any loss caused to them due to the negligence of the DP. However, where the loss is caused due to the negligence of a DP, the depository shall have the right to recover it from such DPs.

A depository is required to make Byelaws governing its operations. The Bye- Laws have to be in conformity with the Depositories Act and the regulations made thereunder, and need to be approved by SEBI before becoming effective.

Records to be maintained by Depository

Every depository is required to maintain the following records and documents. These have to be preserved for a minimum period of five years.

1. Records of securities dematerialised and rematerialized.
2. The names of the transferor, transferee, and the dates of transfer of securities.
3. A register and an index of beneficial owners.
4. Details of the holdings of the securities of beneficial owners as at the end of each day.
5. Records of instructions received from, and sent to, participants, issuers, issuers' agents and beneficial owners.
6. Records of approval, notice, entry and cancellation of pledge or hypothecation.
7. Details of participants.
8. Details of securities declared to be eligible for dematerialisation in the depository.
9. Such other records as may be specified by SEBI for carrying on the activities as a depository.

6.1.6 Services of Depository

A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. Any person willing to avail the services of the depository can do so by entering into an agreement with the depository through any of its participants. A depository can provide depository services only through a DP. A depository cannot directly open accounts and provide services to clients. Every depository in its Byelaws must state which securities are eligible for demat holding. Generally, the following securities are eligible for dematerialisation:

a) Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.
b) Units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificates of deposit, securitised debt, money market instruments, government securities, National Saving Certificates, KisanVikasPatra and unlisted securities.
c) Securities admitted to NSDL depository are notified to all DPs through circulars sent by email. Investors are informed about these securities through NSDL's Website -www.nsdl.co.in and NEST Update - a monthly newsletter of NSDL.

6.2 Functions of Depository

a) **Dematerialisation:** One of the primary functions of depository is to eliminate or minimise themovement of physical securities in the market. This is achieved through dematerialisation of securities. Dematerialisation is the process of converting securities held in physical form into holdings in book entry form.

b) **Account Transfer:** The depository gives effects to all transfers resulting from the settlement of trades and other transactions between various beneficial owners by recording entries in the accounts of such beneficial owners.

c) **Transfer and Registration:** A transfer is the legal change of ownership of a security in the records of the issuer. For affecting a transfer, certain legal steps have to be taken like endorsement, execution of a transfer instrument and payment of stamp duty. The depository accelerates the transfer process by registering the ownership of shares in the name of the depository. Under a depository system, transfer of security occurs merely by passing book entries in the records of the depositories, on the instructions of the beneficial owners.

d) **Corporate Actions**: A depository may handle corporate actions in two ways. In the first case, it merely provides information to the issuer about the persons entitled to receive corporate benefits. In the other case, depository itself takes the responsibility of distribution of corporate benefits.

e) **Pledge and Hypothecation**: the clients may use the securities held with NSDL as collateral to secure loans and other credits. In a manual environment, borrowers are required to deliver pledged securities in physical form to the lender or its custodian. These securities areverified for authenticity and often need to be transferred in the name of lender. This has a time and money cost by way of transfer fees or stamp duty. If the borrower wants to substitute the pledged securities, these steps have to be repeated. Use of depository services for pledging/ hypothecating the securities makes the process very simple and cost effective. The securities pledged/hypothecated are transferred to a segregated or collateral account through book entries in the records of the depository.

f) **Linkages with Clearing System:**Whether it is a separate clearing corporation attached to a stock exchange or a clearinghouse (department) of a stock exchange, the clearing system performs the functions of ascertaining the pay-in (sell) or payout (buy) of brokers who have traded on the stock exchange. Actual delivery of securities to the clearing system from the selling brokers and delivery of securities from the clearing system to the buying broker is done by the depository. To achieve this, depositories and the clearing system should be electronically linked.

Having understood the depository system, let us now look at the organisation and functions of National Securities Depository Limited (NSDL).

6.3 National Securities Depository Limited

National Securities Depository Limited is the first depository to be set-up in India. It was incorporated on December 12, 1995. The Industrial Development Bank of India (IDBI) - the largest developmentbank in India, Unit Trust of India (UTI) - the largest Indian mutual fund and the National Stock Exchange (NSE) - the largest stock exchange in India, sponsored the setting up of NSDL and subscribed to the initial capital. NSDL commenced operations on November 8, 1996.

Table1: NSDL at a Glance (June 30, 2020)

Client Accounts Active	2,00,09,174	
Accounts having Debt instruments	10,05,847	
As on June 30, 2020		
Number of certificates eliminated (Approx.) (in Crore)	4,367	
Number of companies in which more than 75% shares are dematted	13,076	
Average number of accounts opened per day since November 1996	3,970	
Presence of demat account holders in the country	99.23% of all pincodes in the country	
DPs	278	
DP Service Centres	30,989	
DP Geographical Coverage (Cities/Towns)	1,933	
Companies Joined	30,594	
Demat Custody Quantity (Crore securities)	2,18,356	
Demat Custody Value (₹ Lakh Crore)	180.75	
Demat Custody	**Instruments**	**Value (in ₹ Crore)**
Shares	33,101	1,34,70,448
Debt/Bonds	16,721	33,89,698
CP	1,574	4,92,829
Equity Shares	**Qty (in Crore)**	**Value (in ₹ Crore)**
NSE	1,752	3,64,754
BSE	97	12,735
Total	**1,849**	**3,77,489**

Debt/Bonds Settlement		**1,62,925**

Source: https://nsdl.co.in/about/statistics.php

6.3.1 Ownership

NSDL is a public limited company incorporated under the Companies Act, 1956. NSDL had a paid-up equity capital of Rs. 105 crore. The paid up capital has been reduced to Rs. 80 crore since NSDL has bought back its shares of the face value of Rs. 25 crore in the year 2000. However, its net worth is above the Rs. 100 crore, as required by SEBI regulations.

6.3.2 Management of NSDL

NSDL is a public limited company managed by a professional Board of Directors. The Chairman & Managing Director (CMD) conducts the day-today operations. To assist the CMDin his functions, the Board appoints an Executive Committee (EC) of not more than 15 members. The eligibility criteria and period of nomination, etc. are governed by the Byelaws of NSDL in this regard.

6.3.3 Bye-Laws of NSDL

Byelaws of National Securities Depository Limited have been framed under powers conferred under section 26 of the Depositories Act, 1996 and approved by Securities and Exchange Board of India. The Byelaws contain fourteen chapters and pertain to the areas listed below:

1. Short title and commencement
2. Definitions
3. Board of Directors
4. Executive Committee
5. Business Rules
6. Participants
7. Safeguards to protect interest of clients and participants
8. Securities
9. Accounts/transactions by book entry
10. Reconciliation, accounts and audit
11. Disciplinary action
12. Appeals
13. Conciliation
14. Arbitration

Amendments to NSDL Bye-Laws require the approval of the Board of Directors of NSDL and SEBI.

6.3.4 Business Rules of NSDL

Amendments to NSDL Business Rules require the approval of NSDL Executive Committee and filing of the same with SEBI at least a day before the effective date for the amendments.

6.3.5 Functions

NSDL performs the following functions through depository participants:

- Enables the surrender and withdrawal of securities to and from the depository
- (dematerialisation and rematerialisation).
- Maintains investor holdings in the electronic form.
- Effects settlement of securities traded on the exchanges.
- Carries out settlement of trades not done on the stock exchange (off-market trades).
- Transfer of securities.
- Pledging/hypothecation of dematerialised securities.
- Electronic credit in public offerings of companies or corporate actions.
- Receipt of non-cash corporate benefits like bonus rights, etc. in electronic form.
- Stock Lending and Borrowing.

6.3.6 Services Offered by NSDL

NSDL offers a host of services to the investors through its network of DPs:

- Maintenance of beneficiary holdings through DPs
- Dematerialisation
- Off-market Trades
- Settlement in dematerialised securities
- Receipt of allotment in the dematerialised form
- Distribution of corporate benefits
- Rematerialisation
- Pledging and hypothecation facilities
- Freezing/locking of investor's account
- Stock lending and borrowing facilities

6.3.7 Fee Structure of NSDL

NSDL charges the DPs and not the investors directly. These charges are fixed. The DPs inturn, are free to charge their clients, i.e., the investors for their services. Thus, there is a two-tierfee structure.

6.3.8 Inspection, Accounting and Internal Audit

NSDL obtains audited financial reports from all its DPs once every year. NSDL also carries out periodic visits to the offices of its constituents - R&T agents, DPs and clearing corporations – to review the operating procedures, systems maintenance and compliance with the Byelaws, Business Rules and SEBI Regulations.

Additionally, DPs are required to submit to NSDL, internal audit reports every quarter. Internal audit has to be conducted by a chartered accountant or a company secretary in practice. The Board of Directors appoints a Disciplinary Action Committee (DAC) to deal with any matter relating to DPs clients, Issuers and R&T agents. The DAC is empowered to suspend or expel a DP, declare a security as ineligible on the NSDL system, freeze a DP account and conduct inspection or call for records and issue notices. If a DP is aggrieved by the action of the DAC, it has the right to appeal to the EC against the action of the DAC. This has to be done within 30 days of the action by DAC. The EC has to hear the appeal within two months from the date of filing the appeal. The EC has the power to stay the operation of the orders passed by the DAC. The information on all such actions has to be furnished to SEBI.

6.3.9 Settlement of Disputes

All disputes, differences and claims arising out of any dealings on the NSDL, irrespective of whether NSDL is a party to it or not, have to be settled under the Arbitration and Conciliation Act 1996.

6.3.10 Technology and Connectivity

Account holders (investors) open account with the DPs. The account details, entered in a computer system maintained by Depository Participants called DPM, are electronically conveyed to the central system of NSDL called DM. Companies who have agreed to offer demat facility to their shareholders use a computer system called DPM (SHR) to connect to the NSDL central system. DPM (SHR) may be installed by the company itself or through its R&T Agent. This system is used to electronically receive demat requests, confirm such requests or to receivebeneficial owner data (Benpos) from the depository.

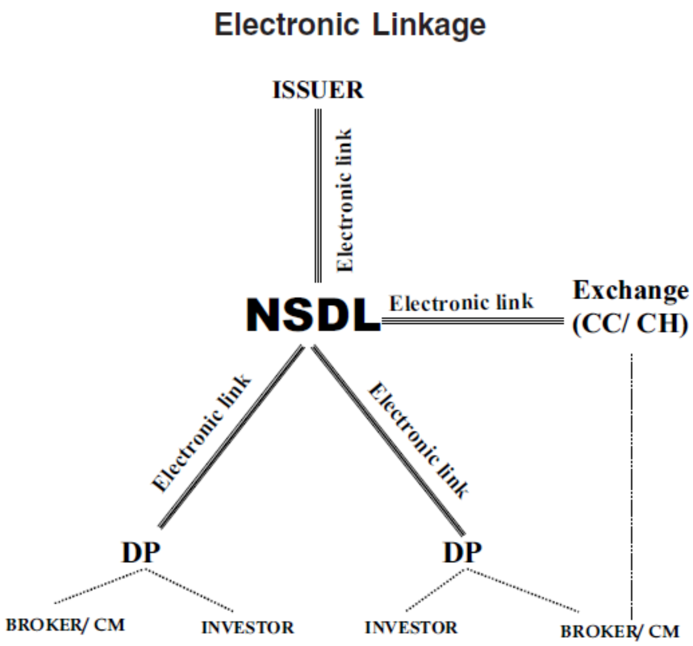

Figure3: System View of NSDL Depository System

Stock exchanges receive pay-in (receiving securities against sales made by brokers) or to payout(giving securities to brokers against their purchases) using a computer system connected to NSDL called DPM (CC). All the computer systems installed by DPs (DPM-DP), companies (DPM-SHRs), and stock exchanges (DPM-CC) are connected to NSDL central system (DM) through V-SAT (very small aperture terminal) or leased lines. These are collectively called Business Partner Systems. Any transaction conducted by any computer system in the NSDL depository system which is targeted to reach any other computer system first gets recorded in DM and then will reach the target. No two-business partners' systems can communicate to each other without passing through the DM.

The NSDL central system known as DM maintains accounts of all account holders in the depository system. All the transactions entered at any point in the computer system connected to it are first effected in the central system and subsequently at these computers. Thus, the central system of NSDL has the records of all details of every transaction conducted in the depository system.

Each of the computer systems connected to NSDL system has its own database relating to itsclients. This helps in giving prompt and accurate service to the clients. However, each of the databases is reconciled with the data at the central system every day in order to ensure that the data in the distributed database tallies with the central database.

NSDL develops software required by depository participants, companies, R&T Agents and clearing corporations for conducting depository operations. Thus, the computer systems used by all the entities will have common software given by NSDL. However, depending on the business potential, branch networks and any other specific features, DPs may develop software of their own for co-ordination, communication and control and provide service to their clients. Such exclusive software is called "back office software". DPM system given by NSDL gives "export and import" facility to take out the transaction details to be used by back office software and to feed in transaction details generated from the back office software.

The computer system used by DPs, companies, R&T Agents and stock exchanges may be connected to NSDL central system through V-SAT network or leased line network. NSDL uses NSE's V-SAT network for the connectivity purposes. Thus, V-SATs used by NSE brokers can connect to NSDL if the software supplied by NSDL is used. V-SAT uses satellites for communication purposes. Some business partners may connect using leased lines provided by MTNL/ BSNL.V-SAT or leased line connections are called primary connectivity. If primary connectivity fails for any reason, BPs must have the ability to connect through other means. Such other means are PSTN lines, ISDN lines, POP lines(normal telephone lines) through which they can dial in to the NSDL system and conduct their transactions.

6.4 Check Your Progress

1. For a NBFC to undertake Depository business for beneficiaries other than itself, the net worth requirement is at least
    (a) Rs. 50 crore.
    (b) Rs. 25 crore.
    (c) Rs. 10 crore.
    (d) Rs. 5 crore.
2. Existing securities are traded in
    (a) primary market
    (b) secondary market
    (c) money market
    (d) barter exchange
3. The DP-Client Agreement

(a) is uniform across DPs but, does not form a part of NSDL Bye-Laws.
(b) is uniform across DPs, forms a part of NSDL Bye-Laws and has been approved by SEBI.
(c) is optional and may or may not be signed depending on the rapport between DP and client.
(d) varies from DP to DP.

4. The operations of private mutual funds are regulated by
    (a) SEBI
    (b) Ministry of Finance
    (c) NSCCL
    (d) AMFI
    (e) I am not attempting the question
5. In case the client defaults on payment of charges within the stipulated time, the DP can charge a maximum of __% p.a. interest on such default.
    (a) 24
    (b) 15
    (c) 18
    (d) None of the above as interest rate is not specified in the DP client agreement.

6.5 Summary

- The erstwhile settlement system on Indian stock exchanges was inefficient and increased risk, due to the time that elapsed before trades were settled. The transfer was by physical movement of papers. There had to be a physical delivery of securities -a process fraught with delays and resultant risks.
- To obviate these problems, the Depositories Act, 1996 was passed. It provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It does so by making securities of public limited companies freely transferable, subject to certain exceptions; dematerialising the securities in the depository mode; providing for maintenance of ownership records in a book entry form.
- The Depositories Act, 1996, defines a depository to mean "a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992.

- The principal function of a depository is to dematerialise securities and enable their transactions in book-entry form. The securities are transferred by debiting the transferor's depository account and crediting the transferee's depository account. A depository is very much like a bank in many of its operations.
- National Securities Depository Limited is the first depository to be set-up in India. It was incorporated on December 12, 1995.
- NSDL enables the surrender and withdrawal of securities to and from the depository, (dematerialisation and rematerialisation), maintains investor holdings in the electronic form, effects settlement of securities traded on the exchanges, pledging/hypothecation of dematerialised securities, receipt of non-cash corporate benefits like bonus rights, etc. in electronic form, stock Lending and Borrowing.
- NSDL obtains audited financial reports from all its DPs once every year. NSDL also carries out periodic visits to the offices of its constituents - R&T agents, DPs and clearing corporations – to review the operating procedures, systems maintenance and compliance with the Bye-Laws, Business Rules and SEBI Regulations

6.6 Keywords

- **Clearing corporation:** An entity that provide legal counterparty guarantee to each trade thereby eliminating counterparty risk.
- **Depositories Act, 1996:** It provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security.
- **Depositories:** It is an important intermediaries in the securities market that is scrip-less or moving towards such a state.
- **Dematerialisation:** It occurs when securities issued in physical form are destroyed and an equivalent number of securities are credited into the beneficiary owner's account.
- **Depository Participant (DP):** It is described as an agent of the depository. It is an intermediary between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act, 199
- **NSDL:** National Securities Depository Limited is the first depository to be set-up in India. It was incorporated on December 12, 1995. The Industrial Development Bank of India (IDBI) - the largest development bank in India, Unit Trust of India (UTI) - the largest Indian mutual fund and

the National Stock Exchange (NSE) sponsored the setting up of NSDL and subscribed to the initial capital

6.7 Self-assessment Test

1. What are the benefits of a depository system?
2. Are custodians required today when the depository system is functioning
3. successfully?
4. Explain the functioning of the NSDL and the SHCIL.
5. Explain the depository process.
6. Compare depository with a bank.
7. What was the need for setting up a depository in India?
8. State the difference between a demat share and a physical share?
9. Who are the business partners of NSDL?
10. What kind of services do custodians provide?

6.8 Answers to Check Your Progress

Question 1	Answer	(a)
Question 2	Answer	(b)
Question 3	Answer	(b)
Question 4	Answer	(a)
Question 5	Answer	(a)

6.9 References/Suggested Readings

- A handbook of Depository operation module. Capital Markets and NSDL Overview, NCFM, New Delhi, 2005.
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Course: **Indian Financial System**	
Course Code: **BC 305**	Author: **Dr. Kapil Choudhary**
Lesson No: **7**	Vetter: **Dr. Suresh K. Mittal**

SEBI: Formation, Role and Recent Developments

STRUCTURE:

7.0 Learning Objectives

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

- Know the objectives and functions of SEBI.
- Understand rules/regulations/guidelines of SEBI.
- Know the recent developments in Indian capital market.

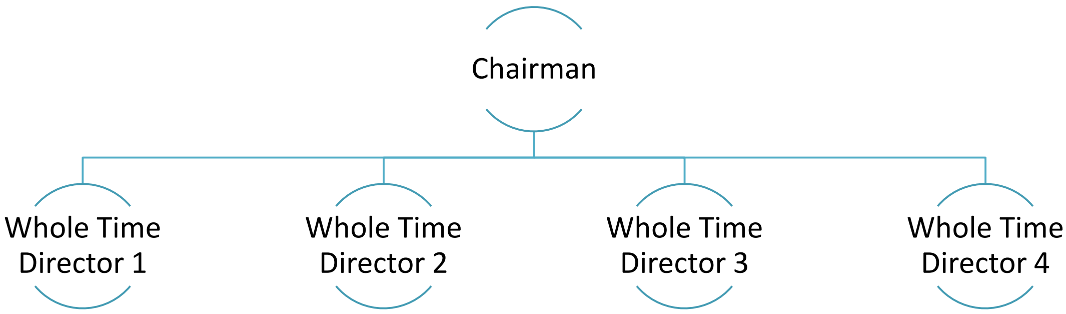
7.1 Introduction

The Securities and Exchange Board of India (SEB) was established on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.The Preamble of the

Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as:

- To protect the interests of investors in securities.
- To promote/aware the developmentsin securities market.
- Toregulate the securities market and for matters connected therewith or incidental thereto.

The organisation structure of SEBI is given below:



SEBI's regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI has been obligated to perform the previously mentioned functions by such measures as it thinks fit. In particular, it has powers for:

- regulating the business in stock exchanges and any other securities markets.
- registering and regulating the working of stock brokers, sub–brokers etc.
- promoting and regulating self-regulatory organizations.
- prohibiting fraudulent and unfair trade practices relating to securities markets.
- calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds and other persons associated with the securities market and other intermediaries and self–regulatory organizations in the securities market.
- performing such functions and exercising according to Securities Contracts (Regulation) Act, 1956, as may be delegated to it by the Central Government.

7.2 SEBI Rules

Following table highlights the rules promulgated by SEBI since its inception. These rules range from securities definition in Securities Contracts (Regulations) Rules, 1957 to norms of issuing share capital in Companies (Share Capital and debentures) Rules, 2014. In this chapter we have covered some of the important rules/regulations/ guidelines of SEBI.

Issued Year	Rules
1992	SEBI (Terms and Conditions of Service of Chairman and Members) Rules, 1992
1993	SEBI (Appeal to Central Government) Rules, 1993
1994	SEBI (Annual Report) Rules, 1994
1994	SEBI (Form of Annual Statement of Accounts and Records) Rules, 1994
1995	SEBI (Procedure for Holding Inquiry and Imposing Penalties) Rules, 1995
1997	Securities Appellate Tribunal Rules, 1997
1998	Depositories (Appeal to Central Government) Rules, 1998
2000	Securities Appellate Tribunal (Procedure) Rules, 2000
2000	Securities Contracts (Regulations) (Appeal to Securities Appellate Tribunal) Rules, 2000
2003	Securities Appellate Tribunal Rules, 2003
2004	Securities Transaction Tax Rules, 2004
2005	Depositories (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005
2005	Securities Contracts (Regulations) (Procedure for Holding Inquiry and Imposing Penalties) Rules, 2005
2014	Companies (Issue of Global Depositories Receipts) Rules, 2014
2014	Companies (Prospectus and Allotment of Securities) Rules, 2014
2014	Companies (Share Capital and debentures) Rules, 2014

7.2.1 SEBI DIP Guidelines, 2000

The Disclosure and Investor Protection (DIP) Guidelines of SEBI, 2000, govern the issues of capital to public by Indian companies. The guidelines provide norms relating to eligibility for companies issuing securities, pricing of issues, listing requirements, disclosure norms, lock-in period for promoters' contribution, contents of offer documents, pre-and post-issue obligations, etc. The guidelines apply to all public issues, offers for sale and rights issues by listed and unlisted companies.

Eligibility Norms any company issuing securities through the offer document has to satisfy the following conditions: ·

A company making a public issue of securities has to file a draft prospectus with SEBI, through an eligible merchant banker, at least 30days prior to the filing of prospectus with the Registrar of Companies (ROCs). The filing of offer document is mandatory for a listed company issuing security through a rights issue where the aggregate value of securities, including premium, if any, exceeds Rs.50 lakh. A company cannot make a public issue unless it has made an application for listing of those securities with stock exchange(s). The company must also have entered into an agreement with the depository for dematerialisation of its securities and the company should have given an option to subscribers/shareholders/investors to receive the security certificates or securities in dematerialised form with the depository. A company cannot make an issue if the company has been prohibited from accessing the capital market under any order or discretion passed by SEBI.

An unlisted company can make an Initial Public Offering (IPO) of equity shares or any other security, which may be converted into or exchanged with equity shares at a later date, only if it meets all the following conditions:

(a) The company has net tangible assets of at least Rs.3 crore in each of the preceding 3 full years (12 months each), of which not more than 50 % is held in monetary assets, provided that if more than 50 % of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business/project.

(b) The company has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years. Provided further, that extraordinary items shall not be considered for calculating distributable profits in terms of section 205 of Companies Act,1956/(c) The company has a net worth of at least Rs.1 crore in each of the preceding 3 full years (of 12 months each).(d) In case the company has changed its name within the last one year, at least 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name.(e) The aggregate of the proposed issue and all previous issues made in the same financial year in terms of the size (i.e. offer through offer document firm allotment promoters' contribution through the offer document),does not exceed five (5) times its pre-issue net worth as per the audited balance sheet of the last financial year.An unlisted company not complying with any of the conditions specified above may make an initial public offering (IPO) of equity shares or any other security which may be converted into or exchanged with equity shares at a later date, only if it meets the two conditions given below.(a) The issue is made through the book-building process, with at least 50 % of the net offer to public being allotted to the Qualified Institutional Buyers (QIBs) failing which the full41subscription monies shall be refunded OR the project has at least 15 % participation by Financial Institutions/Scheduled Commercial Banks of which at least 10% comes from the appraiser(s).In addition to this, at least 10% of the issue size shall be allotted to QIBs, failing which the full subscription monies shall be refunded.(b) The minimum post-issue face value capital of the company shall be Rs.10 crores OR there shall be a compulsory market making for at least 2 years from the date of listing of the shares, subject to the conditions that a) Market makers undertake to offer buy and sell quotes for a minimum depth of 300 shares b)market makers undertake to ensure that the bid-ask spread(difference between quotations for sale and purchase) for their quotes shall not at any time exceed10 % c) the inventory of the market makers on each of such stock exchanges as on the date of allotment of securities shall be at least 5% of the proposed issue of the company.· A listed company shall be eligible to make a public issue of equity shares or any other security which ma y be converted into or exchanged with equity shares at a later date; provided that the aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e. offer through offer document firm allotment promoters contribution through the offer document) issue size does not exceed 5 times its pre issue net worth as per the audited balance sheet of the last financial year.Further, if there is a change in the name of the issuer company within the last 1year (reckoned from the date of filing of the offer document), the revenue accounted for by the activity suggested by the new name is not less than 50 % of its total revenue in the preceding 1 full year period.· Infrastructure companies are exempt from the requirement of eligibility norms if their project has been appraised by a public financial institution or infrastructure development finance corporation or infrastructure leasing and financing services and not less than 5% of the project cost is financed by any of the institutions, jointly or severally, by way of loan and/or subscription to equity or combination of both. Banks and rights issues of listed companies are also exempt from the eligibility norms. For public and rights issues of debt instruments irrespective of their maturities or conversion period, it is mandatory to obtain credit rating from a registered credit rating agency and to disclose the same in the offer document. If the credit rating is obtained from more than one credit rating agency, all the credit ratings, including the unaccepted ones, need to be disclosed. .Thus the quality of the issue is demonstrated by track record/appraisal by approved financial institutions/credit rating/subscription by QIBs.

Pricing of Issues:The companies eligible to make public issue can freely price their equity shares or any security convertible into equity at a later date in cases of public/rights issues by listed companies and public issue by unlisted companies. In addition, eligible infrastructure companies can freely price their equity shares subject to compliance of disclosure norms as specified by SEBI from time to time. The public and private sector banks can also freely price their shares subject to approval by RBI. A company may issue shares to applicants in the firm allotment category at higher price than the price at which securities are offered to public. A listed company making a composite issue of capital may issue securities at differential prices in its public and rights issue. Further, an eligible company is free to make public/rights issue in any denomination determined by it in accordance with the Companies Act, 1956 and SEBI norms.

Contribution of Promoters and lock-in:The promoters' contribution in case of public issues by unlisted companies and promoters' shareholding in case of 'offers for sale' should not be less than 20 percentage of the post issue capital. In case of public issues by listed companies, promoters should contribute to the extent of 20% of the proposed issue or should ensure post-issue holding to the extent of 20% of the post-issue capital. For composite issues, the promoters' contribution should either be20% of the proposed public issue or 20% of the post-issue capital. The promoters should bring in the full amount of the promoters contribution including premium at least one day prior to the issue opening date (which shall be kept in an escrow account with a Scheduled Commercial Bank and the said contribution/amount should be released by the company along with the public issue proceeds). The requirement of promoters contribution is not applicable in case of (i) public issue of securities which has been listed on stock exchange for at least 3 years and has a track record of dividend payment for at least 3 immediate preceding years, (ii) companies where no identifiable promoter or promoter group exists, and (iii) rights issues. For any issue of capital to the public, the minimum promoter's contribution is locked in for a period of 3 years. If the promoters contribution exceeds the required minimum contribution, such excess is locked in for a period of one year. Securities allotted in firm allotment basis are also locked in for a period of one year. The locked-in securities held by promoters may be pledged only with banks or FIs as collateral security for loans granted by such banks or FIs, provided the pledge of shares is one of the terms of sanction of loan.

Issue of Sweat Equity The SEBI (Issue of Sweat Equity) Regulations, 2002 have been framed and the main provisions laid down therein for issue of sweat equity are (a) under the new guidelines, the Sweat Equity shares can be issued by a company to its employees and directors as well as promoters, (b) the pricing of the sweat equity shares should be as per the formula prescribed for that of preferential43allotment, (c) the sweat equity shares should be locked in for a period of 3years from the date of Allotment. In case of a subsequent public issue being made, lock in shall be as per the SEBI (DIP) Guidelines, 2000.

Issue Obligations The lead merchant banker plays an important role in the pre-issue obligations of the company. He exercises due diligence and satisfies himself about all aspects of offering, veracity and adequacy of disclosures in the offer document. Each company issuing securities has to enter into a Memorandum of Understanding with the lead merchant banker, which specifies their mutual rights, liabilities and obligations relating to the issue. In case of under-subscription of an issue, the lead merchant banker responsible for underwriting arrangements has to invoke underwriting obligations and ensure that the underwriters pay the amount of devolvement. It should ensure the minimum number of collection centres. It should also ensure that the issuer company has entered into an agreement with all the depositories for dematerialization of securities. All the other formalities related to post-issue obligations like, allotment, refund and despatch of certificates are also taken care by the lead merchant banker.

Book Building Book Building means a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document. Book building is a process of offering securities in which bids at various prices from investors through syndicate members are collected. Based on bids, demand for the security is assessed and its price discovered. In case of normal public issue, the price is known in advance to investor and the demand is known at the close of the issue. In case of public issue through book building, demand can be known at the end of everyday but price is known at the close of issue. In case of an issuer company makes an issue of 100% of the net offer to public through 100% book building process) Not less than 35 % of the net offer to the public shall be available for allocation to retail individual investors. ii) Not less than 15 % of the net offer to the public shall be available for allocation to non-institutional investors i.e. investors other than retail individual investors and Qualified Institutional Buyers. iii) Not more than 50% of the net offer to the public shall be available for allocation to Qualified Institutional Buyers. Provided that, 50 % of net to public should be mandatorily allotted to the Qualified Institutional Buyers, in case the issuer company is making a public44issue. Further, in respect of issues made under Rule 19(2)(b) of Securities Contract (Regulation) Rules 1957, there should be 60% mandatory allocation to Qualified Institutional Buyers, and the percentage allocation to retail individual investors and non-institutional investors should be 30 % and 10%respectively.In case an issuer company makes an issue of 75% of the net offer to public through book building process and 25% at the price determined through book building i)In the book built portion, not less than 25% of the net offer to the public should be available for allocation to non-qualified institutional buyers and not more than 50% of the net offer to the public should be available for allocation to Qualified Institutional Buyers. ii) The balance 25% of the net offer to the public offered at a price determined through book building should be available only to retail individual investors who have either not participated or have not received any allocation, in the book built portion. Provided that 50% of net offer to public should be mandatorily allotted to Qualified Institutional Buyers in case the issuer company is making a public issue. Out of the portion available for allocation to qualified institutional buyers in case when the company makes an issue through 100% or 75% book building, five percentshould be allocated proportionately to mutual funds. Allotment to retail individual or non-institutional investors is made proportionately. In case of under subscription in any category, the unsubscribed portions are allocated to the bidders as per the proposed manner of allocation among respective categories of investors, in the event of under subscription. The book built portion, 100% or 75%, as the case may be, of the net offer to public, are compulsorily underwritten by the syndicate members or book runners. Other requirements for book building include: bids remain open for at least 3days, only electronic bidding is permitted; bids are submitted through syndicate members; bids can be revised; bidding demand is displayed at the end of every day; allotments are made not later than 15 days from the closure of the issue failing which interest at the rate of 15% shall be paid to investors. The 100% book building has made the primary issuance process comparatively faster and cost effective. The DIP guidelines for book building provides that the company should be allowed to disclose the floor price, just prior to the bid opening date, instead of in the Red herring prospectus, which may be done by any means like a public advertisement in newspaper etc. Flexibility should be provided to the issuer company by permitting them to indicate a 20% price band. Issuer maybe given the flexibility to revise the price band during the bidding period and45the issuers should be allowed to have a closed book building i.e. the book will not be made public.

On-line Initial Public Offers (IPO) A company proposing to issue capital to public through on-line system of the stock exchange has to comply with Section 55 to 68A of the Companies Act, 1956 and SEBI (DIP) Guidelines, 2000. The company is required to enter into an agreement with the stock exchange(s), which have the requisite system for on-line offer of securities. The agreement should cover rights, duties, responsibilities and obligations of the company and the stock exchanges interse, with provision for a dispute resolution mechanism between the company and the stock exchange. The issuer company appoints a Registrar to the Issue having electronic connectivity with the stock exchanges. The issuer company can apply for listing of its securities at any exchange through which it offers its securities to public through on-line system, apart from the requirement of listing on the regional stock exchange. The stock exchange appoints brokers for the purpose of accepting applications and placing orders with the company. The lead manager would co-ordinate all the activities amongst various intermediaries connected in the system. In addition to the above, the DIP guidelines also provide details of the contents of the offer document and advertisement, other requirements for issues of securities, like those under Rule 19(2) (b) of SC(R) Rules, 1957. The guidelines also lay down detailed norms for issue of debt instruments, issue of capital by designated financial institutions and preferential/bonus issues.

Book Building through On-line IPO System Book building is a process used in IPO for efficient price discovery, wherein during the period for which the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The offer price is determined after the bid closing date. In its strive to continuously improve Indian securities market; NSE offers its infrastructure for conducting online IPOs through book building. It helps to discover price as well as demand for a security to be issued through a process of bidding by investors. The advantages of this new system are: a) the investor parts with money only after allotment, b) it eliminates refunds except in case of direct applications and c) it reduces the time taken for issue process. Though the guidelines for book building were issued in 1995, it is being used for IPOs from 1999.

7.2.2 SEBI (Prohibition of fraudulent and Unfair Trade Practices relating to securities market) Regulations, 2003

The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 2003 enable SEBI to investigate into cases of market manipulation and fraudulent and unfair trade practices. The regulations specifically prohibit market manipulation, misleading statements to induce sale or purchase of securities, unfair trade practices relating to securities.

Definitions

The important terms defined under the regulations are:

Fraud includes any act, expression, omission or concealment committed, whether in a deceitful manner or not, by a person or by any other person or his agent while dealing in securities in order to induce another person with his connivance or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and should also include:

- a knowing misrepresentation of the truth or concealment of material fact in order
- that another person may act to his detriment;
- a suggestion as to a fact which is not true by one who does not believe it to be

- true;
- an active concealment of a fact by one having knowledge or belief of the fact;
- a promise made without any intention of performing it;
- a representation made in a reckless and careless manner whether it be true orfalse;
- any such act or omission as any other law specifically declares to be fraudulent;
- deceptive behaviour by a person depriving another of informed consent or full
- participation;
- a false statement made without reasonable ground for believing to be true;
- the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled even though they did not rely on the statement itself or anything derived from it other than the market price. The term "fraudulent" should be construed accordingly. Nothing contained in this clause is applicable to any general comments made in good faith in regard to the economic policy of the Government; the economic situation of the country; trends in the securities market; any other matter of a like nature.

Dealing in Securities is defined to include an act of buying, selling or subscribing pursuant to any issue of any securities, or agreeing to buy, sell or subscribe to any issue of any securities, or otherwise transacting in any way in any security by any person as principal, agent or intermediary as defined under the SEBI Act.

Prohibition of Certain Dealings in Securities

The regulation provides that no person should directly or indirectly:

- buy, sell or otherwise deal in securities in a fraudulent manner;
- use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognised stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made thereunder;
- employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognised stock exchange;
- engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognised stock exchange in contravention of the act, rules and regulations.

Prohibition of Manipulative, Fraudulent and Unfair Trade Practices

The Regulation provides that no person should indulge in a fraudulent or an unfair trade practice in securities. Any dealing in securities is deemed to be fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following:

- indulging in an act which creates false or misleading appearance of trading in the securities market;
- dealing in a security not intended to effect transfer of beneficial ownership but
- intended to operate only as a device to inflate, depress or cause fluctuations in the price of such security for wrongful gain or avoidance of loss;
- advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;
- paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in an security with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security;
- any act or omission amounting to manipulation of the price of a security;
- publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities.
- entering into a transaction in securities without intention of performing it or without intention of change in ownership of such security.
- selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form.
- an intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself.
- an intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security.
- an advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors.

- an intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage.
- an intermediary not disclosing to his client transactions entered into on his behalf including taking an option position.
- circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security.
- encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission.
- an intermediary predating or otherwise falsifying records such as contract notes.
- an intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract.
- planting false or misleading news which may induce sale or purchase of securities.

7.2.3 SEBI (Prohibition of Insider Trading) Regulations, 1992

The malpractice of 'insider trading' affects the innocent investors. In simple terms 'insider trading' means selling or buying in securities on the basis of price sensitive unpublished information of a listed corporate that, if published, could lead to a fall or rise in the prices of shares of the corporate.

To tackle the problem of insider trading, SEBI issued the SEBI (Insider Trading) Regulations 1992. These regulations were further made stringent through amendments in February 2002 and they were notified as the SEBI (Insider Trading) (Amendment) Regulations 2002.

Definitions

The important definitions used in the regulations are:

(i) *Dealing in securities* means an act of subscribing, buying, selling or agreeing to subscribe, buy, sell or deal in any securities by any person either as principal or agent.

(ii) *Insider* means any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information.

(iii) *A connected person* means any person who:

- is a director, as defined in clause (13) of section 2 of the Companies Act, 1956, of a company, or is deemed to be a director of that company by virtue of sub-clause (10) of section 307 of that Act, or
- occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company, whether temporary or permanent, and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company.

(iv) A person is *deemed to be a connected person* if such a person:

- is a company under the same management or group or any subsidiary company
- thereof within the meaning of section (1B) of section 370, or sub-section (11) of section 372, of the Companies Act, 1956 or sub-clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 as the case may be; or
- is an intermediary as specified in section 12 of the SEBI Act, 1992, Investment company, Trustee Company, Asset Management Company or an employee or director thereof or an official of a stock exchange or of clearing house or corporation;
- is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, investment advisor, sub-broker, investment company or an employee thereof, or, is a member of the board of trustees of a mutual fund or a member of the board of directors of the asset management company of a mutual fund or is an employee thereof who have a fiduciary relationship with the company;
- is a member of the board of directors, or an employee, of a public financial institution as defined in section 4A of the Companies Act, 1956;
- is an official or an employee of a self-regulatory organisation recognised or authorised by the Board of a regulatory body;
- is a relative of any of the aforementioned persons;
- is a banker of the company.
- is relative of the connected person.

(v) *Price sensitive information* means any information which is related directly or indirectly to a company and which, if published, is likely to materially affect the price of securities of a company. It includes only such information which, if published, is likely to materially affect the price of securities of a company. The following are deemed to be price sensitive information:

- periodic financial results of the company;
- intended declaration of dividends (both interim and final);
- issue of securities or buy-back of securities;
- any major expansion plans or execution of new projects;
- amalgamation, mergers or takeovers;
- disposal of the whole or substantial part of the undertaking;
- significant changes in policies, plans or operations of the company.

(vi) *Unpublished information* means information which is not published by the company or its agents and is not specific in nature. However, speculative reports in print or electronic media are not considered as published information.

Prohibition on Dealing, Communicating or Counselling

Under this regulation, no insider should:

(a) either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange when in possession of any unpublished price sensitive information;

(b) communicate, counsel or procure, directly or indirectly, any unpublished price sensitive information to any person who, while in possession of such unpublished price sensitive information, should not deal in securities. This is however, not applicable to any communication required in the ordinary course of business or profession or employment or under any law.

The regulations require that no company should deal in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

Investigation

If SEBI suspects any person of having violated the provisions of insider regulation, it may make inquiries with such person or with the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisation in the securities market. Based on this, it will form a prima facie opinion as to whether there is any violation of insider regulations.

Where SEBI forms a prima facie opinion that it is necessary to investigate and inspect the books of accounts, either documents and records of an insider or the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisation in the securities market, it may appoint an investigating authority for the purpose.

The investigating authority has to submit its report to SEBI, after completion of investigations in accordance with the provisions of the regulations. After considering the report, SEBI is required to communicate its findings to the suspected person and seek a reply from such person. Such suspected person is required to reply to the findings within 21 days to SEBI.

After receipt of the reply, SEBI may take such measures to safeguard and protect the interest of investors, securities market and for due compliance with the insider trading regulations. SEBI also has powers to appoint an auditor to investigate into the books of accounts or the affairs of the insider or the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self-regulatory organisation in the securities market.

Disclosures and Internal Procedure for Prevention of Insider Trading

All listed companies and organisations associated with securities markets such as intermediaries, asset management company, trustees of mutual funds, self-regulatory organisations recognised by SEBI, recognised stock exchanges, clearing house or corporations, public financial institutions and professional firms such as auditors, accountancy firms, law firms, analysts, consultants, etc., assisting or advising listed companies, are required to frame a code of internal procedures and conduct as per the prescribed format provided in SEBI (Prohibition of Insider Trading) Regulations without diluting it any manner and ensure compliance of the same. The regulations require certain disclosures to be made by directors, officers and substantial shareholders in listed companies. These are:

(i) Initial Disclosure:

- Any person who holds more than 5% shares or voting rights in any listed company should disclose to the company in prescribed form, the number of shares or voting rights held by such person, on becoming such holder, within 2 working days of:
    - I. the receipt of intimation of allotment of shares; or
    - II. the acquisition of shares or voting rights, as the case may be.
- Any person who is a director or officer of a listed company should disclose to the company in prescribed form, the number of shares or voting rights held by such person, within 2 working days of becoming a director or officer of the company.

(ii) Continual Disclosure

- Any person who holds more than 5% shares or voting rights in any listed company should disclose to the company in prescribed form the number of shares or voting rights held and change in shareholding or voting rights, even if such change results in shareholding falling below 5%, if there has been change in such holdings from the last disclosure and such change exceeds 2% of total shareholding or voting rights in the company.
- Any person who is a director or officer of a listed company, should disclose to the company in prescribed form, the total number of shares or voting rights held and change in shareholding or voting rights, if there has been a change in such holdings from the last disclosure made and the change exceeds Rs. 5 lakh in value or 25,000 shares or 1% of total shareholding or voting rights, whichever is lower. The disclosure mentioned above should be made within 2 working days of:
    I. the receipt of intimation of allotment of shares, or
    II. the acquisition or sale of shares or voting rights, as the case may be.

(iii) Disclosure by Company to Stock Exchanges

Every listed company, within two days of receipt, should disclose to all stock exchanges on which the company is listed, the information relating to continual and initial disclosure given above. The disclosures required under this regulation may also be made through electronic filing in accordance with the system devised by the stock exchanges. Further, the SEBI Act, which inter-alia, prescribes the penalty for insider trading (Section 15G), was amended in 2002 to increase the penalty for insider trading to Rs 25 crore or three times the amount of profits made out of insider trading, whichever is higher.

7.3 SEBI (Intermediaries) Regulations, 2008

One of the main functions of SEBI is to register and regulate the functioning of various types of intermediaries and persons associated with securities market in a manner as to ensure smooth functioning of the markets and protection of interests of the investors.

These intermediaries, as detailed in the SEBI Act are: stock-brokers, sub- broker, share transfer agents, bankers to an issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies, asset management companies, clearing members of a clearing corporation, trading member of a derivative segment of a stock exchange, collective investment schemes, venture capital funds, mutual funds, and any other intermediary associated with the securities market.

SEBI had issued regulations governing the registration and regulatory framework for each of these intermediaries. However, given the fact that many requirements and obligations of most intermediaries are common, SEBI has consolidated these requirements and issued the

SEBI (Intermediaries) Regulations, 2008. These regulations were notified on May 26, 2009. These regulations apply to all the intermediaries mentioned above, except foreign institutional investors, foreign venture capital investors, mutual funds, collective investment schemes and venture capital funds.

The salient features of the Regulations are as under:

- The SEBI Regulations put in place a comprehensive regulation which is applicable to all intermediaries. The common requirements such as grant of registration, general obligations, common code of conduct, common procedure for action in case of default and miscellaneous provisions are applicable for all intermediaries.
- The registration process has been simplified. An applicant can file application in the prescribed format along with additional information as required under the relevant regulations along with the requisite fees. The existing intermediaries may, within the prescribed time, file the disclosure in the specified form. The disclosures are required to be made public by uploading the information on the website specified by SEBI. The information of commercial confidence and private information furnished to SEBI shall be treated confidential. In the event intermediary wishes to operate in a capacity as an intermediary in a new category, such person may only file the additional shortened forms disclosing the specific requirements of the new category as per the relevant regulations.
- The *Fit and Proper* criteria have been modified to make it principle based. The common code of conduct has been specified at one place.
- The registration granted to intermediaries has been made permanent unless surrendered by the intermediary or suspended or cancelled in accordance with these regulations.
- Procedure for action in case of default and manner of suspension or cancellation of certificate has been simplified to shorten the time usually faced by the parties without compromising with the right of reasonable opportunity to be heard. Surrender of certificate has been enabled without going through lengthy procedures.

- While common requirements will be governed by the new regulations, the intermediary specific requirements continue to be as per the relevant regulations applicable to individual intermediaries. The relevant regulations are amended from time to time to provide for the specific requirements.

7.4 SEBI Derivatives Trading Regulation

SEBI set up a 24-member committee under the Chairmanship of Dr. L. C. Gupta to develop the appropriate regulatory framework for derivatives trading in India. On May 11, 1998 SEBI accepted the recommendations of the committee and approved the phased introduction of derivatives trading in India beginning with stock index futures.

Some highlights of this framework are as follows:

- Any Exchange fulfilling the eligibility criteria can apply to SEBI for grant of recognition under Section 4 of the SC(R)A, 1956 to start trading derivatives. The derivatives exchange/ segment should have a separate governing council and representation of trading/clearing members shall be limited to maximum of 40% of the total members of the governing council. The exchange would have to regulate the sales practices of its members and would have to obtain prior approval of SEBI before start of trading in any derivative contract.
- The Exchange should have minimum 50 members.
- The members of an existing segment of the exchange would not automatically become the members of derivative segment. The members seeking admission in the derivative segment of the exchange would need to fulfill the eligibility conditions.
- The clearing and settlement of derivatives trades would be through a SEBI approved clearing corporation/house. Clearing corporations/houses complying with the eligibility conditions as laid down by the committee have to apply to SEBI for approval.
- Derivative brokers/dealers and clearing members are required to seek registration from SEBI. This is in addition to their registration as brokers of existing stock exchanges. The minimum net worth for clearing members of the derivatives clearing corporation/ house shall be Rs.300 Lakh. The net worth of the member shall be computed as follows:
    - Capital + Free reserves
    - Less non-allowable assets viz.,
        - Fixed assets

- Pledged securities
- Member's card
- Non-allowable securities (unlisted securities)
- Bad deliveries
- Doubtful debts and advances
- Prepaid expenses
- Intangible assets
- 30% marketable securities

The minimum contract value shall not be less than Rs.5 Lakh. Exchanges have to submit details of the futures contract they propose to introduce.

The initial margin requirement, exposure limits linked to capital adequacy and margin demands related to the risk of loss on the position will be prescribed by SEBI/Exchange from time to time.

There will be strict enforcement of "Know your customer" rule and requires that every client shall be registered with the derivatives broker. The members of the derivatives segment are also required to make their clients aware of the risks involved in derivatives trading by issuing to the client the Risk Disclosure Document and obtain a copy of the same duly signed by the client.

The trading members are required to have qualified approved user and sales person who should have passed a certification programme approved by SEBI.

7.5 Check Your Progress

1. Choose the correct statement from the following.
    (a) SEBI tries to educate investors about the capital market
    (b) SEBI has the power to register and regulate all market intermediaries
    (c) SEBI was initially established in the year 1988
    (d) All of these
2. In a security market, investors' protection is needed for
    (a) creation of proper investment climate
    (b) building up investors' confidence
    (c) ensuring transparency in dealings and disclosures in capital market
    (d) All of these
3. Choose the correct statement from the following.

(a) There is always a risk element in investing in private securities.

(b) Market risk will always be present in any investment decision.

(c) In any capital market, investors are not homogeneous.

(d) All of these

4. In order to ensure investors' protection, SEBI has formulated

(a) SEBI (Disclosure and Investor Protection) Guidelines, 2000

(b) SEBI (Prohibition of Insider Trading) Regulations, 1992

(c) SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1992

(d) All of these

5. In order to protect investors' interests, SEBI receives complaints from investors

(a) directly

(b) through the RBI

(c) through stock exchanges

(d) through the Department of Economic Affairs

7.6 Summary

- The Securities and Exchange Board of India (SEBI) was established on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992. The objectives of SEBI are to protect the interests of investors in securities, to promote and to regulate the securities market.
- Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market.
- The issues of capital to public by Indian companies are governed by the Disclosure and Investor Protection (DIP) Guidelines of SEBI, 2000. The guidelines provide norms relating to eligibility for companies issuing securities, pricing of issues, listing requirements, disclosure norms, lock-in period for promoters' contribution, contents of offer documents, pre-and post-issue obligations, etc.
- The SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 2003 enable SEBI to prohibit market manipulation, misleading statements to induce sale or purchase of securities, unfair trade practices relating to securities.

- Insider trading means selling or buying in securities on the basis of price sensitive unpublished information of a listed corporate that, if published, could lead to a fall or rise in the prices of shares of the corporate. To tackle the problem of insider trading, SEBI issued the SEBI (Insider Trading) Regulations 1992.
- SEBI had issued regulations governing the registration and regulatory framework for the intermediaries. However, given the fact that many requirements and obligations of most intermediaries are common, SEBI has consolidated these requirements and issued the SEBI (Intermediaries) Regulations, 2008.
- SEBI set up a 24-member committee under the Chairmanship of Dr. L. C. Gupta to develop the appropriate regulatory framework for derivatives trading in India and approved the phased introduction of derivatives trading in India beginning with stock index futures.

7.7 Keywords

- **Securities and Exchange Board of India (SEBI):** It is established to protect the interests of investors in securities, to promote the development of to regulate the securities market.
- **Disclosure and Investor Protection (DIP) Guidelines of SEBI, 2000:** The guidelines provide norms relating to eligibility for companies issuing securities, pricing of issues, listing requirements, disclosure norms, lock-in period for promoters' contribution, contents of offer documents, pre-and post-issue obligations, etc.
- **Initial public offering (IPO):** When an unlisted company makes either a fresh issue of securities or offers its existing securities for sale or both for the first time to the public, it is called an IPO.
- **Book Building:** Book building is a process of offering securities in which bids at various prices from investors through syndicate members are collected. Based on bids, demand for the security is assessed and its price discover
- **Fraud**: Itincludes any act, expression, omission or concealment committed, whether in a deceitful manner or not, by a person or by any other person or his agent while dealing in securities in order to induce another person with his connivance or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss
- **Dealing in Securities**: It is defined to include an act of buying, selling or subscribing pursuant to any issue of any securities, or agreeing to buy, sell or subscribe to any issue of any securities,

or otherwise transacting in any way in any security by any person as principal, agent or intermediary as defined under the SEBI Act.

- **Insider trading:** It means selling or buying in securities on the basis of price sensitive unpublished information of a listed corporate that, if published, could lead to a fall or rise in the prices of shares of the corporate.
- **Price sensitive information**: It means any information which is related directly or indirectly to a company and which, if published, is likely to materially affect the price of securities of a company. It includes only such information which, if published, is likely to materially affect the price of securities of a company

7.8 Self-assessment Test

1. State the powers and functions of the SEBI.
2. How far has the SEBI been in a position to protect the interest of investors in securities market?
3. What are the mechanisms in India through which protection of investors is offered?
4. Discuss the forces hampering the interests of investors in the capital market of India.
5. State the main grievances of investors in relation to stock exchange dealings in India.

7.9 Answers to Check Your Progress

Question 1	Answer	(d)
Question 2	Answer	(d)
Question 3	Answer	(d)
Question 4	Answer	(d)
Question 5	Answer	(a)

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Course: Indian Financial System

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Debt Market: Meaning, Features, Participants and Instruments

STRUCTURE:

8.0 Learning Objectives

After going through this lesson, the learner will be able:

- To understand the concept of debt markets.
- To know aboutvarious participants of debt market and their functions.
- To learn the different instruments of debt market.

8.1 Introduction

Finance is defined as the provision of money at the time when it is required. Every enterprise, whether big, medium, small, needs finance to carry on its operations and to achieve its target. In fact, finance is so indispensable today that it is rightly said to be the blood of an enterprise. Without adequate finance, no enterprise can possibly accomplish its objectives. Modern day enterprises used various instruments to raise the finance to fulfill its capital needs. The funds are raised through the securities. Primarily, two types of securities are prevalent to raise the funds namely debt securities and equity. A security (also called a financial instrument) is a claim on the issuer's future income or assets (any financial claim or piece of property that is subject to ownership).

The economies of developed countries and a large number of developing countries are based on financial systems that contain investors and borrowers, *markets* and trading arrangements. A market can be one in the traditional sense such as an exchange where *financial instruments* are bought and sold on a trading floor, or it may refer to one where participants deal with each other over the telephone or via electronic screens. The basic principles are the same in any type of market. There are two primary users of the capital markets, lenders and borrowers. The source of lenders' funds is, to a large extent, the personal sector made up of household savings and those acting as their investment managers such as life assurance companies and pension funds. The borrowers are made up of the government, local governments and companies (called corporate). There is a basic conflict in the financial objectives of borrowers and lenders, in that those who are investing funds wish to remain *liquid*, which means they have easy access to their investments. They also wish to maximize the return on their investment. A corporate on the other hand, will wish to generate maximum net profit on its activities, which will require continuous investment in plant, equipment, human resources and so on. Such investment will therefore need to be as long-term as possible.

Bond and shares form part of the capital markets. Shares are equity capital while bonds are debt capital. So bonds are a form of debt, much like how a bank loan is a form of debt. Unlike bank loans however bonds can be traded in a market.**Debt markets,** also often referred to generically as the bond market, are especially important to economic activity because they enable corporations and governments to borrow in order to finance their activities. Debt markets are markets in which bonds are issued and traded. They are used to assist in the transfer of funds from individuals, corporations, and government units with excess funds to corporations and government units in need of long-term debt funding. A bond is a debt security that promises to make payments periodically for a specified period of time. Proceeds from a bond issue are used to raise funds to support long-term operations of the issuer (e.g., for capital expenditure projects). In return for the investor's funds, bond issuers promise to pay a specified amount in the future on the maturity of the bond (the face value) plus coupon interest on the borrowed funds (the coupon rate times the face value of the bond). If the terms of the repayment are not met by the bond issuer, the bond holder (investor) has a claim on the assets of the bond issuer.

The debt market is one of the most critical components of the financial system of anyeconomy and acts as theleverage tool of a modern financial system. The debt market in mostdeveloped countries is many times bigger than the other financial markets, including theequity market. The total size of the Indian debt market is currently estimated to be in therange of USD150 billion to 200 billion. India's debt market accounts for approximately 30 per cent of itsGDP.

In the post-reforms era after 1991, a fairly well-segmented debt market has emerged comprising the following:

- Private corporate debt market
- Public sector undertakings bond market
- Government securities market

The government securities market accounts for more than 90 per cent of the turnover in the debt market. It constitutes the principal segment of the debt market.

8.1.1 Indian Debt Market- Historical View

Debt market has a long history in India. The Government Securities market dates back to 1859 when the British Government took over from the East India Company; there has been active debt issuing by the government both before and after independence. Corporate Bonds, mainly debentures, were being issued by companies of good standing in the pre-war and post-war years. There was a decline in corporate bond issues in the decades of sixties and seventies following the arrival of term lending institutions who supplied the bulk of the medium and long term funding requirements of the private sector. The public sector's long term funding needs were met by the State. The Indian debt market has traditionally been a wholesale market with participation restricted to a few institutional players—mainly banks. Banks were the major participants in the government securities market due to statutory requirements. The turnover in the debt market too was quite low at a few hundred crores till the early 1990s. The debt market was fairly underdeveloped due to the administered interest rate regime and the availability of investment avenues which gave a higher rate of return to investors.

In the early 1990s, the government needed a large amount of money for investment in development and infrastructure projects. The government realized the need of a vibrant, efficient, and healthy debt market and undertook reform measures. The Reserve Bank put in

substantial efforts to develop the government securities market but its two segments, the private corporate debt market and public sector undertaking bond market, have not yet fully developed in terms of volume and liquidity.

The debt market plays a key role in the efficient mobilization and allocation of resources in the economy, financing the development activities of the government, transmitting signals for implementation of the monetary policy, facilitating liquidity management in tune with both short-term and long-term objectives and pricing of non-government securities in financial markets. The Indian debt market and the government securities market in particular**,** is at a turning point in India with significant changes taking place in the domestic economic environment along with various proposed legislative changes in last decade.

8.1.2 Regulators of Debt Market

The Securities Contracts Regulation Act (SCRA) defines the regulatory role of various regulators in the securities market. Accordingly, with its powers to regulate the money and Government securities market, the RBI regulates the money market segment of the debt products and the Government securities market. The non-Government bond market is regulated by the Securities and Exchange Board of India (SEBI). The SEBI also regulates the stock exchanges and hence the regulatory overlap in regulating transactions in Government securities on stock exchanges have to be dealt with by both the regulators (RBI and SEBI) through mutual cooperation.

In order to promote an orderly development of the market, the government issued a notification onMarch 2, 2000, delineating the areas of responsibility between the Reserve Bank and the SEBI. The contractsfor sale and purchase of government securities, gold related securities, money market securities andsecurities derived from these securities, and ready forward contracts in debt securities shall be regulatedby the RBI. Such contracts, if executed on the stock exchanges shall, however, be regulated by SEBI in amanner that is consistent with the guidelines issued by the RBI.

8.1.3 Link between the Money Market and Debt Market

The money market is a market dealing in short-term debt instruments (up to one year) while the debtmarket is a market for long-term debt instruments (more than one year). The money market supports thelong-term debt market by increasing the liquidity of securities. A developed money market is a prerequisitefor the development of a debt market.

8.2 Debt Market

The Debt Market is the market where fixed income securities of various types and features are issued and traded. Debt Markets are therefore, markets for fixed income securities issued by Central and State Governments, Municipal Corporations, Govt. bodies and commercial entities like Financial Institutions, Banks, Public Sector Units, Public Ltd. Companies and also structured finance instruments. The debt market is one of the largest segments of Indian financial markets.

In India, the Government debt market is well developed in terms of instruments, size, participants and regulatory frame work. Both the Government of India and State Governments raise funds from this market through issue of various debt instruments. By and large these instruments are issued under the auctions. Investors prefer to invest in the Government debt instruments because there is no credit risk at all. The corporate debt market in India consists of debt instruments issued by banks and financial institutions, public sector undertakings, local bodies and private companies. Such bonds are issued with varied terms and conditions such as bonds with fixed coupon, floating rate bonds, bonds with put and call options and zero-coupon bonds etc. As compared to the Government debt market, corporate debt market in India is not developed. Only the primary market for corporate debt instruments is active.

The principal feature of the debt market is that it sustains the economy. In no country can the government meet its expenditure and all governments need debt. To raise funds, the government asks the central bank of the country to auction bonds from time to time. These bonds range in time from 3 to 30 years and mostly carry a fixed interest rate. Not only national governments but in many countries state, territorial and local governments are also allowed to raise finances by a bond issue.

The nature of debt and equity is the opposite. If the equity market rises then usually the returns from debt market falls. When the equity market falls investment seeks safe haven, i.e. steady gains, and debt prices rise. In this sense, the competitor of the debt market is precious metals such as bullion which are also safe havens. Debt market performs reflecting the mood of the country's economy. If the economy is performing poorly, then investors in the bond of that government want to sell it off quickly leading to its plunge. This is the way in which debt market acts as a barometer for economic health.

8.2.1 Structure of Indian Debt Market

Structure of Indian Debt Market

Government Debt Market

1. Instruments

- Dated Government securities for 2 to 30 years
- Treasury Bills of 91 day, 182 day and 364 day
- State Governments securities for a period up to 10 years

2. Issuers

- Government of India & State Governments

3. Investors

- Banks
- Primary Dealers
- Financial Institutions
- Insurance Companies
- NBFCs
- Mutual Funds
- Foreign Institutional Investors Individuals

4. Regulator

- RBI

5. Settlement of Transactions

- Transactions in the Government securities are settled through CCIL

Corporate Debt Market

1. Instruments

- Fixed interest rate bonds/ debentures
- Floating rate bonds/ debentures
- Bonds / Debentures with put and call options
- Deep discount bonds.

2. Issuers

- Banks & Financial Institutions
- Public Sector Undertakings
- Private Sector Enterprises
- Local bodies
- (Municipal Corporations)
- Non – Banking Finance
- Companies

3. Investors

- Banks
- Financial Institutions
- Mutual Funds
- NBFCs
- Insurance Companies
- Individuals

4. Regulator

- SEBI

5. Settlement of Transactions

- In case of listed debt instruments transactions are settled through stock exchange settlement system
- In case of unlisted debt instruments transaction are settled through OTC route

8.2.2 Functions/Importance of Debt Markets

Debt market of a country performs some important functions and helps in the process of economic development of the country. We know that debt market is the market for medium-term and long-term financial assets. It deals in securities having a maturity period of 1 year and above. It supplies funds for financing fixed capital requirements of firms as well as long-term requirements of the government for funds. By its activities, the debt market of a country makes a considerable contribution towards the process of its economic development. This will be clear if we mention the major functions of the debt market of an economy. The important functions of the debt market may be summarized as follows:

Trade and industry of a country require funds or liquidity for their expansion. Debt market provides medium-term and long-term funds for the development of trade and industry. It thus acts as a provider of liquidity.

For economic development, small savings of the country should be mobilized first. Debt market mobilizes small savings scattered over the country through its various institutions. It thus collects much needed funds required for the economic development of a country.

Mere mobilization of savings is not enough. The mobilized savings are to be properly invested. Debt market arranges proper investment of the funds collected from the savers. It thus makes an efficient allocation of resources. Debt market protects the interests of both the savers and the investors. It thus helps increase propensity to save of the savers and propensity to invest of the investors.

Debt market helps in selling the securities of the government enterprises and autonomous bodies. It thus provides the much needed funds to the government and the autonomous bodies who are important agents in the process of economic development of a country.

On the one hand, debt market opens new opportunities for investment and thus keeps the savings of the economy mobile. On the other hand, it encourages savings, raises the rate of savings and thus helps in the economic development of the country.

In the debt market, some special purpose development financial institutions provide financial help to some targeted sectors. Some of them provide financial help to small and cottage industries. They thus help in the process of economic development of a country.

Credit rating agencies of the debt market provide superior, low-cost information to the investors about their investment. These agencies ensure optimal uses of investible funds. By providing investment information, credit rating agencies increase propensity to invest of the investors and thus help in the economic development of a country.

Merchant bankers of the debt market provide some important services to the corporate sector of an economy. Some of such essential services are: giving advice on financial alternatives, corporate mergers, underwriting new issues, loan syndication, etc. Merchant bankers thus help the corporate sector in proper utilization of their funds.

Some financial institutions of the debt market provide managerial and technical knowhow to industrial organizations. This service is also of great help for the expansion of the industrial sector of an economy.

Other key functions of debt markets can be summarized as follows:

- Mobilize long-term savings to finance long-term investments.
- Provide capital in the form of debt to entrepreneurs.
- Encourage broader ownership of productive assets.
- Provide liquidity with a mechanism enabling the investor to sell financial assets.
- Lower the costs of transactions and information.
- Improve the efficiency of capital allocation through a competitive pricing mechanism.
- Enable quick valuation of financial instruments—both equity and debt.
- Enable wider participation by enhancing the width of the market by encouraging participation through networking institutions and associating individuals.
- Provide operational efficiency through
  - simplified transaction procedures;
  - lowering settlement timings; and
  - Lowering transaction costs.
- Develop integration among
  - real and financial sectors;
  - equity and debt instruments;
  - long-term and short-term funds;
  - long-term and short-term interest costs;
  - private and government sectors; and
  - Domestic and external funds.
- Direct the flow of funds into efficient channels through investment, disinvestment, and reinvestment.

Thus, we can say that without a developed debt market, economic development of a country is not possible. The process of economic development might be slow or may even be halted if the debt market is underdeveloped and unorganized.

8.2.3 Advantages of Debt Market

- The biggest advantage of investing in Indian debt markets is its assured returns.
- The returns that the market offer is almost risk-free (though there is always certain amount of risks, however the trend says that return is almost assured).
- Government securities are safest avenues. There are certain amounts of risks in the corporate, FI and PSU debt instruments. However, investors can take help from the credit rating agencies which rate those debt instruments. The interest in the instruments may vary depending upon the ratings.
- Another advantage of investing in India debt market is its high liquidity.
- Banks offer easy loans to the investors against government securities.
- Greater safety and lower volatility as compared to other financial instruments
- Higher leverage available in case of borrowings against government securities
- Greater diversification opportunities, adequate trading opportunities with continuing volatility expected in interest rates
- It speeds up the economy by making it possible for banks to offer mortgages to consumers.

8.2.4 Disadvantages of Debt Market

- As the returns here are risk free, those are not as high as the equities market at the same time. So, at one hand you are getting assured returns, but on the other hand, you are getting less return at the same time.
- Retail participation is also very less here, though increased recently. There are also some issues of liquidity and price discovery as the retail debt market is not yet quite well developed.
- Debt securities usually have much smaller price changes than stocks or commodities. Traders in debt securities must take larger positions to achieve the same level of profits.
- The debt trading markets are dominated by hedge funds and the trading desks of large financial institutions. These traders have access to information and capital that is difficult or impossible for the individual trader to obtain. By the time the small trader gets the news that these large players are trading on, it may be too late to profit from the news.

- Traders in corporate debt securities trade high-yield or junk bonds to earn the higher interest rates these bonds pay. The trader can also achieve capital gains if the issuing corporation gets an upgrade in its credit rating. The downside of high yield bonds is a bankruptcy and total loss of the principal invested.

8.2.5 Features of the Debt Markets

Bond/ Debt market is of central importance to economic activity. The bond market is vital for economic activity because it is the market where interest rates are determined. Interest rates are important on a personal level, because they guide our decisions to save and to finance major purchases (such as houses, cars, and appliances, to give a few examples). From a macroeconomic standpoint, interest rates have an impact on consumer spending and on business investment. The features of debt markets can be summarized as follows:

1. **Classified into Segments:** There are three main segments in the debt markets in India, viz.
   - Government Securities
   - Public Sector Units (PSU) bonds, and
   - Corporate securities.

   The market for *Government Securities* comprises the Centre, State and State-sponsored securities. In the recent past, local bodies such as municipalities have also begun to tap the debt markets for funds. Some of the PSU bonds are tax free, while most bonds including government securities are not tax-free. Corporate bond markets comprise of commercial paper and bonds. These bonds typically are structured to suit the requirements of investors and the issuing corporate, and include a variety of tailor-made features with respect to interest payments and redemption.
2. **Nomenclature of the Markets:** The debt market often goes by other names, based on the types of debt instrument that are traded. In the event of the debt market dealing mainly with municipal and corporate bond, the debt market may be known as a bond market. If mortgages and notes are the main focus of trading, the debt market may be known as a credit market. When fixed rates are connected with the debt instruments, the market may be known as a fixed income market.
3. **Changing Structure:** In majority of the countries, the debt market is more popular and many times bigger than other financial markets including the equity market. However in India the opposite was true for a very long time, because of the existence of a passive internal debt management policy, where only the government borrowed from a captive group of investors like banks. Indian debt

market, in the pre-liberalization era, was characterized by controls on pricing of assets, segmentation of markets and barriers to entry, low levels of liquidity, limited number of players, near lack of transparency and high transaction costs.

4. **Changes in Post Liberalization Era:** The debt market in India has traditionally been a wholesale market with participation restricted to a few institutional players – mainly banks. Indian securities and bonds markets have witnessed far-reaching reforms in the post liberalization era in terms of market design, technological developments, settlement practices and introduction of new instruments. Today, we have integrated trading, clearing and payment platforms, which enable seamless settlement of transactions. The markets have achieved tremendous stability and as a result, have attracted huge investment.
5. **Diversified Participants:** The investors in the debt markets concentrate in banks, financial institutions, mutual funds, provident funds, insurance companies and corporate. Many of these participants are also issuers of debt instruments.
6. **Fixed Return:** The most distinguishing feature of debt instruments of Indian debt market is that the return is fixed, i.e., returns are almost risk free. This fixed return on the bond is often termed as the 'coupon rate' or the 'interest rate'.
7. **Larger Volume:** The Indian debt market, in terms of volume, is larger than the equity market. The Indian debt market measured by the estimated value of bonds outstanding is next only to Japanese and Korean bond markets in Asia.
8. **Variety of Debt Instruments:** A variety of debt instruments have been introduced into Indian capital market in recent years. They are called new innovative instruments. These new instruments may again be divided into two categories: instruments issued by corporate and instruments issued by financial intermediaries. In the first category, we have participating debentures, convertible debentures with options, fully convertible debentures, warrants and so on. In the second category, we may mention floating rate bonds, zero coupon bonds, regular income bonds, retirement bonds, growth bonds, index bonds, deep discount bonds and so on.
9. **Stringent Regulation:** The regulatory jurisdiction over the corporate debt has been assigned to the Indian securities market regulator SEBI under SEBI Act, 1992. For Government debt securities, RBI has the jurisdiction to provide the guidelines to run the debt market. To avoid the confusion of multiple regulations, a notification issued by the Government on March, 2, 2000 clearly defined the areas of responsibility between RBI and SEBI. The issue of corporate debts is also under the

regulation of SEBI. The issuance of debt instruments by the government is regulated by the Government Securities Act 2006. The issuance of corporate securities is regulated by the SEBI Guidelines for disclosure and Investor protection. The Government Securities Act, 2006 was enacted by the Parliament in August 2006. The RBI made Government Securities Regulation, 2007 to carry out the purpose of the Government Securities Act, 2006. The Act and the Regulations are applicable to Government securities created and issued by the Central and the State Government.

10. **Type of Transactions:** There are two types of transactions in the debt market. Firstly there are direct transactions between wholesale market participants. These account for approximately 25% of the wholesale market volumes. Secondly, there are broker intermediated transactions i.e. where brokers undertake dealings for banks, institutions or other entities.
11. **Dematerialization of Debt Securities:** The government abolished stamp duty on debt securities to boost the dematerialization of debt securities and enhance levels of trading in corporate debt securities. Both the NSDL and the CDSL were permitted to admit debt instruments to the depository. The debt instruments include debentures, bonds, commercial papers, and certificate of deposit, irrespective of whether these instruments are listed, unlisted or privately placed. With dematerialization, it has become possible for banks to sell securities in smaller lots to corporate clients, provident funds, trusts, and others. The cost of holding securities in demat form is negligible as most of the banks are depository participants (DPs) of NSDL.
12. **Wholesale Debt Market:** The National Stock Exchange of India Ltd set up a separate segment for trading in debt securities known as the Wholesale Debt Market segment of the exchange. Prior to the commencement of trading in the WDM segment of the NSE, the only trading mechanism available in the debt market was the telephone. The NSE provided, for the first time in the country, an online, automated, screen-based system known as NEAT (National Exchange for Automated Trading) across a wide range of debt instruments. In the WDM trading system, there are two markets: (a) Continuous Market, and (b) Negotiated Market. In the continuous market, the buyer and seller do not know each other and they put their orders. If the orders match, it results in a trade which is settled directly between the participants. In the negotiated market, no counter-party exposure limit needs to be involved as the participants are familiar with each other. This system is an order-driven system which matches the best buy and sells orders on a price time priority and simultaneously protects the identity of the buyer and the seller.

13. **Retail Debt Market:** It involves participation by individual investors, Small trusts and other legal entities in addition to the wholesale investor classes.

Dematerialization of Debt Securities

The government abolished stamp duty on debt securities to boost the dematerialization of debt securities and enhance levels of trading in corporate debt securities. Both the NSDL and the CDSL were permitted to admit debt instruments to the depository. The debt instruments include debentures, bonds, commercial papers, and certificate of deposit, irrespective of whether these instruments are listed, unlisted or privately placed.

With dematerialization, it has become possible for banks to sell securities in smaller lots to corporate clients, provident funds, trusts, and others. The cost of holding securities in demat form is negligible as most of the banks are depository participants (DPs) of NSDL. Moreover, these banks can STRIP these securities and create a retail market for the same.

With effect from October 31, 2001, banks, financial institutions, and primary dealers can make fresh investments in and hold bonds and debentures, privately placed or otherwise, only in demat form.

Primary and Secondary Segments

In the primary market, new debt issues are floated either through public prospectus, rights issue, or private placement. The private placement market is more attractive because the cost of raising a loan is only half of that of raising loans from the market. Under the current guidelines, corporate are required to report details of resources raised through private placements to the stock exchanges–BSE and NSE. This was aimed at giving investors a good idea of how the companies propose to use these funds and also gauge the risk return allowed. In mid-2006, the US private placement market was opened up for Indian companies. Reliance Industries Limited became the first Indian company to tap the US private placement market, raising $300 million through a 10–12 year loan. More Indian companies are likely to tap this market.

In the secondary market, the debt instruments are traded on the OTCEI, the BSE, and the WDM segment of the NSE. The BSE is the first exchange in the country to provide an electronic trading platform for corporate and other nongovernment debt securities through the order-matching system. The clearing and settlement of the trades is undertaken through the clearing house of the exchange. Deals in respect of privately placed debt instruments (which are not listed on a stock exchange) are executed in the OTC market. In case of listed debt instruments, trades are executed according to the guidelines of stock exchange. Therefore, participants have a choice of platform. They may trade in OTC or on a stock exchange trading platform where debt instruments are listed.

The National Stock Exchange (NSE) provides a distinct platform for trading in debt securities and has created a separate segment for the same, which is called as Wholesale Debt Market (WDM) segment. This segment commenced operations on June 30, 1994. This segment caters to large players in the market, like banks, institutions, etc.The NSE-WDM segment provides a trading platform for trading in various debt securities such as PSU bonds, corporate debentures, bonds issued by financial institutions, etc. Trades in debt securities are executed through the National Exchange for Automated Trading (NEAT) system which is an automatic system that provides trading and reporting facilities. NSE's trading platform has a screen based, order driven and automated order matching system.

The Bombay Stock Exchange (BSE) has introduced trading in all types of debt instruments in the Wholesale Debt Market (WDM) segment through GILT System. This system is an automatic online trading system. Trading members and participants have identified as entities in the system. Trading members (brokers) are admitted on the exchange with trading rights. Trading members execute trades on GILT system for entities like banks, financial institutions, mutual funds, statutory corporations, etc. Even individuals can also transact in corporate debt securities through the members of BSE who have been permitted to undertake deals in debt securities.

Reporting and Settlement of Trade in Debt Securities

In April 2007, the SEBI permitted both the BSE and the NSE to put in place corporate bond trading platforms to enable efficient price discovery and reliable clearing and settlement facility having following characteristics:

- Trade matching platform shall be order driven with essential features of OTC market.
- System of anonymous order.

In August 2007, the SEBI granted approval to the Fixed Income Money Market Derivatives Association (FIMMDA) for starting corporate bond trade reporting system. Accordingly in September 2007, the FIMMDAs reporting platform became operational as the third reporting platform after BSE and NSE. For reporting of OTC trades, the concerned parties are free to opt for reporting their trades on any one of the three reporting platforms. The trades in corporate bonds in OTC market are settled through the clearing corporation of stock exchanges i.e. the Indian Clearing Corporation Limited (ICCL) and the National Securities Clearing Corporation Ltd. (NSCCL). All trades in corporate bonds which are executed in demat mode and reported on any of the specified reporting platform like

FIMMDA and NSE-WDM can be settled through the NSCCL. To facilitate this, buyers and sellers in corporate bond market are required to indicate their intention to settle such deals through the NSCCL.

Issues Concerned with Indian Debt Market

The corporate debt market in India is yet to be fully developed. Despite various reforms in the corporate debt market, still there are certain issues which need to be addressed and changes will have to be made in the existing policy framework. These issues are discussed below.

- **Lack of Liquidity in respect of many Debt Instruments in the Secondary Market:** The secondary market for corporate debt instruments is illiquid. In the absence of active secondary market, investors have difficulties to sale debt instruments in the secondary market. The concepts of Primary Dealers need to be introduced in respect of corporate debt segment to create secondary market in respect of large number of corporate debt securities which are not listed on stock exchanges.
- **Increasing the Number of Participants:** Increasing the number of players in the market will result in participants being available on both sides of the market and will also boost volumes. Various institutional investors need to be encouraged to participate in the secondary market. FIIs also will have to be encouraged to invest in corporate debt securities. The Pension funds, provident funds and charitable funds, etc., need to be encouraged to participate in the market. For this, suitable tax benefits can be offered to the investors.
- **Need for Change in Attitude of Retail Investors:** There is a need to encourage participation of retail investors in the corporate debt market. The retail investors do not trade in the corporate debt securities in the secondary market. The normal tendency is to invest in and hold corporate debt securities till maturity. This attitude needs to be changed. The retail investors will have to be encouraged to trade in corporate debt securities in the secondary market. The primary dealers can play a significant role in this regard. They have to offer two way quotes in respect of large number of debt securities.
- **Need for Innovative Instruments:** There is no point in offering only plain Vanilla debt securities. In order to encourage savings from small investors and attract investment from institutional investors, there is a need to bring innovations in the issue of debt instruments. The debt securities having features such as monthly interest payment, deep discount bonds, bonds with put and call options and floating rate bonds etc., are likely to be subscribed by both

institutions as well as retail investors. Therefore more variety of debt instruments needs to be offered to the retail and institutional investors.

- **Greater Disclosure in Respect of Privately Placed Debt Instruments:** A larger portion of the corporate debt securities is privately placed. In view of this, various issues relating to the private placements need to be addressed. In this context, it is essential to ensure greater transparency, adequate disclosures, minimum credit rating and proper accounting standards. This will enhance the confidence of investors in the debentures issued by private corporate entities. Credit rating agencies will require taking utmost care while rating of debt instruments which are privately placed.

8.3 Participants in Debt Market

The participants in the debt market are a small number of large players which has resulted in the debt market evolving into a wholesale market. Most primary debt issues are privately placed or auctioned to the participants while secondary market dealings are negotiated over the telephone. The NSE Wholesale Debt Market Segment (WDM) has emerged as an active platform for trading in debt instruments. Recently, the BSE also started trading in debt instruments. The debt market has become more diversified with the entry of new participants such as high net worth individuals, cooperative banks, large corporate, mutual funds, and insurance companies. The debt market is differentiated by the characteristics of the investors and the structure of the market. The two segments of debt markets are:

1. Wholesale Debt Market: The participant investors in these markets are mostly banks, financial institutions, the RBI, primary dealers, insurance companies, mutual funds, corporations, and FIIs. The RBI permits banks, primary dealers, and financial institutions in India to trade debt instruments among themselves or with nonbank clients through members of the stock exchanges.

2. Retail Debt Market: The main investors permitted to participate in the retail debt market include Mutual funds, Provident funds, Pension funds, Private trusts, Housing finance companies, Corporate treasuries, Hindu-undivided families, Individual investors, State-level and district-level cooperative banks, Large religious trusts and charitable organizations, Non-Banking Financial Companies (NBFC) and Residuary Non-Banking Companies (RNBC), in addition to the wholesale investor classes.

The major participants in the debt market are as follows:

Central and State Governments

The central government raises money through the issue of dated securities and treasury bills to finance the budget deficit and other short-term and long-term financial requirements. The RBI is the investment banker for the central government, and runs auctions to issue GOI bonds and T-bills. Treasury bills are issued to the market on a regular calendar by the RBI. The calendar is fixed and released to participants at the beginning of the financial year by the RBI. The state government, municipalities, and local bodies also issue securities to finance their budgetary deficits and developmental projects,

Banks

They are the captive investors in the government securities market. They participate both as lenders and borrowers in the call money market and as arrangers and investors in the commercial paper market. They issue certificates of deposits (CDs) to finance their short-term requirements and bonds to finance their long-term requirements. The Government securities are approved securities for the maintenance of Statutory Liquidity Ratio (SLR) by banks.

Primary Dealers (PDs)

Primary Dealers act as market makers for the placement of GOI debt. They are obliged to place bids in the auction for the issuance of government bonds, as well as provide liquidity in the secondary market for these bonds. They are appointed by the Reserve Bank and have emerged as active intermediaries in the government securities market and money market. They require achieving minimum success ratio of 40 per cent for both dated Government securities and treasury bills vis-à-vis bidding commitment and providing underwriting support to the auctions of Government securities.PDs underwrite government securities. They are allowed to underwrite 100 percent of the notified amounts. A minimum of 25% of each issue of Government of India dated securities and treasury bills are offered for underwriting by PDs. At present 21 primary dealers including bank's own PDs have been operating in this market.

Mutual Funds

Other than the state-promoted Unit Trust of India (UTI), mutual funds and asset management companies are relatively new entrants into the Indian financial sector. Therefore, these firms are much smaller in size compared with the financial firms listed above. However, they are less constrained by restrictions on investments and are an active participant in the GOI debt market. In the last ten years, there has been a rapid growth in the number and size of debt fund schemes, which took place with the shift to a market-based regime for interest rates. They are now the predominant investors, in the debt market. They have specialized debt funds such as money market mutual funds, gilt funds, and so on. They have also emerged as active participants and traders in the debt market.

The Remainder

These are such as charitable institutions, trusts and societies, nonfinancial firms and individuals—often somewhat confusingly termed retail investors. Of these, firms and individuals do not have regulatory constraints on their investment in government debt. But trusts and charities are forced to invest largely in government bonds. In addition, these investments are held to maturity. This makes for a captive audience for government bonds that do not contribute to the liquidity of these instruments.

Foreign Institutional Investors (FIIs)

Foreign investors can buy GOI bonds domestically. The main aim is to encourage further flow of foreign capital into the Indian capital market and bridge the gap between domestic saving and investment in a more cost-effective manner. FIIs have also been permitted to invest 100 percent of their funds in the debt market, which is a significant increase from the earlier limit of 30 percent. However, the limit of total foreign institutional investor investment in GOI bonds is $2.6 billion. The government also allows FIIs to invest in T-bills.

Public Sector Undertakings (PSUs)

Several central as well as state level public sector undertakings (PSUs) entered the market for the first time in 1985-86 to raise funds through debt instruments. They issue tax-free and taxable bonds to meet their long-term and working capital needs. They also invest in debt securities to park their surplus funds. The bonds issued by PSUs have been subscribed by banks, insurance companies, mutual funds and other institutions as well as retail investors. The investors prefer to invest in tax free bonds issued by PSUs because the interest income from these bonds is completely exempt from income tax. Bonds are issued by well-known PSUs like the National Thermal Power Corporation, Railway Finance Corporation HUDCO. Most of the PSU bonds are sold on private placement basis to the targeted investors at market determined interest rates.

Financial Institutions (FIs)

Public and private financial institutions which cannot accept demand deposits comprising of savings and current deposits, depend on bond instruments to raise funds from the bond market. Because of higher rating from rating agency, these institutions issue bonds at lower interest rates. In the past many financial institutions like SIDBI, NABARD, IFCI, raised funds through various bonds such as capital gain bonds, deep discount bonds, floating rate bonds, etc. The maturity of these bonds is between five to twenty-five years. Most of the bonds have early exit options.

Corporate

The private corporate enterprises issue debentures to raise funds for longer period. However, the companies cannot issue any debentures carrying voting rights. Further, the companies have to issue secured debentures. In recent past the Companies have issued various types of debentures such as convertible debentures, debentures with put and call options, floating rate debentures etc., a very large proportion of such debts instruments have been issued to the institutional investors such as banks, mutual funds, insurance companies, etc., through private placement. The companies also issues debentures through public offer to the institutional as well as retail investors. They are both issuers and investors in the debt market.

Mutual Fund Houses

Mutual funds are the predominant investors, in the debt market. They have specialized debt funds such as money market mutual funds, gilt funds, and so on. They have also emerged as active participants and traders in the debt market. MFs have many schemes with various proportion of investment on debt instruments. Unlike other investors, the mutual funds are affected by the volatile inflows and outflows of the funds and affect the secondary market activity.

Insurance Companies

They have been permitted to invest in the debt market and the limits of investment have been specified by the IRDA. They are interested in the longer-dated papers.

Provident Funds (PFs) and Pension Funds

They are large investors in government securities and PSU bonds. They are not active traders in their portfolios. They invest in bonds and debentures in accordance with the prescribed guidelines. These funds mainly aim at the safety of the funds. That is why they prefer government securities and bond of PSUs. A very small portion is invested in private sector bonds.

Satellite Dealers (SDs)

They were also one of the participants in the debt market but the Reserve Bank discontinued their participation from May 2002. This was a second level dealers system linked with PDs and acted as a distribution channel. Later, it was felt that SD system resulted in higher transaction costs to retail investors and so discontinued.

Credit Rating Agencies

Simply speaking, these agencies rate or assess the ability of the borrower company to repay its debt. They thus provide useful information to the investors. Ratings are given to financial instruments and not the company. Debentures carrying a first charge on company's assets are rated higher than those carrying second charge. However both rated higher than unsecured debentures. This shows that the debentures from the same company could carry different ratings depending on the nature of the security and the amount raised. Some of the important credit rating agencies in India are:

- Credit Rating Information Services of India Limited (CRISIL)
- Investment and Credit Rating Agency of India Limited (ICRA)
- Credit Analysis and Research Limited (CARE)
- Onida Individual Credit RatingAgency of India Limited (ONICRA)
- Duff and Phelps Credit Rating India (P) Limited (DPCRI)

The Regulatory Bodies

The debt market is mainly regulated by the Reserve Bank of India and the Securities and Exchange Board of India. The RBI mainly regulates the government securities market and the issue of financial institutions and public corporations. SEBI regulates the issue of corporate debt and trading of dated securities and corporate debt instruments.

8.4 Debt Market Instruments

Debt instrument represents a contract whereby one party lends money to another on pre-determined terms with regards to rate and periodicity of interest, repayment of principal amount by the borrower to the lender. In Indian securities markets, the term '*bond*' is used for debt instruments issued by the Central and State governments and public sector organizations and the term '*debenture*' is used for instruments issued by private corporate sector.

Investing in debt instruments is like lending your money to a third party, who utilizes this money to earn more money. Generally, periodically part of this money is passed on to you as interest. The capital is returned after the stipulated time period. These instruments beat inflation to some extent; however taxation may be a concern in many of these instruments. The lock in period could be short, medium or long term depending on the type of debt instrument chosen. Capital is relatively safe; returns are lower than equity but higher than cash instruments.

8.4.1 Nature of Debt Instruments

The various kinds of debt instruments are seen in Indian debt market. These instruments are discussed below:

Fixed and Floating Rate Instruments

Debt instruments are issued either at a fixed or floating rate of interest. In case of fixed rate debt instruments, interest rate is fixed and paid periodically (semi-annually or annually). The fixed rate of interest, which is always stated on the annual basis, is called the coupon rate and the payment itself is called the coupon. The coupon rate of the instrument is fixed at the time of issuance which remains constant throughout the tenor of the instrument. For example, issue of 10 per cent bond by a public company for 10 years. Here 10 per cent interest is fixed and remains the same throughout the tenor of a bond. Such bonds are called as simple or plain vanilla bonds or simply fixed coupon bond. The coupon is determined by a number of factors which includes the credit rating of instrument, tax benefits, the collateral securities offered to secure the issue, overall interest rate scenario in the market and special features offered to the investors. Debt instruments are also issued at a floating interest rate. In such case the floating interest rate is periodically changed reflecting changes in market conditions particularly changes in rate of interest payable on the gilt securities or changes in the base rate. The interest rate on such instruments is linked with benchmark or base rate such as primary market cut-off yield of the 91-day-Treasury bills or 182 day Treasury bills. Such instruments are also known as adjustable rate or variable interest rate debt instruments.

Debt Instruments with Call and Put Option

Nowadays debt instruments are issued with call and put option. A call option allows the bond issuer to call back the bonds and repay them at a predetermined price before maturity. The issuer exercises call option when general interest rates are lower than the coupon or interest rate on the existing debt instruments thereby retiring existing expensive debt instrument and refinancing at a lower interest rate. As against this, put option allows the bond holder or investor to sell the bonds to the issuer at a predetermined price before maturity date. The holder of such debt instrument will exercise the put option when prevailing interest rates on new issue of bonds are higher than the coupon on the existing debt instruments.

Zero Coupon Debt Instruments

Such instruments are issued or sold at its discounted value and accordingly have zero interest rate. The best example is of treasury bills which are issued at discounted value. For example, 91 day Treasury bill with a face value of Rs.100 is issued at Rs.98.50. Therefore such instruments have no coupons or interest rates at all. The difference between the discounted value and face value of the instrument is the gain or income for the investors. In other words, investors are not entitled to any interest income and thus are entitled to receive only repayment of face value of the security on the maturity date. The zero interest debt instruments are beneficial both to the issuers because of the deferred payment of interest and to the investors because of the lucrative yield and absence of reinvestment risk.

Debentures

The term Debenture is derived from the Latin word 'debere' which means 'to owe a debt'. A debenture is an acknowledgment of debt, taken either from the public or a particular source. When borrowed capital is divided into equal parts, then, each part is called as a debenture. Debenture represents debt. For such debts, company pays interest at regular intervals. It represents borrowed capital and a debenture holder is the creditor of the company. Debenture holder provides loan to the company and he has nothing to do with the management of the company.

Non-Convertible v/s Convertible Debt Instruments

A debt instrument can be issued either with non-convertible clause or with convertible clause. A non-convertible debt instrument is that instrument which cannot be converted into equity at all. This means non-convertible debt instrument remains as a debt instrument throughout its tenor. The holder of convertible debt instrument can exercise the right to convert whole of debt instrument or its portion into equity. On conversion of debt instrument into equity, the investors will receive equity shares in place of existing convertible bonds. Once this is done then the investors will receive dividend income instead of interest Such instruments are issued either as fully convertible or partly convertible debt instruments.

Irredeemable and Redeemable Debt Instruments

Debt instruments can be classified according to its irredeemable and redeemable characteristics. The irredeemable debt instruments are those which can be redeemed only at the time of liquidation of an issuer entity. The redeemable debt instruments are those which are issued for a specified period and thus are redeemed once that period gets over. The common practice is to issue debt instruments as redeemable debt instruments. Under the company law provisions companies are not allowed to issue irredeemable debt instruments. They are allowed to issue debt instruments like debentures as redeemable debt instrument with a maximum period of 10 years. A company engaged in the setting up of infrastructure projects like road, power, etc. is allowed to issue secured debentures up to thirty years. This means such debentures cannot be issued as irredeemable debentures.

Secured Debentures v/s Unsecured Debentures The secured debentures are those that are secured by a charge on the fixed assets belonging to the issuing company. In view of this, even if the issuer fails to return money to the debenture holders on maturity, the issuer's assets on which charge is created can be sold to repay dues of the debenture holders. The unsecured debentures are those where if payment is not made to the debenture holders on maturity, then their dues are considered along with other unsecured creditors of the issuing company.

8.4.2 Components of Debt Instruments

The key components of corporate bonds are given as follows:

Maturity: Maturity of a bond refers to the date, on which the bond matures, which is the date on which the borrower has agreed to repay the principal. *Term-to-Maturity* refers to the number of years remaining for the bond to mature. The Term-to-Maturity changes everyday, from date of issue of the bond until its maturity. The term to maturity of a bond can be calculated on any date, as the distance between such a date and the date of maturity. It is also called the term or the tenure of the bond.

Coupon/ Interest: Coupon refers to the periodic interest payments that are made by the borrower (who is also the issuer of the bond) to the lender (the subscriber of the bond). Coupon rate is the rate at which interest is paid, and is usually represented as a percentage of the par value of a bond.

Principal: Principal is the amount that has been borrowed, and is also called the par value or face value of the bond. The coupon is the product of the principal and the coupon rate.

Issue Price: Issue Priceis the price at which the corporate bonds are issued to the investors. Issue price is mostly same as face value in case of coupon bearing bond. In case of non-coupon bearing bond (zero-coupon bond security is generally issuedat discount.

Face Value (FV): Face Value is also known as the ***par value*** or ***principal value***. Coupon (interest) is calculated on the facevalue of bond. FV is the price of the bond, which is agreed by the issuer to pay to the investor, excluding theinterest amount on the maturity date. Sometimes, issuer can pay premium above the face value at the timeof maturity.

Coupon Frequency: It means how regularly an issuer pays the coupon to holder. Bonds pay interest monthly, quarterly, semi-annually or annually.

Call/ Put Option Date: It is the date on which issuer or investor can exercise their rights to redeem the security.

Maturity/Redemption Value: It is the amount paid by issuer other than coupon payment. If the redemptionproceeds are more than the face value of the bond/ debentures, the debentures are redeemed at a premium. Ifone gets less than the face value, then they are redeemed at a discount and if one gets the same as their facevalue, then they are redeemed at par.

8.4.3 Types of Instruments Traded in Debt Market

The different types of instruments traded in the debt market can be classified into the following segments:

Types of Instruments	**Issuer**	**Instruments**
Government Securities	Central Government	Zero Coupon Bonds Coupon Bearing Bonds Floating Rate Bonds STRIPS Dated Securities (Including MSS) Treasury Bills
	State Governments	State Development Loan Coupon Bearing Bonds Floating Rate Bonds
Public Sector Bonds	Government Agencies / Statutory Bodies	Govt. Guaranteed Bonds Debentures
	Public Sector Units	PSU Bonds, Debentures PSU Commercial Paper
Private Sector Bonds	Corporate	Debentures, Bonds Commercial Paper Floating Rate Bonds Zero Coupon Bonds Inter-Corporate Deposits Secured Premium Notes
	Banks	Certificates of Deposits, Debentures, Bonds
	Financial Institutions	Certificates of Deposits, Bonds

Government Bonds

Government debt is the second largest securities market in India by value. Large fiscal deficits have implied a considerable scale of government bond issuance. However, the market has not developed as rapidly as the size of the outstanding debt has increased. Liquidity is poor, localized to a few securities, and unreliable. In times when interest rates are low, the liquidity has been high, and when interest rates rise, the liquidity tends to drop sharply. Despite the high volatility of interest rates, interest rate derivatives are highly inadequate.

The largest issuer of government debt is the Government of India, although there have increasingly been debt issues by state governments as well. As with other countries, GOI bonds define the riskless yield curve, and have a considerable significance. This is also called as the GovernmentSecurities Market.

Nature of Products in the Government Debt Market

As in most other debt markets in the world, the Indian government debt market is divided into short-term debt products- which tend to be indicative of monetary policy in that country and long-term debt.

1. Short-Term Products

Short-term products are *money market products*, and have short maturities, typically within a year. And like money market products worldwide, they are issued and traded at a discount to face value. There are three key elements of this market:

Borrowing and lending is done by the central bank, Reserve Bank of India (RBI), as part of the conduct of monetary policy. In India, there are two distinct rates at which the central bank borrows and lends the repo rate and the reverse repo rate. These rates are generally quite far apart; there is a substantial bid-offer spread.

2. The call money market is a non-collateralized interbank dealer market for overnight funds. This market involves credit risk, for there is no collateral. However, the government has not allowed any important bank in India to fail. Hence, the credit risk is negligible.

3. A collateralized borrowing and lending obligations (CBLO) market is an exchange-traded repo, where there is no credit risk owing to the presence of collateral. Participation in the CBLO market is not limited to banks.

Treasury Bills (T-bills issued by the GoI) are short-term products and are standardized securities, unlike the previously discussed bilateral contracts. T-bills in India have maturities of 91 day, 182 day and 364 day, and are issued and traded like their long-dated counterpart, the Treasury Bonds (T-bonds), also issued by the GoI. The auction for issue of 91 day treasury bills is held on every Wednesday. The auctions for issue of 182 day & 364 day treasury bills are held on alternate Wednesday(once in a fortnight)

2. Long- Term Government of India Dated Securities

Longer maturity government debt products are the Government of India Treasury Bonds (ranging from greater than a year up to 30 years). Treasury bonds issued by the GoI have the following characteristics:

- The face value of all treasury products, both bonds and bills, is Rs.100.
- The maturity of bonds issued goes from over a year, all the way out to 30 years.
- All GoI bonds are *coupon bearing bonds*, with coupons being paid semiannually.

The maturity and the coupon of each bond is defined at the date of issue. There is no zero coupon bonds traded, for all practical purposes. There is also no effort to create a “STRIPS” market as in the United States where investment banks strip T-bonds to sell zero coupon instruments. The RBI publishes calendar for issue of GOI dated securities after every six months (twice in a year.) These securities are issued either at a fixed interest rate or floating interest rate. The coupons offered on dated Government securities are either pre-determined by RBI or arrived through competitive bidding or auction process. As mentioned earlier, the RBI has issued variety of dated Government securities such as fixed coupon bonds, bonds with put and call options, zero coupon bonds, floating rate bonds, etc.

Most developing countries find it difficult to achieve a long-dated government bond market. Markets are averse to holding long-dated government bonds when there is inflation risk. India has apparently achieved considerable success with a local-currency thirty-year bond market. This is puzzling, given the lack of a well-specified monetary policy framework, and given the considerable inflation risk that is present.

This achievement is less impressive than it appears when government bond issuance is placed in the larger context of financial repression. Government forces banks, insurance companies and pension funds to hold a considerable amount of government bonds. Government is able to issue long maturity bonds, knowing that there are captive buyers. Hence, the Indian success in stretching the yield curve is based only partly on the growing mass of sophisticated institutional investors—such as insurance companies—who have a natural need for long-dated bonds. It is largely based on old-fashioned financial repression, and not on a sense, in the mind of the market, that inflation deep in the future is highly predictable.

State Government Bonds

State Government securities are nothing but State Government loans. Compared to the stock of central government bonds, issues of bonds by the state government are significantly smaller. The state Government debt securities are issued by the RBI on behalf of various State Governments. Such securities like dated Government securities are issued either through auctions or with preannounced coupon rates. There has been significant increase in the market borrowings by the State governments. Maturities of SG bonds typically run between 5 and 15 years. SG bonds share the same characteristics as the GoI bonds.

Corporate Bonds

The corporate bond market involves all bonds that have credit risk, i.e., bonds issued by all entities other than the Central Government. This includes not just the bonds issued by private Indian firms but, more significantly, bonds issued by sub-national agencies such as state governments (SG) and municipalities, as well as the Public Sector Units or Entities (PSU/PSE) which are firms where the majority shareholder is the central or state government.

In India, the corporate and sub-national bonds that are raised in the market are largely privately placed, have very low trading, and suffer from severe lack of transparency in pricing and liquidity. It is much smaller in size than the GoI bond market. Unlike some areas of Indian finance where progress has been taking place, the share of corporate debt in the overall bond market has actually been dropping.

Products in the Corporate Debt Market

By definition, corporate bonds are bonds issued by firms and sub-national bonds are issued by any other state-level entity than the Central Government of India. Both financial firms (e.g., banks) and non-financial firms issue bonds. A distinction that is important among firms is that of government ownership. The corporate bond market generally assumes that public sector firms cannot fail, because they are backed by a guarantee from the State.

Public Sector Undertaking Bonds

A public sector enterprise (PSU) is a firm owned by an arm of government- the central government, a state government, or a municipality. They can be straight bonds or structured obligations, which are specific to a particular project. The maturity of these bonds issued by SOEs are typically between 5 and 15 years, whereas the typical term of a municipal bond can typically go up to seven years out. Bonds issued by PSU financial firms, particularly banks, are the biggest single element of this market. Given the majority ownership by the Central Government, the perception is that these bonds are of a very high credit quality, regardless of the fragility of the issuing firm. In addition, some of these bonds also have a tax-exempt status.

Bonds Issued by Private Firms

Corporate debt issued by firms is either in the form of short-term instruments called commercial paper (CP) or corporate debentures/bonds (CB). However, the companies cannot issue any debentures carrying voting rights. CPs are borrowings done with maturities between two weeks and a year, while corporate bonds have longer maturities. Typical corporate bond maturities are between three to seven years in India today.

Further, the companies have to issue secured debentures. In recent past the Companies have issued various types of debentures such as convertible debentures, debentures with put and call options, floating rate debentures etc., a very large proportion of such debts instruments have been issued to the institutional investors such as banks, mutual funds, insurance companies, etc., through private placement. The companies also issues debentures through public offer to the institutional as well as retail investors.

CBs can have significantly different structures compared to those issued by the government or by PSUs. CBs do not necessarily have semi-annual coupons, nor are these cash flows always a fixed value. The most significant difference between CBs and the rest of the corporate bond instruments is that several CBs have embedded options in them: either these contain *call* options, which give the company the right to pre-pay and close the obligations in the bonds before maturity, or they contain *put* options, which give the bond holder the right to convert the bonds into equity shareholding at a predetermined price. These latter are also referred to as warrants in India.

In the 1990s, Indian company law imposed a ceiling on the coupon rate that a corporate bond could offer. Many firms felt that their bonds would not be attractive at this ceiling. They set about bundling warrants with corporate bonds in order to get past this problem.

8.4.4 Risks With Regard to Debt Securities

The following are the risks associated with debt securities:

Default Risk: This can be defined as the risk that an issuer of a bond may be unable to make timely payment of interest or principal on a debt security or to otherwise comply with the provisions of a bond indenture and is also referred to as credit risk.

Interest Rate Risk: This can be defined as the risk emerging from an adverse change in the interest rate prevalent in the market so as to affect the yield on the existing instruments. A good case would be an upswing in the prevailing interest rate scenario leading to a situation where the investors' money is locked at lower rates whereas if he had waited and invested in the changed interest rate scenario, he would have earned more.

Reinvestment Rate Risk: This can be defined as the probability of a fall in the interest rate resulting in a lack of options to invest the interest received at regular intervals at higher rates at comparable rates in the market. The following are the risks associated with trading in debt securities:

Counter Party Risk: This is the normal risk associated with any transaction and refers to the failure or inability of the opposite party to the contract to deliver either the promised security or the sale-value at the time of settlement.

Price Risk: This refers to the possibility of not being able to receive the expected price on any order due to a adverse movement in the prices.

8.5 Check Your Progress

1. The 91-day t-bills are auctioned

(A) Daily (B) Weekly (C) Fortnightly (D) Monthly

2. The ______________ provides an anonymous trading platform ofgovernment securities.

(A) WDM (B) NDS (C) NDS-OM

3. The _________________ is the central counterparty in the settlementof all trades in government securities.

(A) NSCCL (B) NDS (C) CCIL

4. The ___________________ is an electronic screen based quote drivendealing system for call, money and term money operations.

(A) NDS (B) NDS-OM (C) NDS-CALL

State whether the following statements are true or false.

5. Treasury bills are issued as discounted instruments.
6. The market for Government debt securities is regulated by the SEBI.
7. Primary dealers are wholesale traders in the Government Securities Market.
8. Banks are major institutional investors in the Government securities market.
9. All trades in Government securities are settled through the Cleaning Corporation of India Ltd.
10. The companies in India are allowed to issue irredeemable debentures.
11. The debts instruments can be issued with or without convertible clause.
12. A put option allows the bond issuer to call back the bonds repay them at a predetermined price before maturity.
13. The floating rate instruments are also known as variable interest rate debt instruments.

14. Zero coupon bonds are issued at its discounted value.

15. The Government securities market is regulated jointly by the Securities Exchange Board of India (SEBI) and the Reserve Bank of India (RBI).

8.6 Summary

- The debt market is one of the most critical components in the financialsystem of any economy and acts as the fulcrum of a modern financial system.
- In the post-reforms era, a fairly well-segmented debt market has emerged comprising the private corporate debt market; the public sector undertakings bond market; and the government securities market.
- The government securities market accounts for more than 90 per cent of the turnover in the debt market. It constitutes the principal segment of the debt market.
- The RBI regulates the government securities market and money market while the corporate debt market comes under the purview of the Securities Exchange and Board of India (SEBI).
- The major participants in the debt market are central and state governments, primary dealers, public sector undertakings, corporate, banks, mutual funds, foreign institutional, investors, provident funds, charitable institutions, and trusts.
- In the primary market, new debt issues are floated either through prospectus, rights, or private placement. The debt instruments are traded on the OTCEI, the BSE, and the WDM segment of the NSE.
- Corporate adopt either the public offering route or the private placement route for issuing debentures/bonds. The corporate debt market constitutes a small segment of the debt market despite measures taken to promote this market during the 1990s.
- Public sector undertaking bonds are medium-and long-term obligations issued by public sector undertakings. The majority of PSU bonds are privately placed with banks or large investors. PSUs are permitted to issue two types of bonds: tax-free and taxable bonds.PSUs are allowed to issue floating rate bonds, deep discount bonds, and a variety of other bonds. All new issues have to be listed on astock exchange. The level of activityisquite low as most of thePSU bonds are privately placed leading to a reduction in the floatingstock.

- Government securities market not only provides resources to thegovernment for meeting its short-and long-term needs but also actsas a benchmark for pricing corporate papers of varying maturities.
- Government securities are issued by the central government, stategovernments and semi-government authorities which also includelocal government authorities such as city corporations and municipalities.
- The system of ways and means advances (WMAs) has been evolvedto accommodatetemporary mismatches in government receipts andpayments. WMA is not a source of financing budget deficit and isnot included in the budget estimates. It is only a mechanism to coverday-to-day mismatches in receipts and payments of the government.
- The Government of India securities are medium-to long-term obligationsissued by the RBI on behalf of the government to financethe latter's deficit and public sector development programme. Governmentsecurities are issued either through auction, sale, or privateplacement with the RBI.
- Secondary market in government securities can be categorized intotwo segments: the wholesale institutional segment and the retailsegment.
- A system of primary dealers (PDs) was introduced in India in1996 to further strengthen the market infrastructure and to make itmore liquid and broad based. As on March 31, 2009, there were approved PDs in the gilts market.

8.7 Keywords

Convertible Debt Instrument:A debt instrument is issued with convertible clause. The holder of such instrument can exercise the right to convert debt instrument either fully or partially into equity. On conversion of debt instrument into equity, the investors will receive equity shares. Once this is done then the investors will be paid dividend but not interest.

Debt Instrument with Call Option:A call option allows the issuer of debt instrument to call back the bonds and repay them at a predetermined price before maturity date. The issuer may like to exercise call option when interest rates in the market are lower than the coupon or interest rate on the existing debt instruments thereby retiring expensive debt instruments and refinancing them at a lower interest rate.

Debt Instrument with Put Option:A put option allows the bond holder or investor to sell the bonds to the issuer at a predetermined price before maturity or redemption date. The holder of such a debt instrument may like to exercise put option when interest rates in the market are higher than the coupon or interest rates on the existing debt instruments.

Fixed Rate Debt Instrument: In case of such instrument interest rate or coupon is fixed and remains constant throughout the tenor of the instrument. The principal amount is paid on maturity date. This is also called as plain vanilla or simple debt instrument or straight bonds.

Floating Rate Debt Instrument: In case of such debt instrument interest rate or coupon is not fixed. The interest rate is periodically changed so as to reflect changes in market conditions particularly changes in rate of interest on gilt securities or changes in base rate. The interest rate which is floating is linked with bench mark or base rate such as primary market cut off yield of 91 days treasury bills or 182 days treasury bills. Such debt instruments are also known as adjustable rate or variable interest rate debt instruments.

Gilt funds: They are mutual funds encouraged the RBI dealing exclusively in government securities with a view to creating a wider investor base for them.

Government Dated Securities: Theyare medium to long-term coupon bearing obligations issued by the Reserve Bank on behalf of the government to finance the latter's deficit and public sector development programme.

Government Securities: These are the securities issued by the government to raise short and long term funds also known as gilt-edged securities.

Non-Convertible Bond: Such bond cannot be converted into equity. Therefore such bond remains bond till it is redeemed.

Primary Dealers: The primary dealers are wholesale traders in the Government securities market. They are market makers and hence provide liquidity in respect of the Government securities. The primary dealers are active participants in the money and Government securities markets. At present in all there are 21 primary dealers in India.

Private Placement: It is a method for issue of securities like debt instruments. Under this method offer is made privately to a small chosen number of investors (say less than fifty investors) to subscribe debt instruments or other securities.

Public Issue: It is nothing but offer or invitation by an issuer to the public at large to subscribe to the debt and other securities. This method is used to issue shares of public limited companies subject to the company law provisions and guidelines issued by the Securities Exchange Board of India (SEBI).

Redeemable Debt Instrument: Redeemable debt instrument is that instrument which is issued for a specified period and thus is redeemed once the period gets over. Under the company law provisions the companies are allowed to issue debt instrument like debentures for a maximum period of 10 years. A company which is engaged in the setting up of infrastructure project is permitted to issue debentures for thirty years.

STRIPS Separate Trading Registered Interest and Principal Securities: Itis a process of stripping a conventional coupon bearing security into a number of zero coupon securities which can be traded separately.

Tax Free Bond: Interest income from these bonds is completely exempt from income tax.

T-bills: They are short term obligations issued by the Reserve Bank on behalf of the government of India through weekly and fortnightly auctions.

Zero Coupon Debt Instrument: Such instrument is issued or sold at discounted value and redeemed at par value. Hence, it does not have coupon. Example of this instrument is that of treasury bills which are issued at discounted value and redeemed at par. The difference between the discounted value and face value of the instrument is the gain or income to the investors.

8.8 Self-Assessment Test

1. Why is the debt market an important segment of the capital market? Who are the participants in the debt market?
2. What is the importance of the Debt Market to the economy?
3. What are the main features of Govt. Securities in India? Who are the main investors of Govt. Securities in India?
4. What are the various segments in the secondary debt market? Enlist the participants of debt market in India.
5. Discuss the role played by the Reserve Bank of India in thegovernment securities market.
6. State the objectives for the introduction of the primary dealer system? Discuss the role played by them in the governmentsecurities market.

8.9 Answer to Check Your Progress

1. B	4. C
2. C	5. True
3. C	6. False

7. True
8. True
9. True
10. False
11. True
12. False
13. True
14. True
15. True

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Course: Indian Financial System	
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Private, PSUs and Government Securities Market

STRUCTURE:

9.0 Learning Objectives

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

- Understand meaning and characteristics of securities.
- Know the features, advantages, types of government security market.
- Know Participants of government security market.
- Understand private, PSUs security market and security market instruments

9.1 Introduction

The security market of any nation performs a vital role in capital formation of theeconomy facilitating intermediate and long term funds. This is corporate phenomena thatthe money is the lubricant oil for the ever turning wheels of business. Thus, corporateneed huge volume of funds to start, run and expand the business, such fund requirementcan only be availed through capital market. Besides, market also provides liquidity andincentives to the savings and investments. The pricing mechanism enables efficientallocation of fund and helps to remove non- performing companies from the marketthrough mergers and acquisitions. Thus, market efficiency could be maintained throughwell-oiled mechanism. The performance of the companies reflects in the share priceindex. A huge volume of transaction is happening in the secondary market, but it is notleading to capital formation for the economy, because this is happening betweeninvestors over existing outstanding instruments. Though, the secondary market tradingvolume is not connecting capital formation, the price behaviour is considered as thebench mark to price the new instruments to be readily issued in the IPO market. Moreover, it keeps on generating adequate liquidity to canalize the fund to new issuemarket. The capital market is performing an increasing role in the globalized scenario forthe economic development and growth of the country.

Besides, the public sectorcompanies use the market as key means of disinvestment since the cost of debt capital is increasing tremendously. Thus, it is well understood that the economy of any nation could be developed and well established only through ensuring sound and healthy financial system and capital market.

9.1.1 Meaning of Security

Securities are negotiable financial instruments issued by a company or government that give ownership rights, debt rights, or rights to buy, sell, or trade an option. Securities are traded on the exchange markets. Although the term refers to all types of financial instruments, there are differences in its legal definitions, which mostly consider equities and fixed income as securities.

Securities can be stocks, bonds, mutual funds, interest-bearing treasury bills, notes, derivatives, warrants, and debentures. The legal entity that issues securities is the issuer of the security.Securities differ in their level of inherent risk. For example, equities are considered riskier than bonds, but also some equities are riskier than other equities. Depending on the level of risk that an investor wants to accept, he selects the relevant securities. Moreover, securities differ in their level of liquidity. Highly liquid securities like bonds, equities and money market instruments are traded more frequently because investors can increase their price by buying more securities and realizing a higher return on investment.

9.1.2 Characteristics of Security

The features of financial security can be summarized as return, risk, safety, and liquidity.

Return: The return may be received in the form of yield plus capital appreciation.The difference between the sale price and the purchase price is capital appreciation.The dividend or interest received from the investment is theyield.The return from an investment depends upon the nature of the investment, the maturity period and a host of other factors.

Return = Capital Gain + Yield (interest, dividend etc.)

Risk: Risk refers to the loss of principal amount of an investment. It is one of the major characteristics of an investment. The risk depends on the following factors:

- The investment maturity period is longer; in this case, investor will take larger risk.
- Government or Semi -Government bodies are issuing securities which have less risk.
- In the case of the debt instrument or fixed deposit, the risk of above investment is less due to their secured and fixed interest payable on themfor example debentures.
- In the case of ownership instrument like equity or preference shares, the risk is more due to their unsecured nature and variability of their return and ownership character.
- The risk of degree of variability of returns is more in the case of ownership capital compare to debt capital. The tax provisions would influence the return of risk.

Safety: Safety refers to the protection of investor principal amount and expected rate of return. Safety is also one of the essential and crucial elements of investment. Investor prefers safety about his capital. Capital is the certainty of return without loss of money or it will take time to retain it. If investor prefers less risk securities, he chooses Government bonds. In the case, investor prefers high rate of return investor will choose private Securities and Safety of these securities is low.

Liquidity: Liquidity refers to an investment ready to convert into cash position. In other words, it is available immediately in cash form. Liquidity means that investment is easily realizable, saleable or marketable. When the liquidity is high, then the return may be low. For example, UTI units. An investor generally prefers liquidity for his investments, safety of funds through a minimum risk and maximization of return from an investment.

9.2 Meaning of Government Securities Market

The government generates revenue in the form of taxes and income from ownership of assets. Besides these, it borrows extensively from banks, financial institutions, and the public to finance its expenditure in excess of its revenues. Government Securities are financial instruments and securities issued by a government towards raising a loan from the public. The intention of raising government securities is to finance important projects and budget deficits. Government securities comprise of bearer bonds, promissory notes, bonds held in the bond ledger account, etc. These can be in the form of dated government securities or treasury bills. Under normal circumstances, every country's government finance is operations, infrastructure development, defence and public spending from revenues earned from direct and indirect taxation and levies imposed in income earned by individuals and businesses, the sale of goods and services, imports, etc. However, many times, the income generated by the government might not be sufficient to support its public expenditure and infrastructure investment requirement; as a result of this, the Government can fill this gap by raising funds from the public and issuing them government securities in return. As a result of this, government securities are mainly issued to finance the portion of government expenditure and capital infrastructure requirement.

Most government securities issued by the Reserve Bank of India on behalf of the Indian Government are interest-bearing dated instruments. These government securities have a fixed maturity period, and these fixed coupon securities carry a half-yearly coupon interest. As these Government Securities have a specified maturity date, these are also referred to as dated government securities. Most government securities are issued in dematerialized form but can be issued in physical form upon request. Physical Government Securities are issued in multiples or denominations of Rs. 10000/- and the tenor of these government securities can be extended for a period of 30 years.

9.2.1 Features of Government Securities

Some of the most common features of Government Securities are as follows:

- Government Securities are issued at face value.

- Government Securities carry a sovereign guarantee and hence have zero risks of default.
- Investors can sell these Government Securities in the secondary market.
- Payments of Interest on Government Securities are paid on its face value.
- The interest payment on these Government Securities does not attract TDS, or Tax Deducted at Source.
- Government securities can be held in dematerialized form.
- The interest rate of Government Securities is fixed for the entire tenor of the instrument and cannot be changed during its tenor.
- The Government Securities are redeemable at face value at the time of its maturity.
- The maturity period of Government Securities can range between 2 to 30 years.
- Most Government Securities qualify as SLR or Statutory Liquidity Ratio investments

9.2.2 Advantages of Government Securities

The Reserve Bank of India issues government securities on behalf of the Indian Government in the form of interest-bearing dated securities. The securities have a fixed rate of interest, a fixed maturity period and carry half-yearly interest payments. The market value of government securities, similar to stocks is also subject to market risk. The prices of these instruments are often linked to the prevailing rate of interest. The price of government securities falls when the interest rates rise, and the price of government securities rise when the interest rates fall. As a result of this, buying government securities when the rate of interest is high at low rates and selling them at a higher price when the rate of interest fall can help investors make substantial gains. Some of the advantages of investing in Government securities include:

- Government securities offer lower volatility and greater safety when compared to corporate bonds.
- Government securities do not attract TDS deduction on interest payment.
- Government securities offer transparent transactions and simplified settlement procedures through NSDL/CSGL.
- Government investments offer higher diversification opportunities for investors.
- Investors are offered higher leverage while borrowing against government securities.
- Besides providing a return in the form of coupons (interest), G-Secs offer the maximum safety as they carry the Sovereign’s commitment for payment of interest and repayment of principal.

- They can be held in book entry, i.e., dematerialized/ scripless form, thus, obviating the need for safekeeping. They can also be held in physical form.
- G-Secs are available in a wide range of maturities from 91 days to as long as 40 years to suit the duration of varied liability structure of various institutions.
- G-Secs can also be used as collateral to borrow funds in the repo market.
- Securities such as State Development Loans (SDLs) and Special Securities (Oil bonds, UDAY bonds etc.) provide attractive yields.
- The settlement system for trading in G-Secs, which is based on Delivery versus Payment (DvP), is a very simple, safe and efficient system of settlement. The DvP mechanism ensures transfer of securities by the seller of securities simultaneously with transfer of funds from the buyer of the securities, thereby mitigating the settlement risk.
- G-Sec prices are readily available due to a liquid and active secondary market and a transparent price dissemination mechanism.

9.2.3 Risks involved in Government Securities

G-Secs are generally referred to as risk free instruments as sovereigns rarely default on their payments. However, as is the case with any financial instrument, there are risks associated with holding the G-Secs. Hence, it is important to identify and understand such risks and take appropriate measures for mitigation of the same. The following are the major risks associated with holding G-Secs:

Market Risk: Market risk arises out of adverse movement of prices of the securities due to changes in interest rates. This will result in valuation losses on marking to market or realizing a loss if the securities are sold at adverse prices. Small investors, to some extent, can mitigate market risk by holding the bonds till maturity so that they can realize the yield at which the securities were actually bought.

Reinvestment Risk: Cash flows on a G-Sec includes a coupon every half year and repayment of principal at maturity. These cash flows need to be reinvested whenever they are paid. Hence there is a risk that the investor may not be able to reinvest these proceeds at yield prevalent at the time of making investment due to decrease in interest rates prevailing at the time of receipt of cash flows by investors.

Liquidity Risk: Liquidity in G-Secs is referred to as the ease with which security can be bought and sold i.e. availability of buy-sell quotes with narrow spreads. Liquidity risk refers to the inability of an investor to liquidate (sell) his holdings due to non-availability of buyers for the security, i.e., no trading activity in that particular security or circumstances resulting in distressed sale (selling at a much lower price than its holding cost) causing loss to the seller. Usually, when a liquid bond of fixed maturity is bought, its tenor gets reduced due to time decay. For example, a 10-year security will become 8 year security after 2 years due to which it may become illiquid. The bonds also become illiquid when there are no frequent reissuances by the issuer (RBI) in those bonds. Bonds are generally reissued till a sizeable amount becomes outstanding under that bond. However, issuer and sovereign have to ensure that there is no excess burden on Government at the time of maturity of the bond as very large amount maturing on a single day may affect the fiscal position of Government. Hence, reissuances for securities are generally stopped after outstanding under that bond touches a particular limit. Due to illiquidity, the investor may need to sell at adverse prices in case of urgent funds requirement. However, in such cases, eligible investors can participate in market repo and borrow the money against the collateral of such securities.

9.2.4 Risk Mitigation

Holding securities till maturity could be a strategy through which one could avoid market risk. Rebalancing the portfolio wherein the securities are sold once they become short term and new securities of longer tenor are bought could be followed to manage the portfolio risk. However, rebalancing involves transaction and other costs and hence needs to be used judiciously. Market risk and re-investment risk could also be managed through Asset Liability Management (ALM) by matching the cash flows with liabilities. ALM could also be undertaken by matching the duration of the assets and liabilities.Advanced risk management techniques involve use of derivatives like Interest Rate Swaps (IRS) through which the nature of cash flows could be altered. However, these are complex instruments requiring advanced level of expertise for proper understanding. Adequate caution, therefore, need to be observed for undertaking the derivatives transactions and such transactions should be undertaken only after having complete understanding of the associated risks and complexities.

Market Risk: The change in interest rate can affect the value of government securities on the secondary market and is inversely proportional to the change in the rate of interest in the market. The price of government securities falls when the interest rates rise, and the price of government securities rise when the interest rates fall.

Risk of Default: Risk of default means the default of timely interest and principal payment. Government securities are backed by a sovereign guarantee and as a result of this are free from the risk of default.

However, being less risky than corporate bonds, government securities offer a lower rate of interest compared to the rate of interest offered by corporate bonds.

9.2.5 Segments of Dated Government Securities in India

Primary Market: The Primary Market for government securities includes the issuer of these securities. It includes the State and Central Government, buyers such as primary dealers, commercial banks, financial institutions, and insurance companies. The Reserve Bank of India also allows small investors to invest in government securities through its non-competitive bidding.

Secondary Market: The Secondary Market for government securities includes the Reserve Bank of India and various commercial banks, mutual funds, insurance companies, trusts, provident funds, primary dealers, etc. Individuals and corporates can also invest in government securities.

Auction: Government securities are also sold through the process of auction, though they can also be sold on the OMO or Open Market Operations. The process of auction involves calling of bids to arrive at a market price. The auction of government securities is generally priced on the basis of price or yield.

- **In price-based auctions**, the Reserve Bank of India makes an announcement regarding the size of the issue, the notified amount, tenor of the instrument, coupon rate of the paper, etc. The bidders are required to submit their bids, i.e., their price. Bids which are lower than the cut-off price are rejected, and bids higher than the cut-off price are accepted. A price based auction is intended to derive a price discovery for the instrument.
- **In Yield-based auctions**, the Reserve Bank of India makes an announcement regarding the notified amount or issue size of the government security, and the tenor of the instrument to be auctioned. The bidders are required to submit bids in term of the yield. Bids which are lower than the cut-off yield are rejected, and bids higher than the cut-off yield are accepted

9.2.6 Types of Government Securities in India

The Reserve Bank of India issues the following forms of Government Securities on behalf of the Government of India.

Treasury Bills: Treasury bills or T-bills, which are money market instruments, are short term debt instruments issued by the Government of India and are presently issued in three tenors, namely, 91 day, 182 day and 364 day. Treasury bills are zero coupon securities and pay no interest. Instead, they are issued at a discount and redeemed at the face value at maturity. For example, a 91 day Treasury bill of

₹100/- (face value) may be issued at say ₹ 98.20, that is, at a discount of say, ₹1.80 and would be redeemed at the face value of ₹100/-.

Cash Management Bills: Cash management bills are government securities issued with a short validity, which is usually less than 91-days. These are highly flexible financial instruments, and its tenure is dependent on the cash needs and requirement of the Government. Cash management bills are similar to treasury bills and do not pay the instrument holder any form of interest. Instead, the difference between the face value of the instrument and its discounted issue price serves as the profit or gains for the investor.

In 2010, Government of India, in consultation with RBI introduced a new short-term instrument, known as Cash Management Bills (CMBs), to meet the temporary mismatches in the cash flow of the Government of India. The CMBs have the generic character of T-bills but are issued for maturities less than 91 days.

Dated Government Securities: Dated government securities are securities and bonds issued by the Reserve Bank of India on behalf of the Government, and these bonds have a predetermined or fixed maturity date. The Reserve Bank of India sells these bonds or government securities on auction. Dated government securities can be issued as bonds with a call or put options, capital index bonds, zero coupon bonds, fixed and floating rate bonds, etc. Dated government security instruments are as follows:

Fixed Rate Bonds: These are bonds on which the coupon rate is fixed for the entire life (i.e. till maturity) of the bond. Most Government bonds in India are issued as fixed rate bonds.For example – 8.24%GS2018 was issued on April 22, 2008 for a tenor of 10 years maturing on April 22, 2018. Coupon on this security will be paid half-yearly at 4.12% (half yearly payment being half of the annual coupon of 8.24%) of the face value on October 22 and April 22 of each year.

Floating Rate Bonds (FRB): FRBs are securities which do not have a fixed coupon rate. Instead it has a variable coupon rate which is re-set at pre-announced intervals (say, every six months or one year). FRBs were first issued in September 1995 in India. For example, a FRB was issued on November 07, 2016 for a tenor of 8 years, thus maturing on November 07, 2024.

Capital Indexed Bonds: These are bonds, the principal of which is linked to an accepted index of inflation with a view to protecting the Principal amount of the investors from inflation. A 5 year Capital Indexed Bond, was first issued in December 1997 which matured in 2002.

Inflation Indexed Bonds (IIBs): IIBs are bonds wherein both coupon flows and Principal amounts are protected against inflation. The inflation index used in IIBs may be Whole Sale Price Index (WPI) or

Consumer Price Index (CPI). Globally, IIBs were first issued in 1981 in UK. In India, Government of India through RBI issued IIBs (linked to WPI) in June 2013.

Bonds with Call/ Put Options: Bonds can also be issued with features of optionality wherein the issuer can have the option to buy-back (call option) or the investor can have the option to sell the bond (put option) to the issuer during the currency of the bond. It may be noted that such bond may have put only or call only or both options. The first G-Sec with both call and put option viz. 6.72% GS 2012 was issued on July 18, 2002 for a maturity of 10 years maturing on July 18, 2012. The optionality on the bond could be exercised after completion of five years tenure from the date of issuance on any coupon date falling thereafter. The Government has the right to buy-back the bond (call option) at par value (equal to the face value) while the investor had the right to sell the bond (put option) to the Government at par value on any of the half-yearly coupon dates starting from July 18, 2007.

Special Securities: Under the market borrowing program, the Government of India also issues, from time to time, special securities to entities like Oil Marketing Companies, Fertilizer Companies, the Food Corporation of India, etc. (popularly called oil bonds, fertiliser bonds and food bonds respectively) as compensation to these companies in lieu of cash subsidies These securities are usually long dated securities and carry a marginally higher coupon over the yield of the dated securities of comparable maturity. These securities are, however, not eligible as SLR securities but are eligible as collateral for market repo transactions. The beneficiary entities may divest these securities in the secondary market to banks, insurance companies / Primary Dealers, etc., for raising funds.

STRIPS: Separate Trading of Registered Interest and Principal of Securities (STRIPS) are the securities created by way of separating the cash flows associated with a regular G-Sec i.e. each semi-annual coupon payment and the final principal payment to be received from the issuer, into separate securities. They are essentially Zero Coupon Bonds (ZCBs). However, they are created out of existing securities only and unlike other securities, are not issued through auctions. Stripped securities represent future cash flows (periodic interest and principal repayment) of an underlying coupon bearing bond. Being G-Secs, STRIPS are eligible for SLR. All fixed coupon securities issued by Government of India, irrespective of the year of maturity, are eligible for Stripping/Reconstitution, provided that the securities are reckoned as eligible investment for the purpose of Statutory Liquidity Ratio (SLR) and the securities are transferable.

Sovereign Gold Bond (SGB): SGBs are unique instruments, prices of which are linked to commodity price viz. Gold. SGBs are also budgeted in lieu of market borrowing.

7.75% Savings (Taxable) Bonds, 2018: Government of India has decided to issue 7.75% Savings (Taxable) Bonds, 2018 with effect from January 10, 2018 in terms of GOI notification F.No.4(28) - W&M/2017 dated January 03, 2018 and RBI issued notification vide IDMD.CDD.No.1671/13.01.299/2017-18 dated January 3, 2018.

State Development Loans: The State Government issues state development loans with the purpose of meeting their budget deficit and budgetary requirements. These bonds are issued in facilitation with the Reserve Bank of India using the negotiated dealing system. The rate of interest offered by state development loans is higher than dated government bonds.

9.2.7 Major players in the G-Secs market

Following are some major players in the G-Secs market:

- Commercial banks and PDs besides institutional investors like insurance companies. PDs play an important role as market makers in G-Secs market. A market maker provides firm two way quotes in the market i.e. both buy and sell executable quotes for the concerned securities.
- Other participants include co-operative banks, regional rural banks, mutual funds, provident and pension funds.
- Foreign Portfolio Investors (FPIs) are allowed to participate in the G-Secs market within the quantitative limits prescribed from time to time.
- Corporates also buy/ sell the G-Secs to manage their overall portfolio.

9.2.8 Process of issuing Government Securities

- G-Secs are issued through auctions conducted by RBI.
- Auctions are conducted on the electronic platform called the E-Kuber, the Core Banking Solution (CBS) platform of RBI.
- Commercial banks, scheduled UCBs, Primary Dealers, insurance companies and provident funds, who maintain funds account (current account) and securities accounts (Subsidiary General Ledger (SGL) account) with RBI, are members of this electronic platform.
- All members of E-Kuber can place their bids in the auction through this electronic platform. The results of the auction are published by RBI at stipulated time (For Treasury bills at 1:30 PM and for GoI dated securities at 2:00 PM or at half hourly intervals thereafter in case of delay).
- All non-E-Kuber members including non-scheduled UCBs can participate in the primary auction through scheduled commercial banks or PDs (called as Primary Members-PMs). For this purpose,

the UCBs need to open a securities account with a bank / PD – such an account is called a Gilt Account.

- A Gilt Account is a dematerialized account maintained with a scheduled commercial bank or PD. The proprietary transactions in G-Secs undertaken by PMs are settled through SGL account maintained by them with RBI at PDO.
- The transactions in G-Secs undertaken by Gilt Account Holders (GAHs) through their PMs are settled through Constituent Subsidiary General Ledger (CSGL) account maintained by PMs with RBI at PDO for its constituent (e.g., a non-scheduled UCB).

The RBI, in consultation with the Government of India, issues an indicative half-yearly auction calendar which contains information about the amount of borrowing, the range of the tenor of securities and the period during which auctions will be held. A Notification and a Press Communique giving exact particulars of the securities, viz., name, amount, and type of issue and procedure of auction are issued by the Government of India about a week prior to the actual date of auction. RBI places the notification and a Press Release on its website (www.rbi.org.in) and also issues advertisements in leading English and Hindi newspapers. Auction for dated securities is conducted on Friday for settlement on T+1 basis (i.e. securities are issued on next working day i.e. Monday). The investors are thus given adequate time to plan for the purchase of G-Secs through such auctions. A specimen of a dated security in physical form is given at Annex 1. The details of all the outstanding dated securities issued by the Government of India are available on the RBI website at http://www.rbi.org.in/Scripts/financialmarketswatch.aspx.

The Reserve Bank of India conducts auctions usually every Wednesday to issue T-bills of 91day, 182 day and 364 day tenors. Settlement for the T-bills auctioned is made on T+1 day i.e. on the working day following the trade day. The Reserve Bank releases a quarterly calendar of T-bill issuances for the upcoming quarter in the last week of the preceding quarter. e.g. calendar for April-June period is notified in the last week of March. The Reserve Bank of India announces the issue details of T-bills through a press release on its website every week.

Like T-bills, Cash Management Bills (CMBs) are also issued at a discount and redeemed at face value on maturity. The tenor, notified amount and date of issue of the CMBs depend upon the temporary cash requirement of the Government. The tenors of CMBs is generally less than 91 days. The announcement of their auction is made by Reserve Bank of India through a Press Release on its website. The non-competitive bidding scheme has not been extended to CMBs. However, these instruments are tradable and qualify for ready forward facility. Investment in CMBs is also reckoned as an eligible investment in G-Secs by banks for SLR purpose under Section 24 of the Banking Regulation Act, 1949. First set of CMB was issued on May 12, 2010.

9.3 Private, PSUs Securities Market

In private, PSUs security marketfinancial instruments are issued to raise funds. The primary function of the securities markets is to enable to flow of capital from those that have it to those need it. Securities market help in transfer of resources from those with idle resources to others who have a productive need for them. Securities markets provide channels for allocation of savings to investments and thereby decouple these two activities. As a result, the savers and investors are not constrained by their individual abilities, but by the economy's abilities to invest and save respectively, which inevitably enhances savings and investment in the economy.

This securities market has two interdependent and inseparable segments, viz., the primary market and secondary market. The primary market, also called the new issue market, is where issuers raise capital by issuing securities to investors. The secondary market also called the stock exchange facilitates trade in already-issued securities, thereby enabling investors to exit from an investment. The primary market creates financial assets, and the secondary market makes them marketable. Issuers are organizations that raise money by issuing securities. They may have short-term and long-term need for capital, and they issue securities based on their need, their ability to service the securities. Some of the common issuers in the Indian Securities Markets are:

- Companies issue securities to raise short and long term capital for conducting their business operations.
- Central and state governments issue debt securities to meet their requirements for short and long term funds to meet their deficits. Deficit is the extent to which the expense of the government is not met by its income from taxes and other sources.
- Local governments and municipalities may also issue debt securities to meet their development needs. Government agencies do not issue equity securities.
- Financial institutions and banks may issue equity or debt securities for their capital needs beyond their normal sources of funding from deposits and government grants.
- Public sector companies which are owned by the government may issue securities to public investors as part of the disinvestment program of the government, when the government decides to offer its holding of these securities to public investors.

- Mutual funds issue units of a scheme to investors to mobilise money and invest them on behalf of investors in securities.

9.3.1 Security Market Instruments

A security market is a market for securities (debt or equity), where business enterprises andgovernment can raise long-term funds. It is defined as a market in which money is provided forperiods longer than a year, as the raising of short-term funds takes place on other markets (e.g., themoney market). The capital market is characterized by a large variety of financial instruments: equity and preference shares, fully convertible debentures (FCDs), non-convertible debentures (NCDs) andpartly convertible debentures (PCDs) currently dominate the capital market, however new instruments are being introduced such as debentures bundled with warrants, participating preference shares, zero-coupon bonds, secured premium notes, etc. Following are some instruments which are issued in private, PSU security market.

Equity Shares

Equity shares commonly referred to as ordinary sharealso represents the form of fractional ownership in which a shareholder, as a fractional owner, undertake the maximum entrepreneurial riskassociated with business a business venture. Shareholders enjoy voting rights and the right toreceive dividends; however in case of liquidation they will receive residuals, after all the creditors of the company are settled in full. Equity shares signify ownership in a corporation and represent claim over the financialassets and earnings of the corporation. A company may invite investors to subscribefor the shares by the way of:

- Public issue through prospectus (IPO)
- Tender/ book building process
- Offer for sale (OFS)
- Placement method
- Rights issue

Preference Shares

Owners of this kind of shares are entitled to affixed dividend or dividend calculated at a fixed rate to be paid regularlybefore dividend can be paid in respect of equity shares. They also enjoyed priority over the equity shareholders in payment of surplus. But in theevent of liquidation their claims rank below the claims of company’s creditors, bondholders/ debenture holders. Following kinds of preference shares are dealt with by the companies.

Cumulative preference shares: In the case of this type of sharethe dividend payable every year becomes a first claim while declaringdividend by the company. In case the company does not want to paypreference dividend, it gets accumulated for being paid subsequently.

Non-cumulative preference shares: In the case of these shares, dividend does not accumulate. If there are no profits or the profits areinadequate in any year, the shares are not entitled to any dividend for that year.Unless there is a specific provision in the Articles of Association ofthe company.

Convertible preference share: If the term of issue of preference shares includes a right for converting them into equity shares at the end of specified period they are called convertible preference shares.

Redeemable preference shares: If the articles of a company so authorize, redeemable preference shares can be issued. This in contrast tothe principle that the company normally cannot redeem or buy back its own shares vide section 77 of the companies act, 1956, except byfollowing the procedure for reduction of capital and getting the sanction of the high court in pursuance of sections 100 to 104 or section 402 ofthe companies act.

Irredeemable preference shares: If the terms of issue providethat the preference shares are not redeemable except on the happening ofcertain specified events which may not happen for an indefinite periodsuch as winding up, these are called irredeemable preference shares.

Participating preference shares: Preference shareholders are notentitled to dividend more than what has been indicated as part of the terms of issue, even in a year in which the company has made huge profits. Subjects to provision in the terms of issue these shares can be entitled toparticipate in the surplus profits left, after payment of dividend to thepreference and the equity shareholders to the extent provided therein.

Non participating preference shares: Unless the terms of issue indicate specifically otherwise, all preference shares are to be regarded as non-participating preference shares.

Debentures

Debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. Debenture is a documents evidencing a debt oracknowledging it. Debentures are issued in the following forms:-

Naked or unsecured debentures: Debentures of this kind do notcarry any charge on the assets of the company.

Secured Debentures: Debentures that are secured by a mortgageof the whole or part of the assets of the company are called mortgagedebentures of secured debentures.

Redeemable Debentures: Debentures that are redeemable on expiry of certain period are called redeemable debentures. Suchdebentures after redemption can be reissued in accordance with theprovisions of section 121 of the Companies act 1956.

Perpetual Debentures: If the debentures are issued subject toredemption on the happening of specified events which may not happen or an indefinite period, i.e. winding up, they are called perpetualdebentures.

Bearer Debentures: Such debentures are payable to bearer and are transferable by mere delivery. The name of the debenture holder isnot registered the books of the company, but the holder is entitled to claim interest and principal as and when due.

Registered debentures: Such debentures are payable to theregistered holders whose name appears on the debentures certificate /letter of allotment and is registered on the companies register ofdebenture holder maintained as per section 152 of the Companies Act,1956.

Based on convertibility, debentures can be classified under three categories

Fully Convertible Debentures (FCDs): These are converted intoequity shares of the company with or without premium as per terms of theissue on the expiry of specified period or periods.

Non-Convertible Debentures (NCDs): These debentures do not carry the option of conversion into equity shares and are thereforeredeemed on the expiry of the specified period or periods.

Partly Convertible Debentures (PCDs): These may consist of twokinds namely- convertible and non-convertible. The convertible portion isto be converted into equity shares at the expiry of specified period.

Hybrid Instruments

Hybrid instruments are those which are created bycombining the features of equity with bond, preference and equity etc.Examples of hybrid instruments are: Convertible Preference Shares, CumulativeConvertible Preference Shares, Non-Convertible Debentureswith Equity warrants, Partly Convertible Debentures, Partly Convertible withKhokha (buy back arrangement), Optionally Convertible Debenture, Warrants convertible into Debentures or Shares, Secured Premium Noteswith warrants etc.

Secured premium notes: These instruments are issued withdetachable warrants and are redeemable after a notified period says 4 to 7years. The warrants enable the holder to get equity shares allottedprovided the secured premium notes are fully paid. During the lock inperiod no interest is paid. The holder has an option to sell back the SPNto the company at par value after the lock in period.

Equity shares with Detachable Warrants: The holder of the warrant iseligible to apply for the specified number of shares on the appointed dateat the predetermined price. These warrants are separately registered withthe stock exchanges and traded separately. The practice of issuing non-convertible debentures with detachable warrants also exists in the Indianmarket. Reliance has used this method.

Tracking Stocks: Dr. JJ Irani Expert Committee constituted by theGovernment to make recommendation on the Concept Paper on CompanyLaw has recommended in its report for the introduction of 'TrackingStocks' in the Indian Capital Market. A Tracking stock is a type ofcommon stock that "tracks" or depends on the financial performance of aspecific business unit or operating division of a company, rather than theoperations of the company as a whole. As a result, if the unit or divisionperforms well, the value of the tracking stocks may increase, even if thecompany's performance as a whole is not up to mark or satisfactory. Theopposite may also be true.

Bonds

Following kinds of bonds may be issued:-

Deep Discount bond: A bond that sells at a significant discount from par value and has no coupon rate or lowercoupon rate than the prevailing rates of fixed-income securities with a similar risk profile.They are designed to meet the long term funds requirements of the issuer and investors whoare not looking for immediate return and can be sold with a long maturity of 25-30 years at adeep discount on the face value of debentures.Example IDBI and SIDBI had issued this type ofinstrument. For a deep discount price of Rs. 2700/- in IDBI the investorgot a bond with face value of Rs. 100000/-. The bond appreciates to itsface value over the maturity period of 25 years. Alternatively, the investorcan withdraw from the investment periodically after 5 years.

Disaster Bonds: These are issued by companies and institutions toshare the risk and expand the capital to link investors return with the sizeof insurer losses. The bigger the losses, the smaller the return and vice-versa. The coupon rate and the principal of the bonds are decided by theoccurrence of the casualty of disaster and by the possibility of borrowerdefaults.

Option bonds: This instrument covers those cumulative and non-cumulative bonds where interest is payable on maturity or periodicallyand redemption premium is offered to attract investors.

Easy Exit Bonds: This instrument covers both bonds which provideliquidity and an easy exit route to the investor by way of redemption orbuy back where investors can get ready encashment in case of need towithdraw before maturity.

Pay in Kind Bonds: This refers to bonds wherein interest for the firsttime three to five years is paid through issue of additional bonds, whichare called baby bonds as they are derived from parent bond.

Split Coupon Debentures: This instrument is issued at a discountedprice and interest accrues in the first two years for subsequent payment incash. This instrument helps better management of cash outflows in a newproject depending upon cash generating capacity.

Other bonds like floating rate bonds and notes, clip and strip bonds, Dualconvertible Bonds, Debt Instruments with Debt warrants, Indexed RateNotes, Stepped coupon Bonds, Dual Option Warrants, Extendable notes,Level pay floating rate notes, Industrial Revenue Bonds, Commoditybonds, Zero Coupon Convertible Notes, Foreign Currency ConvertibleBonds (FCCBs), are issued by the companies.

9.3.2 Participants in Securities Market

Participants or intermediaries are the agents responsible for maintaining coordination between the issuer and the investor.They take a lot of responsibilities from the time an issuer, issues time to an investor to invest in the securities.So, there are many kinds of intermediaries and we will discuss each in detail, as you will read about every intermediary, all those finance articles in the newspaper will never haunt you again.Without the intermediaries, it will become very difficult for the investors and the issuers to locate each other, so under the SEBI (Intermediaries) Regulations, 2008, following are the type of intermediaries:

Asset Management Companies (AMCs): AMCs offer a variety of securities to the investors and are allowed to pool the money of the investor. They get a fee for rendering their services. They get a fee for rendering their services.

Portfolio Managers: The difference between AMC and the Portfolio Managers is that the Portfolio Managers cannot pool the money of the investors and also cannot offer securities to the investors.They just maintain the portfolio of the securities in which the investor has invested. They also charge fees for their services, why would anyone work without money?

Merchant Bankers: These are the dudes many people inclined towards the finance want to become; one of the highly paid and lucrative jobs.You can call them Lead managers, Issue managers, or Investment Bankers. They assist the issuer in advising, managing, consulting for the securities.

Investment Bankers: These guys will evaluate the capital requirement of the issuer, price the instrument, and manage the entire process until the securities are issued.

Underwriters: To issue the securities, the companies go to the underwriters, for a company to list its shares, 90 percent of the shares have to be subscribed, but what if the 90 percent subscriptions are not received?Then, these underwriters buy the remaining shares which are not subscribed and the company is then able to list its shares in the market.

Stock Brokers: Stockbrokers are responsible for the new issuance of the securities to the investors. These are the registered trading members on the stock exchange.

Sub Brokers: These are a support to the stockbrokers and perform analysis, research about the securities and help reach out the investors for the stock brokers.

Banker to an issue: These are the banks who are appointed to collect the payment from the investors; they send the record of collection to the lead managers, the application and detail of the investors to the registrars and the money into the issuer account.

Registrars and Share transfer agents: They keep the record of the investors to the securities. They keep a record of their names, nominee, address and the signatures.But, nowadays it is automatically recorded in the depositories. They keep a record of any transfer of the securities.

Depository Participants: Nowadays, all the records are maintained electronically in a demat account, so the securities that the investors buy are known to be in the dematerialized form.So to buy them, one needs to have a demat account, these depository participants create demat account for the investors. The depository participants handle the investor’s level account as well as the issue level accounts.

Custodians in Securities: They are majorly the big banks who manage the portfolio for the institutional investors. They keep account of the securities and money after the trade has been made by the broker and also manages their delivery and money. In India NSDL, CDSL are the custodians in securities.

Trustees: These are the participants who are responsible to supervise if the investors’ money is being managed in the best possible way.

Credit Rating Agencies: An investor cannot perform full fledge research on the company we want to invest because of the lack of expertise and also that we do not have access to the internal documents. These credit rating agencies evaluate the companies on their capacity to repay the obligations these companies have against them and rate them accordingly. Some credit rating agencies are CRISIL, ICRA, and CARE.

Investment Advisers: These are the people who help the investors to make a decision about the securities they need to invest on the basis of time horizons, risk preference and return expectations of the investors.

9.4 Check Your Progress

1. Which organisation regulates security market?
   a) Government of India
   b) RBI
   c) SEBI
   d) None of the above
2. Debt market is a place where _______________ are bought and sold
   a) Debt Securities
   b) Shares
   c) Commodities
   d) Gold
3. Government Securities are Sovereign rated debt papers issued by the Government.
   a) True
   b) False
4. As compared to Government Securities, corporate bonds may turn out to be less risky.
   a) True
   b) False
5. ____________ refers to the market where the requirement or arrangement of funds is for a period of less than one year.
   a) PSU Bond Market
   b) Money market
   c) G-secs
   d) Corporate deposits

9.5 Summary

The security market performs an important role in capital formation of theeconomy facilitating intermediate and long term funds. All the sectors whether government, private, or PSUs need funds for smoothly function of their activities. Government generates revenue in the form of taxes and income from ownership of assets. Besides these, it borrows extensively from banks, financial institutions, and the public to finance its expenditure in excess of its revenues. Government securities are issued by a government towards raising a loan from the public. Reason behind raising government securities is to finance important projects and budget deficits. Government securities comprise of bearer bonds,

promissory notes, bonds held in the bond ledger account, etc. Inprivate, PSUsectors money is the lubricant oil for the ever turning wheels of business. Therefore, these sectors need huge volume of funds to start, run and expand the business, such fund requirementcan only be availed through capital market. They can mobilise money through shares, preference shares, debentures, bonds etc. Every security market instruments have their own advantages, disadvantages, risk, and return. For example government securities are considered as one of the safest forms of investment as sovereign guarantees back these, but return is less as compared to shares, corporate bonds. Likewise shares, corporate bonds are riskier than government security, but return is higher as compared to government security. There are many participants in security markets such as bankers, brokers, sub-brokers, depositories, credit rating agencies. An investors with the help of these participants choose the securities as per his requirement like return, time, and risk appetite etc. then buy and sell these securities to earn capital gains, and enjoy a stable interest payment on their investment.

9.6 Keywords

- **Security Market:** It's where trades of securities such as stocks and bonds take place based on demand and supply.
- **Government Security:** Government securities are debt instruments that a sovereign government.
- **Risk:** Risk is the possibility of something bad happening (in finance it is loss of money).
- **Return:** A measures the gain or loss generated on an investment relative to the amount of money invested.
- **Share:** A share is one of the equal parts into which a company's capital is divided, entitling the holder to a proportion of the profits.
- **Debentures:** A long-term security yielding a fixed rate of interest, issued by a company and secured against assets.
- **Bonds:** A bond is a fixed income instrument that represents a loan made by an investor to a borrower.
- **T-Bills:** These are government bonds or debt securities with maturity of less than a year.
- **Preference Share:** A share which entitles the holder to a fixed dividend, whose payment takes priority over that of ordinary share dividends.
- **Dividend:** A sum of money paid by a company to its shareholders out of its profits

- **Interest:** Money paid regularly at a particular rate for the use of money lent, or for delaying the repayment of a debt.
- **Discount Rate:** The discount rate is the interest rate used to calculate the present value of future cash flows from a project or investment.

9.7 Self-Assessment Test

1. What do you mean by government security market? What are the features, advantage, and risk involved with government securities?
2. Explain government security market? What risk involved with this market? How an investor can mitigate this risk?
3. Explain segments of Dated Government Securities in India.
4. Describe government security. What are various types of Government Securities available in India?
5. What is private, PSUs security market? What type of instruments issued in this market to raise funds?
6. Explain private, PSUs security market. Also explain various participants who function in this market.
7. What is the process of issuing government securities?
8. Write short note on:
    - Treasury Bills
    - STRIPS
    - Fixed & Floating rates bonds
    - Deep Discount Bonds

9.8 Answers to check your progress

1(c), 2 (a), 3(a), 4 (b), 5(b)

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Course: Indian Financial System	
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RBI: Organization, Management, Functions, Credit Creation and Credit Control

STRUCTURE:

10.0 Learning Objectives

After going through this lesson, the learner will be able:

- To know about the history of Reserve Bank of India (RBI).
- To describe the organization and management of RBI.
- To explain the functions and roles of RBI.
- To explain the techniques of Credit Creation and Credit Control.

10.1 Introduction

In the monetary system of all countries, the central bank occupies an importantplace. The Central bank of a country enjoys a special status in the banking structureof the country. It is an apex institution of the monetary system, which seeks toregulate the functioning of the commercial banks of a country. It is a monetaryauthority of the country and has to function in a manner so as to promote economicstability and development. The Central Bank of Indiais called the Reserve Bank ofIndia which was set up in 1935.

Macro-economic environment in India is affected by the monetary policy andfiscal policy. Monetary policy refers to the regulation and control of money supplyand credit by the monetary authority of a country. This chapter analyzes history ofReserve Bank of India, functions of RBI, instruments of credit control and mainfeatures of Reserve Bank of India.

10.1.1. The Genesis of Central Banking in India

In 1926, the Royal Commission on Indian Currency and Finance (Hilton Young Commission) recommended that dichotomy of functions and division of responsibilities for control of currency and credit should be ended. The Commission suggested the establishment of a central bank to be called the Reserve Bank of India, whose separate existence was considered necessary for augmenting banking facilities throughout the country. The Bill to establish the Reserve Bank of India (RBI) was introduced in January 1927 in the Legislative Assembly, but it was dropped due to differences in views regarding ownership, constitution and composition of its Board of Directors. The White Paper on Indian Constitutional Reforms (1933) proposed the setting up of the RBI free from political influences. The Indian Central Banking Enquiry Committee (1931) had also strongly recommended the establishment of a Reserve Bank. These events led to the introduction of a fresh Bill in 1933. The Bill was passed in 1934 and the RBI Act came into force on January 1, 1935. The Reserve Bank was inaugurated on April 1, 1935.It was inaugurated with a share capital of Rs. 5Crore, divided into shares of Rs.100 each fully paid. In the beginning, the entireshare capital was owned by private shareholders.

Central banks occupy a pivotal position in the institutional fabric of an economy. The evolution of central banking in the Indian context has its own specificity. The RBI, while discharging its statutory responsibilities, has played a crucial role in the nation building process, particularly in the development of the financial sector. In fact, institution building constitutes a distinguishing feature of central banking in India. For analytical convenience,evolution of central banking in India over the period 1935-2005 is sub-divided into three broad phases: foundation phase (1935-1950), development phase (1951-1990) and reform phase (1991 onwards).

a) **Foundation Phase (1935-50):**During most of the formation phase it was a private bank, though formed under a statute and overseen by the then colonial government. The functions of the Bank during this phase were confined essentially to traditional central banking, *i.e.*, note issue authority and banker to the Government. During the war and post war years, its major preoccupation was facilitation of war finance, repatriation of sterling debt and planning and administration of exchange control. Upon the nationalization of the Bank in 1949 in terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 and the enactment of the Banking Regulation Act, 1949, regulation and supervision of banks received the focus. On the initiative of the Reserve Bank, the Government appointed the Rural Banking Enquiry Committee in1949 to consider important policy issues relating to the extension of banking facilities in the country.
b) **Development Phase (1951-1990):**With the launching of five-year plans, the Bank's functions became more diversified in terms of plan financing and establishment of specialized institutions to promote savings and investment in the Indian economy and meet the credit requirements of the priority sectors. Two important events during the 1960s – the devaluation of the rupee in June 1966 and nationalization of 14 private commercial banks in July 1969 – greatly influenced the functions of the Reserve Bank in the subsequent years. Externally, the uncertainties in the global economy following the breakdown of the Bretton Woods system of stable exchange rates and the emergence of the floating regimes exacerbated by the oil shock of 1973-74 presented serious challenges for exchange rate management and gave rise to balance of payments difficulties in India as in many other developing countries. The Government re-focused on the Foreign Exchange Regulation Act (FERA), 1947 for conserving foreign exchange rather than regulating the entry of foreign capital. The FERA, 1973 was drafted incorporating the changes necessary for effective implementation of the Government policy and removing the difficulties

in the working of the existing legislation. The major responsibilities devolving on the Reserve Bank during the 1970s related to regulation and management of the country's scarce foreign exchange reserves and expansion in the volume and scope of its refinance facilities for agriculture and rural development. During the 1980s, monetary policy assumed a new focus. On the whole, the development phase was characterized by a plethora of controls and regulations in the Indian economy.

c) **Reform Phase (1991 Onwards):** The process of liberalization and globalization the Indian economy initiated since 1991 added several new dimensions to the responsibilities of the Reserve Bank. Along with financial sector reforms, the monetary policy framework has been fine-tuned and the conventional central banking functions including those of currency management and payment and settlement systems have been revamped in tandem with the global trends and domestic expediency. The reform measures in the financial sector and the initiatives taken by the Reserve Bank for developing financial markets to ensure efficient transmission of monetary policy impulses, constituted the hallmark of this phase. The first phase of reforms, guided by the recommendations of the Committee on Financial System (Narasimham Committee-I), aimed at enhancing the operational flexibility and functional autonomy of the financial sector with a view to fostering efficiency, productivity and profitability. The second phase, based on the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee-II), focused on strengthening the foundations of the banking system and bringing about structural improvements.

10.2 The Reserve Bank of India: Organization and Management

The Reserve Bank of India after its establishmenton April 1, 1935took over the function of issuing paper currency from the Government of India and of controlling credit from the Imperial Bank of India.The Central Office of the Reserve Bank was initially established in Kolkata but was permanently moved to Mumbai in 1937. The Central Office is where the Governor office exists and where policies are formulated.

10.2.1 Preamble

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."

The preamble prescribes the objectives as: to secure monetary stability within the country and to operate the currency and credit system to the advantage of the country. In other words, the objectives of the RBI are price stability and ensuring adequate credit availability to finance economic activities for the benefit of the country.

10.2.2 Management of Reserve Bank of India

The Reserve Bank of India had a paid-up capital of Rs. 5 Croresdivided into 5 lakhs shares of Rs. 100 each. The Government of India owns all shares. The management is vested in the Central Board of Directors oversees the Reserve Bank's business. The Central Board has primary authority for the oversight of the Reserve Bank. It delegates specific functions to its committees and sub-committees. The total members in Central Board of Directors are twenty whose description is as given below:

1. 1 Governor and 4 Deputy Governors appointed by the Government of India for a period of five years. Their salary, etc., are decided by the Central Board of Directors in consultation with the Government of India.
2. 4 Directors nominated from the local boards, located at Mumbai, Kolkata, Chennai and New Delhi by the Government of India. Their tenure is also five years.
3. Ten other directors nominated by the Government of India with expertise in various segments of the economy for a term offour years each.
4. An official of the Government of India to attend the meetings of the Central Board. His tenure is not fixed and he does not enjoy the right to vote in the meetings.
5. The Central Board is required, under the Act, to meet at least six times a year. At least 1 meeting at a minimum in each quarter must be called. The Governor of the Reserve Bank can call the meeting of the Central Board, whenever he thinks necessary. Each local board has at least four members, appointed by the Government of India for a period of four years and representing all interests. The local boards render advice to the Central Board and also perform the various jobs assigned to them by the Central Board.

The details about the central board and its committees and sub-committees include the following:

Central Board

The Reserve Bank's affairs are governed by a Central Board of Directors. The Central Board is appointed or nominated by the Government of India in keeping with the Reserve Bank of India Act for a period of four years. It consists of official directors and non-official directors.

Official directors: The governor and not more than four deputy governors are full-time official directors.

Non-official directors: They are fifteen in number. Ten directors from various fields and one government official are nominated by the government while four directors from four local boards are nominated as non-official directors.

The functions of the central board are general superintendence and direction of the bank's affairs. It oversees the current business of the central bank and typically meets every week, on Wednesdays. The agenda focuses on current business, including approval of the weekly statement of accounts related to the Issue and Banking Departments.

Local Boards

There are four local boards, one each for the four regions of the country in Mumbai, Kolkata, Chennai and New Delhi. The membership of each local board consists of five members appointed by the central government for a term of four years.

The functions of the local board is to advise the central board on local matters; to represent territorial and economic interns of local cooperative and indigenous banks' interests, and to perform such other functions as delegated by the central board from time to time.

Board of Financial Supervision

The Reserve Bank of India performs the supervisory function under the guidance of the Board for Financial Supervision (BFS). The Board was constituted in November 1994 as a committee of the Central Board of Directors under the Reserve Bank of India (Board for Financial Supervision) Regulations, 1994.It regulates and supervises commercial banks, Non-Banking Finance Companies (NBFCs), development finance institutions, urban co-operative banks and primary dealers.

Board for Payment and Settlement Systems

It regulates and supervises the payment and settlement systems.

Sub-committees of the Central Board

It includes those on Inspection and Audit; Staff; and Building. Focus of each sub-committee is on specific areas of operations.

10.2.3 Organization of the Reserve Bank

The bank is managed by a central board of directors and four local boards of directors.

The Governor is the Reserve Bank's chief executive. The Governor supervises and directs the affairs and business of the Reserve Bank. The management team also includes Deputy Governors and Executive Directors.

The RBI is made up of:

1. **26 Departments:** These focus on policy issues in the Reserve Bank's functional areas and internal operations.
2. **26 Regional Offices and Branches:** These are the Reserve Bank's operational arms and customer interfaces, headed by Regional Directors. Smaller branches / sub-offices are headed by a General Manager / Deputy General Manager.

3. **Training Centers:**The Reserve Bank Staff College at Chennai addresses the training needs of RBI officers; the College of Agricultural Banking at Pune trains staff of co-operative and commercial banks, including regional rural banks. The ZonalTraining Centers, located at regional offices, train non-executive staff.

4. **Research institutes:** RBI-funded institutions to advance training and research on banking issues, economic growth and banking technology, such as, National Institute of Bank Management (NIBM) at Pune, Indira Gandhi Institute of Development Research (IGIDR) at Mumbai, and Institute for Development and Research in Banking Technology (IDRBT) at Hyderabad.

5. **Subsidiaries:** Fully-owned subsidiaries include National Housing Bank (NHB), Deposit Insurance and Credit Guarantee Corporation (DICGC), Bharatiya Reserve Bank Note Mudran Private Limited (BRBNMPL). The Reserve Bank also has a majority stake in the National Bank for Agriculture and Rural Development (NABARD).

10.2.4 Legal Framework

There are various acts governing the Reserve Bank functions, specific functions, banking operations and individual institutions owned by RBI. These are:

1. Umbrella Acts

- The Reserve Bank of India Act, 1934 governs the Reserve Bank functions.
- The Banking Regulation Act, 1949 governs the financial sector.

The RBI Act, alongwith the Banking Regulation Act, 1949, provides wide-ranging powers to the Reserve Bank to issue directions to the banking and financial sectors.

2. Acts Governing Specific Functions

- The Public Debt Act, 1944/The Government Securities Act, 2006 govern government debt market.
- The Securities Contract (Regulation) Act, 1956 regulates government securities market.
- The Indian Coinage Act, 1906 governs currency and coins.
- The Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999 govern foreign exchange market.

3. Acts Governing Banking Operations

- The Companies Act, 1956 governs banks as companies.
- The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/ 1980, relate to nationalization of banks.
- The Banker's Books Evidence Act, 1891.
- The Banking Secrecy Act, 1970.
- The Negotiable Instruments Act, 1881.

4. Acts Governing Individual Institutions

- The State Bank of India Act, 1954.
- The Industrial Development Bank of India Act, 1964.
- The Industrial Finance Corporation of India Act, 1948.
- The National Bank for Agriculture and Rural Development Act, 1981.
- The National Housing Bank Act, 1987.
- The Deposit Insurance and Credit Guarantee Corporation Act, 1961.

10.3 Main Functions of RBI

The Central Bank is the apex monetary institution in the money market. It acts as the monetaryauthority of the country and serves as the government bank as well as the bankers' bank. Itundertakes the major financial operations of the government. It influences the behaviorof financial institutions to ensure that they support the economic policy of government.

The main function of the Central Bank is to regulate the monetary mechanism comprising of thecurrency, banking and credit systems. For this purpose, the bank is given wide powers. Anotherimportant function of the central bank is to conduct the banking and financial operations of thegovernment. Besides, it discharges certain other functions. These functions are performed withthe service motive and not for making profits.

The Reserve Bank is the umbrella network for numerous activities, all related to the nation's financial sector, encompassing and extending beyond the functions of a typical central bank. An overview of primary activities of RBI as given below:

1) Monetary Authority
2) Issuer of Currency
3) Banker and Debt Manager to Government
4) Banker to Banks

5) Regulator of the Banking System

6) Manager of Foreign Exchange

7) Regulator and Supervisor of the Payment and Settlement Systems

8) Developmental Role

10.3.1 Primary Activities of RBI

1) Monetary Authority

Monetary policy refers to the use of instruments under the control of the central bank to regulate the availability, cost and use of money and credit. The goal of monetary policy is to achieve specific economic objectives such as low and stable inflation and promoting growth. RBI monitors and analyses the movement of a number of indicators including interest rates, inflation rate, money supply, credit, exchange rate, trade, capital flows and fiscal position, along with trends in output as it develops its policy perspectives. The Reserve Bank's Monetary Policy Department (MPD) formulates monetary policy. The Financial Markets Department (FMD) handles day-to-day liquidity management operations. There are several direct instruments such as

Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR) andRefinance Facilities and indirect instruments such as Liquidity Adjustment Facility (LAF), Open Market Operations (OMO), Market Stabilization Scheme (MSS), Repo/ Reverse Repo Rate and Bank rate are used in the formulation and implementation of monetary policy.

The Reserve Bank explains the relative importance of its objectives in a given context in a transparent manner, emphasizes a consultative approach in policy formulation as well as autonomy in policy operations and harmony with other elements of macroeconomic policies. The monetary policy formulation is aided by advice and input from:

- Technical Advisory Committee on Monetary Policy
- Pre-policy consultations with bankers, economists, market participants, chambers of commerce and industry and other stakeholders
- Regular discussions with credit heads of banks
- Feedback from banks and financial institutions
- Internal analysis

The RBI's Annual Policy Statements, announced in April, are followed by three quarterly reviews, in July, October and January. A detailed background report — *Review of Macro Economic and Monetary*

Developments — is released the day before the policy review. Faced with multiple tasks and a complex mandate, the RBI emphasizes clear and structured communication for effective functioning. Improving transparency in decisions and actions is a constant endeavor of RBI. The RBI looks at both short term and longer term issues related to liquidity management.

2) Issuer of Currency

The RBI is the nation's sole note issuing authority. Along with the Government of India, RBI is responsible for the design and production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. The Reserve Bank also makes sure there is an adequate supply of coins, produced by the government. In consultation with the government, RBI routinely addresses security issues and targets ways to enhance security features to reduce the risk of counterfeiting or forgery.

The Department of Currency Management in Mumbai, in cooperation with the Issue Departments in the Reserve Bank's regional offices, oversees the production and manages the distribution of currency. Currency chests at more than 4,000 bank branches—typically commercial banks—contain adequate quantity of notes and coins so that currency is accessible to the public in all parts of the country. The Reserve Bank has the authority to issue notes up to value of Rupees Ten Thousand.

Four printing presses actively print notes: Dewas in Madhya Pradesh, Nasik in Maharashtra, Mysore in Karnataka, and Salboni in West Bengal. The presses in Madhya Pradesh and Maharashtra are owned by the Security Printing and Minting Corporation of India (SPMCIL), a wholly owned company of the Government of India. The presses in Karnataka and West Bengal are set up by BRBNMPL, a wholly owned subsidiary of the Reserve Bank. Coins are minted by the Government of India. RBI is the agent of the Government for distribution, issue and handling of coins. Four mints are in operation: Mumbai, Noida in Uttar Pradesh, Kolkata, and Hyderabad.

RBI's Anti-counterfeiting Measures

- Continual upgrades of bank note security features.
- Public awareness campaigns to educate citizens to help prevent circulation of forged or counterfeit notes.
- Installation of note sorting machines.

RBI's Clean Note Policy

- Education campaign on preferred way to handle notes: no stapling, writing, excessive folding and the like.
- Timely removal of soiled notes: use of currency verification and processing systems and sorting machines.
- Exchange facility for torn, mutilated or defective notes: at currency chests of commercial banks and in Reserve Bank issue offices.

Focus continues on ensuring availability of clean notes and on strengthening the security features of bank notes. Given the volumes involved and costs incurred in the printing, transport, storage and removal of unfit/soiled notes, the RBI is evaluating ways to extend the life of bank notes—particularly in the lower denominations.

3) Banker and Debt Manager to Government

Managing the government's banking transactions is a key RBI role. Like individuals, businesses and banks, governments need a banker to carry out their financial transactions in an efficient and effective manner, including the raising of resources from the public. As a banker to the central government, the Reserve Bank maintains its accounts, receives money into and makes payments out of these accounts and facilitates the transfer of government funds. RBI also acts as the banker to those state governments that have entered into an agreement with it.

The role as banker and debt manager to government includes several distinct functions:

- Undertaking banking transactions for the central and state governments to facilitate receipts and payments and maintaining their accounts.
- Managing the governments' domestic debt with the objective of raising the required amount of public debt in a cost-effective and timely manner.
- Developing the market for government securities to enable the government to raise debt at a reasonable cost, provide benchmarks for raising resources by other entities and facilitate transmission of monetary policy actions.

At the end of each day, our electronic system automatically consolidates all of the government's transactions to determine the net final position. If the balance in the government's account shows a negative position, RBI extends a short-term, interest-bearing advance, called a Ways and Means Advance(WMA) the limit or amount for which is set at the beginning of each financial year in April.

The RBI's Government Finance Operating Structure

The RBI's Department of Government and Bank Accounts oversees governments' banking related activities. This department encompasses:

- **Public accounts departments:** manage the day-to-day aspects of our Government's banking operations. The Reserve Bank also appoints commercial banks as its agents and uses their branches for greater access to the government's customers.
- **Public debt offices:** provide depository services for government securities for institutions and service government loans.
- **Central Accounts Section at Nagpur:** consolidates the government's banking transactions.

The Internal Debt Management Department based in Mumbai raises the government's domestic debt and regulates and develops the government securities market. RBI plans to enhance efficient and user-friendly conduct of banking transactions for central and state governments while ensuring cost-effective cash and debt management by deepening and widening of the market for government securities.

RBI as the Governments' Debt Manager

In this role, RBI sets policies, in consultation with the government and determines the operational aspects of raising money to help the government finance its requirements:

- Determine the size, tenure and nature (fixed or floating rate) of the loan.
- Define the issuing process including holding of auctions.
- Inform the public and potential investors about upcoming government loan auctions

The Reserve Bank also undertakes market development efforts, including enhanced secondary market trading and settlement mechanisms, authorization of primary dealers and improved transparency of issuing process to increase investor confidence, with the objective of broadening and deepening the government securities market.

4) Banker to Banks

Like individual consumers, businesses and organizations of all kinds, banks need their own mechanism to transfer funds and settle inter-bank transactions - such as borrowing from and lending to other banks – and customer transactions.

As the banker to banks, the Reserve Bank fulfills this role. In effect, all banks operating in the country have accounts with the Reserve Bank, just as individuals and businesses have accounts with their banks.

As the banker to banks, RBI focuses on:

- Enabling smooth, swift and seamless clearing and settlement of inter-bank obligations.

- Providing an efficient means of funds transfer for banks.
- Enabling banks to maintain their accounts with us for purpose of statutory reserve requirements and maintain transaction balances.
- Acting as lender of the last resort.

The RBI provides similar products and services for the nation's banks to what banks offer their own customers. RBI helps the banks by Non-interest earning current accounts, deposit account department, remittance facilities, lender of the last resort and Loans & advances. RBI is planning to implement core banking solutions for its customers to enhance the safety and efficiency of the payments and settlement services in the country.

5) Regulator of the Banking System

Banks are fundamental to the nation's financial system. The central bank has a critical role to play in ensuring the safety and soundness of the banking system—and in maintaining financial stability and public confidence in this system. As the regulator and supervisor of the banking system, the RBI protects the interests of depositors, ensures a framework for orderly development and conduct of banking operations conducive to customer interests and maintains overall financial stability through preventive and corrective measures.

The Reserve Bank regulates and supervises the nation's financial system. Different departments of the Reserve Bank oversee the various entities that comprise India's financial infrastructure. RBI oversees commercial banks and all-India development financial institutions, urban co-operative banks,Regional Rural Banks (RRB), District Central Cooperative Banks, State Co-operative Bank and Non-Banking Financial Companies (NBFC).

The Reserve Bank makes use of several supervisory tools such as on-site inspections; Off-site surveillance, making use of required reporting by the regulated entities; and thematic inspections, scrutiny and periodic meetings. The Board for Financial Supervision oversees the Reserve Bank's regulatory and supervisory responsibilities.

The RBI's Regulatory Role

As the nation's financial regulator, the Reserve Bank handles a range of activities, including

- Licensing
- Prescribing capital requirements
- Monitoring governance

- Setting prudential regulations to ensure solvency and liquidity of the banks
- Prescribing lending to certain priority sectors of the economy
- Regulating interest rates in specific areas
- Setting appropriate regulatory norms related to income recognition, asset classification, provisioning, investment valuation, exposure limits and the like
- Initiating new regulation

6) Manager of Foreign Exchange

With the transition to a market-based system for determining the external value of the Indian rupee, the foreign exchange market in India gained importance in the early reform period. In recent years, with 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.

The Reserve Bank plays a key role in the regulation and development of the foreign exchange market and assumes three broad roles relating to foreign exchange:

- Regulating transactions related to the external sector and facilitating the development of the foreign exchange market.
- Ensuring smooth conduct and orderly conditions in the domestic foreign exchange market.
- Managing the foreign currency assets and gold reserves of the country.

The Reserve Bank is responsible for administration of the Foreign Exchange Management Act, 1999 and regulates the market by issuing licenses to banks and other select institutions to act as Authorized Dealers in foreign exchange. The Foreign Exchange Department (FED) is responsible for the regulation and development of the market. 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. The Department of External Investments and Operations (DEIO) invests the country’s foreign exchange reserves built up by purchase of foreign currency from the market.In investing its foreign assets, the Reserve Bank is guided by three principles: safety, liquidity and return.

The challenge for RBI is to liberalize and develop the foreign exchange market, with an eye toward ushering in greater market efficiency while ensuring financial stability in an increasingly global financial market environment. With current account convertibility achieved in 1994, the key focus is now on capital account management.

7) Regulator and Supervisor of Payment and Settlement Systems

Payment and settlement systems play an important role in improving overall economic efficiency. They consist of all the diverse arrangements that we use to systematically transfer money - currency, paper instruments such as cheques, and various electronic channels.

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, RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms.

The Reserve Bank has a two-tiered structure. The first tier provides the basic framework for our payment systems. The second tier focuses on supervision of this framework. As part of the basic framework, the RBI's network of secure systems handles various types of payment and settlement activities. Most operate on the security platform of the Indian Financial Network (INFINET), using digital signatures for further security of transactions.Here is an overview of the various systems used:

- **Retail payment systems:** Facilitating cheques clearing, electronic funds transfer, through National Electronic Funds Transfer (NEFT), settlement of card payments and bulk payments, such as electronic clearing services. Operated through local clearing houses throughout the country.
- **Large value systems:** Facilitating settlement of inter-bank transactions from financial markets. These include:
    - Real Time Gross Settlement System (RTGS): for funds transfers
    - Securities Settlement System: for the government securities market
    - Foreign Exchange Clearing: for transactions involving foreign currency
- **Department of Payment and Settlement Systems:** The Reserve Bank's payment and settlement systems regulatory arm.
- **Department of Information Technology:** Tech support for the payment systems and for the Reserve Bank's internal IT systems.

RBI is proactively identifying and addressing issues that help mitigate the risks for large value systems. Efforts on the retail payment system side will focus on operational efficiencies, cost effectiveness, innovation and risk management.

8) Developmental Role

This role is, perhaps, the most unheralded aspect of our activities, yet it remains among the most critical. This includes ensuring that credit is available to the productive sectors of the economy, establishing institutions designed to build the country's financial infrastructure, expanding access to affordable financial services and promoting financial education and literacy.

Over the years, the Reserve Bank has added new institutions as the economy has evolved. Some of the institutions established by the RBI include:

- Deposit Insurance and Credit Guarantee Corporation (1962), to provide protection to bank depositors and guarantee cover to credit facilities extended to certain categories of small borrowers.
- Unit Trust of India (1964), the first mutual fund of the country.
- Industrial Development Bank of India (1964), a development finance institution for industry.
- National Bank of Agriculture and Rural Development (1982), for promoting rural and agricultural credit.
- Discount and Finance House of India (1988), a money market intermediary and a primary dealer in government securities.
- National Housing Bank (1989), an apex financial institution for promoting and regulating housing finance.
- Securities and Trading Corporation of India (1994), a primary dealer.

The Reserve Bank continues its developmental role, while specifically focusing on financial inclusion. Key tools in this on-going effort include:

- **Directed credit for lending to priority sector and weaker sections:** The goal here is to facilitate/enhance credit flow to employment intensive sectors such as agriculture, micro and small enterprises (MSE), as well as for affordable housing and education loans.
- **Lead Bank Scheme:** A commercial bank is designated as a lead bank in each district in the country and this bank is responsible for ensuring banking development in the district through coordinated efforts between banks and government officials. The Reserve Bank has assigned a Lead District Manager for each district who acts as a catalytic force for promoting financial inclusion and smooth working between government and banks.

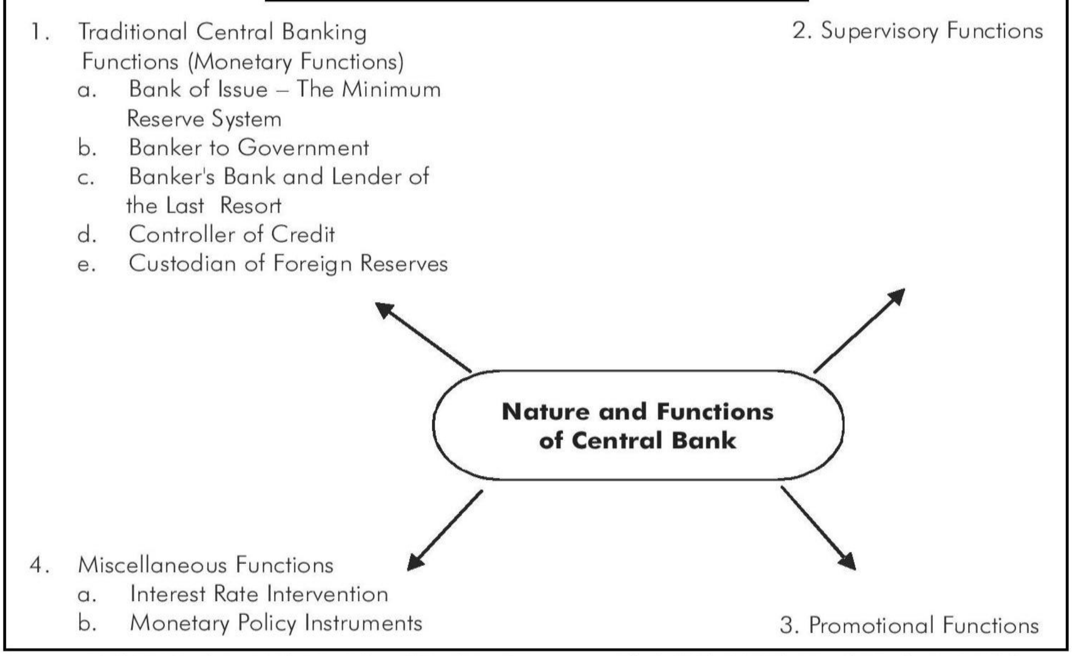
- **Sector specific refinance:** The Reserve Bank makes available refinance to banks against their credit to the export sector. In exceptional circumstances, it can provide refinance against lending to other sectors.
- **Strengthening and supporting small local banks:** This includes regional rural banks and cooperative banks
- **Financial Inclusion:** Expanding access to finance and promoting financial literacy are a part of our outreach efforts.

The development role of the Reserve Bank will continue to evolve, along with the Indian economy. Through the outreach efforts and emphasis on customer service, the Reserve Bank will continue to make efforts to fill the gaps to promote inclusive economic growth and stability.

In nutshell, the main functions of the Reserve Bank are as follows:

- To formulate, implement and monitor the monetary policy.
- To prescribe broad parameters of banking operations within which the country's banking and financial system functions.
- To facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.
- To issue and exchange or destroy currency and coins not fit for circulation.
- To perform a wide range of promotional functions to support national objectives.
- To perform merchant banking function for the central and the state governments.
- To maintain banking accounts of all scheduled banks.

Figure 3.2: Role and Functions of Central Bank



Source: Gulati, Neelam C, "*Principles of Banking Management*", (2010), (P-61), Excel Books Pvt. Ltd.

10.4 Credit Creation and Credit Control

Essentially, commercial banks are considered as dealers in credit. Interest is the pricing factorthat directs them in building business decision. These banks were initially started as institutions for meeting the short term credit requirements of trade industry and commerce and even today, it remains their primary function. In view of that requirement, the legal framework never put restrictions on the credit creation power of these banks. However, legislation always required the central bank of each country to oversee and control that power so that it may not be used to the detriment of social well-being.

10.4.1 Meaning of Credit Creation

Credit creation is one of the essential functions of a commercial bank. The term credit can bedefined in both narrow and broad senses. In broad terms, credit is finance that is made available by one party – lender, seller, or shareholder/owner – to another party – borrower, buyer, or abusiness firm. The former could be a pure lender – a financial institution or a private moneylender, a seller/supplier of goods on the promise of the buyer to make payment in future, or ashareholder/owner of a firm making funds available to the firm recognized as a separate entity.More commonly, the term credit is practiced in a narrow sense that is only for debt finance.Credit is simply the opposite of debt; both are created instantly by the same contract. It is aspecial sort of exchange transaction involving future payments, interest added to debt at its time value. This view of credit lies at the heart of modern commercial banking.The commercial banks create multiple expansions of their bank deposits and due to this, theseare called the factories of credit.

The customers have full faith on the bank. The banks expand loans by much more than theamount of cash possessed by them. This tendency on the part of the banks to lend more than theamount of cash possessed by them is called creation of credit in economics. Credit creationconstitutes the major component of money supply in the economy. Commercial banks differfrom other financial institutions in this aspect. Other financial institutions transfer money fromthe lenders to the borrowers.

While performing the same function, commercial banks create credit or bank money also. Theprocess of credit creation takes place when banks provide loans and advances and accepts deposits.When the customer deposits money with the bank, they are called primary deposits. This moneywill not be withdrawn by them immediately. Hence, banks keeps a certain amount of depositsas reserves which is known as cash reserve ratio and provide the balance amount as loans andadvances. Thus, each and every deposit creates a loan. Commercial banks give loans and advancesagainst some security to the public. But the bank does not give the amount of loan directly. Itopens an account in the name of the borrower and deposits the amount in that account. Thus,every loan creates a deposit. The loan amount can be withdrawn by means of cheques. Theycreate deposits while lending money as well. These deposits created by banks with the help ofprimary deposits are called derivative deposits. These loans are used by customers to make payments. While paying they issue a cheque againstthese deposits. The person who receives the cheque, deposit it in another bank. For that bank,this will be the primary deposit. A part of the deposit will be kept as a reserve and the balancewill be used for giving loans and advances. This process is repeated by other banks. When all thebanks are involved in this process, it is called Multiple Credit Creation.

Reserve Bank of India is the first source of supply of money in the form of currency in circulation.The central bank is the only note issuing authority of the country. The RBI ensures availabilityof currency to meet the transaction needs of the economy. The total volume of money in theeconomy should be enough to facilitate the various types of economic activities such as production,distribution and consumption. The commercial banks are the second most significant source ofmoney supply. The money supplied by commercial banks is called as the credit money.

Normally, banks create credit in two ways:

- By over drafting.
- By purchase of securities.

According to Benhen, "*A bank may receive interest simply by permitting a customer to overdraw theiraccount or by purchasing securities and having for them with its own cheques, thus, increasing the totalbank drafts. One should remember that single bank creates a very little credit. It is a whole banking systemwhich can expand the credit*."

Secondly when loans are advanced, it is not given in cash. The bank opens a deposit account inthe name of the borrower and allows him to withdraw whenever required.

Sometimes, a question arises that if the borrower withdraws these deposits for the repayment to other individual, then how will credit be created by the banks. The answer is that other individuals who receive money may also be the clients of the bank. Naturally they will also deposit their cash in the same bank. This process keeps on repeating itself. It can be better explained by the following example:

Example: Suppose a person deposits Rs. 1,000 in a bank. According to experience bank can keep 20% cash reserve to meet the demands of the depositors, and can lend the rest safely to the borrowers. If the entire bank maintains a reserve ratio of 20% then banks can succeed in creating a credit a credit of Rs. 5000 against an original deposit of Rs. 1,000 in cash.

10.4.2 Basis of Credit Creation

Bank deposit is the basis for credit money. The bank deposits are of two kindsviz., (1) Primary deposits and (2) Derivative deposits.

1. Primary Deposits: Primary deposits arise or spring up when cash or cheque is deposited by customers. When a person deposits cash or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants through cheque. These deposits are called "primary deposits" or "cash deposits." It is out of these primary deposits that the banks provide loans and advances to its customers. The initiative is taken by the customers themselves. In this case, bank plays a passive role. So, these deposits are also called "passive deposits." These deposits merely convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.

2. Derivative Deposits: Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called "derivative deposits." Since the bank play an active role in the creation of such deposits, they are also known as "active deposits." When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. No cash is paid by the bank to the banker for doing so. Customer is free to withdraw the amount whenever he require by the medium of cheque. Thus, the banker lends money in the form of deposit credit. The creation of a derivative deposit results in a net increase in the total supply of money in the economy; Hartly Withers says "every loan creates a deposit." It may also be said "loans make deposits" or "loans create deposits." It is rightly said that "deposits are the children of loans, and credit is the creation of bank clerk's pen."

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank purchase government securities or discounts a bill. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus, assets acquired by a bank create equivalent bank deposits. It is perfectly correct to state that "bank loans create deposits." The derivative deposits are regarded as bank money or credit. Thus, the power of commercial banks to expand deposits through loans, advances and investments is known as "credit creation." Thus, credit creation implies multiplication of bank deposits. Credit creation may be defined as "the expansion of bank deposits through the process of more loans and advances and investments."

10.4.3 Limitations of Credit Creation

Though commercial banks have the power to create credit, they possess limited powers. Certain factors affect the process of credit creation. They are termed as limitations to credit creation by commercial banks.

The limitations of credit creation by commercial banks are as follows:

- **Amount of Deposit:** The most significant factor which determines credit creation is the amount of deposits made by the depositors. Higher is the amount of deposits; greater is the supply of credit and vice versa.
- **Cash Reserve Ratio (CRR):** There exists an indirect relationship between Credit Creation and Cash Reserve Ratio. Higher is the Cash Reserve Ratio more will be the reserves to be maintained and less credit will be created by banks. The CRR is fixed by the RBI in India. It ranges from 3% to 15%.

- **Banking Habits of People:**If the banking habits of the people are well-developed, then all of their transactions would be through banks, and this will lead to expansion of credit and vice-versa.
- **Supply of Securities:** Loans are sanctioned on the basis of the securities provided to thebanks. If securities are available then the credit creation will be more and vice-versa.
- **Willingness of people to borrow:** Commercial banks may have enough money to lend.Customers should be willing to borrow from the banks to facilitate credit creation. If theyare willing to borrow, then the credit created by banks will be less.
- **Monetary Policy of Central Bank:** While credit is created by commercial banks, it iscontrolled by the Central Bank. Credit control is one important function of the centralbank. Central Bank uses various methods of Credit Control from time to time and thusinfluences the banks to expand or contract credit.
- **External Drain:** External Drain refers to withdrawal of cash from the banking system bythe public. It lowers the reserves of the banks and limits the credit creation.
- **Uniform Policy:** If all the commercial banks follow a uniform policy related to CRR, thencredit creation would be smooth. If some banks follow liberal and others follow aconservative one, then credit creation would be affected.

Thus, various limitations hinder the path of ability of the banks to create credit. Still, one shouldnot underestimate the significance of credit creation function of the banks. This function haslong-run implications on the functioning of the economy, particularly on the activities of business.Bank credit acts as the oil which lubricates the wheels of the business machine.

10.4.4 Meaning of Credit Control

The chief objective of the Central bank is the regulation and control of the aggregate money supply, currency and credit in the economy. The Reserve Bank of India is the controller of the credit, i.e. it has the power to influence the volume of credit created by banks. The banks have made use of both traditional and quantitative methods of credit control and selective or qualitative control.

10.4.5 Techniques of Credit Control

Several tools and techniques of credit control used by the Reserve Bank of India can be broadlycategorized as quantitative or general methods and qualitative or selective methods.

Quantitative or General Methods

The tools used by the central bank to influence the volume of credit in totality in the bankingsystem, without any regard for the use to which it is put, are called quantitative or generalmethods of credit control. These methods govern the lending power of the financial sector of thewhole economy and do not discriminate among the several spheres of the economy. The crucialquantitative methods of credit control are:

- **Bank Rate Policy:** The standard rate at which the central bank is ready to buy or rediscountbills of exchange or other commercial papers eligible for purchase under the provisions ofthe Act of RBI. Thus, the Reserve Bank of India rediscounts the first class bills in the handsof commercial banks to furnish them with liquidity in case of need. Bank rate is subjected to change from time to time in accordance with the economic stability and its credibility of the nation.

  The bank rate indicates the central bank's long-term outlook on interest rates. If the bankrate moves up, long-term interest rates also tend to move up, and vice-versa.

  Banks make a profit by borrowing at a lower rate and lending the same money at a higherrate of interest. If the RBI hikes the bank rate (this is currently 6 per cent), the interest thata bank pays for borrowing money (banks borrow money either from each other or fromthe RBI) increases. It, in turn, raises its own lending rates to ensure it continues to make aprofit.
- **Open Market Operations:** It means of enforcing monetary policy by which RBI controlsthe short term rate of interest and the supply of base money in an economy, and thusindirectly the total supply of money. In times of inflation, RBI sells securities to finish offthe excess money in the market. Similarly, to increase the money supply, RBI purchasessecurities.
- **Adjusting with CRR and SLR:** By adjusting the CRR (Cash Reserve Ratio) and SLR(Statutory Liquidity Ratio) which are short term tools to be used to shortly govern thecash and fund flows in the hands of the banks, people and government, the central bank ofIndia regularly make necessary alterations in these rates. These variations in the rates willeasily have a larger control over the cash flow of the country.
  - **CRR (Cash Reserve Ratio):** All commercial banks are required to retain a certainamount of its deposits in cash with RBI. This percentage is called the cash reserveratio. The present CRR requirement is 4 per cent. This serves two purposes. Firstly,it ensures that a part of bank deposits is totally risk-free and secondly it enables RBIto control liquidity in the system, and thereby, inflation by tying their hands inlending money

- **SLR (Statutory Liquidity Ratio):** Indian banks are required to maintain 25 per cent oftheir time and demand liabilities in government securities and certain approvedsecurities. What SLR does is again restrict the bank's leverage in lifting more moneyinto the economy by investing a part of their deposits in government securities as apart of their statutory liquidity ratio requirements.

- **Lending Rate:** Lending rates can be defined as the ratios fixed by RBI to lend the money to the customers on the basis of those rates. The higher the rate of lending signifies thecostlier credit to the customers. The lower the rate of lending signifies the credit to thecustomers is less which will encourage the customers to borrow funds from the banksmore that will facilitate the flow of more money in the hands of public.
- **Repo Rate:** Repo rate is the rate at which banks borrow funds from the central bank to fillthe gap between the demand they are facing for providing loans to their customers andhow much funds they have on hand to lend.If the RBI wants to make it more costly for the banks to borrow money, it hikes the reporate; similarly, if it wants to make it cheaper for banks to borrow money, it cuts the reporate.
- **Reverse Repo Rate:** The rate at which Reserve Bank of India borrows money from thebanks (or banks lend money to the RBI) is termed as the reverse repo rate. The RBI uses thisinstrument when it feels there is too much funds floating in the banking industry.If the reverse repo rate is rising up, it means the RBI will borrow money from the bank and offerthem a lucrative rate of interest. As a result, banks would prefer to keep their money with theRBI (which is absolutely risk free) in lieu of lending it out (this option comes with a certainamount of risk) to other customers.

Qualitative or Selective Methods

The tools used by RBI to govern the flows of credit into specific directions of the economy arecalled qualitative or selective methods of credit control. Unlike the quantitative methods, whichaffect the total volume of credit, the qualitative methods affect the types of credit extended bythe commercial banks; they affect the composition of credit rather than the size of credit in theeconomy. The important qualitative or selective methods of credit control are:

- **Marginal Requirements:** Every commercial bank has to keep a margin whenever it providesloans against the security. It means that the amount of loan is lower than the real value ofsecurity. For example: Actual value of security is 100 and the amount of loan is 85, therefore margin requirement is 15%.

Central bank can increase or decrease the supply of money by altering the requirements of margin. For example: if central bank wants to decrease the money supply it can do so by increasing the margin requirements. In this way amount of loans decreases.

- **Regulation of Consumer Credit:** Consumer credit facility refers to the act of selling aconsumer good on a credit basis to the customers. This tool is used by government orReserve Bank of India to enforce certain regulations on the goods that are sold on credit.If the central bank wants to increase the money supply it can do so by adopting a lenientpolicy about the credit for purchase of consumer goods. Similarly central bank can cut themoney supply by putting limitations on consumer credit.
- **Credit Rationing:** Central bank uses credit rationing to fix the credit ceiling allowed foreach and every commercial bank. The central bank fixes the credit limit for each commercial bank and does not give credit to them beyond that limit.

  Whenever the RBI desires to cut the supply of money, it decreases the limit up to which itcan give loans to the member banks. Likewise, central bank can increase the moneysupply by increasing the credit limit.
- **Moral Suasion:** In some cases central bank morally persuades or requests the commercialbanks not to get involved themselves in such economic activities which are unfavorableto the interest of the country. It regularly guides and proposes the member banks tofollow a specific policy for loans and abstain themselves from giving loan for speculativepurposes.
- **Direct Action:** Direct action is the last option through which central bank takes a directaction against the bank which does not act in conformity with the policy of Reserve Bankof India. In case of direct action the central bank can impose fine and penalty and can denygiving out loans to the commercial bank. Such type of force keeps commercial banks awayfrom unsought credit activities.
- **Publicity:** Central bank also publishes details concerning its policies and importantinformation about assets and liabilities, credit and business situation etc. of commercialbanks. This facilitates commercial banks as well as general public to realize the monetaryneeds of country. Central bank discloses some of the important information about thecommercial banks so that the people

know about the several activities of commercialbanks and can protect themselves from any potential loss in the future.

10.5 Check Your Progress

State whether the following statements are true or false:

1. A central bank controls certain types of long-term interest rates.
2. Through open market operations, a central bank influences the money supply in an economy directly.
3. Commercial banks can never expect the Reserve Bank of India to come to their help in times of banking crisis.
4. The Reserve Bank has to act as the custodian of India's reserve of international currencies.

Fill in the blanks

5. Direct action is the last option through which central bank takes a direct action against the bank which does not act in ……… with the policy of Reserve Bank of India.
6. This tool is used by government or Reserve Bank of India to enforce certain ……. on the goods that are sold on …………
7. Credit creation constitutes the major component of money supply in the………..
8. When the customer deposits money with the bank, they are called ………. Deposits.
9. ………….. bank is the first source of money supply in the form of currency in circulation.
10. The ……… banks are the second most important sources of money supply.
11. External Drain refers to …….. of cash from the banking system by the public.
12. Bank credit is the oil which ……….. the wheels of the business machine.
13. Loans are sanctioned on the basis of the …….. provided to the banks.
14. Credit is created by …….. Banks, it is controlled by the ……. Bank.

10.6 Summary

- The RBI Act 1934 was passed and the Reserve Bank of India became the first Central bank of the country w.e.f. 01.04.1935, it took over the Central Banking activities from the Imperial Bank of India.
- Banks can be classified as (a) Central Bank, (b) Public Sector Banks, (c) Private Sector Banks, and (d) Cooperative Banks.

- The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems.
- RBI performs its functions with the service motive and not for making profits.
- The Reserve Bank acts not only as the banker's bank but also as the lender of the last resort.
- CRR ensures that a portion of bank deposits is totally risk-free and it enables RBI to control liquidity in the system.
- Lending rates are the ratios fixed by RBI to lend the money to the customers on the basis of those rates.
- Repo rate is the rate at which banks borrow funds from the RBI to meet the gap between the demands they are facing for money.
- Every commercial bank has to keep a margin whenever it extends loans against the security.
- Regulation of Consumer credit is used by government or central bank to implement certain regulations on goods sold on credit.
- Credit creation is one of the essential functions of a commercial bank. Credit is finance that is made available by one party – lender, seller, or shareholder / owner – to another party – borrower, buyer, or a business firm.
- Credit is simply the opposite of debt; both are created instantly by the same contract. It is a special sort of exchange transaction involving future payments, interest added to debt at its time value.
- The commercial banks create multiple expansions of their bank deposits and due to this, these are called the factories of credit.
- Credit creation constitutes the major component of money supply in the economy. Commercial banks differ from other financial institutions in this aspect.
- Commercial banks give loans and advances against some security to the public. But the bank does not give the amount of loan directly. It opens an account in the name of the borrower and deposits the amount in that account.
- Reserve Bank of India is the first source of supply of money in the form of currency in circulation. The central bank is the only note issuing authority of the country. The RBI ensures availability of currency to meet the transaction needs of the economy.

10.7 Keywords

Active Deposits: Its id the other name for derivative deposits.

Bank Rate: The interest rate at which a nation's central bank lends money to domestic banks.

Borrow: Take and use money from a person or bank under an agreement to pay it back later.

Cash Reserve Ratio (CRR):CRR is the amount of funds that all Scheduled Commercial Banks excluding Regional Rural Banks are required to maintain without any floor or ceiling rate with RBI with reference to their total net Demand and Time Liabilities to ensure the liquidity and solvency of Banks.

Contraction: The act of decreasing (something) in size or volume or quantity or scope.

Credit: The ability to obtain goods or services before payment, based on the trust that payment will be made in the future.

Deposit:A sum of money placed or kept in a bank account, usually to gain interest.

Economy: The wealth and resources of a country or region, esp. in terms of the production and consumption of goods and services.

External Drain: It refers to withdrawal of cash from the banking system by the public. It lowers the reserves of the banks and limits the credit creation.

Governance: Governance is the act of governing. It relates to decisions that define expectations, grant power, or verify performance.

Insolvency: When an individual or organization can no longer meet its financial obligations with its lender or lenders as debts become due.

Interim: An interval of time between one event, process, or period and another.

Liquidity: The ability to convert an asset to cash quickly. Also known as "marketability."

Ownership: The relation of an owner to the thing possessed; possession with the right to transfer possession to others.

Passive Deposits: It is the other name for primary deposits.

Resilience: The physical property of a material that can return to its original shape or position after deformation that does not exceed its elastic limit.

Statutory Liquidity Ratio (SLR): The ratio of liquid assets to demand and time liabilities is known as Statutory Liquidity Ratio.

10.8 Self-Assessment Test

1. Discuss the role of RBI in Indian banking sector.
2. What do you understand by the different functions of RBI.

3. Explain how CRR and SLR help in regulating the cash and fund flows in the hands of people, banks and government?
4. What are the qualitative methods of selective credit control? Discuss in detail.
5. Name different quantitative methods of credit control and explain bank rate policy in detail.
6. Write notes on (a) Repo Rate, and (b) Reverse Repo Rate.
7. What are the various techniques of credit control?
8. What do you mean by ‘credit creation’?
9. What is the basis of credit creation?
10. What is the important aspect of the credit creating function of the commercial banks?
11. What are the limitations of credit creation?

10.9 Answer to Check Your Progress

1. False
2. True
3. False
4. True
5. Conformity
6. Regulation, Credit
7. Economy
8. Primary
9. Central
10. Commercial
11. Withdrawal
12. Lubricates
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14. Commercial,Central

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Course Code: Indian Financial System	
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Commercial Banks: Functions, Structure and Recent Developments in Indian Commercial Banking System

STRUCTURE:

11.0 Learning Objectives

After going through this lesson, the learner will be able:

- To know about the characteristics of Indian Commercial Banking System.
- To describe functions of commercial banks.
- To learn about the recent developments in Indian commercial banking system.

11.1 Introduction

11.1.1 Origin of Banking in India

Banking in India is indeed as old as the civilization. But, the banking functions became an effective force only after the first decade of 20th century. Banking is an ancient business in India with some of oldest references in the writings of Manu. Bankers played an important role during the Mogul period. During the early part of East India Company era, agency houses were involved in banking. Modern banking (i.e. in the form of joint-stock companies) may be said to have had its beginnings in India as far back as in 1786, with the establishment of the General Bank of India.

The Modern banking System started with the opening of Bank of England in 1964. Bank of Hindustan was the first bank to be established in India in 1770. The earliest institutions that undertook banking business under the British regime were agency houses which carried on banking business in addition to their trading activities. Most of these agency houses were closed down during 1929-32. Three Presidency Banks known as Bank of Bengal, Bank of Bombay and Bank of Madras were open in 1809, 1840 and 1843 respectively at then Calcutta, Bombay and Madras. These were later merged in to Imperial Bank of India in 1919 following a banking crisis.

The first bank of limited liability managed by Indians was Oudh Commercial Bank Started in 1881.Earlier between 1865 and 1870, only one bank, the Allahabad Bank Ltd., was established. Subsequently, Punjab National Bank started in 1894 with its office at *Anarkali Market* in Lahore (now in Pakistan). Swadeshi movement, which started in 1906, prompted formation of a number of commercial banks such as Peoples Bank of India Ltd., Central Bank of India, Indian Bank Ltd. and Bank of Baroda Ltd. Banking crisis between1913-1917 witnessed the failure of 588 banks. The Banking companies (inspection Ordinance) came in January 1946 and the Banking companies (Restriction of Branches) Act was passed in February 1946. The Banking Companies Act was passed in February 1946 which was later, amended to be known as Banking Regulation Act, 1949.

Meanwhile, the RBI Act, 1934 was passed and the Reserve Bank of India became the first Central Bank of the country *w.e.f.* 01.04.1935, it took over the Central Banking activities from the Imperial Bank of India. The RBI was nationalized on 1.1.1949. The Imperial Bank of India was partially nationalized to form State Bank of India in 1955. In 1959, subsidiaries of the SBI namely, State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Indore, State Bank of Mysore, State Bank of Patiala, State Bank of Saurashtra and State Bank of Travancore were established.

On July 19, 1969, the Govt. of India took over ownership and control of 14 major banks in the Country with deposits exceeding Rs. 50 Croreeach. Again on 15th April 1980, six more banks with total time and demand liabilities exceeding Rs. 200 Crore were nationalized. In 1993, one of the nationalized banks namely New Bank of India was merged with another nationalized bank i.e. Punjab National Bank.

11.1.2 Origin of the Word 'Bank'

The name bank is derived from the Italian word banco "desk/bench", used during the Renaissance by Florentine's bankers. These bankers used to make their transactions above a desk covered by a green tablecloth.There are traces of banking activity even in ancient times. In fact, the word traces its origins back to the ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed *courtyards called macella on a long bench called a bancu*. It is from here that the words banco and bank were derived.As a money changer, the merchant at the banco did not invest much money but merely converted the foreign currency into the only legal tender in Rome that is the Imperial Mint.

Another belief says that the word 'Bank' is said to be derived from French word "Bancus" or "Banque", i.e., a bench. It is believed that the early bankers, the Jews Lombardy, transacted their business on benches in the Market place. One more believe says that it is derived from German word "Back" meaning a Joint Stock Fund.

11.1.3 Meaning of Bank

In simple terms, a bank is an institution that accepts various types of deposits and then advances money in form of loans to people requiring it. Money and credit provide the pivot (axle) around which all the economic activities revolve. Banks are institutions, which accept deposits and use these funds to grant loans. Banks collect the surplus funds of millions of individual savers who are widely scattered. The money so collected is channelized to the investors i.e. people asking for loans for further investment purposes. Banks help in money growth and capital formation. They are reservoirs of resources for economic growth and development of the nation. They help in building the infrastructure, boosting the agriculture, setting up industries and aid to global trade. Thus, a bank, by discharging its functions effectively enhances the productive and industrious capacity of the nation and boosts the pace of growth. Banks are the heart of the financial system.

It is a financial institution that provides banking and other financial services to their customers.Kinley defines, “A bank is an establishment which makes to individuals such advance of money as may be required and safely made and to which individuals entrust money when not required by them for use”.

The definition of R.S. Sayers, however, reveals the true character of a modern bank. In his words, “Banks are institution whose debts usually referred to as bank deposits are commonly accepted in final settlement of other people’s debts”.

Under British Law, “A banker is one who in the ordinary course of his business, honors cheques drawn upon him by persons from and for whom he receives money on current accounts”. (Dr. Herbert L. Hart)

Under Indian law, Banking Regulation Act of India, 1949, “Accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft and order or otherwise” (Section 5b)

11.1.4 Characteristics of indian banking system

The characteristics/features of a bank may be listed as follows:

1. **Dealing in money:** bank is a business activity which deals with other people’s money i.e. Getting money from depositors and lending the same to borrowers.
2. **Banking business:** a bank is a financial institution which does banking activities of selling financial services like home loans, business loans, lockers, fixed deposit etc. In order to enable people to confirm that it is a bank and is dealing in money, for easy identification, a bank should add the word “bank” as its last name.
3. **Acceptance of deposit:** a bank accepts money from the people in the form of deposits where there is an obligation to refund deposits on demand or after the expiry of a fixed tenure as they feel it is a safest place to deposit money.
4. **Lending money:** a bank provides advance money in the form of loans to needy persons for promotion & development of business, purchase of home, car etc.
5. **Easy payment and withdrawal facility:** payment & withdrawal of money can be made through issuance of cheques& drafts, atm, online fund transfer without the need for carrying money in

hand. A bank provides easy payment and withdrawal facility to its customers in the form of cheques, drafts, atm's and etf.

6. Motive of profit with service orientation: a bank has a motive of employing funds received as deposits from the public in a profitable manner with service oriented approach.

7. Linking bridge: banks collect money from those who have surplus money and give the same to those who are in need of money. It acts as a trust/custodian of funds of its customers.

8. Ever increasing functions: banking is an evolutionary concept. There is continuous expansion and diversification as regards the functions, services and activities of a bank.

9. Banking business: a bank's main activity should be to do business of banking which should not be subsidiary to any other business.

10. Name identity: a bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.

11.1.5 Role of Banks

A proper financial sector is of special importance for the economic growth of developing and underdeveloped countries. The commercial banking sector which forms one of the backbones of the financial sector should be well organized and efficient for the growth dynamics of a growing economy. The importance of a sound system of commercial banking for a developing country may be depicted as follows:

1.capital formation: the rate of saving is generally low in an underdeveloped economy due to the existence of deep-rooted poverty among the people. Even the potential savings of the country cannot be realized due to lack of adequate banking facilities in the country. To mobilize dormant savings and to make them available to the entrepreneurs for productive purposes, the development of a sound system of commercial banking is essential for a developing economy.

2. Monetization: an underdeveloped economy is characterized by the existence of a large no monetized sector, particularly, in the backward and inaccessible areas of the country. The banks, by opening branches in rural and backward areas, can promote the process of monetization in the economy.

3. Innovations: innovations are an essential prerequisite for economic progress. These innovations are mostly financed by bank credit in the developed countries. But the entrepreneurs in underdeveloped countries cannot bring about these innovations for lack of bank credit in an adequate measure. The banks should, therefore, pay special attention to the financing of business innovations by providing adequate and cheap credit to entrepreneurs.

4. Finance for priority sectors: the commercial banks in underdeveloped countries generally hesitate in extending financial accommodation to such sectors as agriculture and small scale industries, on account of the risks involved there in. They mostly extend credit to trade and commerce where the risk involved is far less. But for the development of these countries it is essential that the banks take risk in extending credit facilities to the priority sectors, such as agriculture and small scale industries.

5. Provision for medium and long-term finance: the commercial banks in underdeveloped countries invariably give loans and advances for a short period of time. They generally hesitate to extend medium and long term loans to businessmen. It is well known that the new business need medium and long term loans for their proper establishment.

6. Cheap money policy: the commercial banks in an underdeveloped economy should follow cheap money policy to stimulate economic activity or to meet the threat of business recession. In fact, cheap money policy is the only policy which can help promote the economic growth of an underdeveloped country. It is heartening to note that recently the commercial banks have reduced their lending interest rates considerably.

7. Need for a sound banking system: a sound system of commercial banking is an essential prerequisite for the economic development of a backward country.

11.2 Commercial Banks

Commercial bank can be described as a financial institution that offers basic investment products like a savings account, current account, etc to the individuals and corporate. Along with that, it provides a range of financial services to the general public such as accepting deposits, granting loans and advances to the customers. It is a profit making company, which pays interest at a low rate to the depositors and charges higher rate of interest to the borrowers and in this way, the bank earns the profit.

11.2.1 Types of Commercial Banks

Commercial banks are classified into two categories i.e. scheduled commercial banks and non-scheduled commercial banks.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 commercial banks refer to the banks which are not covered in the Reserve Bank of India's second schedule. The paid-up capital of such banks is not more than Rs. 5 lakhs.Unlike scheduled banks, they are not entitled to borrow from the RBI for normal banking purposes, except, in emergency or "abnormal circumstances."

11.2.2 Functions of Commercial Banks

The functions of commercial banks are divided into two categories: Primary functionsand Secondary functions including agency functions.

1. Primary Functions

The primary functions of a commercial bank include:

(a) Accepting Deposits: The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. Example: If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

(b) Grant of Loans and Advances: The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the loans is the main source of a bank's income.

(i) Loans: A loan is granted for a specific time period. Generally, commercial banks grant short-term loans. But term loans, that is, loan for more than a year, may also be granted. The borrower may withdraw the entire amount in lump-sum or in installments. However, interest is charged on the full amount of loan. Loans are generally granted against the security of certain assets. A loan may be repaid either in lump-sum or in installments.

(ii) Advances: An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but advances are normally granted for a short period of time. Further, the purpose of granting advances is to meet the day to day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount. Modes of short-term financial assistance: Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting.

- **Cash Credit:** Cash credit is an arrangement whereby the bank allows the borrower to draw amounts up to a specified limit. The amount is credited to the account of the customer. The customer can withdraw this amount as and when he requires. Interest is charged on the amount actually withdrawn. Cash credit is granted as per agreed terms and conditions with the customers.
- **Overdraft:** Overdraft is also a credit facility granted by bank. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. It is a temporary arrangement. Overdraft facility with a specified limit is allowed either on the security of assets, or on personal security, or both.
- **Discounting of Bills**: Banks provide short-term finance by discounting bills that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonored on the due date, the bank can recover the amount from the customer.

2. Secondary Functions

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These are as follows:

(a) Issuing letters of credit, traveler'scheque, circular notes etc;

(b) Undertaking safe custody of valuables, important documents, and securities by providing safe deposit vaults or lockers;

(c) Providing customers with facilities of foreign exchange;

(d) Transferring money from one place to another; and from one branch to another branch of the bank;

(e) Standing guarantee on behalf of its customers, for making payments for purchase of goods, machinery, vehicles etc;

(f) Collecting and supplying business information;

(g) Issuing demand drafts and pay orders; and

(h) Providing reports on the credit worthiness of customers.

3. Agency Functions and General Utility Functions

Primary activities of commercial banks include acceptance of deposits from the public and lending money to businessmen and other members of society. Besides these two main activities, commercial banks also render a number of ancillary services. These services supplement the main activities of the banks. They are essentially non-banking in nature and broadly fall under two categories:

(a) Agency Services: Agency services are those services which are rendered by commercial banks as agents of their customers. They include:

- Collection and payment of cheque and bills on behalf of the customers;
- Collection of dividends, interest and rent, etc. on behalf of customers, if so instructed by them;
- Purchase and sale of shares and securities on behalf of customers;
- Payment of rent, interest, insurance premium, subscriptions etc. on behalf of customers, if so instructed;
- Acting as a trustee or executor;
- Acting as agents or correspondents on behalf of customers for other banks and financial institutions at home and abroad.

(b.) General Utility Services: General utility services are those services which are rendered by commercial banks not only to the customers but also to the general public. These are available to the public on payment of a fee or charge. They include:

- Issuing letters of credit and traveler'scheque;
- Underwriting of shares, debentures, etc.;
- Safe-keeping of valuables in safe deposit locker;
- Underwriting loans floated by government and public bodies;
- Supplying trade information and statistical customers;
- Acting as a referee regarding the financial status;
- Undertaking foreign exchange business.

11.2.3 Types of Accounts

A financial account between a bank and a customer is known as a bank account. Deposit accounts are those accounts which are opened with the purpose of holding credit balances whereas loan accounts are opened with the purpose of holding debit balances. Accounts are categorized by the function rather than nature of the balance they hold, e.g. savings account.

1. Current Account

An account which can be operated any number of times on a working day without any restriction on the number and amount of withdrawals is known as a current account. As the banker is under a responsibility to repay these deposits on demand, they are called deemed deposits.Current accounts suit the requirements of joint stock companies, public authorities, corporations, etc. whose banking transactions happen to be numerous per day. Cheque facility is available for the investor.

A current account carries certain privileges which are not available to other account holder.

- Third party cheques and cheques with endowments may be deposited in the current account for collection and credit.
- Overdraft facilities are given in case of current accounts only.
- The loans allowed by banks to their customer are not given in the form of cash but via the current accounts. Thus current accounts earn interest on all types of advances allowed by the banker.

2. Savings Account

The main purpose of savings accounts is encouraging savings of households. The main features of savings account are:

1. Restriction on withdrawals: In the interest of the objective of savings bank accounts, the banks levy certain limitations on the right of depositor to withdraw money within a given period. The number of withdrawals over a period of 6 months is limited to 50. Minimum amount to withdraw by a withdrawal form is one and that from a cheque is five.

2. Restriction on deposits: The banks do not accept cheques or other official documents payable to a third party for the purpose of deposit in the savings account.

3. Minimum balance: There is a minimum balance that needs to be maintained in the SB accounts as prescribed by the banks and specific charges are levied if the minimum balance is not maintained.

4. Payment of interest: The rate of interest payable by the banks on deposits maintained in savings accounts is prescribed by the RBI. Interest is computed at quarterly or longer rests of period.

5. Cheques: Cheque facility is provided to the deposit only when they keep a minimum balance with the bank according to its rules. Only cheques payable to the customer having SB accounts are collected.

6. Prohibition on savings account: The RBI has forbade the banks to open a savings account in the name of

(a) Trading or Business concern

(b) A Company or an Association

(c) Government Departments

(d) Bodies depending upon budgetary allocations for performance of their functions

(e) Municipal Corporations

(f) Panchayat Samitis

(g) State Housing Boards

3. Recurring Account

In order to inculcate the habit of savings on a regular or recurring basis, the banks have started various daily, weekly, or monthly deposit schemes in recent yea. In these accounts, the money is generally deposited in monthly installments for a fixed period and is repaid to the deposit along with interest on maturity. These are referred to as recurring deposits. The period of recurring deposit varies from bank to bank. Generally banks open such accounts ranging from one to ten years. The main features of recurring account are:

- **Opening and functioning of account:** The RD account can be opened by any person, by a guardian in the name of a minor and even by a minor, more than one peon jointly or individually.While opening the account, a pass book is provided to the depositor which is to be presented to the bank at the time of deposits and repayment of amount. Installments for each month should be paid before the last working day of that month.
- **Rate of interest:** According to the directive of the RBI, the interest provided by banks on RD must be in accordance with the rates prescribed for various term deposits. The rate of interest is therefore almost equal to that of fixed deposits.

4. Fixed Deposits

Fixed deposits refer to the deposits repayable after the expiry of a certain period, which generally varies from 3 months to 5 years. The fixing of the period enables the banker to invest money without having to keep a reserve and hence is very popular with the bank. The main features of fixed deposit account are:

- **Rate of interest:** Higher rates of interest are offered on fixed deposits as the depositor parts with liquidity for a certain period. The longer the period, the higher will be the rate of interest.

- **FD for senior citizens:** Special FD schemes have been formulated by RBI for senior citizens in whom they are offered higher and fixed rates of interest.
- **FD in joint names:** FDs can also be opened in joint names of two or more peons, which are payable to either or survivor in accordance with the terms of the acknowledgement. The problems faced by the banker before date of maturity are:
    - Request for untimely refund by one of the depositor
    - Loan against FDR by one of the depositor
    - Request for duplicate receipt by one of the depositor

    In all these cases the banker should obtain consent of other depositor/s.
- **Payment before due date:** Even though a FD is payable after expiry of defined period, banks allowing encashment even before maturity. In such a case, certain interest will be charged for the same. According to the RBI directive, banks should not charge the penalty in case of premature withdrawal for immediate reinvestment in another FD for a longer term than the remaining period of the original contract.
- **Overdue deposits**: If the receipt is not encashed on the date of maturity, the interest ceases to run from that date. The banks allow interest as per RBI directives, if it is renewed.

11.2.4 Advantages of Bank Account

A bank account is a fund established in a bank by a customer who deposits money against which the customer may make withdrawals.

1. **Bank account facilitates a safe custody of money:** The bank is the custodian of cash. Whenever the account holders need the money, they can withdraw it depending upon the type of account.
2. **Bank account helps in making payments:** The bank account holder can make payment to third parties through his bank account. It may be regarding electricity bills, insurance premium, etc. The bank also makes direct payment on the instructions of the customer.
3. **Bank account holders get advances and loans:** The current account holder can obtain an OD facility from his bank. The savings account holders can also obtain loans to purchase computers and such other equipments. The recurring and fixed deposit account holders can get a loan up to 75% of the amount to their credit.

4. **Bank account helps in smooth transactions:** The bank account makes it possible for the businessmen to conduct their business operations smoothly in both domestic trade as well as foreign markets.
5. **Bank account holders get a safe deposit locker:** The bank provides safe deposit locker facility to its account holders to keep their valuables like gold items, share certificates, property documents, etc.

11.2.5 Financial Assets of Commercial Banks

The various financial assets of commercial banks are as follows:

Liquidity and Profitability

In order to be able to meet demands for cash as and when they are made a bank must not only arrange to have sufficient cash available but it must also distribute its assets in such a way that some of them can be readily converted into cash.

Thus, the bank's cash reserves can be reinforced quickly in the event of heavy drawings on them. Assets which are readily convertible into cash are called liquid assets, the most liquid being cash it. The shorter the length of a loan the more liquid because it will soon mature and be repayable in cash; the less profitable because, other things being equal the rate of interest varies directly with the loss of liquidity experienced by the lender.

Cash-in-Hand

It represents a bank's holding of notes and coins to meet the immediate requirements of its customers. Nowadays, there is no limit set on the amount of cash which banks in India must hold and it is taken for granted that they will hold enough to maintain their depositors' confidence. The general rule seems to be to hold something in the region of 4% of total assets in the form of cash.

Cash at the Central Bank

It represents the commercial banks' accounts with the central bank. When banks in India require notes or corns they obtain them from the Central Bank by drawing on their accounts there in the same way as their customers obtain it from them. The banks also use their central bank accounts for setting debts among themselves. This process is known as the clearing system.

Money at Call and Short Notice

This consists mainly of day-to-day loans to the money market but also includes some seven-day and fourteen- day loans to the same body and to the stock exchange. This asset is by nature very liquid and enables a bank to recall loans quickly in order to reinforce its cash.

Being so very short these loans carry a very low rate of interest; consequently they are not very profitable. The money market consists of discount houses. Then, main function is to discount bills of exchange.

Bills Discounted

Another link between the banks and the money market lies in the way in which the banks acquire their own portfolios of bills. By agreement the banks do not tender directly for these bills but instead buy them from the discount houses when they have two months or less to run. They also buy them in such a way that a regular number mature each week, thus providing an opportunity for reinforcing their cash bases.

Thus, the money market provides two notable services to the banks. It enables them to earn some return on funds which would otherwise have to be held as cash and it also strengthens their liquidity as regards their bill portfolios.

Government Securities with One Year or Less to Maturity

These securities consist of central government stocks and nationalized industries' stocks guaranteed by the government. Since they are so close to the date when they are due for redemption, i.e., repayment at their face value, they can be sold for amounts very near to that value. Thus banks can sell them to obtain cash without suffering any loss. They are very liquid assets.

Certificates of Deposit

These are receipts for specified sums deposited with an institution in the banking sector for a stated period of up to five years. They earn a fixed rate of interest and can be bought and sold freely.

Investments

These consist mainly of government stock which is always marketable at the stock exchange. The classification of investments as more liquid than advances can be justified by the greater ease with which investments can be converted into cash, for the latter, although they can technically be recalled at a moment's notice, can in fact only be converted into cash if the borrower is in a position to repay, and, of course, at the risk of the bank losing its customer if any inconvenience is caused.

Loans and Advances

These are the principal profit earning assets of the commercial banks. They composed mainly of customers' overdrafts whereby in return for interest being paid on the amount actually drawn, banks agree to customers over-drawing their accounts, i.e., running into debt, up to stated amounts. These facilities are usually limited to relatively short periods of time, e.g., 6 to 12 months, but they are renewable by agreement.

Special Deposits

These may be called for the central bank when it wishes to restrict the banks' ability to extend credit to their customers. Conversely, a release of existing special deposits will encourage bank lending. As any release of these deposits depends entirely on the central bank they are illiquid and, as they carry only a low rate of interest, they are not profitable assets.

11.2.6 Profitability of Commercial Banks

Profitability is a key parameter in assessing the performance of any business firm. Even in the banking sector after the banking sector reforms the priorities in banking operations underwent far reaching changes. There had been a shift in the emphasis from development or social banking to commercially viable banking. Profitability became the prime mover of the financial strength and performance of banks; hence the performance of the bank is measured on the basis of its profitability. Now the main agenda is to enhance the profitability and reduce the hurdles which are faced by the banks in their profit maximization and to develop strategies to achieve this objective. In this changed scenario, profitability and productivity are the twin indicators of the competitive edge of the banking industry. The main reason for the fundamental paradigm shift in the banking from social banking to "profit banking" was the introduction of capital adequacy requirements. There are four ways to achieve and sustain the required capital adequacy: fresh equity issue, ploughing back of profit, debt offering and revaluation of assets. Raising capital through equity route is very difficult because servicing the equity base, offering reasonable returns, raising fresh capital when the capital market is not favorable and when the performance of banks is not good. Similarly debt rising also will have the limitations too, as tier II capital cannot exceed tier I capital and subordinated debt cannot exceed 50% of the tier II capital. The scope of revaluation of assets for improving capital adequacy is limited and hence banks are left fee-based activities like letters of credit, guarantees, and acceptance commission is also responsible for growth in profitability of the banks now-a-days because of thin interest margin.

- **Provisioning for loan losses, loan quality improvements or non-Performing Assets:**

Provisioning for loan losses and non-performing assets reduce the profitability of the banking system. NPAs, reduces the net profits of banks on account of loss in income and the provisioning for NPAs will reduce the profit of the banks.

- **Interest rate movements:**

Interest rate movements affect the net interest margins of the banks. A net interest margin refers to difference between interest on deposits and interest on advances. When interest rates increase, the impact is immediate on the advances, which reduces the demand for advances and reduces the profits of the banks. The change in interest rates are exposed to interest rate risks and asset-liability mismatches, which calls for Asset Liability Management (ALM).

- **Rigidity of the operating cost structure:**

About 60 to 70 per cent of the operating costs of Indian commercial banks is on account of employee costs. The other significant cost components are real estate and technology costs. These costs are non-controllable to a significant extent and are rising constantly hence, reducing the profitability of banks.

11.3 Structure of Banking Sector in India

The Central Bank of our country is Reserve Bank of India. It was established on 1st April 1935 under the RBI Act of 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions. As of now 12 public sector banks in India out of which 11 are nationalized banks and one is State Bank of India. There are total 62 scheduled commercial banks and 37 regional rural banks in India. Public sector banks hold near about 75% of the total bank deposits in India. The structure of banking system differs from country to country depending upon their economic conditions, political structure, and financial system. Banks can be classified on the basis of the volume of operations, business pattern and areas of operations. Indian Banks are classified into commercial banks and Co-operative banks. Commercial banks comprise:

(1) Schedule Commercial Banks (SCBs) and Non-Scheduled Commercial Banks- SCBs are further classified into private, public, foreign banks and Regional Rural Banks (RRBs); and

(2) Co-operative Banks which include urban and rural Co-operative banks.

In the evolution of strategic industry spanning over two centuries in India, immense developments have been made in terms of the regulations governing banks, the ownership structure, products and services offered and the technology deployed. The entire evolution of bankscan be classified into four distinct phases:

1. Phase I- Pre-Nationalization Phase (prior to 1955)

2. Phase II- Era of Nationalization and Consolidation (1955-1990)

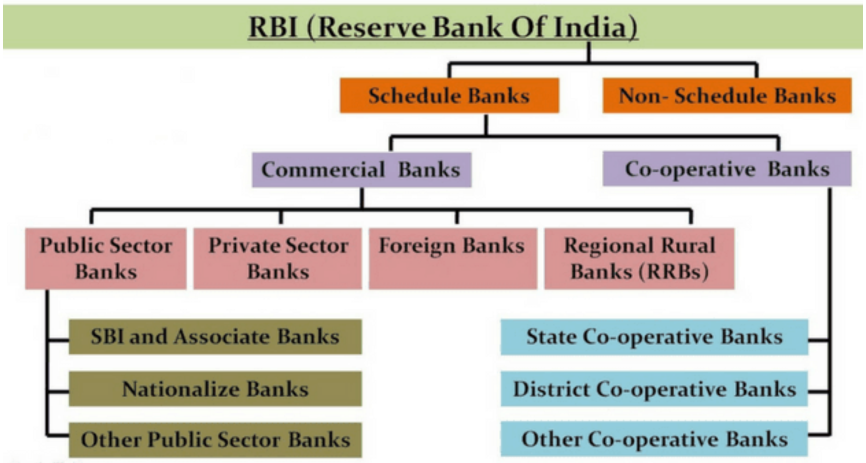
3.Phase III- Introduction of Indian Financial & Banking Sector Reforms and Partial Liberalization (1990-2004)

4. Phase IV- Period of Increased Liberalization (2004 onwards)

11.3.1 Organizational Structure

The existing banking structure in India evolved over several decades, is elaborate and has been serving the credit and banking services needs of the economy. There are multiple layers in today's banking structure to cater to the specific and varied requirements of different customers and borrowers. The structure of banking in India played a major role in the mobilization of savings and promoting economic development. In the post-financial sector reforms (1991) phase, the performance and strength of the banking structure improved perceptibly. Financial soundness of the Indian commercial banking system compares favorably with most of the advanced and emerging countries.

Structure of Indian Banking System is as Follows:



1. Reserve Bank of India

Reserve Bank of India is the Central Bank of our country. It was established on 1st April 1935 accordance with the provisions of the Reserve Bank of India Act, 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions.

It has given wide powers to supervise and control the banking structure. It occupies the pivotal position in the monetary and banking structure of the country. In many countries central bank is known by different names.

For example, Federal Reserve Bank of U.S.A, Bank of England in U.K. and Reserve Bank of India in India. Central bank is known as a banker's bank. They have the authority to formulate and implement monetary and credit policies. It is owned by the government of a country and has the monopoly power of issuing notes.

2. Commercial Banks:

Commercial bank is an institution that accepts deposit, makes business loans and offer related services to various like accepting deposits and lending loans and advances to general customers and business man.These institutions run to make profit. They cater to the financial requirements of industries and various sectors like agriculture, rural development, etc. it is a profit making institution owned by government or private of both.**Commercial bank includes public sector, private sector, foreign banks and regional rural banks.**

3. Public Sector Banks:

Currently there are 12nationalized banks in India. The public sector accounts for 75 percent of total banking business in India and State Bank of India is the largest commercial bank in terms of volume of all commercial banks.Now from April 1, 2017 all the 5 associate banks of SBI and BhartiyaMahila Bank are merged with State Bank of India. After this merger now SBI is counted among the top 50 largest banks of the world.

Nationalized Banks in India are

1.Bank of Baroda
2. Bank of India
3. Bank of Maharashtra
4. Canara Bank
5. Central Bank of India
6. Indian Overseas Bank
7. Indian Bank
8. Punjab National Bank
9. Punjab & Sindh Bank
10. State Bank of India
11. UCO Bank
12. Union Bank of India

4. Private Sector Banks:

The private-sector banks in India represent part of the Indian banking sector that is made up of both private and public sector banks. The "private-sector banks" are banks where greater parts of stake or equity are held by the private shareholders and not by government.

List of Private Sector Banks is:

1. Axis Bank Limited (earlier UTI Bank)
2. Bandhan Bank Limited
3. CSB Bank Limited (formerly The Catholic Syrian Bank Ltd)
4. City Union Bank Limited (formerly The Kumbakonam Bank Limited)
5. DCB Bank Limited (formerly Development Credit Bank)
6. Dhanlaxmi Bank Limited
7. Federal Bank Limited
8. HDFC Bank Limited
9. ICICI Bank Limited
10. IndusInd Bank Limited
11. IDFC FIRST Bank Limited
12. Jammu & Kashmir Bank Limited
13. Karnataka Bank Limited
14. KarurVysya Bank Limited
15. Kotak Mahindra Bank Limited
16. Lakshmi Vilas Bank Limited
17. Nainital Bank Limited
18. RBL Bank Limited (formerly Ratnakar Bank)
19. South Indian Bank Limited
20. Tamilnad Mercantile Bank Limited
21. YES Bank Limited
22. IDBI Bank Limited

5. Foreign Banks:

A foreign bank works with the obligation of following the regulations of both its home and its host countries. Loan limits for these banks are based on the capital of the parent bank, thus allowing foreign banks to provide more loans than other subsidiary banks.Foreign banks are those banks, which have their head offices abroad. CITI bank, HSBC, Standard Chartered etc. are the examples of foreign bank in India. Currently India has 46 foreign banks.

6. Regional Rural Bank (RRB):

The government of India set up Regional Rural Banks (RRBs) on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural laborers, and small entrepreneurs. There are 45 RRBs in the country. NABARD holds the apex position in the agricultural and rural development. List of some RRBs is given below:

7. Co-operative Bank:

Co-operative bank was set up by passing a co-operative act in 1904. They are organized and managed on the principal of co-operation and mutual help. The main objective of co-operative bank is to provide rural credit.The cooperative banks in India play an important role even today in rural co-operative financing. The enactment of Co-operative Credit Societies Act, 1904, however, gave the real impetus to the movement. The Cooperative Credit Societies Act, 1904 was amended in 1912, with a view to broad basing it to enable organization of non-credit societies. As of today there are four categories of co-operative banks exists, which includes Scheduled Urban Cooperative Banks (54), Non-Scheduled Urban Cooperative Banks (1487), State Cooperative Banks(33) and District Cooperative Banks (364).

Name of some co-operative banks India are:

1. Andhra Pradesh State Co-operative Bank Ltd
2. The Bihar State Co- operative Bank Ltd.
3. The Chandigarh State Co-operative Bank Ltd
4. The Gujarat State Co-operative Bank Ltd.
5. The Haryana State Co-operative Apex Bank Ltd.

Three tier structures exist in the cooperative banking:

i. State cooperative bank at the apex level.

ii. Central cooperative banks at the district level.

iii. Primary cooperative banks and the base or local level.

Scheduled and Non-Scheduled Banks:

The scheduled banks are those which are enshrined in the second schedule of the RBI Act, 1934. These banks have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs, they have to satisfy the RBI that their affairs are carried out in the interest of their depositors.All commercial banks (Indian and foreign), regional rural banks, and state cooperative banks are scheduled banks. Non-scheduled banks are those which are not included in the second schedule of the RBI Act, 1934. At present these are only three such banks in the country.

11.4 Recent Developments in Banking Sector in India

The Banking industry and financial institutions are vital sectors of any economy. Development of these two sections of the economy can impact the growth of the country in an incredible way. In the era of "Digital India", the banking and financial services in India have undergone a massive evolution and the phenomenon continues. The change can be attributed to various components like new regulatory policies and customer expectations.

DIGITIZATION

With the rapid growth of digital technology, it became imperative for banking and financial services in India to keep up with the changes and invented digital solutions for the tech-savvy customers. Besides the financial institutions, insurance, healthcare, retail, trade, and commerce are some of the major industries that are experiencing the enormous digital shift. To stay competitive, it is necessary for the banking and financial industry to take the leap on the digital bandwagon.

In India, it all began not earlier than the 1980s when the banking sector introduced the use of information technology to perform basic functions likes customer service, book-keeping, and auditing. Soon, Core Banking Solutions (CBS) were adopted to enhance customer experience. However, the transformation began in the 1990s during the time of liberalization, when the Indian economy exposed itself to the global market. The banking sector opened itself for private and international banks which are the prime reason for technological changes in the banking sector. Today, banks and financial institutions have benefitted in many ways by adopting newer technologies. The shift from conventional to convenience banking is incredible.

Modern trends in banking system make it easier, simpler, paperless, signature less and branchless with various features like IMPS (Immediate Payment Service), RTGS (Real Time Gross Settlement), NEFT (National Electronic Funds Transfer), Online Banking, and Tele-banking. Digitization has created the comfort of 'anywhere and anytime banking'. It has resulted in the reduced cost of various banking procedures, improved revenue generation, and reduced human error. Along with increased customer satisfaction, it has enabled the customers creating personalized solutions for their investment plans and improves the overall banking experience.

ENHANCED MOBILE BANKING

Mobile banking is one of the most dominant current trends in banking systems. As per the definition, it is the use of a smart phone to perform various banking procedures like checking account balance, fund transfer, and bill payments, without the need of visiting the branch. This trend has taken over the traditional banking systems. In the coming years, mobile banking is expected to become even more efficient and effortless to keep up with the customer demands. Mobile banking future trends hint at the acquisition of Internet of Things (IoT) and Voice-Enabled Payment Services to become the reality of tomorrow. These voice-enabled services can be found in smart televisions, smart cars, smart homes, and smart everything. Top industry leaders are collaborating to adopt IOT-connected networks to create mobile banking technologies that require users' voice to operate.

UPI (UNIFIED PAYMENTS INTERFACE)

UPI or Unified Payments Interface has changed the way payments are made. It is a real-time payment system that enables instant inter-bank transactions with the use of a mobile platform. In India, this payment system is considered the future of retail banking. It is one of the fastest and most secure payment gateways that is developed by National Payments Corporation of India and regulated by the Reserve Bank of India. The year 2016 saw the launch of this revolutionary transactions system. This system makes funds transfer available 24 hours, 365 days unlike other internet banking systems. There are approximately 39 apps and more than 50 banks supporting the transaction system. In the post-demonetization India, this system played a significant role. In the future, with the help of UPI, banking is expected to become more 'open'.

BLOCK CHAIN

Block chain is the new kid on the block and the latest buzzword. The technology that works on the principles of computer science, data structures and cryptography and is the core component of crypto currency is said to be the future of banking and financial services globally. Block chain uses technology to create blocks to process, verify and record transactions, without the ability to modify it.

NITI Aayog is creating India Chain, India's largest block chain network, which is expected to revolutionize several industries, reduce the chances of fraud, enhance transparency, speed up the transaction process, lower human intervention and create a database which cannot be hacked. Several aspects of banking and financial services like payments, clearance and settlement systems, stock exchanges and share markets, trade finance, and lending are predicted to be impacted. With its strenuous design, block chain technology is a force to be reckoned with.

ARTIFICIAL INTELLIGENCE ROBOTS

Several private and nationalized banks in India have started to adopt chat bots or Artificial Intelligence (AI) robots for assistance in customer support services. For now, the use of this technology is at a nascent stage and evolution of these chat bots is not too far away. Usage of chat bots is among the many emerging trends in the Indian banking sector that is expected to grow.

More chat bots with the higher level of intelligence are forecasted to be adopted by the banks and financial institutions for improved customer interaction personalized solutions. The technology will alleviate the chances of human error and create accurate solutions for the customers. Also, it can recognize fraudulent behavior, collate surveys and feedback and assist in financial decisions.

THE RISE OF FINTECH COMPANIES

Previously, banks considered Fintech companies a disrupting force. However, with the changing trends in the financial services sector in India, fintech companies have become an important part of the sector. The industry has emerged as a significant part of the ecosystem. With the use of financial technology, these companies aim to surpass the traditional methods of finance. In the past few decades, massive investment has been made in these companies and it has emerged into a multi-billion-dollar industry globally.

Fintech companies and fintech apps have changed the way financial solutions are provided to the customers. Besides easy access to financial services, fintech companies have led to a massive improvement in services, customer experience, and reduced the price paid. In India, the dynamic transformation has been brought upon by several important elements like fintech startups, established financial institutions, initiatives like ‘Start-Up India’ by Government of India, incubators, investors, and accelerators. According to a report by National Association of Software and Services Companies (NASSCOM), the fintech services market is expected to grow by 1.7 times into an $8 billion market by 2020.

DIGITAL-ONLY BANKS

It is a recent trend in the Indian financial system and cannot be ignored. With the entire banking and financial services industry jumping to digital channels, digital-only banks have emerged to create paperless and branchless banking systems. This is a new breed of banking institutions that are overtaking the traditional models rapidly. These banks provide banking facilities only through various IT platforms that can be accessed on mobile, computers, and tablets. It provides most of the basic services in the most simplified manner and gives access to real-time data. The growing popularity of these banks is said to be a real threat to traditional banks.

ICICI Pockets is India's first digital-only bank. These banks are attractive to the customers because of their cost-effective operating models. At the same time, though virtually, they provide high-speed banking services at very low transaction fees. In today's fast lane life, these banks suit the customer needs because they alleviate the need of visiting the bank and standing in a queue.

CLOUD BANKING

Cloud technology has taken the world by storm. It seems the technology will soon find its way in the banking and financial services sector in India. Cloud computing will improve and organize banking and financial activities. Use of cloud-based technology means improved flexibility and scalability, increased efficiency, easier integration of newer technologies and applications, faster services and solutions, and improved data security. In addition, the banks will not have to invest in expensive hardware and software as updating the information is easier on cloud-based models.

BIOMETRICS

Essentially for security reasons, a Biometric Authentication system is changing the national identity policies and the impact is expected to be widespread. Banking and financial services are just one of the many other industries that will be experiencing the impact. With a combination of encryption technology and OTPs, biometric authentication is forecasted to create a highly-secure database protecting it from leaks and hackers attempts. Financial services in India are exploring the potential of this powerful technology to ensure sophisticated security to customers' account and capital.

WEARABLES

With smart watch technology, the banking and financial services technology is aiming to create wearables for retail banking customers and provide more control and easy access to the data. Wearables have changed the way we perform daily activities. Therefore, this technology is anticipated to be the future retail banking trend by providing major banking services with just a click on a user-friendly interface on their wearable device.

These are some of the recent trends in the banking and financial sector of India and all these new technologies are predicted to reshape the industry of business and money. The future is going to bring upon a revolution of sorts with historical changes in traditional models. The massive shift in the landscape has few challenges. Nonetheless, the customers are open to banking innovations and the government is showing great support with schemes like 'Jan DhanYojana', which aims at proving a bank account to every citizen. Meanwhile, the competition from the foreign and private sector banks have strained the government regulators, nationalized banks and financial institutions to adopt new technology in order to stay relevant in the race.

11.4.1 Present Scenario of Banking System in India

Banking industry of India has shown an enormous growth over the last decade. When the whole world was on spin during the global financial crisis, banking sector of India has been able to maintain its elasticity providing growth opportunities simultaneously which is an unlikely feat to be compared to other developed markets of the world. The world economy has developed severe problems in terms of lapse of various banking and financial institutions and dipping demand in the recent times. Prospects became very unsure causing recession in major economies. However, amidst all this topsy-turvy India's banking sector has been amongst the few to maintain resilience. A progressively growing balance sheet, higher rate of credit expansion, expanding profitability and productivity akin to banks in developed markets, lower incidence of non-performing assets and focus on financial inclusion have contributed to making Indian banking vibrant and strong. Indian banks have commenced to revise their growth approach and reassess the prospects on hand to keep the economy wheeling.

The way forward for the banks of India is to innovate to take advantage of the new business opportunities and simultaneously ensure the continuous assessment of risks.

From traditional banking practices during the British Rule to reforms period, nationalization to privatization and to the present trend of increasing number of foreign banks, Indian banking sector has undergone substantial transformation. The move from old to new business environment has created fresher demands on Indian banks like enhanced work flow, full access of customers to banking transactions through electronic mode etc. In the emerging scenario of cutthroat competition backed by parallel force of deregulation and technology, the degree of competition in the Indian financial Sector has increased to unprecedented level. Hence the functional efficiency of banks has achieved huge significance for their survival in the present scenario. In contrast to earlier 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning, modern outlook and tech-savvy methods of working for traditional banks has been ushered. All this has led to the retail boom in India. People are not just demanding more from their banks but also receiving more. With easy credit facilities the banks are transforming the consuming tendency of Indians with everything from microwave ovens to houses on sale at easy monthly installments EMIs.

Using information technology, banks have upgraded their systems to provide better customer services. Automatic Teller Machines (ATMs) dispensing any time money are visible in most localities of big cities and users are increasingly responding to banking transactions without visiting the banks. Online and mobile banking has brought the banks virtually to their doorsteps. However, all this has exposed the banks to new kinds of risks. The intimacy between bank employees and customers has become increasingly remote. Though the banks allot various back end and front end operations to minimize risk and use highly secures socket layers SSLs, digital certificates and facilities like virtual key boards to reduce the risks in online transactions, attacks have been hit up. Since the Lehman Brothers declared bankruptcy in 2008, incidences, every now & then, have sustained the concerns over global financial stability.

While most Emerging Market Economies (EMEs), including India, have healed from global financial crisis, advanced nations continue to be plagued with growth figures looking dismal. Euro zone crisis seems to be spreading across the EU countries following ripple effect, political turmoil persists in Middle East & North African (MENA) region, and economic stagnation in US forecasts no imminent respite from the worsening global situation. Indian banks, however, not only emerged unscathed from the global financial crisis but continued to manage growth with resilience during 2010-11. Presently, domestic demand stays restrained on account of slower pace of growth & high level of commodity prices but favorable demographics & growth potential of Indian economy are expected to mitigate the dampening effect in the long run. As per Census 2011, about 40 % of households still do not avail banking facilities. Banks with their forward looking strategies, improved customer relationship, diversification of revenue sources etc. are anticipated to continue their impressive performance. The idea of creating bigger banks to take on competition sounds attractive.

The lack of global scale for banks of India came into sharp focus during the recent financial crisis which saw various international banks reneging on their funding commitments to Indian companies, but local banks could not step into the breach because of balance sheet limitations. In this light there is need to consider expanding the operations in the future.

The last decade has seen many positive developments in the banking sector of India. The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favorably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market evaluation. However, improved regulations, innovation, growth and value creation in the sector remain confined to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. The banking industry of India needs to make it stronger because it has to support the vibrant and modern economy that India aspires to be. An enabling policy and good regulatory framework will be very crucial for the success of management of bank with the burden of this change. Many developed countries have failed to react to the changing market realities and the same has stunted the development of their financial sectors. A weak banking structure could not enable itself to fuel its continued development that has harmed the long-run development of their economies.

11.5 Check Your Progress

Fill in the blanks:

1. There are traces of banking activity even in ……………….. times.
2. Banks are a medium through which economic and fiscal …………….. of the government are materialized.
3. Financial institutions are the primary source of long term…………………. for large projects.
4. A bank provides easy payment and ………………. facility to its customers in theform of cheques, drafts, ATM’s, ETF.
5. A bank is a financial institution which does ………….. activities of selling……………… services.
6. A bank provides advance money in the form of loans to needy persons for ……………….. & development of business.
7. Agency functions include purchase and sale of shares and ……………………… on behalf ofcustomers.
8. General utility services comprises of …………………………. of shares and debentures. State whether the following statements are true or false:
9. Loans may be granted only for long periods by banks.
10. Primary activity of commercial banks includes accepting deposits and lending money.
11. Difference of interest allowed to public on deposits and charged on loan is the main sourceof income of banks.

11.6 Summary

- Banks are institution whose debts usually referred to as bank deposits are commonly accepted in final settlement of other people's debts.
- A banker is one who in the ordinary course of his business, honors cheques drawn upon him by persons from and for whom he receives money on current accounts.
- Money and credit provide the pivot (axle) around which all the economic activities revolve.
- Banks are reservoirs of resources for economic growth and development of the nation.
- The Indian financial system is identified with two set of institutions viz. regulators and intermediaries.
- The commercial banking structure in India consists of two major set of players scheduled commercial banks and unscheduled banks.
- A bank accepts money from the people in the form of deposits.
- A bank provides easy payment and withdrawal facility to its customers in the form of cheques, drafts, ATM's, ETF.
- A bank should always add the word "bank" to its name to enable people to know that it is a bank and that it is dealing in money.
- The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks.
- The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment.
- The Banking sector, as the most important financial intermediary for mobilization of savings leading to investments towards growth, would thus, play the most crucial role in attaining the economic objectives of the country.
- Banks can be classified as (a) Central Bank, (b) Public Sector Banks, (c) Private Sector Banks, and (d) Cooperative Banks.
- The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems.
- RBI performs its functions with the service motive and not for making profits.
- The Reserve Bank acts not only as the banker's bank but also as the lender of the last resort.
- Banks make a profit by borrowing at a lower rate and lending the same funds at a higher rate of interest.
- A customer is one who has a (Saving/Current/Fixed) deposit account irrespective of its debit or credit balance with the bank. Even an agreement to open an account makes one a customer.

- Two types of demand deposit accounts are: current account and savings account; and Two types of time deposit account are fixed account and recurring deposit account.

11.7 Keywords

Advances: Prepayment received for goods or services to be rendered.

Agency:A department or body providing a specific service for a government or similar organization.

ATMs: Automatic Teller Machines

Bank:A bank is a financial institution licensed to receive deposits and make loans. Banks may also provide financial services such as wealth management, currency exchange, and safe deposit boxes.

Banking: As per Section 5(b) of Banking Regulation Act, 1949, banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdraw able by cheque, draft, and order or otherwise.

Cheque: a written order directing a bank to pay money.

Commercial Bank:A bank that offers services to the general public and to companies.

Credit: The ability to obtain goods or services before payment, based on the trust that payment will be made in the future.

Deposit: A sum of money placed or kept in a bank account, usually to gain interest.

Fiscal: Relating to government expenditures, revenues, and debt.

Loans: A thing that is borrowed, especially a sum of money that is expected to be paid back with interest. A loan is a type of debt. Like all other debt instruments, it is to be repaid with interest as per agreed terms.

Recurring Account: Recurring deposit Account in a bank is a special account in which certain fixed amount can be deposited in every month for a specified period. The rate of interest in recurring deposit account is higher than savings account. After maturity period the total deposited amount along with accrued interest is paid to the account holder either in cash or by credit to the savings account in the same bank.

11.8 Self-Assessment Test

1. Write a brief note on evolution of banks.
2. What are the different types of banks operating in India?
3. Discuss the role of RBI in Indian banking sector.
4. Write a descriptive note on types of accounts.
5. Explain Profitability of Commercial Banks.
6. Describe recent developments in banking sector in India in detail.

7. What is the **structure of Indian Banking System?**

8. Briefly explain the meaning and functions of Commercial Banks.

11.9 Answer to Check Your Progress

1. Ancient
2. Policies
3. Lending
4. Withdrawal
5. banking, financial
6. Promotion
7. Securities
8. Underwriting
9. False
10. True
11. True

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Course: Indian Financial System	
Course Code: **BC 305**	Author:**Dr. Sanjeev Kumar Garg**
Lesson No.: **12**	Vetter: **Dr. Suresh K. Mittal**

E- Banking

STRUCTURE:

12.0 Learning Objectives

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

- Understand the meaning and characteristics of E-banking.
- Know the advantages and disadvantages of E-banking
- Know E-banking services providers in India

- Understand the Risks related to E-banking services and guidelines related to E-banking functioning.

12.1 Introduction

Over the years, banking has drastically changed and has affected the lives of millions of individuals around the globe. E-banking or virtual banking, or net banking or internet banking is an electronic payment system wherein customers of a given bank can perform all their banking transactions.It is entirely automated facility based on IT delivery mechanism to conventional banking users' products and services. It provides online medium of conducting and providing various banking services, such as, online accessibility of bank account, online fund transfer facility, online bills paying facility etc. Customers are easily able to access their accounts & perform various financial transactions just by using their phones & laptops. It is all possible because of e-banking. It saves the time of customers & provides 24×7 service.Customers can use their banking services any time & from anywhere through the e-banking feature. E-banking services are of different types like Telebanking, smart cards, ATMs, E-cheques & debit cards. Customers are able to secure their account & protect them from frauds using e-banking service.They can easily monitor their account continuously.

The benefits provided by e-banking medium have resulted into swift growth of banking sector worldwide.It also reduces the workload & operation cost of banking organisations. E-banking has also reduced the chances of human errors as there is no possibility of errors occurring in a fully automated system.

In other words E-banking refers to the process of using banking services online over the internet. It is a technique through which customers avail all services of banks through the internet. It is also termed as internet banking, electronic banking & virtual banking.From paying bills and transferring money into accounts to applying for loans, you can take advantage of all the facilities that a traditional bank offers.

12.1.1 Characteristics of E-Banking

The important characteristics of E-banking are as follows:

Faster Transactions: E-banking provides the facility of instant transfer of funds to its customers. It saves the time of customers as funds get transferred very fast from one account to another. Whole system of E-banking is automated & works over the internet. People don't need to wait in queue to transfer their funds or pay off their bills; they can easily do it through their device. It saves the time of customers as they can easily access their account with the help of their device.

Lowers Transaction Cost: E-Banking reduces the cost involved in doing financial transactions. Electronic transactions are termed as the cheapest medium of doing transactions. It has reduced the manpower requirements as workload is reduced. Whole transactions are done online over the internet. It has also reduced the paperwork in organisations as all transactions are recorded digitally. There is no need to manually enter & store each record.

Provides 24×7 Service: This is the most important feature of E-banking. E-Banking provides customers with all-time access facility to their accounts. Customers can easily access their account anytime & from anywhere with no limitations. It provides convenience to the customers as they can perform transactions as per their wish.

Reduces Chances of Error: E-banking has reduced the chance of human error. It has reduced the role of the human in the whole transaction process. E-banking system works fully automated over the internet. All transactions are recorded and stored digitally. There is no need to manually maintain each & every record in books of account. So, the chances of human error are minimised.

Develops Loyalty in Customers: E-banking helps the banks to develop large number of loyal customers. Through E-banking service banks are able to serve their customers well. They are able to provide fast and better service to customers. Customers are able to get a user-friendly interface from the banking website. They are able to avail services any time even from their home comfort. This develops a sense of loyalty among customers when they are happy with the services of their banks.

Removes Geographical Barriers: E-Banking has removed all distance barriers for performing transactions. It has removed all distance barriers that customers used to face in the traditional method of performing transactions. E-banking provides the facility of instant transfer of funds both nationally and internationally. All systems are connected to each other online which facilitate easy transfer of funds.

Provides Better Productivity: It has an efficient role in increasing the productivity of the businesses. Whole financial transaction system is supported by automated software systems. These systems are specially designed for doing transactions of funds. It reduces the time required for doing transactions & also reduces the workload of business organisations. Everything is stored digitally & they don't need to store anything manually. It increases the overall productivity of the businesses.

Reduce in frauds transactions: Another important feature of e-banking is that it helps in continuously monitoring of accounts. You can easily track each & every transaction of your accounts. You can easily track if any fraud is done by anyone in financial transactions. It provides a complete digital footprint of all those who can modify your banking activities & commit fraud. It thereby adds transparency to your accounts which reduces the overall chances of fraud.

12.1.2 Advantages of E-Banking

All the advantages of e-banking are closely related to each other; from convenience to efficiency, following are the advantages of net banking.

For Banks:

Less transaction costs: Electronic transactions are the cheapest than other modes of transaction. So e-banking helps to save transaction related cost for the banks.

A reduced margin for human error: All transactions are done electronically. So, there is no room for human error

Lesser paperwork: Digital records reduce paperwork and make the process easier to handle. Also, it is environment-friendly.

Reduced fixed costs: Customers do their banking work from there sitting points. Therefore a lesser need for branches which translates into a lower fixed cost.

More loyal customers'-banking services are customer-friendly; banks provide better services, experience higher loyalty from its customers.

For Customers:

Benefits and Rewards: A lot of online banks offer more benefits and rewards to their customers that not only benefit the bank but also benefit their customers.Online banks are willing to offer higher interest rates and better transfer services to their customers who regularly use online banking. This happens partly due to the fact that the banks have to bear reduced costs when serving online customers. Therefore, the overall banking experience is obviously better than that of visiting a physical bank branch and handling the same transaction.

Notifications and Alerts: Customers are instantly alerted or notified about new changes in the system. From changes in the policy to logins from new devices, customers get instant notifications and alerts. However, if you're associated with a real bank, you would probably get a text alert or a customer service agent will call you to notify about major changes. Chances are, you're missing out on a lot of changes. Banks also endorse new products, services and schemes like new investment options, changes in the loan policies, etc. to online customers first.

Faster Transactions: You don't have to wait for your turn to transfer funds – you can do that with a single tap of your finger or a single click of your mouse. Funds from one account will be transferred to another in a matter of a few seconds. Anything that requires quick payments can be done with the help of e-banking. For instance, you are required to immediately pay your child's school fees. You can do it via the bank's app or website or you can physically go to the bank to withdraw cash and then going to the school to deposit the fees. You'll probably end up wasting half the day to perform this transaction which with the app's help could've been performed in a matter of minutes.

Convenience: You can conveniently handle your account transactions without all the hassle of being in the queue on a sultry afternoon. E-banking is extremely convenient if you have a decent internet connection (wifi or 3G/4G data).You can access the website from anywhere without actually having to visit the bank. If your banking needs don't involve the assistance of any staff member or a manager, online banking is the best option for you.

Security: With internet banking, you can always monitor your account activities. This not only serves as a history of all the transactions but also helps you identify threats and suspicious activities before any severe damage can be done to your account. Online accounts are protected with encryption software that ensures complete safety to the user. Alerts related to passwords and digital signatures are sent periodically to maintain the security of the account.

Easy Access: Customers can enjoy easy access with online accounts by simply typing in the log-in credentials. In addition to that, customers can also handle several accounts at a time. Since the internet remains the medium of connection; users can also access different accounts in different banks from a single device.

Speed and Efficiency: In a hurry to apply for an educational loan? Or quickly need to pay bills? Or perform any banking transaction without having to waste half your day? Do it via the internet. There's no waiting nor do you have to rush through anything – you can take your time and perform all banking transactions with patience and it will be done in nearly 1/10th the time spent on actually driving down to the bank and getting it done.

Lesser Limitations: Traditional banks have several constraints like operating hours, the physical location of the bank branch, holidays, etc.You don't have to wonder if it's a holiday with online banking, or what time is it to perform a transaction. Be it Sunday or the middle of the night and you will still be able to do everything (and even more) through their app or website as its available twenty-four hours a day, throughout the year.

More Features: Apart from being flexible, some banks go out of their way to satisfy their customers by not penalizing on withdrawals on the certificate of deposits, letting customers maintain accounts with no minimum balance, etc.Moreover, banks generally offer more offers and discounts on credit and debit cards used by customers who have online accounts.

Better Customer Service: Banking websites and apps come with customized web pages to solve customer queries and often have a dedicated 'Frequently Asked Question' (FAQs) section that helps in answering common customer queries. You can chat with a customer service agent or call them if you need more help. This not only saves the time of the customers but also that of the bank employees who can shift their focus to more important things.

For Businesses:

Account reviews: Business owners and designated staff members can access the accounts quickly using an online banking interface. This allows them to review the account activity and also ensure the smooth functioning of the account.

Lower costs: Usually, costs in banking relationships are based on the resources utilized. If a certain business requires more assistance with wire transfers, deposits, etc., then the bank charges it higher fees. With online banking, these expenses are minimized.

Less error: Electronic banking helps reduce errors in regular banking transactions. Bad handwriting, mistaken information, etc. can cause errors which can prove costly. Also, easy review of the account activity enhances the accuracy of financial transactions.

Reduced fraud: Electronic banking provides a digital footprint for all employees who have the right to modify banking activities. Therefore, the business has better visibility into its transactions making it difficult for any fraudsters to play mischief.

12.1.3 Disadvantages of E-banking

Everyone and everything has some shortcomings. Similarly, there are some limitations of net banking; from security to technology issues, following are some disadvantages of net banking. Let us look at them one by one.

Difficult for Beginners: For the beginners, it appears as a complex mode of service as customer find it complicated to navigate through bank's website. While opening an account online, bank's website requires a number of information and that seems time taking and inconvenient process to the first time users.

Lack of trust: Fake websites and phishing sites are common in this age of technology. Can you really trust all websites? What if the website folds up and all your money is gone? This wouldn't happen in a real bank. There is trust between the bank and their customers, you know your money is safe with the bank, because they take responsibility for your money. Real banks are permanent and reliable while some websites are not.

Inconvenience: Sure, online banks are open throughout the year but they are a serious cause of inconvenience in certain instances. For example, if you get locked out of your account you will be unable to perform any banking transactions. However, in a real bank, you establish relationships with the staff, who know you on a personal level and will be willing to assist you in such cases. You wouldn't have to be on the phone explaining your situation to an unknown customer service agent which by the way, might also take several days. Also, a few online banks don't allow cash deposits. To deposit cash, you will be required to email a check and transfer money from another account or bank, or use their e-check deposit service.

Inability to handle complex transactions: While you can easily pay bills and transfer funds, you can't perform complex transactions online. When a large sum of money is involved, it is advisable to visit a real bank and sort it out in-person rather than doing it online. Some financial transactions also need a document verification (like buying a house) so it is better to submit them physically than digitally.

Financial Jargon: Financial jargon can often get between you and your money. Knowledge is power-or, in this case, knowledge is money. Though financial literacy can't be achieved overnight, it can be helped along by a grasp of the basic terms that are commonly used by advisors, analysts, economists, and commentators.

Security Issues: Sure, most banks are well-reputed and established; there are times when you face security issues. There's always a risk of actual and/or identity theft. It's also possible to get unauthorized access to your account via stolen or hacked log-in credentials.

Technology Issues: If you don't have a decent connection or there are bugs in the software, or say, there is a power cut or maybe the servers have gone down – websites are bound to crash and you will undoubtedly face a lot of technological issues. While you may get various types of customer service at the moment but sooner or later, you will get frustrated. However, someone is always around to help you in a real bank.

Virtual Assistance: When you need assistance during e-banking, your concern is generally assigned to an anonymous customer service agent who is unlikely to know you. Wouldn't you rather talk to a personal banker when you’re in a fix than an unknown agent? A personal banker will also know your transaction history, your personal details and will be in a better position to assist you.

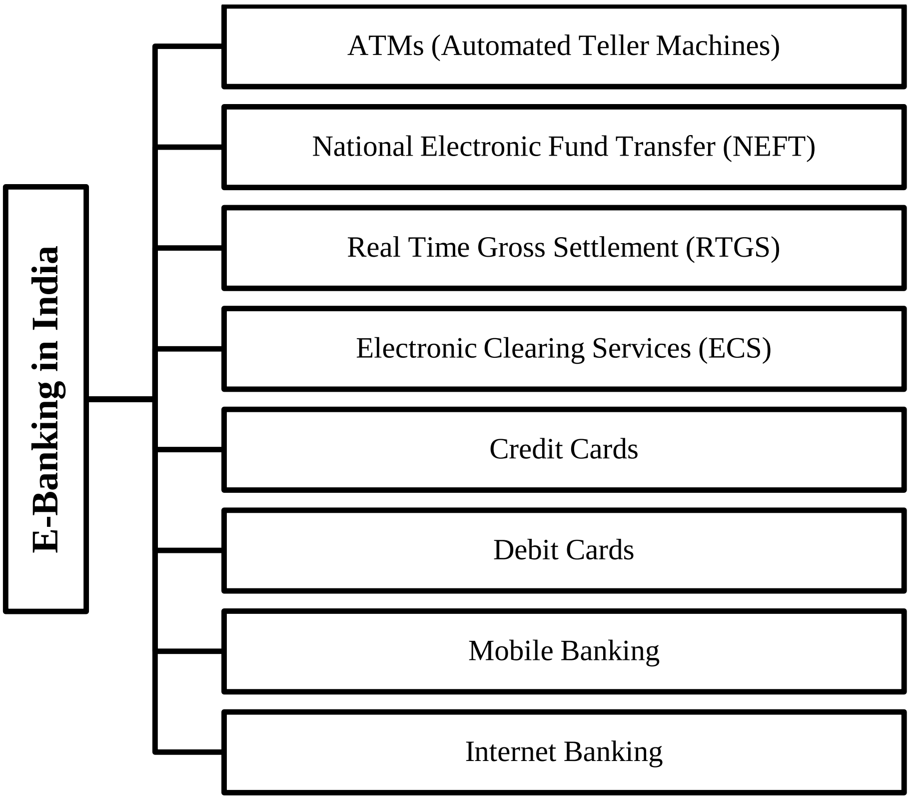
Complicated Websites: Some websites look like a page straight from a super complex scientific experiment. Written in a secret code language with bizarre fonts and colors. I mean, sure some websites are simple and you can get all the things done in a jiffy. But some websites are downright complicated and confusing. With pop-ups, errors, links, and interlinks, redirections to probably a million pages, it gets really difficult to understand.

Other Limitations: E-banking isn’t for everyone. Illiterate and the elderly cannot use online banking. Neither can an individual access their accounts if they don’t have an internet connection.

- If the bank’s server is down, customer can’t use it.
- To use internet banking, customer is compelled to have computer with internet access.
- There is always the possibility of a cracker gaining access to customer’s account.
- Many banks don’t show customer how to use online banking very well and those are usually the ones with the non- intuitive interface & cluttered design, which makes it pretty easy for customer to screw up something.
- Banks bears heavy costs to install high firewall.
- It leads to missing of personal services.
- E-banking promotes lack of socializing or social contacts

12.2 E-banking in India

In India, since 1997, when the ICICI Bank first offered internet banking services, today, most new-generation banks offer the same to their customers. In fact, all major banks provide e-banking services to their customers.Popular services under e-banking in India



Automated Teller Machines (ATM)

These are the cash dispensing machines which are frequently seen at banks and other locations such as shopping centres and building societies. Their main purpose is to allow customer to draw cash at any time and to provide banking services where it would not have been viable to open another branch. By the end of 1990, private and public sector banks in India came up with their own ATM networks under the initiative of the Indian Banks Association in Mumbai. The Bank of India was the first nationalised bank to render ATM facilities to its customers in Mumbai.

ATM is now the most accepted and popular user friendly technology for even the rural customers. An ATM is one, which a customer can use with a card having PIN to withdraw cash and for other services. ATM is a modern device introduced by the banks to have access to money day in day out without visiting the bank branches in person.

In ATMs customers can withdraw their money 24 hours a day, 7 days a week and round the year.The system is known as ‘Any Time Money’ or ‘Anywhere Money’, because it allows the customers to withdraw money from the bank from any of its ATMs round the clock even on Sundays and National holidays. Through this facility, customers of the bank are not restricted to remain a customer of the branch where the account is maintained.The services of ATMs are made available by the banks both at the bank premises (On-site ATMs) and also at convenient locations (Off-site ATMs) viz. at public places like petrol bunks, markets, railway stations, bus stands air ports, etc.

Depending on the business, banks install ATMs for their customers at convenient places in the same town. Another significant milestone in this mode of delivery channel was the introduction of the Shared Payment Network System (SPNS) of ATMs by the Indian Banks Association, Mumbai. Under this system the banks having no ATM facility in a locality provide ATM services to their customers in that locality through a tie up with other banks with ATM to share their ATM. The ATMsharing in India across banks started with SWADHAN.

Services offered by ATM

Following are the important services offered by the Indian banks through their ATM:

- Cash and Cheque deposit
- Transfer of funds between accounts
- Printing of mini-statement
- Paying of insurance premium
- Balance enquiry
- Product information
- Change of Personal Identification Number (PIN)
- Ordering of Cheque book
- Receipt of cash
- Recharge of prepaid mobile card
- Option for mobile banking etc.

National Electronic Fund Transfer (NEFT)

It is a national wide funds transfer system to facilitate transfer of funds from any branch to any other bank branch. The operationalisation of the NEFT in November 2005 was a major step in the direction of setting up and operating a National Level Payment System. There is no restriction of centre or of any geographical area inside the country. The individual branches participating in NEFT could be located anywhere across the country.

NEFT facility is available with all Core Banking Branches (CBS). The beneficiary gets the credit on the same day or the next day depending on the time of settlement. Available across a longer time window, the NEFT system provides for batch settlements at hourly intervals, thus enabling near real-time transfer of funds. Certain other unique features viz. accepting cash for originating transactions, initiating transfer requests without any minimum or maximum amount limitations, facilitating one-way transfers to Nepal, receiving confirmation of the date / time of credit to the account of the beneficiaries, etc., are available in the system.

Real Time Gross Settlement (RTGS)

RBI introduced Real Time Gross Settlement (RTGS) system with a view to enhance the efficiency of the Cheque clearing system. The Real Time Gross Settlement was implemented by the RBI after a comprehensive audit and review of the software and also by conducting extensive training of users at commercial banks on March 26, 2004. The Real Time Gross Settlement system is being designed to provide large volume funds transfer and settlement in an on-line real time environment to the banking industry, with settlement on a gross basis.

RTGS system is a funds transfer mechanism where transfer of money takes place from one bank to another on a 'Real time' and on 'Gross' basis. Settlement in 'Real Time' means payment transaction is not subjected to any waiting period. The transactions are settled as soon as they are processed. 'Gross settlement' means the transaction is settled on one to one basis without bunching with any other transactions. Considering that money transfer takes place in the books of the Reserve Bank of India, the payment is taken as final and irrevocable.

RTGS system is mainly for large value transactions. The minimum amount to be remitted through RTGS is Rs.200, 000. There is no upper ceiling for RTGS transactions. The time taken for effecting funds transfer from one account to another account under normal circumstances is that the beneficiary branches are expected to receive the funds in real time as soon as funds are transferred by the remitting bank. The beneficiary bank has to credit the beneficiary's account within two hours of receiving the funds transfer message.

It is expected that the receiving bank will credit the account of the beneficiary instantly. If the money cannot be credited for any reason, the receiving bank would have to return the money to the remitting bank within two hours. Once the money is received back by the remitting bank, the original debit entry in the customer's account is reversed. The payments are settled through a transaction by transaction. The settlement of funds is final and irrevocable.The remitting customer has to furnish the following information to the bank for effecting a RTGS remittance:

- Amount to be remitted
- His account number which is to be debited
- Name of the beneficiary bank

- Name of the beneficiary customer
- Account number of the beneficiary customer
- Sender to receiver information, if any
- The IFSC code of the receiving branch

The beneficiary customer can obtain the IFSC code from his branch. This code number and bank branch details can be communicated by the beneficiary to the remitting customer.RTGS system which was initially started (March 26, 2004) with four banks, besides the RBI, as participants, at present has 109 direct participants (the RBI, 94 scheduled banks and 14 primary dealers) of which 84 banks are offering RTGS based customer services across the country.

Electronic Clearing Service (ECS)

Indian banks are competing with one another to offer new products and services to their customers. Banking services and products in India witnessed transformation on a large scale in the last few years. Technology has played a significant role in facilitating the transformation in the banking sector. Electronic clearing service is one of the new electronic banking services.

Electronic clearing service is a mode of electronic funds transfer from one bank account to another bank account using the services of a clearing house. This is normally for bulk transfers from one account to many accounts or vice versa. This can be used both for making payments like distribution of dividend, interest, salary, pension etc. by institutions or for collection of amounts for purposes such as payments to utility companies like telephone, electricity or charges such as house tax, water tax etc. or for loan instalments of financial institutions/banks or regular investments of persons.

Electronic Clearing Service (ECS) is a non-paper based movement of funds which is encouraged by the Reserve Bank of India on a wide scale. Indian banking sector has made a quantum leap forward in terms of switching over from paper- based transactions like use of currency notes, cheques, drafts or challans to electronic means like Real Time Gross Settlement (RTGS), National Electronic Fund Transfer (NEFT) and other electronic modes.

Credit Cards

Credit card is the modern system of payment which has to a large extent replaced the traditional forms of payment by cash, cheque etc. Visa and Master Card, Maestro are associations of banks, which dealt in credit cards. Bank credit cards are a type of consumers' loan with in specific limits. The holder has the option to utilize it in part or full depending upon his needs. The credit so availed has to be paid within a period and with repayment, the limit gets renewed automatically.

It has a method of identification of users by means of either signature identification or a stamp size photo of the card holders. It authorises the holder to charge goods and services to his account for which he is billed. Credit card is otherwise called 'Plastic money'. The most important difference between a credit card and a debit card is that while credit card is a 'post-paid' one the latter is a 'pre-paid'.

Credit cards began to be used in USA as early as 1920's and their use began to increase after 1950. Diners Club introduced their credit card in 1950 and the American company in 1958 and Bank of America in1959.In India, the Central Bank of India was the first bank to introduce the credit card known as 'Central Card' in the middle of 1981. Credit card facility became immensely popular among customers in India by 1990. With the introduction of credit card system, the concept of every-where and any-where banking became a reality.

Debit Cards

Debit card is a pre-paid card with some stored value, which optimizes conveniences for the customers. A customer possessing a debit card need not carry cash. It is like carrying cash from the bank account, without the inconvenience or risk of carrying liquid cash. In other words, debit card allows 'anywhere any time access' to the customer with their savings or current account.To receive a debit card, an individual need only to open an account, either current or savings with the issuing bank. However, debit card facility does not extend to cash credit and other loan account.The banks should issue cards to its customers only having good financial standing with satisfactory record on accomplishment forat least six months. A Personal Identification Number (PIN) will be issued to the customers for using a debit card. Debit card can be used at all outlets that accounts such card for payments viz., departmental stores, petrol bunks, jewellery shops, restaurants, textile shops, hospitals, airlines, railways, etc.

Debit card works in the same way as a credit card for purchase transactions at merchant outlets, the only difference is that the transaction amount is directly debited to the bank account of the customers. After finishing the purchases, card holder has to submit the card to the business outlet. The card holder enters the personal identification number on the shop's pin pad. The merchant on an electronic data capture terminal for authorization swipe the debit card. When the card is swiped through the electronic terminal, it dials the acquiring bank system, which validates the PIN and finds out from the issuing bank whether to accept or not the transaction. The terminal wills assured approval regarding the availability of balance in the account from the card issuing bank. After a successful authorization or an approval from the bank, the terminal will print a charge slip. The transaction generated by the point of sale will be conclusive and binding on the cardholder.

Mobile banking

Mobile banking refers to the banking and financial services with the help of mobile telecommunication devices. The scope of offered services may include facilities to conduct bank and stock market transactions, to manage accounts and to access customized information. Thus, mobile banking is the usage of mobile phone as a platform for banking transactions. The high penetration of mobile phones in India is the biggest drive for mobile banking in India.

Mobile phones as a delivery channel for extending banking services have off-late been attaining greater significance. The rapid growth in users and wider coverage of mobile phone networks have made this channel an important platform for extending banking services to customers. Banks have started offering information based services like balance enquiry, stop payment instruction of cheques, transactions enquiry, and location of the nearest ATM/branch etc. In order to ensure a level playing field and considering that the technology is relatively new, Reserve Bank has brought out a set of operating guidelines for adoption by banks. Mobile banking transactions are undertaken by using mobile phones by bank customers that involve credit/debit to their accounts. It also covers accessing the bank accounts by customers for non-monetary transactions like balance enquiry etc.

Internet Banking

Banks have traditionally been in the forefront in making use of technology to update their products, services and efficiency. They began using electronic and telecommunication networks for delivering a wide range of value added products and services for a long time. With the popularity of personal computers, easy and better access to internet and World Wide Web (WWW) is highly possible. It is being used increasingly by banks as a channel of receiving instructions and delivering their products and services to their customers.

Internet banking also called on-line banking is nothing more than traditional banking services delivered through an electronic communication device viz. the internet. It demolishes the traditional geographical barriers and thus reaches out to customers across the world. It is an efficient and cost effective delivery mechanism for banking service. Through internet banking, banks are in a position to offer extensive range of products and services of varied content and sophistication.

Internet banking enables customers to open accounts, pay bills, know account balances, forward loan applications, calculate interest, view and print copies of cheques and deposits, transfer funds, stop payments, recording of stop- payment instructions, reorder Cheque books and statements, receive banking industry news, send and receive messages to and from the bank through e-mail and other forms of traditional banking services. Different banks have different levels of such services offered, starting from level-1 where only information is disseminated through Internet to level-3 where on line transactions are put through.

Further, under Internet banking, the following services are available in India:

Bill payment: Every bank has a tie-up with different utility companies, service providers, insurance companies, etc. across the country. The banks use these tie-ups to offer online payment of bills (electricity, telephone, mobile phone, etc.). Also, most banks charge a nominal one-time registration fee for this service. Further, the customer can create a standing instruction to pay recurring bills automatically every month.

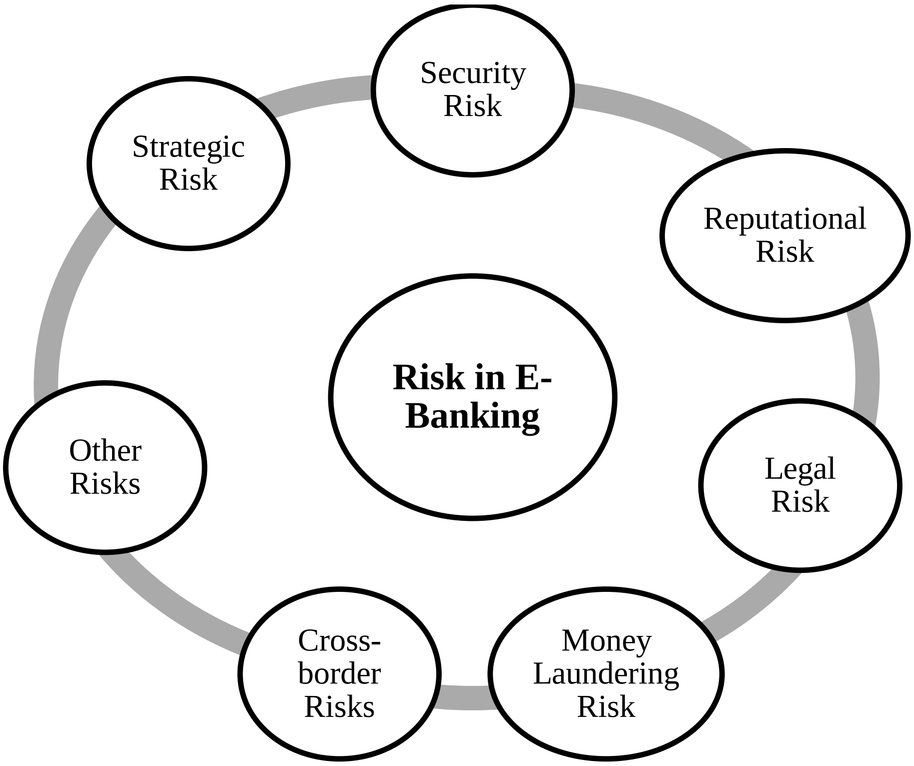
Funds transfer: A customer can transfer funds from his account to another with the same bank or even a different bank, anywhere in India. He needs to log in to his account, specify the payee's name, account number, his bank, and branch along with the transfer amount. The transfer is affected within a day or so.

Investing: Through electronic banking, a customer can open a fixed deposit with the bank online through funds transfer. Further, if a customer has a demat account and a linked bank account and trading account, he can buy or sell shares online too. Additionally, some banks allow customers to purchase and redeem mutual fund units from their online platforms as well.

Shopping: With an e-banking service, a customer can purchase goods or services online and also pay for them using his account. Shopping at his fingertips.

12.3 Risks in E- Banking

As we cannot deny the advantages offered through e-banking, same way we cannot ignore the risks involved in e-banking. Bank should maintain adequate leverage between the advantages and risks of e-banking. Although, marketing and advertising campaign initiated by banks are encouraging a number of customers to adapt e-banking, but for managing such a huge customer base banks need to prepare their internal system on prior basis. To have a deep understanding about the risks of e- banking system, it is categorized in various categories, so that bank can effectively design risk management strategies for e-banking. As now e-banking enabled banking beyond the geographical boundaries, banks have local as well as international customers to process their requests or solve their problems. Complexity of e-banking system has increased due to its close network that involves various service delivery mode offered by a bank and open network, such as internet facility that is subject tosecurity and reputational risks. It also includes operational risk, legal & regulatory risks, systematic risks, credit risks, market risks and liquidity risks. To achieve efficiency in e-banking, banks should properly identify, manage and control the risks involved in it. Following are risks associated with E-banking.



Security Risk: When we talk about banking transactions, security of the transaction is of paramount importance. All customers want their transactions to be confidential.However, since all information is online, there is always a chance that someone might retrieve the information and misuse it. The security risk of e-banking also arises from hacking threats and unauthorized access to the bank's systems.

In order to manage various operational and security risks of e-banking, it is important that the bank has appropriate system architecture and controls in place. Banks always carry the risk of choosing the wring system design or technology or have inadequate control processes. If the bank has an outdated system which is not upgradable, then it can turn into an investment loss for the bank along with inefficient service.Banks need to keep updating their systems to keep up with the rapidly changing technology to avoid any holes in its security system. Further, the bank's staffs require regular training to keep up with the new technologies too.

Reputational Risk: For any business, its reputation is of critical importance. When it comes to electronic banking, if a bank fails to perform critical functions or not work according to the expectations of its customers, then it faces a risk of loss of reputation. This eventually leads to a loss of funding or customers. Some reasons for this risk are a system or product not functioning as expected, significant deficiencies in the system, security breaches (external or internal), misinforming customers about the processes and policies of using e-banking, certain communication issues that hinder the customer from accessing his account, etc.

Legal Risk: Whenever there is a violation of laws, regulations, or prescribed practices, or when the legal rights and obligations of any of the parties to a transaction are not established, then there is a legal risk involved. E-Banking is relatively new to the industry and there is a lot of uncertainty and ambiguity about certain laws and rules. This increases the legal risk.

Money Laundering Risk: All transactions through the e-banking channel are done remotely. Therefore, it is difficult for banks to use traditional methods to detect and prevent criminal activities. While there are certain money laundering rules in place, for electronic payments, their feasibility is questionable. Therefore, banks carry the risk of money laundering.

Cross-border Risks: The core idea of electronic banking is to extend the geographical reach of both banks as well as customers. This means that the expansion can go beyond national borders. This leads to several cross-border risks:

- Legal and Regulatory risks: There is a possibility about uncertainties regarding the legal requirements in certain countries and jurisdiction ambiguities of different national authorities.
- Operational risk: If the bank uses a service provider located in a different country, then it is difficult to monitor it causing operational risk.
- Credit risk: Cross-border transactions can increase credit risk. This is because it is difficult to appraise an application for a loan from a customer in a different country.

Strategic Risk: This risk is associated with issues pertaining to:

- The development of a business plan
- Having sufficient resources available to support the business plan
- In the case of outsourced activities, the credibility of the vendor
- For employees, any change in the work environment
- Level of technology used in comparison with the available technology, etc.

Other Risks: The other risks of e-banking are the same as those of traditional banking like credit risk, liquidity risk, interest rate risk, market risk, etc. However, in e-banking, these risks are magnified due to the use of electronic channels and the absence of geographical boundaries.

All the risks mentioned above can arise due to some flaws in design, insufficient technology, negligent employees, and unauthorized system access (intentional or not). Therefore, it is important that banks adopt the right technology and systems and have proper access control for a secure transacting environment.

12.4 Guidelines for E-banking

Guidelines related to technology and security:

- Banks should designate a network and database administrator with clearly defined roles.
- Banks should have a security policy duly approved by the Board of Directors. There should be a segregation of duty of Security Officer/Group dealing exclusively with information systems security and Information Technology Division which actually implements the computer systems.
- Banks should introduce logical access controls to data, systems, application software, utilities, telecommunication lines, libraries, system software, etc. Logical access control techniques may include user-ids, passwords, smart cards or other biometric technologies.
- At the minimum, banks should use the proxy server type of firewall so that there is no direct connection between the Internet and the bank's system. It facilitates a high level of control and in-depth monitoring using logging and auditing tools.For sensitive systems, a stateful inspection firewall is recommended which thoroughly inspects all packets of information, and past and present transactions are compared. These generally include a real time security alert.
- All the systems supporting dial up services through modem on the same LAN as the application server should be isolated to prevent intrusions into the network as this may bypass the proxy server.
- Public Key Infrastructure (PKI) is the most favoured technology for secure Internet banking services. However, as it is not yet commonly available, banks should use the following alternative system during the transition, until the PKI is put in place:
    - Usage of SSL (Secured Socket Layer), which ensures server authentication and use of client side certificates issued by the banks themselves using a Certificate Server.
    - The use of at least 128-bit SSL for securing browser to web server communications and, in addition, encryption of sensitive data like passwords in transit within the enterprise itself.

- It is also recommended that all unnecessary services on the application server such as FTP (File Transfer Protocol), telnet should be disabled. The application server should be isolated from the e-mail server.
- All computer accesses, including messages received, should be logged. Security violations (suspected or attempted) should be reported and follow up action taken should be kept in mind while framing future policy. Banks should acquire tools for monitoring systems and the networks against intrusions and attacks.
- These tools should be used regularly to avoid security breaches. The banks should review their security infrastructure and security policies regularly and optimize them in the light of their own experiences and changing technologies. They should educate their security personnel and also the end-users on a continuous basis.
- The information security officer and the information system auditor should undertake periodic penetration tests of the system, which should include;
    - Attempting to guess passwords using password-cracking tools.
    - Search for back door traps in the programs.
    - Attempt to overload the system using DDoS (Distributed Denial of Service) &DoS (Denial of Service) attacks.
    - Check if commonly known holes in the software, especially the browser and the e-mail software exist.
    - The penetration testing may also be carried out by engaging outside experts (often called 'Ethical Hackers').
- Physical access controls should be strictly enforced. Physical security should cover all the information systems and sites where they are housed, both against internal and external threats.
- Banks should have proper infrastructure and schedules for backing up data. The backed-up data should be periodically tested to ensure recovery without loss of transactions in a time frame as given out in the bank's security policy. Business continuity should be ensured by setting up disaster recovery sites. These facilities should also be tested periodically.
- All applications of banks should have proper record keeping facilities for legal purposes. It may be necessary to keep all received and sent messages both in encrypted and decrypted form.

- Security infrastructure should be properly tested before using the systems and applications for normal operations. Banks should upgrade the systems by installing patches released by developers to remove bugs and loopholes, and upgrade to newer versions which give better security and control.

Guidelines related to Legal issues:

- Considering the legal position, there is an obligation on the part of banks is not only to establish the identity but also to make enquiries about integrity and reputation of the potential customer. Therefore, accounts should be opened only after proper introduction and physical verification of the identity of the customer.
- From a legal perspective, security procedure adopted by banks for authenticating users needs to be recognized by law as a substitute for signature. In India, the Information Technology Act, 2000, in Section 3(2) provides for a particular technology (viz., the asymmetric crypto system and hash function) as a means of authenticating electronic record.
- Under the present system there is an obligation on banks to maintain secrecy and confidentiality of customers' accounts. In the Internet banking scenario, the risk of banks not meeting the above obligation is high on account of several factors.The banks should, therefore, institute adequate risk control measures to manage such risks.
- In Internet banking situation there is very little scope for the banks to act on stop payment instructions from the customers. Therefore, banks should clearly notify to the customers the timeframe and the circumstances in which any stop-payment instructions could be accepted.
- The Consumer Protection Act, 1986 defines the rights of consumers in India and is applicable to banking services as well. Considering the banking practice and rights enjoyed by customers in traditional banking, banks' liability to the customers on account of unauthorized transfer through hacking, denial of service on account of technological failure etc. needs to be assessed and banks providing Internet banking should insure themselves against such risks.

Guidelines related to Regulatory and Supervisory Issues

Given the regulatory approach as above, banks are advised to follow the following instructions:

a) All banks, who propose to offer transactional services on the Internet should obtain prior approval from RBI. Bank's application for such permission should indicate its business plan, analysis of cost and benefit, operational arrangements like technology adopted, business partners, third party service providers and systems and control procedures the bank proposes to adopt for managing risks.After the initial approval the banks will be obliged to inform RBI any material changes in the services/products offered by them.

b) Banks will report to RBI every breach or failure of security systems and procedure and, its decision, may decide to commission special audit / inspection of such banks.

c) Guidelines issued by RBI on 'Risks and Controls in Computers and Telecommunications' will equally apply to Internet banking. The RBI as supervisor will cover the entire risks associated with electronic banking as a part of its regular inspections of banks.

d) Banks should develop outsourcing guidelines to manage risks arising due to third party service providers, such as, disruption in service, defective services and personnel of service providers etc.

e) Due to increase in popularity of e-commerce, it has become necessary to set up 'Inter- bank Payment Gateways' for settlement of such transactions. The protocol for transactions between the customer, bank, andgateway for setting up of payment should be adopted.Only institutions who are members of the cheque clearing system in the country will be permitted to participate in Inter-bank payment gateways for Internet payment. Each gateway must nominate a bank as the clearing bank to settle all transactions.

f) Payments using credit cards, out of cross border e-commerce transactions, and all intra-bank payments should be excluded for settlement through an inter-bank payment gateway.Inter-bank payment gateways must have capabilities for both net and gross settlement. All settlement should be intra-day and as far as possible, in real time.

g) Connectivity between the gateway and the computer system of the member bank should be achieved using a leased line network not through Internet with appropriate data encryption standard. All transactions must be authenticated.Reserve Bank may get the security of the entire infrastructure both at the payment gateway's end and the participating institutions' end certified prior to making the facility available for customers use.

h) Mutual contracts between the payee and payee's bank, the participating banks and service provider and the banks themselves will form the legal basis for such transactions. The rights and obligations of each party must be clearly defined and should be valid in a court of law.

i) Banks must make mandatory disclosures of risks, responsibilities and liabilities of the customers in doing business through Internet through a disclosure template. The banks should also provide their latest published financial results over the net.

j) Hyperlinks from banks' websites, often raise the issue of reputational risk. Such links should not mislead the customers into believing that banks sponsor any particular product or any business unrelated to banking. Hyperlinks to banks' websites from other portals are normally meant for passing on information relating to purchases made by banks' customers in the portal. Banks must follow the minimum recommended security precautions while dealing with request received from other websites, relating to customers' purchases.

RBI's recommendation on E-Banking:

The Reserve Bank of India (RBI) has a working group which examines various issues of e-banking and suggests different ways to solve them. Some of these recommendations are:

- Keeping security concerns in mind, all banks in India must follow a standard. Also, the Indian Banks Association should design this standard.
- All banks must adopt adequate security measures to maintain the secrecy and confidentiality of data. Further, they must use logical access control to implement it.
- In order to mitigate the money laundering risk, banks must develop an anti-money laundering (ALM) technology for reporting and querying.
- Banks must have an internal grievance redressal system to adopt a fraud-free culture of banking.
- All banks must have an explicit security plan along with documentation. Further, banks must strictly ensure physical access control.
- Banks must adopt an extensive e-banking network so that the rural and remote areas of the country can also benefit.

12.5 Check Your Progress

1. Which one of the following is a safety measure in banking network?
   (a) Router
   (b) Firewall
   (c) Modem
   (d) None of the above
2. Knowing someone else password by certain illegal means is…….
   (a) Hacking
   (b) Plagiarism
   (c) Log on script

(d) Password policy

3. PIN in ATM card id of:

(a) 4 alphabets

(b) 2 alphabets and 2 digits

(c) 4 digits

(d) None of the above

4. In credit card what is the grace period of payment?

(a) 1-2 days

(b) 10-20 days

(c) 15-45 days

(d) 50-60 days

5. Who can pass the law for e-banking?

(a) SBI

(b) RBI

(c) Banking Association

(d) Finance Department

6. A Debit Card/ATM card is a............digit number:

(a) 12

(b) 13

(c) 14

(d) 16

12.6 Summary

E-Banking has transformed not only the banking relationships but transformed the whole banking industry. The e- banking, therefore taken as a mandate by the banks rather than just an additional feature in most of the developed nations, as it is the economical medium to cater the banking customers. Today banking is not restricted to the traditional physical branch system, where banking staff need to be there personally for enabling banking transactions. Through e- banking, customers can process any banking transaction without even visiting bank branch at any time anywhere and this is known as “anywhere banking”. Providing e- banking is no more considered as an additional feature of a banking institution, but now it is became an essential feature of a bank.

In India, since 1997, when the ICICI Bank first offered internet banking services, today, most new-generation banks offer the same to their customers. In fact, all major banks provide e-banking services to their customers.Popular services under e-banking in India ATM, RTGS, NEFT, Credit Cards, Debit Cards, Mobile Banking, Internet Banking etc.

As we cannot deny the advantages offered through e-banking, same way we cannot ignore the risks involved in e-banking. Complexity of e-banking system has increased due to its close network that involves various service delivery mode offered by a bank and open network, such as internet facility that is subject tosecurity and reputational risks. It also includes operational risk, legal & regulatory risks, systematic risks, credit risks, market risks and liquidity risks. To achieve efficiency in e-banking, banks should properly identify, manage and control the risks involved in it.

Guidelines that **b**anks should follow are to designate a network and database administrator with clearly defined roles, banks should have a security policy duly approved by the Board of Directors. Banks should introduce logical access controls to data, systems, application software, utilities, telecommunication lines, libraries, system software, etc. Banks should have proper infrastructure and schedules for backing up data. Banks should establish the identity about integrity and reputation of the potential customer. All banks, who propose to offer transactional services on the Internet should obtain prior approval from RBI. Mutual contracts between the payee and payee's bank, the participating banks and service provider and the banks themselves will form the legal basis for such transactions.

The Reserve Bank of India (RBI) recommendall banks in India must follow a standard.All banks must adopt adequate security measures to maintain the secrecy and confidentiality of data, banks must develop an anti-money laundering (ALM) technology for reporting and querying, adopt a fraud-free culture of banking and adopt an extensive e-banking network so that the rural and remote areas of the country can also benefit.

12.7 Keywords

- **RBI:** The Reserve Bank of India RBI is India's central banking and monetary authority
- **ATM:** An automated teller machine (ATM) is machine that dispenses cash or performs other banking services when an account holder inserts a bank card.
- **RTGS:** Real-time gross settlement (RTGS) refers to a funds transfer system that allows for the instantaneous transfer of money and/or securities.

- **NEFT:** National Electronic Funds Transfer is an electronic payment system which facilitates the transfer of money from one bank to another or one branch to another.
- **ECS:** Electronic Clearing Service is an electronic mode of funds transfer from one bank account to another.
- **E-commerce:** Refers to the buying and selling of goods or services using the internet.
- **Banking:** Banking is the business activity of banks and similar institutions.
- **Payment Bank:** A payment bank is a normal bank but restricted to perform only few of the banking services as compared to traditional banks.
- **E-Banking:** E-banking refers to all the financial transactions undertaken by any financial institution over the internet
- **Credit Card:** A small plastic card issued by a bank, building society, etc., allowing the holder to purchase goods or services on credit.
- **Debit Card:** A card allowing the holder to transfer money electronically from their bank account when making a purchase.
- **Mobile Banking:** Mobile banking is the act of making financial transactions on a mobile device.

12.8 Self-Assessment Test

1. What do you mean by E-banking? What are the characteristics, advantage, and disadvantages of E-banking services in India?
2. Describe E-banking, what are the services offered by E-banking system in India?
3. Explain in detail risk related with E-banking.
4. What are various guidelines with regard to E-banking in India? Explain.
5. Write short note on:

   ATM

   RTGS

   NEFT

   Credit and Debit Cards

12.9 Answers to check your progress

1(b), 2 (a), 3(c), 4 (c), 5(b), 6 (d)

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Course: Indian Financial System	
Course Code:**BC 305**	Author:**Dr. Sanjeev Kumar Garg**
Lesson No.: **13**	Vetter: **Dr. Suresh K. Mittal**

NPA's in Commercial Banks

STRUCTURE:

13.0 Learning Objectives

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

- Understand the meaning of Non-Performing Assets (NPAs) and types of NPAs
- Know the reasons for NPAs and steps to reducing NPAs in banking sector
- Understand the RBI guidelines related to NPA provisioning

13.1 Introduction

Money or assets provided by banks to companies as loans sometimes remain unpaid by borrowers. This late or non-payment of loans is defined as Non-Performing Assets (NPA). They are also termed as bad assets. In India, the RBI monitors the entire banking system and, as defined by the country's Central Bank, if for a period of more than 90 days, the interest or instalment amount is overdue then that loan account can be termed a Non-Performing Asset. The increase in non-performing assets in Indian banks follows the recognition standards being pursued by the banks after the RBI highlighted it in the Asset Quality Review (AQR).

A Non-Performing Asset (NPA) refers to a classification for loans or advances that are in default or in arrears. A loan is in arrears when principal or interest payments are late or missed. A loan is in default when the lender considers the loan agreement to be broken and the debtor is unable to meet his obligations.

In other words, NPA or Non-Performing Asset is those kinds of loans or advances that are in default or in arrears. These are those kinds of loans wherein principal or interest amounts are late or have not been paid. These are also the kinds of loans where the lender considers the loan agreement to be broken and the receiver of the loan is unable to pay back the loan amount.

13.1.1Definition of Non-Performing Assets

"A non-performing asset (NPA) is a loan or advance for which the principal or interest payments remained overdue for a period of 90 days .Banks are required to classify NPAs further into Substandard, Doubtful and Loss assets.

In simpler terms, if the customers do not repay principal amount and interest for a certain period of time, then such loans are considered as Non-Performing Assets or NPA. Any asset which stops giving returns to its investors for a specified period of time is known as Non-Performing Asset.

According to the Narasimham Committee Report (1991):" those assets (advances, bills discounted, overdrafts, cash credit etc.) for which the interest remains due for a period of four quarters (180 days) now it is 90 days, should be considered as NPA".

As per section 2(o) of the SARFAESI Act 200215: "non-performing asset means an asset or account of a borrower which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset.

a) In case such bank or financial institution is administered or regulated by any authority or body established ,constituted or appointed by any law for the time being in force ,in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;

b) In any other case, in accordance with the directions or guidelines relating to assets classifications issued by Reserve Bank". With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days' overdue' norm for identification of NPAs, from the year ending March 31, 2004.

For Example: Suppose the State Bank of India (SBI) gives a loan of Rs. 10 crores to a ABC Company. Consider that they agreed upon for an interest rate of say 10% per annum. Now suppose that initially everything was good and the market forces were working in support to the airline industry, therefore, ABC Company was able to service the interest amount. Later, due to administrative, technical or corporate reasons suppose the company is not able to pay the interest rates for 90 days. In that case, a loan given to the ABC Company is a good case for the consideration as NPA.

NPAs as per Reserve Bank of India (RBI)

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank. Technical definition by RBI on NPA on different cases:

- NPA is a loan or an advance where Interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- The account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC).
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- The instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops.
- The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.
- The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

13.1.2 Types of NPA

Gross NPA: Gross NPAs are the advance which is considered irrecoverable, for bank has made provisions, and which is still held in banks' books of account. Gross NPAs are the sum total of all loan assets that are classified as NPAs as per RBI guidelines as on Balance Sheet date. Gross NPA reflects the quality of the loans made by banks. It consists of all the Non-Standard assets like as sub-standard, doubtful and loss assets. It can be calculated with the help of following formulas:

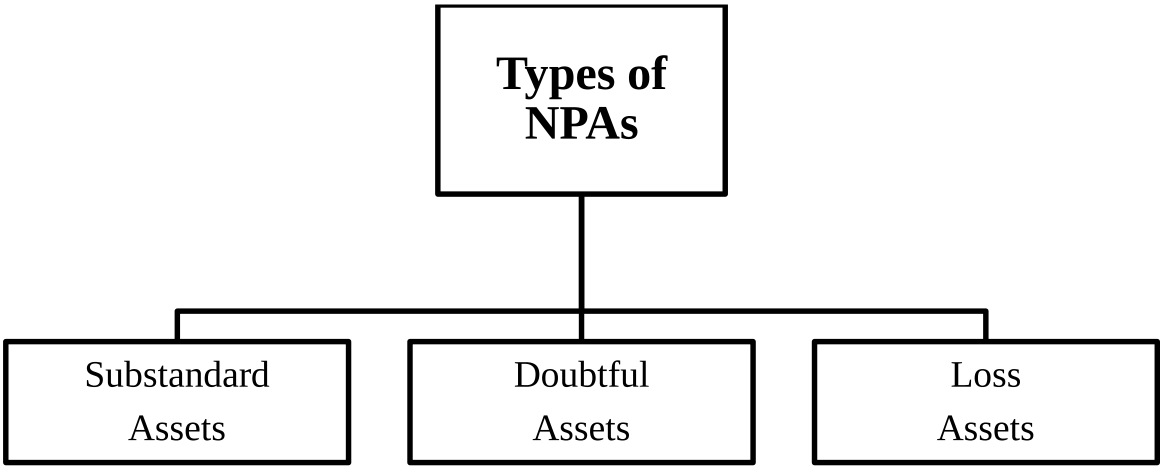
- Gross NPAs= Sub-standard Assets + Doubtful Assets + Loss Assets Gross
- NPAs Ratio = Gross NPA / Gross Advances

Net NPA: Net NPA is obtained by deducting items like interest due but not recovered, part payment received and kept in suspense account from Gross NPA. In other words, Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. Net NPA shows the actual burden of banks. In India, bank balance sheets contain a huge amount of NPAs and the process of recovery and write off of loans is very time consuming, the provisions the banks have to make against the NPAs according to the central bank guidelines, are quite significant. That is why the difference between Gross and Net NPA is quite high. It can be calculated by following ways:

- Net NPAs = Gross NPAs –Provisions/Gross Advances –Provisions
- Net NPA= Gross NPA – (Balance in Interest Suspense account + DICGC/ECGC claims received and held pending adjustment + Part payment received and kept in suspense account + Total provisions held)

Types of Non-Performing Assets (NPAs)

Based upon the period to which a loan has remained as NPA, it is classified into 3 types:



Substandard assets: Loans and advances which are non-performing assets for a period of 12 months fall under the category of Sub-Standard Assets.

Doubtful assets: An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months.

Loss assets: As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value." Asset where loss has been identified by the bank or the RBI, however, there may be some value remaining in it. Therefore loan has not been not completely written off.

13.1.3 Provisioning for NPAs

Standard Assets: It is a kind of performing asset which creates continuous income and repayments as and when they become due. These assets carry a normal risk and are not NPA in the real sense of the word. Hence, no special provisions are required for standard assets.

Provisions for Standard Assets: For urban coop banks the general provisioning requirement for all types of 'standard advances' shall be 0.40 per cent. However, direct advances to agricultural and SME sectors which are standard assets, would attract a uniform provisioning requirement of 0.25 per cent of the funded outstanding on a portfolio basis, as hitherto. Further, with effect from Dec 8, 2009, all UCBs (Both Tier I & Tier II) are required to make a provision of 1.00 percent in respect of advances to the Commercial Real Estate Sector classified as 'standard assets'. For, Commercial Real Estate Residential Housing Sector (CRERH) 0.75 percent provision should be made.

For commercial banks direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent; advances to Commercial Real Estate (CRE) Sector at 1.00 per cent; Commercial Real

Estate Residential Housing Sector (CRERH) 0.75 percent, all other loans and advances not included in (a) (b) and (c) above at 0.40 per cent.

The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in Schedule 5 of the balance sheet.

Provisions for Sub Standard Assets: For urban coop banks a general provision of 10 per cent on total outstanding should be made without making any allowance for DICGC / ECGC guarantee cover and securities available. For commercial banks a general provision of 15 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available. The 'unsecured exposures' which are identified as 'substandard' would attract an additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance. However, in view of certain safeguards such as escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as substandard will attract a provisioning of 20 per cent instead of the aforesaid prescription of 25 percent.

Provisions for Doubtful Assets: For coop banks Provision should be for 100 per cent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse should be made and the realisable value is estimated on a realistic basis. For secured portions 20%, 30% and 100% for D1, D2, D3 category respectively. (D1 = doubtful up to 1 year, D2= doubtful 1 to 3 years, and D3= doubtful more than 3 years).

For commercial banks 100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis. For secured portions 25%, 40% and 100% for D1,D2,D3 category respectively. (D1 = doubtful up to 1 year, D2= doubtful 1 to 3 years, and D3= doubtful more than 3 years).

Provisions for Loss Assets: Loss assets should be written off. If loss assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

Provisions for Standard Assets	General Provisioning • 0.40 per cent. Direct advances to agricultural and SME • 0.25 per cent

<table>
<tr><td></td><td>From Dec 8, 2009, all UCBs (Both Tier I & Tier II)
1 percent in respect of advances to the Commercial Real Estate Sector
Commercial Real Estate Residential Housing Sector 0.75 percent.
Direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;
All other loans and advances not included above at 0.40 per cent.</td></tr>
<tr><td>Provisions for Sub Standard Assets</td><td>For urban coop banks a general provision of 10 per cent on total outstanding.
For commercial banks a general provision of 15 percent on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.
The ‘unsecured exposures’ which are identified as ‘substandard’ would attract an additional provision of 10 per cent, i.e., a total of 25 per cent on the outstanding balance.
Where escrow accounts available in respect of infrastructure lending, infrastructure loan accounts which are classified as substandard will attract a provisioning of 20% instead of 25%.</td></tr>
<tr><td>Provisions for Doubtful Assets</td><td>For coop banks Provision should be for 100 per cent. For secured portions
D1 = doubtful up to 1 year, 20%
D2= doubtful 1 to 3 years, 30%,
D3= doubtful more than 3 years).100%
For commercial banks 100 percent of the extent to which the advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis. For secured portions
D1 = doubtful up to 1 year, 25%
D2= doubtful 1 to 3 years, 40%,
D3= doubtful more than 3 years).100%</td></tr>
<tr><td>Provisions for</td><td>Loss assets should be written off. If loss assets are permitted to</td></tr>
</table>

Loss Assets	remain in the books for any reason, 100 percent of the outstanding should be provided for.

13.1.4 Relevance of NPAs

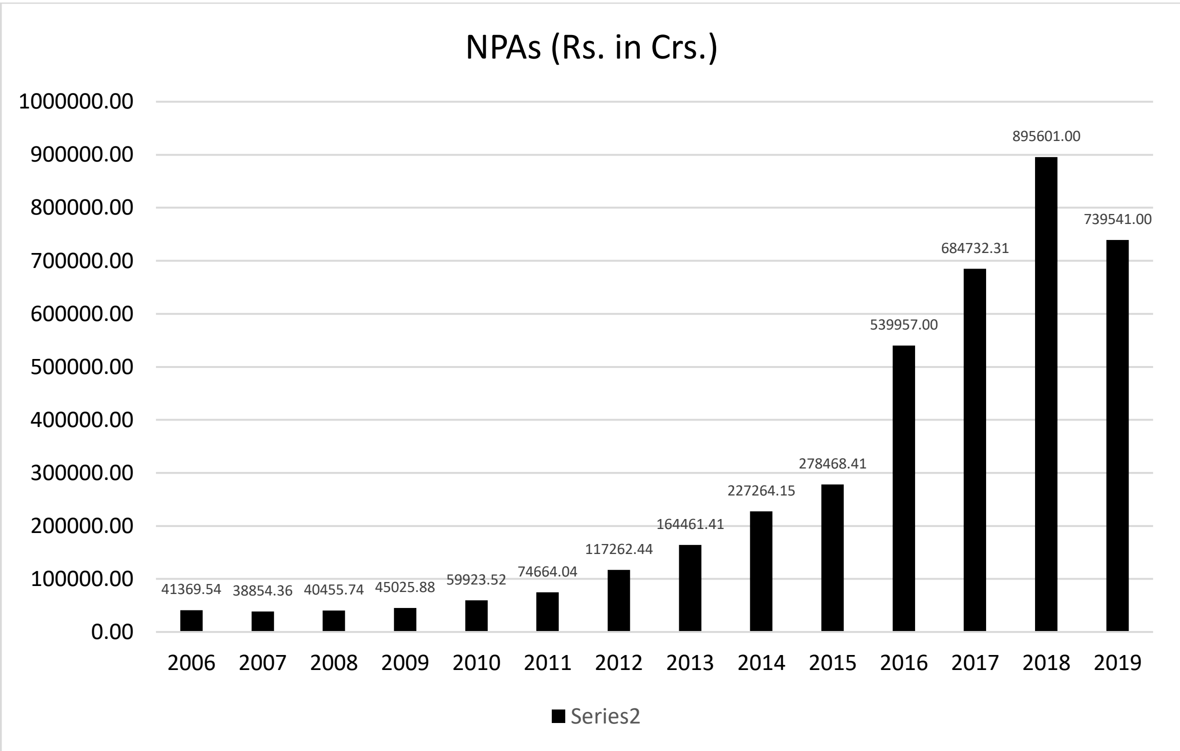
- It is important for both the borrower and the lender to be aware of performing versus non-performing assets. For the borrower, if the asset is non-performing and interest payments are not made, it can negatively affect their credit and growth possibilities. It will then hamper their ability to obtain future borrowing.
- For the bank or lender, interest earned on loans acts as a main source of income. Therefore, non-performing assets will negatively affect their ability to generate adequate income and thus, their overall profitability. It is important for banks to keep track of their non-performing assets because too many NPAs will adversely affect their liquidity and growth abilities.
- Non-performing assets can be manageable, but it depends on how many there are and how far they are past due. In the short term, most banks can take on a fair amount of NPAs. However, if the volume of NPAs continues to build over a period of time, it threatens the financial health and future success of the lender.

13.2 NPAs in Indian Banking Sector

In India, more than Rs. 7 lakh crore worth loans are classified as Non-Performing Loans in year 2019. This is a huge amount. The figure roughly translates to near 10% of all loans given. This means that about 10% of loans are never paid back, resulting in substantial loss of money to the banks. When restructured and unrecognised assets are added the total stress would be 15-20% of total loans.NPA crisis in India is set to worsen. Restructuring norms are being misused. This bad performance is not a good sign and can result in crashing of banks as happened in the sub-prime crisis of 2008 in the United States of America. Also, the NPA problem in India is worst when comparing other emerging economies in BRICS. Following table showing year wise NPA data from 2006 to 2019.

Year	NPA (Rs.)
2006	41369.54 Crore
2007	38854.36 Crore
2008	40455.74 Crore

2009	45025.88 Crore
2010	59923.52 Crore
2011	74664.04 Crore
2012	117262.44 Crore
2013	164461.41 Crore
2014	227264.15 Crore
2015	278468.41 Crore
2016	539957.00 Crore
2017	684732.31 Crore
2018	895601.00 Crore
2019	739541.00 Crore



(Sources: RBI data)

If we are seeing the above data it can be observed that there is sharp rise in NPAs over the last 15 years. This situation adversely affects the banking sector business, and their profitability in India.

13.2.1Reasons for Non-Performing Assets

Political Causes: A major portion of bad debts arose out of lending to the priority sector, at the dictates of politicians and bureaucrats. If only banks had monitored their loans effectively, the bad debt problem could have been contained, if not eliminated. The top managements of the banks were forced by politicians and bureaucrats to throw good money after bad in the case of unscrupulous borrowers. Many big borrowers defaulted only due to the recession in the economy. The absence of proper bankruptcy laws and the dilatory legal procedures in enforcing security rights are the root cause of bad debts in banks.

Economic causes: Causes of non-performing advances and come to the conclusion that macro-economic environment like recessions, infrastructure bottlenecks, changes in government policies, etc. result in some lending of banks becoming unproductive and borrowers turning defaulters, changes in economic policy, i.e. fiscal and monetary, effected in response to economic and political needs from time to time in the context of domestic and international scenario, have a bearing on the performance of banks and business, as also on loans going bad. Changes in Industrial and Agricultural policies, Export Import policy, Credit policy, Exchange Rate policy, Labour policy are also stated to have partially contributed to the failure of some borrowers in there payment of loans, as the borrowed funds could not be used fruitfully due to some of the unfavourable impact and effects of policy measures. Both banks and borrowers have been caught unaware by the fast changing policies and find themselves trapped with funds locked up in units producing nothing".

Internal factor: While banks and borrowers have not much of control over external factors, lack of co-ordination between banks and other agencies involved particularly to have a tie up for funding requirements etc. adds to the woes of the borrowers making them difficult to perform. Factors like diversion of funds for business expansion/ diversification of associate concerns, business/ market failure, time/ cost overrun in the implementation of projects, inefficient management on the part of borrowers, etc. have resulted in poor utilisation of credit and consequent repayment problems. Wilful default by some of the borrowers taking advantage of weak legal system is cited as another major cause of NPAs. On banks" side, delay in the sanctioning of loans, grant of inadequate credit deficiency in the credit appraisal standards, lack of supervision and follow-up, general level of inefficiency in containing the cost of funds due to very high overheads, poor productivity, high intermediation costs, low level of technological and high rate of interest charged to borrowers to cover up the loss on account of Non-Performing Advances have been emphasised as important causes for mounting NPAs."

Social Reasons: On the social side, lack of education and enlightenment among the borrowers and the other side poor legal infrastructure generally stated to be supportive of the borrowers rather than lenders. In large cases, corruption has been observed to be major stumbling blocks in the recovery of loans. Lack of integrity on the part of both bankers and borrowers has also influenced formation of NPAs. Erosion in social, values, ethics and accountability have been highlighted as some of the reasons for formation of huge NPAs. Awareness that banks lend public money which is required to be returned, is unfortunately found missing, aggravating the problem of recovery of loans. The other causes aggravating the problem of NPAs can be found inability of borrowers to tie up the required funds as promoters contribution and in general financial indiscipline in the utilisation of funds for the purpose for which loans are availed, inordinate delay in realisation of their own dues from debtors, poor capital market support, lack of competitive spirit in the conduct of business and ability to cope with the competition observed in product market, capital market, money market and foreign exchange market witnessed in the area of efficiency, quality, cost, etc. resulting in the inability to compete in the open market which in turn has resulted in the units turning sick/getting closed without having funds to clear the banks' dues. Lack of accountability on the part of borrowers, lenders, auditors, accountants, lawyers, values and all connected professionals have also been accelerating NPA formation.

Wilful Defaulters: "The major culprits behind high NPAs are intentional defaults, mismanagement and lack of planning. Public money obtained from banks has been systematically siphoned away from our industries. The problem of NPAs has degenerated to such an extent where in an effort to assign the blame, even Trade Unions have ventured in recent times to publish lists of defaulters because of whom, they consider that some of the banks are in dire financial straits. These lists are over and above the official lists published by RBI of bank-wise defaulters of Rs. one crore and above in the banking system.

Better Creditworthy Companies moved away from banks: With the introduction of varieties of debt instrument like Commercial paper, corporate bonds, Debentures, etc. in the credit market and linking of interest rates to the market forces and creditworthiness of the borrowers, many of the better rated corporate concerns have moved away from banks, leaving the latter with only second and third grade borrowers. This adds to the problem of NPAs of banks.

Poor Appraisal Quality: The history of NPAs is complex. Poor appraisal quality and lack of appreciation and understanding of broader economic, financial and market forces impacting project and corporate viability are major reasons. External pressures in credit decisions have played their part. Lack of integrity on the part of some appraising official's and bank managements is another proximate cause. One more significant factor is the logjam in accessing collaterals and recovery of its market value because of legal hurdles.

Long Drawn-out Legal Procedures: The RBI Bulletin argues that India's high level of NPAs is a historical legacy. This is a rather dubious claim. It is far better to focus on the systematic failures such as lacunae in the credit recovery system, arising from adequate legal provisions on foreclosure and bankruptcy, long drawn-out legal procedures, and difficulties in the execution of the decree awarded by the court. These continue to be a feature of the present financial situation. Banks may themselves play an important role in raising NPAs levels through sheer delay in offering adequate credit limits to working capital and thus lead to poor operating results.

Priority Sector Lending Regulations: Other causative factors responsible for NPAs relate to cyclical weaknesses, structural weaknesses and miscellaneous reasons. The weak capital position of Indian Banking System is largely a reflection of growing assets-quality problems stemming from weak underwriting and credit management systems and vulnerabilities of the Indian Banking Sector to the impact of globalisation on the country's key industrial sectors. The asset-quality position has also suffered from regulations with respect to lending to priority sectors.

Weak Credit Risk Management: Banks are derivative institutions. The health of the real sector is reflected in the banking system's health. If the credit discipline is weak and state intervention in the financial sector is pronounced, there is every possibility that the banking system will be weak and often unsound. Experiences from and around the world indicates that poor credit quality coupled with weak credit risk management practices continues to be a dominant factor in bank failures and banking crises. Severe credit losses in a banking system reflect simultaneous problems in several areas such as credit concentrations; credit processes issues, and market and liquidity sensitive credit exposures.

Misuse of Funds: The borrowers' misuse the amount given as loan by the banks. They do not utilize the money for the purpose for which they have applied; rather they use it for some other purposes. For instance, a farmer has taken loan for installing a tube well but has utilized the money in the construction of house. Then under such circumstances, it becomes difficult for that farmer to pay back the money and from the point of view of loan it becomes non-performing.

Non verification of Document & No proper follow up: It is not a new fact that Banks while giving out loan rely heavily on documents submitted by the borrowers and insist on certificates from the borrower that amount borrowed will be used only for purpose for which loan is taken but fails to verify both i.e. whether the documents are authentic or not and whether the amount is being misutilised or used as per the terms of loan or not. Thus, non-verification of documents & no proper follow up adds hugely to the problem of NPA of Banks.

Natural Causes and Calamities: It has been experienced that sometimes natural calamities have caused the emergence of NPA. Destruction of property/newly built factory of the infant companies which took loan for doing business or occurrence of drought in particular area or excessive rain, demolition of properties due to earthquake are few examples of the manner in which the persons / entities which took loan and due to natural calamities did not remain in the position to pay off the loan, thus, loan became NPA. Thus, sometimes natural calamities also may cause NPA.

Pressure of seniors on the Operating Managers: Sometimes excessive pressure of the seniors on their operating staff/managers, forces them to advance credit. These managers know it fully that it will be very difficult to recover the amount of debt. But force circumstances compel them to obey the order and grant loans. This also leads to the emergence of NPAs. In this type of cases, seniors may have good personal relations with the borrowers or they want to advance those loans to their family members/relatives.

Under/Over Financing: Sometimes it has been noticed that the firms/individuals who require higher amount of debt are given less amount and who are needed less amount are given higher amount. In both the cases, the amount of debt is trapped. The person/firm, getting inadequate amount is not in a position to run his business smoothly and is also incapable of paying back the same. On the other hand, the person, who gets excess loan, uses the same in an uneconomic way and in unproductive activities. In both the cases, there is delay in paying back the amount. Thus, it leads to emergence of NPAs.

Competition in Marketing of the Product: A businessman/producer borrows money for the production of a product, but sometimes any other producer starts producing the similar product. If it happens to be superior to the former, then this product fails in the market due to competition. It becomes difficult for the former business person or the producer to return the money back. Sometimes due to lack of transport facility, the product does not reach the market in time for sale and thus, there is a delay in paying back the debt. Both these causes are also responsible for emergence of NPAs.

Non-Availability of Proper Security against Funds: Some loans are given without adequate mortgage/security. The non-availability of proper security against these funds makes them insecure to recover.

Large Branch Expansion: In recent years, there has been a vast expansion of branches of the banks, especially of public sector banks. The main motive behind this branch expansion was to provide adequate banking facilities in rural, backward and remote-far off areas and small towns. For the expansion of these branches, land was purchased, building was constructed, banking infrastructure was purchased, employees were sent there, and new employees were recruited as per the requirement. A lot of expenditure was incurred in all this process. But many of these branch expansions proved to be uneconomic, and the recurring expenditure without any yield is still going on. Some branches opened by the banks in rural areas failed to generate return, hence turned out to be NPAs."

Other reasons

- Diversification of funds to unrelated business/fraud.
- Lapses due to diligence.
- Business losses due to changes in business/regulatory environment.
- Lack of morale, particularly after government schemes which had written off loans.
- Global, regional or national financial crisis which results in erosion of margins and profits of companies, therefore, stressing their balance sheet which finally results into non-servicing of interest and loan payments. (For example, the 2008 global financial crisis).
- The general slowdown of entire economy for example after 2011 there was a slowdown in the Indian economy which resulted in the faster growth of NPAs.
- The slowdown in a specific industrial segment, therefore, companies in that area bear the heat and some may become NPAs.
- Unplanned expansion of corporate houses during the boom period and loan taken at low rates later being serviced at high rates, therefore, resulting in NPAs.
- Due to mal-administration by the corporate, for example, wilful defaulters.
- Due to mis-governance and policy paralysis which hampers the timeline and speed of projects, therefore, loans become NPAs for example the Infrastructure Sector.
- Severe competition in any particular market segment. For example the Telecom sector in India.
- Delay in land acquisition due to social, political, cultural and environmental reasons.
- A bad lending practice which is a non-transparent way of giving loans.
- Due to natural reasons such as floods, droughts, disease outbreak, earthquakes, tsunami etc.

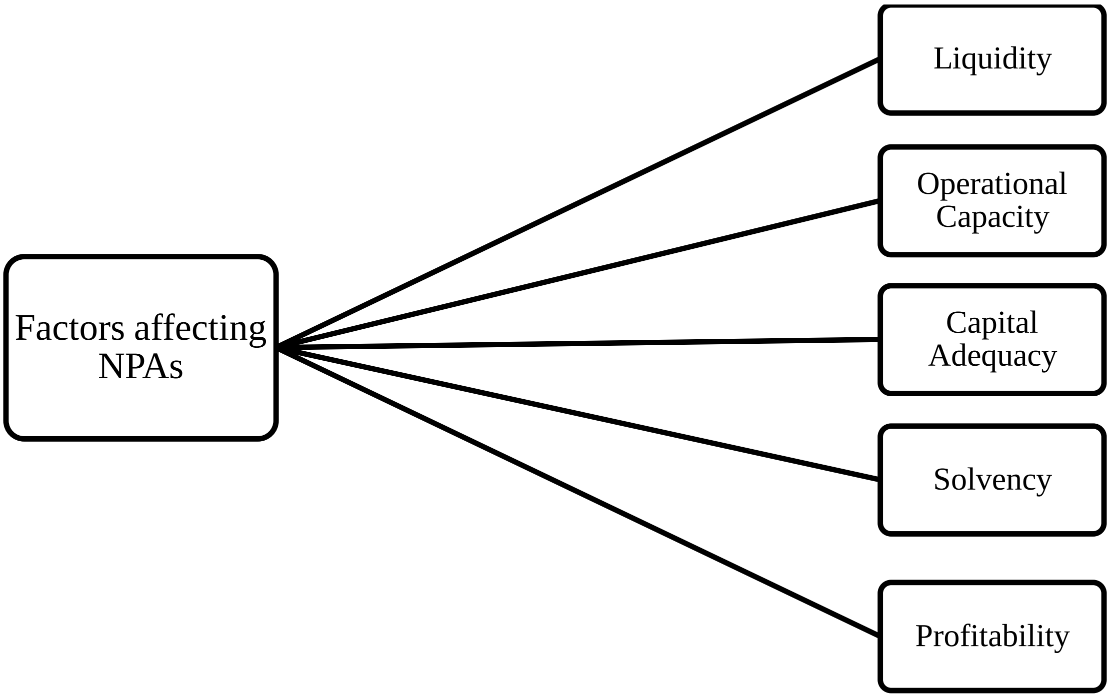
- Cheap import due to dumping leads to business loss of domestic companies. For example the Steel sector in India.

13.2.2 Impact of Non-Performing Assets

- Lenders suffer a lowering of profit margins.
- Stress in banking sector causes less money available to fund other projects, therefore, negative impact on the larger national economy.
- Higher interest rates by the banks to maintain the profit margin.
- Redirecting funds from the good projects to the bad ones.
- As investments got stuck, it may result in it may result in unemployment.
- In the case of public sector banks, the bad health of banks means a bad return for a shareholder which means that the government of India gets less money as a dividend. Therefore it may impact easy deployment of money for social and infrastructure development and results in social and political cost.
- Investors do not get rightful returns.
- Balance sheet syndrome of Indian characteristics that is both the banks and the corporate sector has stressed balance sheet and causes halting of the investment-led development process.
- NPAs related cases add more pressure to already pending cases with the judiciary.

13.2.3 Factors affecting NPAs

We find that liquidity, operational capability, solvency, capital adequacy, business development capacity and profitability parameters of a bank affect NPAs. We begin with describing how the first parameter, liquidity, affects NPAs and subsequently explain how the other ratios under operational capability, solvency, capital adequacy, business development capacity and profitability affect NPAs.



Liquidity: Liquidity is represented through cash to deposit ratio. When the NPA level increases, the cash level is likely to decrease as the borrower is unable to repay loan interest and principal. This will likely create a temporary shortage of cash and the bank will have to approach alternate sources to improve liquidity. This ratio will have a negative relationship with NPA. As NPAs reduce, liquidity improves.

Operational capability: The second parameter that affects NPAs is operational capability (OC). Operational capability refers to the ability of the bank to efficiently manage its resources. When an asset stops generating income in the form of principal payments, the principal that is extended from deposits is not recovered. This reduces the deposit base by the amount unrecovered. High NPAs reduce the deposit base and affect the credit generation capacity. When a bank has a higher proportion of secured assets, the bank has a safety net to fall back on in case an asset becomes an NPA. If a loan asset becomes an NPA, the bank has the option to recover the amount through liquidation of the security pledged. This reduces the possibility of a bank losing the entire amount in case of a secured asset.

This implies that when a higher portion of the loan assets are secured, banks have a lesser risk of losing the entire amount in case of loan default. A bank's operational capability using the non-interest income was to serve as indicator of the bank's diversification. If a bank was well-diversified, the bank protected itself from the downside of loan assets going bad. When a loan asset becomes an NPA, the interest earned reduces, while the bank has to still pay interest on deposits. The net interest income earned in case of NPA reduces.

Capital adequacy: Capital adequacy is a tool to control excessive risk taking by banks to prevent them from becoming insolvent through capitalisation. When there is a large portion of owned capital in the total bank capital structure, the managers of the bank have more incentive to follow the owner(s) objectives. This curbs the risk undertaking behaviour of the managers to a certain extent. When NPAs are high, there is a higher loan loss provision to be maintained, hence the portion of Tier 2 capital is increased. The bank's capital requirements increase when the NPAs are high. So, there exists a positive relation between the two.

Solvency: When the loan assets stop generating income, the bank assets start witnessing a decrease in their value. Gradually, if the loan assets discontinue to generate income, the value of liabilities surpasses the value of assets. First, the bank resorts to bank capital for this loan loss absorption; thereafter to fulfil the capital requirements, banks have to approach the market to raise capital. Banks raise debt or equity to meet the capital requirements. Therefore, when NPAs are high solvency adversely affected.

Profitability: Returns on assets is the net income generated by the bank on its total assets (including fixed assets). The higher the portion of income generates assets among total bank assets, the higher would be the likelihood of the bank earning interest income. Income generating assets for a bank are usually Loan assets, investments, foreign currency assets and cash balances with other banks. When NPAs increase, interest earned reduces, and hence return on asset declines. Hence, NPAs and return on asset have a negative relation.

13.2.4 Steps taken to tackle NPAs

NPAs story is not new in India and there have been several steps taken by the GOI on legal, financial, policy level reforms. In the year 1991, Narsimham committee recommended many reforms to tackle NPAs. Some of them were implemented. Following are some recent developments to tackle NPAs.

Regulatory Developments:

Following are some regulatory development for reducing NPAs in banking sector.

The Debt Recovery Tribunals (DRTs) 1993: To decrease the time required for settling cases. They are governed by the provisions of the Recovery of Debt Due to Banks and Financial Institutions Act, 1993. However, their number is not sufficient therefore they also suffer from time lag and cases are pending for more than 2-3 years in many areas.

Credit Information Bureau 2000: A good information system is required to prevent loan falling into bad hands and therefore prevention of NPAs. It helps banks by maintaining and sharing data of individual defaulters and wilful defaulters.

LokAdalats 2001: They are helpful in tackling and recovery of small loans however they are limited up to 5 lakh rupees loans only by the RBI guidelines issued in 2001. They are positive in the sense that they avoid more cases into the legal system.

Compromise Settlement 2001: It provides a simple mechanism for recovery of NPA for the advances below Rs. 10 Crores. It covers lawsuits with courts and DRTs (Debt Recovery Tribunals) however wilful default and fraud cases are excluded.

SARFAESI Act 2002: The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 – The Act permits Banks / Financial Institutions to recover their NPAs without the involvement of the Court, through acquiring and disposing of the secured assets in NPA accounts with an outstanding amount of Rs. 1 lakh and above. The banks have to first issue a notice. Then, on the borrower's failure to repay, they can:

- Take ownership of security and/or
- Control over the management of the borrowing concern.
- Appoint a person to manage the concern.
- Further, this act has been amended last year to make its enforcement faster.

ARC (Asset Reconstruction Companies): The RBI gave license to 14 new ARCs recently after the amendment of the SARFAESI Act of 2002. These companies are created to unlock value from stressed loans. Before this law came, lenders could enforce their security interests only through courts, which was a time-consuming process.

Corporate Debt restructuring 2005: It is for reducing the burden of the debts on the company by decreasing the rates paid and increasing the time the company has to pay the obligation back.

Rule 2014: Also known as, Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries. It was proposed to maintain the cash flow of such companies since the project timeline is long and they do not get the money back into their books for a long time, therefore, the requirement of loans at every 5-7 years and thus refinancing for long term projects.

Joint Lenders Forum 2014: It was created by the inclusion of all PSBs whose loans have become stressed. It is present so as to avoid loan to the same individual or company from different banks. It is formulated to prevent the instances where one person takes a loan from one bank to give a loan of the other bank.

Mission Indradhanush 2015: The Indradhanush framework for transforming the PSBs represents the most comprehensive reform effort undertaken since banking nationalization in the year 1970 to revamp the Public Sector Banks (PSBs) and improve their overall performance by ABCDEFG.

- A-Appointments: Based upon global best practices and as per the guidelines in the companies act, separate post of Chairman and Managing Director and the CEO will get the designation of MD & CEO and there would be another person who would be appointed as non-Executive Chairman of PSBs.
- B-Bank Board Bureau: The BBB will be a body of eminent professionals and officials, which will replace the Appointments Board for the appointment of Whole-time Directors as well as non-Executive Chairman of PSBs.
- C-Capitalization: As per finance ministry, the capital requirement of extra capital for the next four years up to FY 2019 is likely to be about Rs.1, 80,000 crore out of which 70000 crores will be provided by the GOI and the rest PSBs will have to raise from the market.

Financial Year	**Total Amount**
FY15-16	25,000 Crore
FY16-17	25,000 Crore
FY17-18	10,000 Crore
FY18-19	10,000 Crore
Total	**70,000 Crore**

- D-DE stressing: PSBs and strengthening risk control measures and NPAs disclosure.
- E-Employment: GOI has said there will be no interference from Government and Banks are encouraged to take independent decisions keeping in mind the commercial the organizational interests.
- F-Framework of Accountability: New KPI (key performance indicators) which would be linked with performance and also the consideration of ESOPs for top management PSBs.

- G-Governance Reforms: For Example, Gyan Sangam, a conclave of PSBs and financial institutions. Bank board Bureau for transparent and meritorious appointments in PSBs.
- **Strategic debt restructuring (SDR) – 2015:**Under this scheme banks who have given loans to a corporate borrower gets the right to convert the complete or part of their loans into equity shares in the loan taken company. Its basic purpose is to ensure that more stake of promoters in reviving stressed accounts and providing banks with enhanced capabilities for initiating a change of ownership in appropriate cases.

  Asset Quality Review – 2015: Classify stressed assets and provisioning for them so as the secure the future of the banks and further early identification of the assets and prevent them from becoming stressed by appropriate action.

  Sustainable structuring of stressed assets (S4A) – 2016: It has been formulated as an optional framework for the resolution of largely stressed accounts. It involves the determination of sustainable debt level for a stressed borrower and bifurcation of the outstanding debt into sustainable debt and equity/quasi-equity instruments which are expected to provide upside to the lenders when the borrower turns around.

  Insolvency and Bankruptcy code Act-2016: It has been formulated to tackle the Chakravyuaha Challenge (Economic Survey) of the exit problem in India. The aim of this law is to promote entrepreneurship, availability of credit, and balance the interests of all stakeholders by consolidating and amending the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time-bound manner and for maximization of value of assets of such persons and matters connected therewith or incidental thereto. With the RBI's push for the IBC, the resolution process is expected to quicken while continuing to exercise control over the quality of the assets.
- **Pubic vs. Private ARC – 2017:**This debate is recently in the news which is about the idea of a Public Asset Reconstruction Companies (ARC) fully funded and administered by the government as mooted by this year's Economic Survey Vs. the private ARC as advocated by the deputy governor of RBI Mr. Viral Acharya. Economic survey calls it as PARA (Public Asset Rehabilitation Agency) and the recommendation is based on a similar agency being used during the East Asian crisis of 1997 which was a success.

- **Bad Banks – 2017:** Economic survey 16-17, also talks about the formation of a bad bank which will take all the stressed loans and it will tackle it according to flexible rules and mechanism. It will ease the balance sheet of PSBs giving them the space to fund new projects and continue the funding of development projects.

Managerial steps to control over NPAs

Credit Risk Management: This involves credit appraisal and monitoring accountability and credit by performing various analyses on profit and loss accounts. While conducting these analyses, banks should also do a sensitivity analysis and should build safeguards against external factors.

Tightening Credit Monitoring: A proper and effective Management Information System (MIS) needs to be implemented to monitor warnings. The MIS should ideally detect issues and set off timely alerts to management so that necessary actions can be taken.

Amendments to Banking Law to give RBI more power: The present scenario allows the RBI just to conduct an inspection of a lender but doesn't give them the power to set up an oversight committee. With the amendment to the law, the RBI will be able to monitor large accounts and create oversight committees.

More "Haircuts" for Banks: For quite some time, PSU lenders have started putting aside a large portion of their profits for provisions and losses because of NPA. The situation is so serious that the RBI may ask them to create a bigger reserve and thus, report lower profits.

Stricter NPA recovery: It is also discussed that the Government needs to amend the laws and give more power to banks to recover NPA rather than play the game of "wait-and-watch."

Corporate Governance Issues: Banks, especially the public sector ones, need to come up with proper guidance and framework for appointments to senior-level positions.

Accountability: Lower-level executives are often made accountable today; however, major decisions are made by senior-level executives. Hence, it becomes very important to make senior executives accountable if Indian banks are to tackle the problem of NPAs.

Steps taken at banking level to raise capital to address the problem of NPAs

Due to huge amount of non-performing assets bank every time face liquidity problem, here are some steps by which banks raise capital to reduce the problem of liquidity arise due to NPAs.

Using unclaimed deposits: Similar to provisions for unclaimed dividends, the government may also create a provision and transfer unclaimed deposits to its account. These funds, in return, can be transferred to banks as capital.

Monetization of assets held by Banks: In this case, banks with retail franchisees should create value by auctioning a bank assurance association rather than running it themselves as an insurance company. The current set-up blocks capital inflows and doesn't generate much wealth for the owners.

Make Cash Reserve Ratio (CRR) attractive: At present, the RBI asks Indian banks to maintain a certain limit on CRR on which the RBI doesn't pay interest. Hence, banks lose out a lot on interest earnings. If the CRR is made more financially rewarding for banks, it can reduce capital requirements.

Refinancing from the Central Bank: The US Federal Reserve spent $700 billion to purchase stressed assets in 2008-09 under the "Troubled Asset Relief Program." Indian banks can adopt a similar arrangement by involving the RBI directly or through the creation of a Special Purpose Vehicle (SPV).

Structural change to involve private capital: The compensation structure and accountability of banks creates a problem for the market. Banks should be governed by a board while aiming to reduce the government's stake and making the financial institutions attractive to private investors.

With the potential solutions above, the problem of NPAs in Indian banks can be effectively monitored and controlled, thus enabling the banks to achieve a clean balance sheet.

13.3 Check Your Progress

1. NPA implemented under the recommendation of which committee.
   a) Shivraman committee
   b) Narshimham committee
   c) K P committee
   d) None of these
2. When RBI started implementation of NPA guidelines.
   a) 1990
   b) 1991
   c) 1992
   d) 1995
3. Under asset classification of NPA accounts above one year but up to three years assets due know as______________.
   a) substandard assets
   b) standard assets
   c) doubtful assets

d) bad debts
e) Loss assets

4: The Indian banking sector is facing the problem of heavy NPAs. Which among the following industries has contributed least to the level of NPAs?

a) Real estate sector
b) Iron and steel
c) Software and BPO
d) Infrastructural development

5: Which of the following is not part of criteria laid down by RBI for NPA?

a) Interest on loan remains overdue for a period of 90 days.
b) Interest on loan taken for a long-duration agricultural crop remains unpaid for one crop season.
c) Interest on loan taken for a short duration agricultural crop remains unpaid for two crop seasons.
d) Interest on loan taken to purchase personal asset remains overdue for 60 days.

6. The government has launched Mission Indradhanush as a seven-pronged plan to resolve the problems faced by public-sector banks. Which of the following recommendation is not part of mission Indradhanush?

a) Capital infusion in public-sector banks
b) Regular gyan sangam to discuss state of banks
c) Infusion of technology in functioning of banks
d) Reduction in government interference in the appointments of public-sector banks

13.4 Summary

The banking industry plays a critical role in the economy of our country. So measuring and maintaining the asset quality of the banks is important for the development of the banks. The asset quality in banks is constantly deteriorating and thus causing intolerable stress to the banking sector, regulators, and the Indian economy. The Non-Performing Assets (NPAs) have always created a big problem for the banks in India. It is just not only problem for the banks but for the economy too. The money locked up in NPAs has a direct impact on profitability of the bank as Indian banks are highly dependent on income from interest on funds lent. It can be observed from the data that of NPA is continuously rising in banks. Although various steps have been taken by government to reduce the NPAs but still a lot needs to be done to curb this problem. It is not at all possible to have zero NPAs. The bank management should speed up the recovery process. The problem of recovery is not with small borrowers but with large borrowers and a strict policy should be followed for solving this problem. The government should also make more provisions for faster settlement of pending cases and also it should reduce the mandatory lending to priority sector as this is the major problem creating area. So the problem of NPA needs lots of serious efforts otherwise NPAs will keep killing the profitability of banks which is not good for the growing Indian economy at all.

13.5 Keywords

- **Non-Performing Assets:** When borrower does not repay the loan instalment within 90 days from the date on which the debt was due, terms as NPA.
- **RBI:** The Reserve Bank of India (RBI) is India's central bank, which controls the issue and supply of the money.
- **CRR:**Cash Reserve Ratio is the percentage of cash required to be kept in reserves by banks.
- **Commercial Banks:** A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans to earn profit.
- **Bad Bank:** A bad bank is a bank set up to buy the bad loans and other illiquid holdings of another financial institution.

13.6 Self-Assessment Test

1. What do you mean by NPAs? What are the types of NPAs? Also explain the guidelines related to NPA provisioning.
2. Explain the problem of NPAs in Indian Banking sector and their impact on this sector.
3. What is the reason for increasing NPAs in banking sectors? What steps could be taken for reducing NPA.
4. What is NPA? Explain those factors which have impact on NPAs.
5. Write short note on:

   Gross NPA

   Net NPA

13.7 Answers to check your progress

1(b), 2 (c), 3(c), 4 (c), 5(d), 6 (c)

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Course: Indian Financial System	
Course Code:**BC 305**	Author:**Dr. Sanjeev Kumar Garg**
Lesson No.:**14**	Vetter: **Dr. Suresh K. Mittal**

Payments Banks

STRUCTURE:

14.0 Learning Objectives

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

- Understand the meaning and characteristics of Payment Banks.
- Know advantages and disadvantages of Payment Banks.
- Distinguish between Payment Banks and Commercial Banks.

• Know the services offered by Payment Banks.

14.1 Introduction

A payment bank is a recent player in the banking system in India. A payment bank is just similar to a normal bank but restricted to perform only few of the banking services as compared to traditional banks. Payment bank is basically a newer concept in the banking sector. A payment bank shall be regulated by Reserve Bank of India (RBI). These banks have been categorised as a "Scheduled bank". But, it is mandatory for the companies to include the word "Payment bank" in its name in order to differentiate it from other regular banks. Further, payment bank is allowed to perform not all but only certain selective functions of banking.

Payment banksare the new entrants in the field of digital India.The main objective of introducing these payment banks in India was to extend the financial services horizon to small business, migrant labour workforce & low income households. This was meant to further provide services to the remote areas of the country especially the unorganised sector in India.

Payments banks like any other bank operatein a smaller scale without involving any credit risk. In simple words, it can carry out most banking operations but can't advance loans or issue credit cards. It can accept demand deposits (up to Rs 1 lakh), offer remittance services, mobile payments/transfers/purchases and other banking services like ATM/debit cards, net banking and third party fund transfers.

14.1.1 History of Payment Bank

In September 2013, the Reserve Bank of India constituted a committee headed by Dr Nachiket Mor to study 'Comprehensive financial services for small businesses and low income households'. The objective of the committee was to propose measures for achieving financial inclusion and increased access to financial services.

The committee submitted its report to RBI in January 2014. One of the key suggestions of the committee was to introduce specialised banks or 'payments bank' to cater to the lower income groups and small businesses so that by January 1, 2016 each Indian resident can have a global bank account.

In February 2015, RBI published the list of bodies that had applied for a payments bank authorization. There were 41 applications. RBI further announced that an external advisory committee (EAC), would be evaluating the applications received. In February 2015, it was announced in the budget session that

India Post will use its wide network to run payments bank. The EAC submitted its report on the applications received in July 2015.

The applicants were scrutinized for their financial track record and administrative issues. In August 2015, the RBI gave ‘in-principle’ license to 11 of the 41 applicants to launch payments bank. The ‘in-principle’ license was valid only for 18 months within which the entities had to fulfill all the requirements and they were not allowed to engage in banking activities within the period. The RBI would then grant full licenses under Section 22 of the Banking Regulation Act, 1949, after the entities fulfilled all the requirements.

Bharti Airtel launched India's first payments bank by the name ‘Airtel Payments bank’ in March 2017. Paytm Payments Bank, India Post Payments Bank, Fino Payments Bank and Aditya Birla Payments Bank are the other payments banks. Cholamandalam Distribution Services, Sun Pharmaceuticals and Tech Mahindra have surrendered their licenses.Following are the authorized entities for payments banking in India:

1. Aditya Birla Nuvo Limited
2. Airtel M Commerce Services Limited
3. Cholamandalam Distribution Services Limited
4. India Department of Posts
5. FinoPayTech Limited
6. National Securities Depository Limited
7. Reliance Industries Limited
8. ShriDilipShantilalShanghvi
9. Shri Vijay Shekhar Sharma
10. Tech Mahindra Limited
11. Vodafone m-pesa Limited

List of Payment Banks in India that are currently active: On November 27, 2014; the Reserve Bank of India has granted “in-principle” approval to the following 11 applicants to set up payment banks in the country. As of now, only 6 banks are working namely;

1. Airtel Payments Bank Limited
2. India Post Payments Bank Limited
3. Fino Payments Bank Limited
4. Paytm Payments Bank Limited

5. NSDL Payments Bank Limited

6. Jio Payments Bank Limited

However, if the entities have complied with all the requirements and fulfilled all the conditions in the said “in-principle” approval, RBI shall consider granting them a license for commencement of banking business.But, these payment banks cannot operate in a full-fledged banking business. They can offer only specified set of services discussed in next paragraph.

14.1.2 Objectives of Payment Banks

According to the Reserve Bank of India (RBI) data, almost 60% of the people of the country are still not connected with the banking sector. This includes many lower-income people; who live in rural areas of the country, work in unorganized sector and often migrate to cities/abroad in the search of a job. Objectives of setting up of payment banks are as follows:

1. The main objectives of setting up of payments banks are to ensure the financial inclusion by providing payments/remittance services to migrant labour workforce.
2. Opening up small savings accounts of small business holders, low-income households, workers of the unorganised sector.
3. Extend the spread of payment and financial services to small business, low-income households, and migrant labour workforce in secured technology-driven environment.
4. Increase the penetration level of financial services to the remote areas of the country.
5. Existing prepaid payment instruments (PPI model) like Airtel Money does not give pay any interest on deposits.

14.1.3 Characteristics of Payments Banks

Payments banks will do almost all the work that is currently being done by commercial banks, main characteristics of payments banks are as follows:

Deposits: As the commercial banks, the payment banks will also accept the money of the people as a deposit but the limit is fixed, which means the payments banks can accept deposits up to a maximum of Rs. 1 lakh from a customer.

Issuing Cards: Payments banks; will be entitled to issue ATM or debit cards to their customers but cannot issue a credit card.

Accounts: Payments banks; will be authorised to open both savings and current accounts of their customers.

Loan: Payments banks cannot provide loans or lending services to customers.

Deposits from NRIs: Payments banks cannot accept deposits from the Non-Resident Indians (NRIs). It means; the people of Indian origin who have settled abroad cannot deposit their money in the payment banks.

CRR: Payments banks will have to deposit the amount in the form of a Cash Reserve Ratio (CRR) with RBI as other commercial banks do.

Investment of demand deposits: Payments Banks will have to invest a minimum of 75% of its demand deposits in government treasury/securities bills with maturity up to one year and hold a maximum of 25 %in currents and fixed deposits with other commercial banks for operational purposes.

Opening of subsidiary: Payments banks cannot open subsidiaries to undertake Non-Banking Financial Services activities.

Partnership with other commercial banks: Payments bank; with approval from RBI, can work as a partner with other commercial banks and also can sell mutual funds, pension products, and insurance products. Payments banks can become a business representative of any other bank, but it will have to comply with the guidelines of the Reserve Bank of India.

Using word "Payment Bank": Payments banks must use the word "Payments Bank" in their names to look different from other banks.

Mode of transaction: Payments banks will be allowed to provide internet banking and mobile banking facility to their customers.

Payment mechanism: The payments banks can accept remittances to be sent to or receive remittances from multiple banks through payment mechanism approved by RBI, such as RTGS / NEFT / IMPS.

14.1.4 Advantages of Payments Banks:

Zero Balance Account: There is no minimum balance to be maintained. This facilitates individuals earning low income.

Higher Interest Rate: The interest rate offered by a payments bank is 7.25% which is much higher than what a normal savings bank offers. India Post Payments Bank offers 5.5% and Airtel Payments Bank offers 7.25%.

Convenience: Payments banks have wide network, which makes it convenient for the customers to avail facilities.

Safe and Secure: These banks are driven with highly safe technology.

Account Number is same as Mobile Number: The account number is the same as mobile number, which makes it is easy to remember. It provides cashback similar to mobile wallets.

Cashback, discounts and other Benefits: Certain merchants offer cashback, discounts and other benefits on making payments through these banks.

14.1.5 Disadvantages of Payment Bank

Mode of transaction: Transaction in payments banks can be done only through internet banking and mobile banking. Customer who is not fully aware about using this facility cannot make transaction. So it's difficult to use payment banking facility in remote areas.

Charges on value added services: Just like interest rates, it is essential to be aware of the charges levied on the services offered by payment banks. For instance, Airtel payment bank charges 0.65% if you withdraw cash and 0.5% of the transferred amount if you transfer funds to another other bank.Customers need to watch out for fee escalations on value-added features and transaction charges which can be substantial for higher ticket transactions.

Not a substitute for traditional banks: Payment banks cannot lend or offer credit advance to customers like traditional banks. They can issue cheque books and debit cards but not credit cards. Also, unlike traditional banks, you can keep a limited sum in a payment bank account, currently capped at Rs 1 lakh per account. Payment banks are not a replacement for the established traditional banks. The later offers many more services. Both traditional banks and digital banks have their own merits and cannot replace each other.

Don't provide loan facility: If any customer need loan, payments banks cannot provide loans or lending services to customers.

Not issuing credit card: Payment banks can issue only debit card not credit cards. While traditional bank can issue credit card also. So, customers of payment banks can not enjoy the benefit of credit card in payment banking.

Don't accepting deposits from NRIs: Payments banks cannot accept deposits from the Non-Resident Indians (NRIs). Therefore, people of Indian origin who have settled abroad cannot deposit their money in the payment banks.

14.1.6 Services offered by Payment Banks in India

A payment bank cannot provide all the services that are provided by a traditional bank. The services of payment banks are limited to:

- A payment bank can accept deposits up to a maximum of Rs.1 lakh only per individual customer. Demand Deposits and saving bank deposits can be accepted from individuals, small firms and other entities.
- You can open a Savings bank account or a current account with these payment banks. Payment bank pay interest on the deposits just like normal banks.
- Payment banks are allowed to transfer payments through any channels like Branches, Automated Teller Machines (ATMs), business correspondents etc.
- Payment banks can issue debit cards/ATM cards to its customers.
- Mobile banking can be accessed through these payment banks. Internet banking services can be provided by a payment bank. This includes payment mechanism as approved by RBI such as RTGS/NEFT/IMPS.
- A payment bank app can be used to make utility bill payments as well.
- A payment bank can involve in providing basic financial services like access to mutual funds, insurance products, pension products, forex services subject to the conditions set by RBI.

Services Payment Banks Cannot Offer: Here is a list of some of the major services that payment banks cannot offer.

- As per the RBI guidelines, these Payment banks cannot issue credit cards.
- Payment banks cannot deal with any kind of lending business i.e. they are not allowed to issue any kinds of loans like personal loans or any other loans to their customers.
- Payments banks cannot accept deposits from Non Resident Indians or NRIs.
- They are not allowed to setup subsidiaries for undertaking non-banking financial services.

14.2 Difference between Payments Banks and Commercial Banks

Payments Banks and the Commercial Banks both work as per the Banking Regulation Act, 1949. The basic difference between commercial banks and payment banks is that later can accept deposits upto maximum Rs. 1 lakh/customer while there is no such limit for commercial banks.The payments banks have been registered as a public limited company under the Companies Act, 2013. These banks have been licensed under section 22 of the Banking Regulation Act, 1949. Currently there are 7 payments banks are operating in the country.

In addition to the Banking Regulation Act, 1949; the payments banks will also be governed by the provisions of the Deposit Insurance and Credit Guarantee Corporation Act, 1961, Reserve Bank of

India Act, 1934, Payment and Settlement Systems Act, 2007 and Foreign Exchange Management Act, 1999.

In India both the Payments Banks and the Commercial Banks work under the Banking Regulation Act, 1949, but still there is a huge difference between the functions of the commercial banks and payments banks.How Payments Banks and the Commercial Banks are different from each other's:

Difference between Payments Banks and Commercial Banks

Basis	Commercial Banks	Payment Banks
Establishment	It is believed that the banking system in India was started in 1786 after the establishment of the Bank of Calcutta.	Whereas the payments bank started its operation in November 2017.
Deposits	The Commercial Banks can accept any amount as deposit per customer.	But the payments bank will be restricted to holding a maximum balance of Rs. 1, 00,000 per individual customer.
Credit and Debit Cards	While there is no such rule for commercial banks.	Payments banks are allowed to issue ATMs or debit cards to their account holders but they can't issue a credit card
Capital Requirement	The initial minimum paid-up voting equity capital for a commercial bank shall be 500 crore rupees	While the minimum paid-up equity capital for payments banks shall be Rs. 100 crore.
Loan facility to Account Holder	While the main earning of the commercial banks comes from the loan services only.	Payment banks can't give loan services to the people,
Deposits from NRIs	While commercial banks can accept deposits from NRIs.	Payments banks can't accept deposits from the NRI persons. It means, the Non Resident Indians (NRIs) who have settled abroad can't

		deposit their money in the payments banks.
Using Name	But commercial banks need not to do so.	Payment banks must use the word "Payments Bank" in their name to look different from other banks
Investment of Deposits	While commercial banks have to invest maximum 22% of demand deposits in such securities.	Payment banks should invest at least 75% of their total demand deposits in government securities (called Statutory Liquidity Ratio) with a maturity period of at least one year
Minimum Balance	Few banks have minimum balance to be maintained, failing which will attract penalties.	There is no minimum balance to be maintained.
Investment	Commercial banks are allowed to invest the money in deposits like open market – shares, equities, debt instruments and so on	Can invest only in government bonds. If they don't want to invest, they can give the money to commercial banks for investing.
Service Catering	Regular banks have very limited number of branches in rural areas.	Payments banks are established mainly to attract customers in semi urban and rural areas.
Technology	Regular banks have not yet adopted high end technology in their services.	Payments banks have adopted a very high end technology and are mainly technology driven.
Forex	Regular banks offer forex services. Banks make a lot of profit out of forex services.	Even payments banks offer forex services however, they charge less thancommercial banks on forex

		services.
Financial Products	Banks are allowed to offer a lot of financial products like insurance, mutual funds and so on. Payments banks have also bagged approval from RBI to distribute such financial products.	However, unlike commercial banks which can actually create and distribute products, Payments banks can only distribute products but cannot create them.

14.3 Payment Banks in India

The idea behind "Payment banks" was to bring financial inclusion in the country. This financial innovation was expected to further speed up the process of turning India into a cashless economy.With the introduction of these payment banks, the dream of "Banking at your doorstep" could turn out to be a reality even in the remotest of areas in India. This was a bold step to redefine banking system in India thereby extending services to the common masses at a larger scale."Payment banks" are yet another important addition to digital innovation in the banking sector. But, they need to be managed properly to sustain and grow in this vast and dynamic banking arena.

The Central Bank of India had encouraged the idea of "Payment Banks in India" to extend the banking services to the unbanked sectors. However, these new business models didn't meet the expectations. The reasons may be lack of clarity or different internal and external business factors.Although, license was issued to 11 entities originally, but 4 of these returned their permits. Out of the remaining 7 also, only 4 payment banks are fully operational these are:

- Airtel Payments Bank
- India Post Payments Bank
- Fino Payments Bank
- Paytm Payments Bank

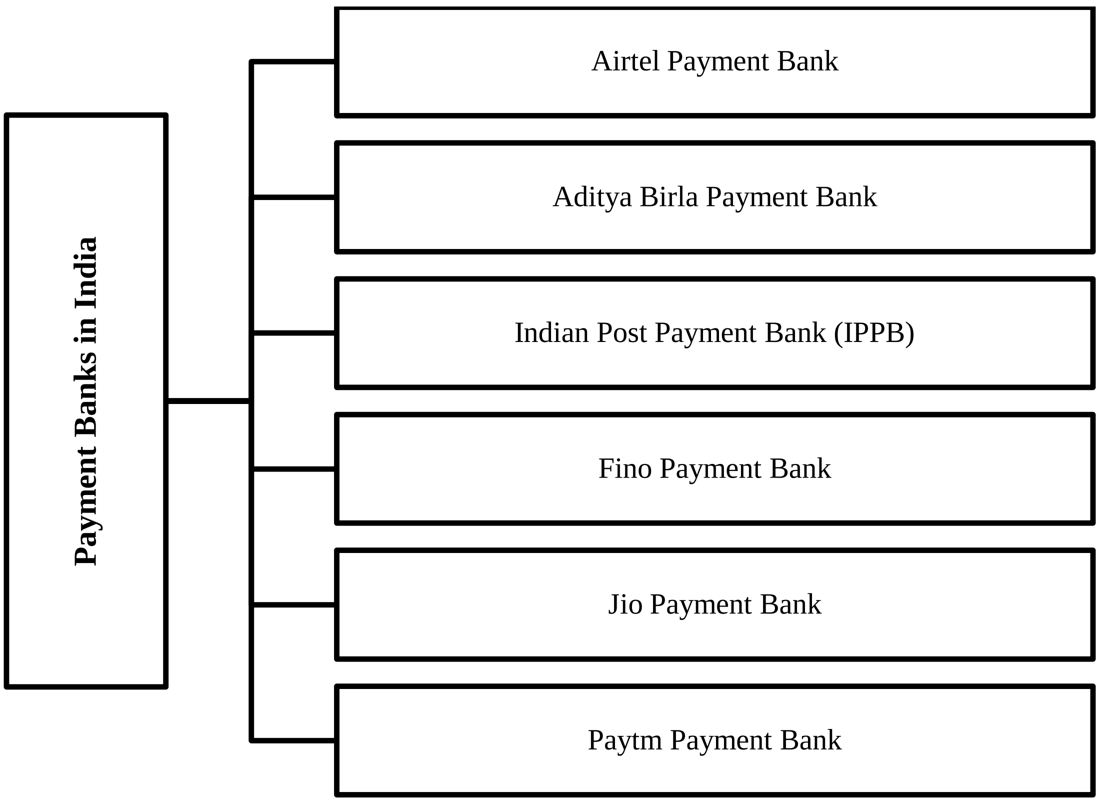
Payment Banks with Limited Services:

- NSDL Payments Bank
- Jio Payments Bank
- Aditya Birla Payments Bank
- Vodafone: This didn't start owing to complications.

Out of the above list, Airtel was the first payment bank to start its nationwide operations in November 2016 and is presently providing services to customers. Airtel Payment Bank is providing 7.25% interest rate on deposits made in a Savings account. However, it charges 0.65% on withdrawal made above Rs.4000.So, on one hand you are getting good interest rate. But, on the other hand, you shall be charged for withdrawing over a specified limit.

Paytm Payment bank was launched officially in May 2017 inviting limited users initially to open a bank account. It is likely to expand its horizon in the coming months. In fact, your current Paytm wallet shall be moved to Paytm Payment bank in the same capacity. This simply means, that in addition to the benefits of a wallet, you can now open a savings or current account plus enjoy an access to a wide range of financial services.

Fino Payment Bank also started its banking operations in the month of July 2017 thereby adding to the list of functional payment banks in India. It has become the fourth payment bank to launch its services. Presently in India following payment banks are actively working:



Airtel Payments Bank

Airtel Payments Bankas India's first Payments Bank aim to give every Indian access to an equal, effective and trustworthy banking experience.Airtel Payments Bank was launched in January 2017, by

Bharti Airtel, India’s largest telecom provider, to support the cashless revolution promised by the Government of India.

Airtel Payments Bank is a different kind of bank that provides essential financial services to its customers. In order to cater to the needs of the underserved and unbanked population in the country, our products are built as a solution to the problems posed by traditional banking – from long queues to endless documentation to inconvenient travelling. We aim to make banking simpler, more convenient, and more intuitive.

With Airtel Payments Bank, you can:

- Open a Savings Bank account at any of our 5 lakh+ banking points
- Get free personal accident insurance cover of Rs 1 Lac
- Earn 3.0% rate of interest
- Get an online debit card
- Deposit cash at any Banking Point in your vicinity
- Withdraw cash through our banking points or select bank ATMs
- Buy third party insurance products
- Transfer money to any bank account in India through IMPS or UPI
- Recharge prepaid mobiles/DTH and pay utility bills (electricity, water, gas, postpaid, etc.)
- Book bus and train tickets

We also aim to make payments cashless and seamless, and that's precisely what you can do with Airtel Money Wallet, the digital wallet of Airtel Payments Bank. You can make online/offline digital payments, recharge your phone, pay utility bills, and much more with Airtel Money Wallet. The wallet provides you with an option to make simple, secure and quick payments through your phone. With Airtel Money Wallet, you can:

- Make digital payments at thousands of online and offline merchants through:
- QR Code Scanning
- Payment to a phone number
- BHIM UPI
- Merchant Initiated Payment
- You can also transfer money, recharge prepaid mobiles/DTH, pay utility bills, book bus / train tickets and more.

As we mentioned, we aim to provide a seamless banking experience to every Indian, including business owners (corporate, start-ups, SMEs). Our range of business solutions include:

- Salary Management Solution
- Salary disbursal
- Reimbursement solutions
- Loan Management Solution
- Disbursement
- Collection
- Cash Management Solution

Aditya Birla Payments Bank

Aditya Birla Payments Bank Limited (ABPB) was a payment bank started as a joint venture by Aditya Birla Nuvo Ltd. and Idea Cellular. Launched on February 22, 2018, it is the fourth payment bank to begin operations since issuance of licenses to 11 firms by the Reserve Bank of India in August 2015. Payments Banks are a special category of banks that can accept deposits of up to 1 lakh but cannot give loans or credit cards.On 20 July 2019, Aditya Birla Payments Bank announced that it would be shutting down operations subject to the receipt of requisite regulatory consents and approval.

Aditya Birla Nuvo (Now Grasim Industries Limited) was one of the 11 entities to receive an in-principle approval by Reserve Bank of India (RBI) to set-up payments banks in India, in August 2015. Post the in-principle approval, RBI had issued a license to Aditya Birla Payments Bank under Section 22 (1) of the Banking Regulation Act, 1949 to commence with the business of payments bank in April 2017.

Aditya Birla Payments Bank earlier operated as IMCSL (Idea Mobile Commerce Services Ltd) as a brand of Idea Cellular Ltd.Aditya Birla Nuvo Limited holds 51 percent shares while the remaining 49 percent are with Idea Cellular.

India Post Payments Bank

At India Post Payments Bank, we believe that a nation can grow when every citizen has an opportunity to prosper, regardless of their way of life. With simple, diverse and growth-oriented offerings, IPPB aims to provide every household in India an access to efficient banking services and enable them to become financially secure and empowered.

India Post Payments Bank (IPPB) was setup under the Department of Post, Ministry of Communication with 100% equity owned by Government of India. IPPB was launched as a pilot project on 30 January 2017 in Ranchi (Jharkhand) and Raipur (Chhattisgarh), with the objective of being present across India by the FY 2018-2019. IPPB has expanded its strength across India covering post offices, through a network of 650 IPPB branches/controlling offices, working on a hub and spoke model.

Services provided by IPPB

At India Post Payments Bank (IPPB), we understand your needs. That is why we have tailored our banking products and services to be simple and efficient.

DEPOSITS	- Savings Account - Current Account
MONEY TRANSFER	- Simple & Secure - Instant - 24x7
DIRECT BENEFITS TRANSFERS	- MGNREGA - Scholarships - Social welfare benefits and other - Government subsidies
THIRD PARTY PRODUCTS	- Loans - Insurance - Investments - Post Office Savings schemes
BILL & UTILITY PAYMENTS	- Mobile and DTH recharge - Electricity, water & gas bills - Donations & insurance premiums
ENTERPRISE AND MERCHANT PAYMENTS	- Postal products - Digital Payment of e-commerce delivery(COD) - Small merchants/kirana stores/unorganized retail

	- Offline payments - Cash Management Services

Value Proposals

Accessibility:IPPB will be leveraging the vast postal network of nearly 1.55 lakh post offices and 3.0 lakh postal employees in every district, town and village of the country to serve. As continue to expand IPPB services to every doorstep, postman will become trusted financial services advisor, working hard to ensure to get what you need - be it receiving money in the fastest way possible, using it at ease for essentials, saving for loved ones, or even investing for a bright future. For IPPB, every customer is important, every transaction is significant, and every deposit is valuable no matter what the value.That is what IPPB truly mean – Aapka Bank, AapkeDwaar.

Approachability: Last mile delivery of services through the postman – a son of the soil and a friend, philosopher and financial guide to the people.

Ease of banking:IPPB integrates easily with the existing bouquet of post office services, extends the services though a frictionless shift.The last mile delivery agent is empowered with financial knowledge and intuitively designed digital tools to offer financial services and guidance with relative ease.

Digital Ecosystem: Macro Level, IPPB's 360-degree payments suite creates transparency, removes corruption and leakages and contributes to a less-cash economy.Individual Level, Provides customers with the ability to transact without cash through digital channels and enable small businesses to accept digital payments, thus closing the loop.

IPPB Aspiration: Customers Financial Empowerment

- Wealth grows from wealth – even small savings can go a long way towards ensuring a better future
- Securing the unsecured – small investments and insurance to protect you against unforeseen events
- Ensuring financial freedom – money in your hands whenever you need it

India Post Payments Bank is gearing up to lead the next revolution of banking as one of the largest financial inclusion networks in India, covering both urban and rural areas. Our new model of banking aims to enable individuals, small businesses, merchants and others to utilise full-fledged digital banking services. We are paving the way for India's largest banking network to reach every corner of the nation. IPPB endeavour to stay true to our motto -**'Every customer is important, every transaction is significant and every deposit is valuable, no matter the value'**.

Fino Payments Bank

Fino Payments Bank comes to you from an institution that has served the country's banking needs for over a decade. We truly value your hard work and understand how important it is to you and your family. It is therefore, our continuous endeavour to provide you with an unmatched banking experience, through our simple products & services that can easily be accessed anytime, anywhere, and in your neighbourhood too.Fino Payments Bankis the first payments bank to go live with 410 branches and more than 25,000 banking points on day one. The bank was incorporated on 4th April, 2017 with the name Fino Payments Bank Limited.

- Fino Payments Bank Legacy – FinoPaytech Limited
- Fino Payments Bank Journey So Far - Fino Payments Bank

Erstwhile parent company FinoPaytech Limited is a thought leader, innovator and implementer of technology solutions for institutions like banks, governments and insurance companies.Fino Payments Bank is a business and banking technology platform combined with extensive services delivery channel. As an alternate banking channel, FPB enable end-to-end customer sourcing and servicing.

Fino Payments Bank business model derives its strength from robust in-house technology, versatility of operations, scale of the channel, and customer know-how. The challenges of serviceability and scalability of the traditional banking channels have been addressed by way of innovation. In ten years, FPB have touched the lives of over 100 million customers through over 25000 touch points in 499 districts across 28 states in India.

Jio Payments Bank

Reliance Industries Limited was granted an in-principle approval by the Reserve Bank of India (RBI) to establish a new Payments Bank under the Banking Regulation Act, 1949. It then partnered with the State Bank of India to support this ambitious initiative of building Payments Bank capabilities for every Indian and accordingly, Jio Payments Bank Limited, was incorporated in November 2016.

With the track record of the Reliance Group of leadership in chosen areas of businesses and large scale roll-outs, the Payments Bank initiative is seen by Reliance as a significant opportunity to make a transformative impact on India's financial inclusion landscape to lead and co-create an eco-system to provide accessible, simple and affordable banking solutions to all constituents of our country - especially the financially excluded, to digitise payments and to act as a catalyst towards a cashless society.

Paytm(Pay through mobile) Payments Bank

In August 2015, Paytm received a license from Reserve Bank of India to launch the payments bank. The Paytm Payments Bank is a separate entity in which founder Vijay Shekhar Sharma will hold 51% share, One97 Communications holds 39% and 10% will be held by a subsidiary of One97 and Sharma. The bank was officially inaugurated in November 2017 by the Indian Finance Minister, ArunJaitley. The inauguration ceremony featured prominent banking personalities including former RBI Executive Director PV Bhaskar, Saama Capital Director Ash Lilani and former Shriram Group Director GS Sundarajan.

It was set to launch over 100,000 banking outlets across India by the end of 2018. However, the bank's branches are yet to touch double digits. Paytm Payments Bank has appointed veteran banker Satish Kumar Gupta as its new Managing Director and CEO.

14.4 Payments Banking Regulations in India

Guidelines for Licensing: Guidelines for licensing of Payment banks issued by the RBI to govern the Payment banks.

Activities

- Acceptance of demand deposits: A maximum balance of Rs. 1L per customer is allowed.
- Issuance of ATM/debit cards. Cannot issue credit cards.
- Payments and remittance services through various channels.
- Payment banks can act as Business Correspondents (“BCs”) of another bank, subject to the Reserve Bank guidelines on BCs.
- Distribution of non-risk sharing simple financial products like mutual fund units and insurance products, etc.
- Internet Banking: RBI is open to Payment banks offering Internet Banking services, they are required to comply with RBI instructions on internet banking and all the other related guidelines.
- Payment banks can undertake utility bill payments etc. on behalf of its customers and the general public.

Arrangement of Funds: Payment banks cannot undertake lending activities.Apart from amounts maintained as Cash Reserve Ratio (CRR) with the RBI on its outside demand and time liabilities. Payment banks are also required to invest minimum 75 per cent of its “demand deposit balances” in Statutory Liquidity Ratio (SLR) eligible Government securities/treasury bills with maturity up to one year and hold maximum 25 per cent in current and time/fixed deposits with other scheduled commercial banks for operational purposes and liquidity management.

Capital requirement: The minimum paid-up equity capital for payments banks shall be Rs. 100 crore.The payments bank will have a leverage ratio of not less than 3% which basically mean that its outside liabilities should not exceed 33.33 times its net worth (paid-up capital and reserves).

Promoter's Contribution: The promoter's minimum initial contribution to the paid-up equity capital of the payment bank has to be at least 40% for the first five years after the commencement of business.

Foreign Shareholding: It will be according to the FDI Policy for private sector banks which is notified from time to time. The permitted limit right now is 74% out of which 49% can be through the automatic route and the remaining 25% beyond 49% will be through the government route.

Other Conditions: Operations have to be technology and network driven from Day I. Conforming to generally acceptable standards is a given. Payment banks should have a Customer Grievances Cell which is able to handle the customer complaints.

Procedure for Application: Applications should be in conformity with Rule 11 of the BR (Companies) Rules, 1949. They should be in the format as given in Form III and should be submitted to the Chief General Manager, Department of Banking Regulation, Reserve Bank of India, 13th Floor, Central Office Building, Mumbai – 400 001.

Procedure for RBI Decisions: An External Advisory Committee (EAC) which will consist of eminent professionals like bankers, chartered accountants, finance professionals, etc., will evaluate the applications.

- The decision to issue an in-principle approval for setting up a PB will be taken by the RBI. The RBI's decision in this regard will be final.
- The validity of the in-principle approval issued by the RBI will be 18 months.
- The names of applicants for bank licences will be placed on the RBI's website.

KYC Norms: The RBI has updated the Operating Guidelines for Payment banks with respect to KYC in the wake of Airtel Payments Bank rerouting of subsidies by creating Payments Bank accounts for subscribers validating mobile phone numbers.

Further below mentioned are the payments banking regulations set by RBI:

- Promoter contribution of at least 40% for the first 5 years.Stake holding can be brought down to 40% at the end of five years, to 30% at the end of ten years, and to 26% at the end 12 years of commencement of payment bank.
- Foreign shareholding is subject to following FDI rules, similar to the private banks in India.
- Any acquisition of more than 5% needs approval from RBI.
- The board of directors should be independent directors, who will be appointed as per the RBI guidelines. It must comply with the 'fit and proper' criteria for Directors as directed by the RBI.
- The payment bank must have wide network and driven technology, right from commencement.
- At least 25% of its branches must be in the unbanked rural areas.
- The entity name must have 'payments bank' so as to differentiate it from other types of banks.
- These banks would be registered as public limited company under the Companies Act, 2013.
- The RBI has mandated all payments banks to have 'Customer Grievance Cell' to handle customer complaints and concerns.

14.5 Check Your Progress

1. Which among the following activities are not permitted to payments banks?
   a) Remittance services
   b) Issuing ATM cards
   c) Issuing credit cards
   d) Accepting demand deposits
2. Which is India's first Payment bank?
   a) Paytm Payments Bank
   b) JIO Payments Bank
   c) Airtel Payments Bank
   d) Fino Payments Bank
3. What is the maximum amount of loan can be extended by payments banks?
   a) Rs. 25000
   b) Rs. 50000
   c) Rs. 100000
   d) Rs. No lending power
4. What is the maximum amount of balance can be maintained an individual in payments bank?

a) Rs. 1,50,000

b) Rs. 1,00,000

c) Rs. 50,000

d) Rs. 25,000

5. Which committee mooted the idea of payments banks?

a) BimalJalan Committee

b) NachiketMor Committee

c) P J Nayak Committee

d) YV Reddy Committee

6. What is the minimum capital required to set up payments bank?

a) Rs 100 crore

b) Rs 75 crore

c) Rs 50 crore

d) Rs 25 crore

14.6 Summary

The setting up of the payments banks will not only increase the financial inclusion in the country but also strengthen the weaker section of the country so that they can also give their contribution in the economic development of the country.The primary objective of payments banks was to "further financial inclusion by providing small savings accounts and payments/remittance services to migrant labour workforce, low-income households, small businesses, other unorganized sector entities and other users, by enabling high volume-low value transactions in deposits and payments/remittance services in a secured technology-driven environment."

The Central bank of India had encouraged the idea of "Payment Banks in India" to extend the banking services to the unbanked sectors. 11 license was issued to entities originally, only 4 payment banks are fully operational. Airtel was the first payment bank to start its nationwide operations in November 2016 and is presently providing services to customers.

Payment banks, which were supposed to be the next big thing, sadly have not lived up to the hype so far. The jury is still out on whether the Payment banks will ever succeed in the country, but one thing is clear: it won't be easy for them to survive.

14.7 Keywords

- **Banking:** Banking is the business activity of banks and similar institutions.
- **Payment Bank:** A payment bank is a normal bank but restricted to perform only few of the banking services as compared to traditional banks.
- **E-Banking:** E-banking refers to all the financial transactions undertaken by any financial institution over the internet
- **Credit Card:** A small plastic card issued by a bank, building society, etc., allowing the holder to purchase goods or services on credit.
- **Debit Card:** A card allowing the holder to transfer money electronically from their bank account when making a purchase.
- **Mobile Banking:** Mobile banking is the act of making financial transactions on a mobile device.

14.8 Self-Assessment Test

1. What is the meaning of payment banks?
2. What is the purpose of payment banks? What are the advantages and disadvantages of payment banks?
3. How does payment bank work? What type of services offered by payment banks in India?
4. What is a payment bank, how it is differ from commercial banks?
5. Explain meaning of Payment Bank, what are the guidelines for opening up payment banks in India?
6. Write a short note on:
    - Airtel Payment Bank
    - Indian Post Payment Bank

14.9 Answers to check your progress

1(c), 2 (c),
3(d), 4 (b),
5(b), 6 (a)

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Course: Indian Financial System	
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Development Banking: Concept, Objectives, Functions and Recent Developments in Development Banking

STRUCTURE:

15.0 Learning Objectives

After going through this lesson, the learner will be able:

- To understand and explain the meaning of Development Bank.
- To discuss the characteristics and functions of Development Banking System.

- To discuss the role of Development Banks in Indian economy.
- To know about the recent developments in Development Banking in India.

15.1 Introduction

A financial institution which performs the functions ofaccepting deposits and giving loans is called a 'Bank'. Banks are classified on thebasis of their functions and nature. For example, Commercial Bank, InvestmentBank, Saving Bank, Foreign Exchange Bank, Development Bank etc. Developmentbank is thus a type of bank.

Industrial Revolution in Europe coincided with the establishment of developmentbanks. Such a bank was established in Belgium in 1822. In France it was establishedin 1852, in Japan in 1920, in Canada in 1944, in England in 1945 and it was set upin India in 1948.

DevelopmentBanks or Development Financial Institutions (DFIs) provide long-term credit for capital-intensive investments spread over a long period and yielding low rates of return, such as urban infrastructure, mining and heavy industry and irrigation systems. Such banks often lend at low and stable rates of interest to promote long term investments with considerable social benefits. Development banks are also known as term-lending institutions or development banks require correspondingly long-term sources of finance, usually obtained by issuing long-dated securities in capital market, subscribed by long-term savings institutions such as pension and life insurance funds and post office deposits. Considering the social benefits of such investments, and uncertainties associated with them, development banks are often supported by governments or international institutions. Such support can be in the form of tax incentives and administrative mandates for private sector banks and financial institutions to invest in securities issued by development banks.

15.1.1 Definition of Development Banks

A development bank maybe 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. In short, a development bank is a development-oriented bank.

According to Prof. Shirley Bosky, a financial institution providing loans to developmental projects and other banking services in accordance with the banking rules is called as Development Bank. In other words, a financial institution which functions in accordance with the banking rulesand distributes loans to economically viable developmental projects after careful study and also provides other banking services is termed as a development bank.

In view of Prof. William Diamond, development bank is one which encourages new enterprises, provides them capital and thus helps in industrial development.

Dr. K.V. Prabhakar opines that development bank is a multipurpose institution, which shares the organizational risk, changes its policy as per the industrial environment and encourages new industrial projects.

According to B.K. Madan, development bank is an institution which not only supplies capital to industries but also provides them technical and managerial advice and helps in sale and management.

From the above definitions, it can be argued that development bank is one which encourages industrial progress by supplying long term capital and by guiding industrial units about technology, management and other relevant aspects and thus speeds up the economic development of a country.

Development bank is established with the intention of providing long term loans to industrial units, and units engaged in trade and agriculture. It provides medium or long term loans for setting up production unit, expansion of the existing unit or for increase in production. It buys shares or debentures of companies, helps in the sale of share and debentures and provides other banking services. Some countries have seen establishment of the development banks in the private sector, while some in public sector. These banks provide loan assistance to economically viable units, provide them advice and guidance, solve their problems and therefore, help in their development and the development of the economy. It is because of thisthat they are termed as partners in development.

15.1.2 Features of Development Banks

1. **It is a Financial Institution:** It distributes its share capital, debentures to people and collects funds, which are used for giving loans. It is an institution functioning in accordance with the banking rules.
2. **Multipurpose Financial Institute:** These banks help in starting new projects, in raising capital, guide in the purchase of machines, vehicles etc., provide advice for running an enterprise, guide in the purchase of raw material and sale of finished products and help in other respects also.
3. **Medium & Long-term Loans to Business Firms:** These banks provide medium and long term loan assistance to economically viable business units.
4. **Don’t accept Deposits:** These banks don’t accept deposits from the people like commercial banks. General public cannot open current, savings or recurring accounts with these banks.

5. **Expert Institution:** These banks appoint experts from various fields like industry, commerce, agriculture and take their help. These banks function in consultation with these experts. Borrowers therefore, can avail their advice at concessional rate fee.
6. **Developmental Finance:** These banks help in the process of economic development by making finance available to the productive units. These units, which have the potential of survival, which can withstand competition, are assisted by the development banks.
7. **Encouragement to the Investment and Entrepreneurship:** These banks not only assist existing units but also motivate setting up of new units, and help them in their further development.
8. **More Stress on Implementation:** These banks do not merely provide finance, but guide industrial units in deciding location of plant, in the purchase and installation of machinery, in the production and management of the unit and also in the sale of final produce. Development banks assist industrial & other units so that they will succeed and others will draw lessons from them.
9. **Inspiration to New and Small Units:** Experts of these development banks motivate new and small business units for their development.
10. **Social & Economic Objectives:** These banks work for the achievement of those objectives which will promote overall development of the country.
11. **Encouragement to Savings and Investment:** As these banks promote the development of new and existing business units; they indirectly help in improving savings and investment levels in the economy.
12. **Objective of Social Well-being:** The development banks function for the social well-being by assisting in the development of both public and private business units from industry, commerce and trade, agriculture, services. They provide advice and guidance for the success of these business units. Thus, these banks work for the improvement of social well-being.

15.2 Objectives and Functions of Development Banks

15.2.1 Objectives of Development Banks in India

Development banks have been started with the motive of increasing the pace of industrialization. The traditional financial institutions could not take up this challenge because of their limitations. To help all round industrialization development banks were made multipurpose institutions. Besides financing, they were assigned promotional work also. The objectives of development banks are as follows:

1. To serve as an agent of development in various sectors, namely, industry, agriculture, and international trade.
2. To accelerate the growth of the economy.
3. To allocate resources to high priority areas.
4. To foster rapid industrialization, particularly in the private sector, so as to provide employment opportunities as well as higher production.
5. To develop entrepreneurial skills.
6. To promote the development of rural areas.
7. To finance housing, small scale industries, infrastructure, and social utilities.

In addition, they are assigned a special role in the following:

1. **Financial Gap Fillers:**

Development banks do not provide medium-term and long-term loans only but they help industrial enterprises in many other ways too. These banks subscribe to the bonds and debentures of the companies, underwrite their shares and debentures and, guarantee the loans taken from foreign and domestic sources. They also help undertakings to acquire machinery from within and outside the country.

2. **Undertake Entrepreneurial Role:**

Developing countries lack entrepreneurs who can take up the job of setting up new projects. It may be due to a lack of expertise and managerial ability. Development banks were assigned the job of entrepreneurial gap filling. They undertake the task of discovering investment projects, promotion of industrial enterprises; provide technical and managerial assistance, undertaking economic and technical research, conducting surveys, feasibility studies, etc. The promotional role of the development bank is very significant for increasing the pace of industrialization.

3. **Commercial Banking Business:**

Development banks normally provide medium and long-term funds to industrial enterprises. The working capital needs of the units are met by commercial banks. In developing countries, commercial banks have not been able to take up this job properly. Their traditional approach in dealing with lending proposals and assistance on securities has not helped the industry. Development banks extend financial assistance for meeting working capital needs to their loan if they fail to arrange such funds from other sources. So far as taking up other functions of banks such as accepting of deposits, opening letters of credit, discounting of bills, etc. there is no uniform practice in development banks.

4. **Joint Finance:**

Another feature of the development bank's operations is to take up joint financing along with other financial institutions. There may be constraints of financial resources and legal problems (prescribing maximum limits of lending) which may force banks to associate with other institutions for taking up the financing of some projects jointly. It may also not be possible to meet all the requirements of concern by one institution, so more than one institution may join hands. Not only in large projects but also in medium-sized projects it may be desirable for a concern to have, for instance, the requirements of a foreign loan in a particular currency, met by one institution and under the writing of securities met by another.

5. **Refinance Facility:**

Development banks also extend the refinance facility to the lending institutions. In this scheme, there is no direct lending to the enterprise. The lending institutions are provided funds by development banks against loans extended' to industrial concerns. In this way, the institutions which provide funds to units are refinanced by development banks. In India, the Industrial Development Bank of India (IDBI) provides reliance against term loans granted to industrial concerns by state financial corporations.

6. **Credit Guarantee:**

The small scale sector is not getting proper financial facilities due to the clement of risk since these units do not have sufficient securities to offer for loans, lending institutions are hesitant to extend the loans. To overcome this difficulty many countries including India and Japan have devised the credit guarantee scheme and credit insurance scheme.

7. **Underwriting of Securities:**

Development banks acquire securities of industrial units through either direct subscribing or underwriting. The securities may also be acquired through promotion work or by converting loans into equity shares or preference shares. So, as learn about development banks may build portfolios of industrial stocks and bonds. These banks do not hold these securities permanently. They try to disinvest in these securities in a systematic way which should not influence the market prices of these securities and also should not lose managerial control of the units. Development banks have become worldwide phenomena.

15.2.2 Functions of Development Banks in India

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

1. Small Scale Industries (SSI):

Development banks play an important role in the promotion and development of the small-scale sector. The government of India (GOI) started the Small Industries Development Bank of India (SIDBI) to provide medium and long-term loans to Small Scale Industries (SSI) units. SIDBI provides direct project finance and equipment finance to SSI units. It also refinances banks and financial institutions that provide seed capital, equipment finance, etc., to SSI units.

2. Development of Housing Sector:

Development banks provide finance for the development of the housing sector. GOI started the National Housing Bank (NHB) in 1988. *NHB promotes the housing sector in the following ways:*

- It promotes and develops housing and financial institutions.
- It refinances banks and financial institutions that provide credit to the housing sector.

3. Large Scale Industries (LSI):

The development bank promotes and develops large-scale industries (LSI). Development financial institutions like IDBI, IFCI, etc., provide medium and long-term finance to the corporate sector. They provide merchant banking services, such as preparing project reports, doing feasibility studies, advising on the location of a project, and so on.

4. Agriculture and Rural Development:

Development banks like the National Bank for Agriculture & Rural Development (NABARD) help in the development of agriculture. NABARD started in 1982 to provide refinance to banks, which provide credit to the agriculture sector and also for rural development activities. It coordinates the working of all financial institutions that provide credit to agriculture and rural development. It also provides training to agricultural banks and helps to conduct agricultural research.

5. Enhance Foreign Trade:

   Development banks help to promote foreign trade. The government of India started the Export-Import Bank of India (EXIM Bank) in 1982 to provide medium and long-term loans to exporters and importers from India. It provides Overseas Buyers Credit to buy Indian capital goods. Also, encourages abroad banks to provide finance to the buyers in their country to buy capital goods from India.

6. Review of Sick Units:

   Development banks help to revive (cure) sick-units. The government of India (GOI) started the Industrial Investment Bank of India (IIBI) to help sick units. IIBI is the main credit and reconstruction institution for a revival of sick units. It facilitates modernization, restructuring, and diversification of sick-units by providing credit and other services.

7. Entrepreneurship Development:

   Many development banks facilitate entrepreneurship development. NABARD, State Industrial Development Banks, and State Finance Corporations provide training to entrepreneurs in developing leadership and business management skills. They conduct seminars and workshops for the benefit of entrepreneurs.

8. Regional Development:

   The development bank facilitates rural and regional development. They provide finance for starting companies in backward areas. Also, they help companies in project management in such less-developed areas.

9. Contribution to Capital Markets:

   The development bank contributes to the growth of capital markets. They invest in equity shares and debentures of various companies listed in India. Also, invest in mutual funds and facilitate the growth of capital markets in India.

15.2.3 Difference between Commercial Banks and Development Banks

There are several differentiating factors between a development bank and a commercial bank. Some extreme observations below are made in order to emphasize “traditional” differences between the two in order to emphasize the point. Actual practice, of course, differs from commercial bank to commercial bank and from development bank to development bank. As the country’s capital markets develop, there shall be less difference between these specialized institutions and the similarities shall become more apparent. With this as a premise, the traditional differences between development and commercial banks are in the following areas:

a) **Impetus for the Creation of the Institution:** A development bank is created as an instrument of economic development while a commercial bank is created by business opportunities.

b) **Posture Relative to Business Opportunities:** A development bank is supposed to be pro-active as it should take an active role to promote projects and to develop institutions (entrepreneurs). The projects chosen are those that are consistent with the economic development priorities. A commercial bank is known to be reactive to business opportunities. It requires bankability only after the entrepreneur's decision has been made; it waits for the idea to culminate into a funding requirement.

c) **Types of Projects Supported:** For a development bank, there is an explicit effort to support economic development projects. The following desired 'impact' projects form the basis for scanning for opportunities: import substitution (at competitive prices); exports; increased local demand; regional development (for example, tourism); and increased industrial efficiency through better technology. For a commercial bank, the abovementioned goals are not the starting point for the identification of projects. Rather, they would most likely be side-benefits. A commercial bank has little concern for these objectives, except for the viability of the bank transaction. In short, a development bank's activities are project-based while that of the commercial bank are transaction-based.

d) **Search Process for Projects Financed:** A development bank goes into a planning cycle, identifying which are the likely areas to go into. For example, if it determines that exports are an area to be promoted, then it conducts a marketing study and seeks entrepreneurs to implement related projects. For the commercial bank, the search process is different. It asks, "Are you an exporter?", and then looks at that entrepreneur's cash balance to determine if there is a marketing opportunity for the transaction.

e) **Project Promotion Activities:** A development bank offers counseling and advisory services for enterprise development and promotion as part of its development lending process. A commercial bank offers legal and business advice, appraisal services and credit investigation, usually for a fee. It undertakes very little project promotion and institutional development. Its emphasis is on client development and marketing.

f) **Strategic Goals:** A development bank has a more difficult strategic objective because it is involved with the concerns of the country, specifically economic development. Apart from this, after providing financing, it is also concerned with developing the enterprise. Developing them explicitly would mean additional costs to the bank. Enterprise development dramatically limits the number of accounts that a development can handle because this is time-consuming. A commercial bank's main concern is to generate profits. Other benefits are only incidental. With a commercial bank's cost-consciousness, economic development would be its last priority.

g) **Criteria for Financing:** A development bank assumes project risks and does not insist on too much collateral. It will provide financing as long as the other criteria are met. A commercial bank pays less attention to the project in relation to the collateral requirements. However, the more progressive banks are lending against project cash flow and without collateral.

h) **Assessment of the Loan Proposal:** A development bank employs project appraisal as a means to determine the viability of the project submitted for financing. Project appraisal looks at the technical, financial, marketing, management, environmental and economic aspects of the project. Loan repayment is based on the cash flow to be generated by the project. A commercial bank uses risk asset management as tool to assess the borrower. It looks at the so-called 5 C's of credit, i.e., character, capacity, capital, collateral and condition. It bases loan repayment on the capacity of the borrower to pay (even from other sources) than from the 'project' itself. Thus, it can be said that development bank financing is project-focused while that of a commercial bank is borrower-oriented.

i) **Term of Loans Extended:** A development bank provides mainly term loans (maturity of more than one year). On the other hand, a commercial bank provides mainly short-term loans (less than one year maturity).

j) **Sources of Loan Funds:** A development bank is dependent on concessionary, long-term funds, e.g. pension funds, funds from multilateral financial institutions like the World Bank, Asian Development Bank, etc. It has traditionally limited access to domestic or commercial funds. A commercial bank has a strong deposit base and its corporate borrowers are also depositors. They can match its commercial borrowing against its own short-term loans.

k) **Lending Policies for Cyclical Industries:** A development bank supports its clients in spite of short-term cycles while a commercial bank does not like cyclical industries.

l) **Resource Mobilization:** A development bank undertakes project promotion work to match concessionary long-term financing while a commercial bank mobilizes deposit funds from small depositors which are lent out to large companies.

m) **Client Relationship:** A development bank relates more to clients as borrowers. There is less day-to-day business relationship. Trade transactions of a commercial bank allow for frequent monitoring and close client relationship.

n) **Scope of Institutional Mandate:** A development bank is essentially a specialized institution. It has limited branching and range of products. The commercial bank has a generalized charter. It can offer a wide range of products (especially in the case of universal banks) and can open more branches.

15.3 Structure of Development Banks in India

The Indian agricultural and industrial development banking system has travelled a lot and many changes have happened in tune with the requirements of the industry, trade, agriculture and other specialized sectors. The financial institutions which help industry, agriculture and other sectors in India can be classified into five categories and they consist of the following institutions:

Category I: All India Developmental Financial Institutions

- Industrial Finance Corporation of India (IFCI)
- Industrial Credit Investment Corporation of India (ICICI)
- Industrial Development Bank of India (IDBI)
- Small Industries Development Bank of India (SIDBI)
- Industrial Investment Bank of India (IIBI) or Erstwhile Industrial Reconstruction Bank of India (IRBI)

Category II: State Level Financial Institutions

- State Financial Corporations (SFCs)
- State Industrial Development Corporations (SIDCs)

Category III: Specialized Financial Institutions

- Export and Import Bank of India
- Risk Capital and Technology Finance Corporation Ltd (RCTC)
- Technology Development and Information Company of India Ltd. (TDICI)
- Shipping Credit and Investment Company of India Ltd. (SCICI)
- Tourism Finance Corporation of India Ltd. (TFCI)
- Housing and Urban Development Corporation of India (HUDCO)
- Housing Development and Finance Corporation (HDFC)

Category IV: Agricultural and Micro Financial Institutions

- National Bank for Agricultural and Rural Development (NABARD)
- Micro Financial Institutions (MFIs)

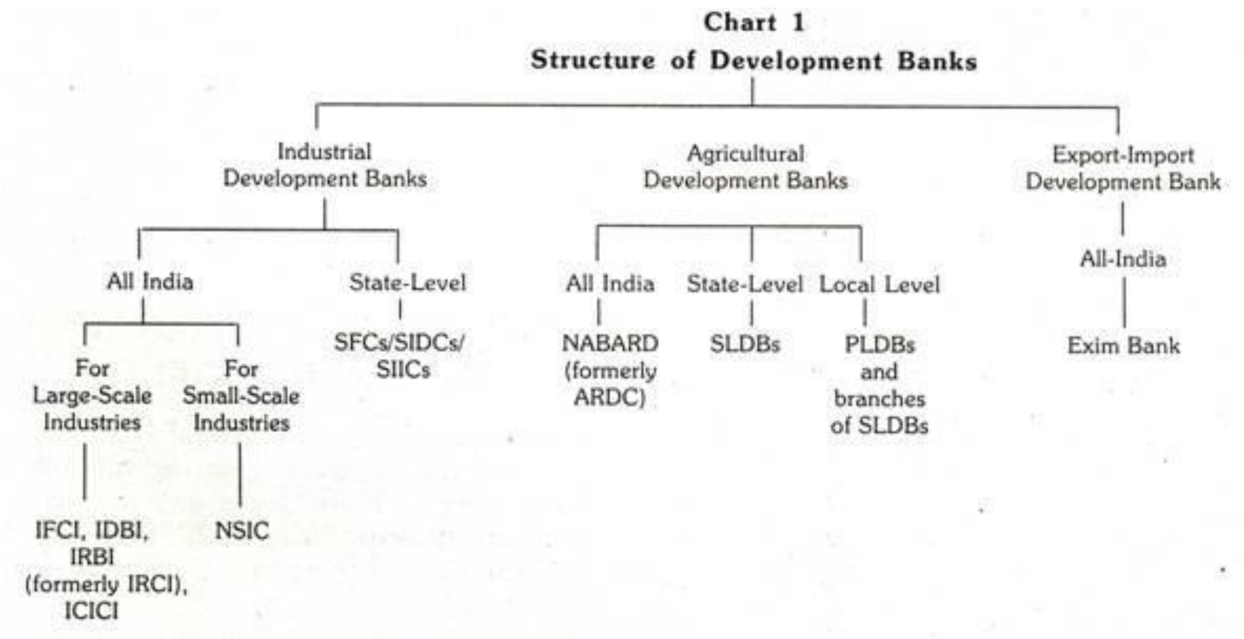
Category V: Investment Institutions

- Unit Trust of India (UTI)
- Life Insurance Corporation (LIC)

- General Insurance Corporation (GIC)

Besides the above financial institutions, there are some **International Financial Institutions** which help many countries. They include

- International Monetary Fund
- International Bank for Reconstruction and Development (IBRD)
- International Development Association (IDA)
- International Finance Corporation (IFC)



Source: Internet

Let us now understand what are the different prominent Development Banks and their role and functions.

15.3.1 National Bank for Agriculture and Rural Development(NABARD)

The Indian economy post independence was an agricultural economy. After independence, the focus was mainly on manufacturing and trade sector of the economy to boost development. However, a major part of population in India lives in the rural sector and so it is important to develop rural financial activities. This is why the government set up NABARD. As the name suggests NABARD is a development bank focusing primarily on the rural sector of the country. It is, in fact, India's apex development bank. It is one of the most important institutions in the country. NABARD is responsible for the development of the small industries, cottage industries, and any other such village or rural projects. Established on 12th July 1982, it had an initial capital of 100 crore. The bank is under the supervision of a Board of Directors appointed by Government of India. The headquarters of NABARD is in Mumbai but it has many branches and regional divisions. NABARD is instrumental in the development and efficiency of the current rural credit system. NABARD is responsible for regulating and supervising the functioning of such banks. Over the years NABARD has been pushing for development in the credit schemes for rural populations to meet their new credit requirements. Other than meeting credit requirements of the rural sector NABARD is also instrumental in social innovations and projects. It partners with various organizations for many innovative projects such as SHG-Bank linking, innovative schemes for water and soil conservation. Over the last three decades, the institution has gained goodwill and trust in the farmers and rural communities.

Functions of the NABARD

It basically performs three kinds of roles, i.e. credit functions, development functions, and supervisory functions. The key functions include:

- Frames the policy for rural credit in the country for all financing institutions
- National Bank for Agriculture and Rural Development will itself provide finance and refinancing facilities to the banks and rural regional banks
- Identification of credit potential and preparation of the credit plans for all districts
- It also helps all regional banks and institutes under its governance with the preparation of their own credit plans and policies
- Helps Regional Rural Banks establish an agreement with State Governments and other Co-op Banks and institutions
- It will also monitor the implementation of such plans and track their progress
- Helps banks improve their MIS system, modernize their technology, develop human resources etc
- As per the Banking Regulation Act 1949, NABARD has to conduct the inspection of Regional Rural Banks and other Co-op banks
- It communicates and consults the RBI in matters such as issuing of licenses for new banks, the opening of branches of Rural Banks etc.
- From time to time it will also inspect the investment portfolios of Regional Rural Banks and other State Co-op Banks

15.3.2 Industrial Finance Corporation of India (IFCI)

Initially established in 1948, the Industrial Finance Corporation of India was converted into a public company on 1 July 1993 and is now known as Industrial Finance Corporation of India Ltd. The main aim of setting up this development bankwas to provide assistance to the industrial sector to meet their medium and long-term financial needs.The IDBI, scheduled banks, insurance sector, and co-op banks are some of the major stakeholders of the IFCI. The authorized capitalof the IFCI is 250 crore and the Central Government can increase this as and when they wish to do so.

Functions of the IFCI

- The main function of the IFCI is to provide medium and long-term loans and advances to industrial and manufacturing concerns. It looks into a few factors before granting any loans. They study the importance of the industry in our national economy, the overall cost of the project, and finally the quality of the product and the management of the company. If the above factors have satisfactory results the IFCI will grant the loan.
- The IFCI can also subscribe to the debentures that these companies issue in the market.
- The IFCI also provides guarantees to the loans taken by such industrial companies.
- When a company is issuing shares or debentures the IFCI can choose to underwrite such securities.
- It also guarantees deferred payments in case of loans taken from foreign banks in foreign currency.
- There is a special department the Merchant Banking & Allied Services Department. They look after matters such as capital restructuring, mergers, amalgamations, loan syndication, etc.
- It the process of promoting industrialization the Industrial Finance Corporation of India has also promoted three subsidiaries of its own, namely the IFCI Financial Services Ltd, IFCI Insurance Services Ltd and I-Fin. It looks after the functioning and regulation of these three companies.

15.3.3 Small Industries Development Bank of India(SIDBI)

The government established SIDBI under a special Parliament Act as a subsidiary of the IDBI. Now the SIDBI is an independent body of its own that focuses mainly on the financing of the Small, Micro and Medium Enterprise (MSME) Sectors of the economy. It now is responsible for the allocation of the Small Industries Development Fund (which was the responsibility of the IDBI previously).SIDBI makes use of the current banking network to extend credit facilities to the small business and micro industries sector. It provides direct financial assistance to such banks and institutes which are passed over to the MSME sector. It also provides indirect financial assistance via line of credit, refinancing facilities, bills discounting, etc.

Functions of the SIDBI

- When a private bank or institution provides loans or advances to small units for business purposes, the SIDBI will refinance such loans.
- SIDBI has arrangements with banks; government bodies other international agencies, etc. to enable a holistic approach for the development of the MSME sector.
- It will also discount or rediscount bills of such private institutions.

- SIDBI offers small-scale units with additional services like leasing, factoring, etc.
- Ensures the timely flow of credit to make sure these small scale industries always have adequate working capital.
- Provides assistance to the MSME sector to expand its market for their products in both the domestic and the international market.
- It helps the small-scale industries modernize their technology for higher efficiency and better products.
- Especially helps organizations such as MahilaUdyamNidhi, National Equity fund, etc. with initial capital, soft loans, advances, etc.
- Financially supports other organizations doing similar work. For example, it provides financial assistance to SSI Development Corporations who then pass on the assistance to the small units.
- Besides providing credit, SIDBI also provides these small scale industries with support for development and promotion activities. They educate about entrepreneurial development, responsible financing, environment protection, energy efficiency. This we call as the Credit plus Approach.

15.3.4 EXPORT AND IMPORT BANK OF INDIA (EXIM)

Once our economy opened up post liberalization and globalization, the import and export industry became a huge sector in our economy. Even today India is one of the largest exporters of agricultural goods. So to provide financial support to importers and exporters the government set up the EXIM Bank. The Export and Import Bank of India, popularly known as the EXIM Bank was set up in 1982. It is the principal financial institution in India for foreign and international trade. It was previously a branch of the IDBI, but as the foreign trade sector grew, it was made into an independent body.

The main function of the Export and Import Bank of India is to provide financial and other assistance to importers and exporters of the country. And it oversees and coordinates the working of other institutions that work in the import-export sector. The ultimate aim is to promote foreign trade activities in the country.

Functions of the EXIM Bank

Let us take a look at some of the main functions of Export and Import Bank of India bank:

- Finances import and export of goods and services from India.
- It also finances the import and export of goods and services from countries other than India.
- It finances the import or export of machines and machinery on lease or hires purchase basis as well.

- Provides refinancing services to banks and other financial institutes for their financing of foreign trade.
- EXIM bank will also provide financial assistance to businesses joining a joint venture in a foreign country.
- The bank also provides technical and other assistance to importers and exporters. Depending on the country of origin there are a lot of processes and procedures involved in the import-export of goods. The EXIM bank will provide guidance and assistance in administrative matters as well.
- Undertakes functions of a merchant bank for the importer or exporter in transactions of foreign trade.
- Will also underwrite shares/debentures/stocks/bonds of companies engaged in foreign trade.
- Will offer short-term loans or lines of credit to foreign banks and governments.
- EXIM bank can also provide business advisory services and expert knowledge to Indian exporters in respect of multi-funded projects in foreign countries.

Importance of the EXIM Bank

Other than providing financial assistance, the Export and Import Bank of India bank is always looking for ways to promote the foreign trade sector in India. In the early 1990s, EXIM introduced a program in India known as the Clusters of Excellence.The aim was to improve the quality standards of our imports and exports. It also has a tie-up with the European Bank for Reconstruction and Development. It has agreed to co-finance programs with them in Eastern Europe.In order to promote exports EXIM bank also has schemes such as production equipment finance program, export marketing finance, vendor development finance, etc.

15.3.5 State Finance Corporations-SFC

The State Finance Corporations (SFCs) are an integral part of institutional finance structure of a country. SFC promotes small and medium industries of the states. Besides, SFCs help in ensuring balanced regional development, higher investment, more employment generation andbroad ownership of various industries.At present in India, there are 18 state finance corporations (out of which 17 SFCs were established under the SFC Act 1951). Tamil Nadu Industrial Investment Corporation Ltd. which is established under the Company Act, 1949, is also working as state finance corporation.

Functions of the SFCs

The various important functions of State Finance Corporations are:

- The SFCs provides loans mainly for the acquisition of fixed assets like land, building, plant, and machinery.
- The SFCs help financial assistance to industrial units whose paid-up capital and reserves do not exceed Rs. 3 crore (or such higher limit up to Rs. 30 crores as may be notified by the central government).
- The SFCs underwrite new stocks, shares, debentures etc., of industrial units.
- The SFCs grant guarantee loans raised in the capital market by scheduled banks, industrial concerns, and state co-operative banks to be repayable within 20 years.

15.3.6 States Industrial Development Corporations- SIDC

Currently, there are 28 SIDCs present in India. The main objective of establishing SIDC was to increase the process of industrialization in India. Also, it is considered as one of a financial institution to be established in India.SIDC came on to scene much after the SFCs. Thus, they were entirely set up by the state governments. Along with finance, they also provide a variety of functions like arranging power, lands, roads, licenses, etc. Also, they provide sponsoring of units, moreover in the backward areas.Out of their total finance, one-third is provided in the form of underwriting or direct subscriptions. The remaining two-thirds are done in the form of term loans.The corporation was first established in 1995. Since then the total amount sanctioned by them is Rs. 9800 crores. The disbursed amount is close to Rs. 7000 crores. The significant part of the sanctioned amount goes to the public sector and joint sector.So, the rest amount goes to the private sector. These funds are raised using means like reserves, share capital, etc. Furthermore, they take borrowings from the state government, IDBI, banks, and bonds, and debentures. Like other institutes, these ones also suffer from problems like the inexperienced staff, inadequate staff, defaults, and organizational deficiencies.

Functions of the **SIDCs**

The SIDC was set up by the various states governments. Also, these governments fully own the corporation. SIDC is more than a financial institution and act as an instrument to speed up the process of industrialization in the respective states.So, to achieve this process; they provide loans, guarantees, subscription of shares, etc to the companies. Besides loans to the respective industries, SIDC undertakes various promotional programs like project identification, techno-economic surveys, preparation of feasibility studies, and entrepreneurial training.Also, they provide financial assistance by means like loans, underwriting or direct subscriptions to debentures and shares, guarantees, etc. Furthermore, they promote joint sector projects along with private promoters. In these types of projects, SIDC has a 26% share, private co-promoter takes 25%, and the rest goes to the investing public.Also, SIDC takes the construction of sheds, development of industrial areas, and provision of various infrastructure facilities. Also, they take care of the development of various new growth centers. They also undertake various incentive schemes for state governments. For refinancing, IDBI helps it. They provide it using the term loans.Furthermore, SIDC uses bonds to borrow the amount. They also accept the deposits to fund their resources.

15.3.7 Industrial Credit and Investment Corporation of India- ICICI

Industrial Credit and Investment Corporation of India (ICICI) is a financial institution in India and was established in 1955 as a public limited company. The Indian Company Act governs it. ICICI is incorporated for developing medium and small industries of the private sector. Initially, the equity capital of ICICI was owned by companies, institutions, and individuals. At present, it has been owned by public sector institutions like—Banks, LIC, CIC, and its associated companies. In March 2002, the ICICI merged with the ICICI Bank and become a first universal bank in India. Due to this merger, ICICI does not exist anymore as a financial institution.

Financial Assistance of the ICICI

- *Project Finance: ICICI provides project finance to industries for establishment cost, modernization or expansion of manufacturing and processing activities. This assistance provided in the form of the rupee and foreign loans, underwriting, subscription to shares and debentures and guarantees to supply of equipment and foreign donors.The rupee loan is provided for the purchase of various equipment and machinery, construction and preliminary expenses. The foreign currency loans are provided for the purchase of imported equipment.*
- *Leasing: The ICICI commenced its leasing operations in 1983. Leasing assistance is provided for computerization, modernization/replacement, equipment of energy conservation, export orientation, pollution control activities, etc.*
- *Project Advisory Services: ICICI provides project advisory services to the Central and State Governments and public sector and private sector companies. It provides advice to the governments on policy reforms and on value chain analysis and to private sector companies on strategic management.*
- *Facilities for Non-resident Indians: ICICI gives information regarding facilities and incentives by the Government of India to the non-resident Indians for judicious investing in India.*
- *Provision of Foreign Currency Loans: The ICICI provides foreign currency loans and advances to enable Indian Industrial concerns to secure essential capital goods from foreign countries.*

- *Other Institutions Promoted: (a) ICICI promoted the Housing Development Finance Corporation (HDFC) to make available long-term finance to individuals in middle and lower income groups, co-operation, etc. Its primary objective was the construction and purchase on ownership basis of residential houses all over the country.*

  (b) Credit Rating Information Services of India Ltd. (CRISIL) was also set up by ICICI in association with Unit Trust of India (UTI) to provide credit rating services to the corporate industries.

  (c) ICICI promoted technology Development and Information Company of India Ltd. (TDICI), to finance the transfer and Up gradation of technology and provide technical information.

  (d) Program for the Advancement of Commercial Technology (PACT) set up by ICICI with a grant of US $10 million provided by USAID (United States Aid) to assist market-oriented R&D activity by Indian and US companies. ICICI has been entrusted with the administrative activities and management activities of PACT.

  (e) Program for Acceleration of Commercial Energy Research (PACER) funded by USAID with a grant of US $ 20 million to provide assistance to selected research and technology development proposals in the Indian energy sector. PACER was also launched by ICICI.

15.3.8 Industrial Development Bank of India- IDBI

IDBI is the Industrial Development Bank of India, set up in the year 1964. Its headquarters are in Mumbai and its parent company is Life Insurance Corporation (LIC).The purpose of setting up the IDBI is to financial and other credit facilities to struggling industries. Moreover, the IDBI came into existence with the aim to provide financial support credit assistance to needy industries.Initially, the IDBI continued to operate as an RBI subsidiary. But over time, the RBI it underwent a transfer and now functions under the Government of India (GOI).Like any other bank that provides e-banking, IDBI has recently begun offering new services as well.With the constant development of digitization, it has become the need of the hour to provide convenience to customers.

Functions of the IDBI

- Being an apex bank, it regulates industrial development in India, formulates schemes for new projects, implements them and also tries to remove lacunae in the industrial pattern.
- Provides technological and administrative help for the expansion and management of the industrial sector.
- Provides refinance facility to IFCI and SFCs with the permission of Govt. of India.

- It co-ordinates the activities of development financial institutions.
- It helps in sale or purchase of industrial bonds / debentures.
- It carries out research work by collecting information about market conditions, investment, technological progress etc., and the same is made available to the industrial sector.

15.3.9 Micro Units Development and Refinance Agency Bank (*Mudra Bank*)

Government of India launched a flagship scheme called **Prime Minister MUDRAYojana (PMMY)** on 8th April 2015 to extend affordable loans to the non-corporate, non-farm micro and small enterprises to cater to their funding needs. One of the major aims of **MUDRA loans** was to bring the target audience into the formal financial fold.Micro Units Development and Refinance Agency Limited is created as a refinancing institution providing loans up to Rs. 10 lakhs maximum to the eligible enterprises through the Commercial Banks, RRBS, Cooperative Banks, NBFC and MFI etc. The borrowers can approach the nearby branches of the lending institutions or apply for loans under the **MUDRA scheme** or apply online.

MUDRA Mission

The mission statement of **PradhanMantri Mudra Loan** is to create an inclusive value based entrepreneurial culture which is sustainable in partnership with financial institutions in achieving financial security and success.The key benefits of MUDRA loan:

- Micro and small enterprises engaged in income generation are the prime target for extension of loan facilities.
- The borrowers are not required to provide any collateral or security to avail of Mudra Loan.
- There are no processing charges for availing of the loan.
- The loans are provided for the funded and non-funded category, inducing an element of flexibility in the usage of funds.
- The loans can be in the form of term loans, overdraft facility, letters of credit or bank guarantees, thus catering to a wide array of requirements.
- The Mudra loan scheme does not prescribe any minimum amount.

MUDRA Loan Details

The name of the type of loan facilities under the **PradhanMantri Mudra Loan** is suggestive of the developmental phases of an enterprise and the quantum of loan sanctioned. There are three Categories of the **MUDRA loans** based on the stated parameters making the business viable**.** Apply today at lendingkart.com for all the named schemes.

1. Shishu: This loan is meant for entrepreneurs who are looking to start a business or in the process of establishing one. The maximum loan sanctioned under this category is Rs.50000. The basic norms of the loan are:

- To provide finance for machinery.
- Valid quotation and supplier details are essential.

2. Kishor: This category of loan is targeted towards entrepreneurs looking to expand their business through the infusion of fresh funds. Thus, the loan sanctioned under this category is in the range of Rs.50001 to Rs.5 lakhs. The key requirements for availing of this loan are:

- The existing balance sheet for the previous two years.
- Bank account statement.
- Income and sales returns.
- Estimated balance sheet for the current year.
- Technical and economic viability of the project.

3. Tarun: The third type of loan is for entrepreneurs who are well entrenched and have established themselves in the business and yet looking for further growth or diversification. The loan sanctioned under this type of loan is in the range of Rs.500001 to Rs.10 lakhs. The amount involved being the highest under the **MUDRA Scheme**; the requirements are more stringent than the other two loans. Some of the key requirements are:

- All the requirements listed for Kishor **Mudra Loan.**
- Address and Identity proof.
- Caste certificate, if eligible for reservation.

Primarily the loan facilities are extended to non-corporate, non-farm enterprises. However, farm sector enterprises involved in allied services like fisheries, food processing and horticulture, to name a few are eligible.

15.3.10 The Industrial Investment Bank Of India (IIBI)

Govt. of India set up Industrial Reconstruction Corporation of India (IRCI) in 1971 with the objective of helping sick industrial units. The IRCI was converted into Industrial Reconstruction Bank of India (IRBI) in 1985. Again in 1997, IRBI was renamed as Industrial Investment Bank of India (IIBI).

This bank not only provides loan assistance but it thoroughly reviews the position of sick industrial units and helps in their restructuring and rehabilitation. It focuses on making sick industrial units economically viable. It extends help in the form of financial assistance, technical and managerial assistance, transportation and marketing facilities, solving labor problems etc. IIBI has given a new life to several sick industrial units. As a result, unemployment has been avoided, wastage of investment has been prevented and all this has helped India's industrial economy.

15.4 Recent Developments in Development Banking

Development bank plays a very important role in economic development of our country. Since independence they have contributed to the inception of industrialization and all other technological innovations. Recently the Finance Minister NirmalaSitharaman (2019) while, announcing a slew of measures to boost the economy and financial market sentiments, had an interesting idea. It was about setting up a development bank. Ms. Sitharaman said: "In order to improve access to long-term finance, it is proposed to establish an organisation to provide credit enhancement for infrastructure and housing projects, particularly in the context of India now not having a development bank and also for the need for us to have an institutional mechanism. So, this will enhance debt flow toward such projects." The announcement could have far-reaching implications for India's financial system.

Universal Banking: One of the latest developments in the field of development banking is the concept of 'Universal Banking'. Universal banking is a system in which banks provide a wide variety of financial services, including commercial and investment services. Universal banks may offer credit, loans, deposits, asset management, investment advisory, payment processing, securities transactions, underwriting and financial analysis. While a universal banking system allows banks to offer a multitude of services, it does not require them to do so. Banks in a universal system may still choose to specialize in a subset of banking services. Universal banking combines the services of a commercial bank and an investment bank, providing all services from within one entity. The services can include deposit accounts, a variety of investment services and may even provide insurance services. Deposit accounts within a universal bank may include savings and checking. Some of the more notable universal banks include ICICI, IDBI and Axis Bank (erstwhile UTI).

Assistance to Backward Areas: Operations of Development Banks 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 banks 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. In recent years, development banks in India have launched special programmes 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.

Promotion of New Entrepreneurs: Development banks in India have also achieved aremarkable success in creating a new class of entrepreneurs and spreading the industrial cultureto newer areas and weaker sections of the society. Special capital and seed Capital schemes havebeen 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 oflong-term benefits to the society from the emergence of a new class of entrepreneurs.Development banks have been actively involved in the entrepreneurship development programmes and in establishing a set of institutions which identify and train potential entrepreneurs. 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 programmes for up gradation of skill of State level development banks and other industrial promotion agencies, conducting special studies on important issues concerningindustrial development, encouraging voluntary agencies in implementing their programmes for the uplift of rural areas, village an cottage industries, artisans and other weaker sections of the society.

National Development Bank (Proposed): The role of development banks was diluted during the early 2000s, not only in India but also in other developing countries. This was attributable to the progressive withdrawal of concessional funds made available by governments, which in turn was an integral part of deregulation and reform in the financial sector almost everywhere. It was hoped that the evolution of domestic capital markets would enable commercial banks to enter into long-term lending. This dilution did not happen everywhere. There were exceptions, such as Brazil and Korea in the developing world, or Germany and Japan among industrialized countries. In fact, the China Development Bank was established as late as 1994, and it performed a critical role in the industrialization surge that began in the mid-1990s. Between 2000 and 2010, the outstanding loans of development banks as a percentage of gross domestic product dropped from 7.4% to 0.8% in India, but rose from 6.4% to 9.7% in Brazil and 6.2% to 11.2% in China, and declined from 8.6% to 6.8% in Korea, while this proportion rose from 8.5% to 15.9% in Germany and from 3% to 7.2% in Japan. The shortcomings of development banks in India simply passed on the burden to commercial banks, not equipped for the task, which have accumulated NPAs as a consequence. This has demanded and initiated the process to establish a National Development Bank (NDB) in India. Such a new institution would start with a clean slate, without any baggage from the past. At this juncture, an NDB is both necessary and desirable. It would help reindustrialize India. It would also de-stress commercial banks.

15.5 Check Your Progress

State whether following statements are **Trueor False.**

1. Development banks provide loan assistance to every person-demandingloan.
2. Development banks extend loans to production units for purchasing rawmaterials and payment of wages.
3. A borrower from development bank receives other facilities free of cost.
4. Development banks are termed as partners in economic development ofthe country.
5. Development banks help in industrial growth.
6. Development banks offer medium or long-term loans to production units.
7. Commercial banks and development bank have similar functions.
8. Projects which do not undertake production in accordance with needs ofthe economy are not financed by development banks.
9. Exim Bank is the only bank established to fund India's exports andimports.
10. At present ICICI is working as a development bank.
11. IFCI is working for the rehabilitation of sick industrial units.
12. State Industrial Development Corporations extend financial help to largeindustrial units.
13. The Industrial Credit and Investment Corporation of India (ICICI) is acommercial bank.
14. The state governments also own a portion of the EXIM Bank.
15. NABARD only focuses on rural credit facilities as a means of development.

Answer the following:

16. **Does IDBI only provide its services to industrial customers or to individual customers as well?**
17. In which year Small Industries Development Bank of India came into existence?
    a) 1990
    b) 1991
    c) 1992

d) 1993

18. Where is the Head Office of the Industrial Finance Corporation of India?
    a) New Delhi
    b) Nagpur
    c) Mumbai
    d) Bangalore
19. Currently, how many SIDCs are present in India?
    a) 30
    b) 28
    c) 26
    d) 32
20. What is the full form of SIDC?
    a) State Institutional Development Corporation
    b) Small Industrial Development Corporation
    c) Small Institutional Development Corporation
    d) State Industrial Development Corporation
21. Specify some objectives of the Industrial Credit and Investment Corporation of India (ICICI)?

15.6 Summary

- Development Banks are financial agencies that provide medium-andlong-term financial assistance and act as catalytic agents in promotingbalanced development of the country. They are engaged inpromotion and development of industry, agriculture, and other keysectors. They also provide development services that can aid in theaccelerated growth of an economy.
- The concept of development banking originated during the postSecond World War period. The International Bank for Reconstructionand Development (IBRD) known as the World Bank and theInternational Monetary Fund (IMF) are examples of developmentbanks at the international level.
- To fill in the gaps in the banking system and capital markets, newinstitutional machinery were devised- the setting up of specializedfinancial institutions.

- The country is being served by 57 financial institutions, comprising11 institutions at the national level and 46 institutions at the statelevel. These financial institutions have a wide network of branches.
- Development banks are in the process of converting themselves into universal banks.ICICI has become a universal bank by a reverse merger with its subsidiaryICICI Bank. IDBI has transformed itself into a universal bank.
- Industrial Finance Corporation of India Limited (IFCI), India's first Development banks, was established on July 1, 1948, under the Industrial FinanceCorporation Act as a statutory corporation. It was set up to provideinstitutional credit to medium and large industries. IFCI Ltd is now being regulatedas a systemically important non-deposit taking NBFC.
- The Industrial Development Bank of India (IDBI) was establishedin 1964 by parliament as a wholly owned subsidiary of the RBI.In 1976, the bank's ownership was transferred to the Governmentof India. It was accorded the status of the principal financial institutionfor coordinating the working of institutions at national andstate levels engaged in financing, promoting, and developing industries.IDBI was merged with its private banking arm, IDBI Bank, in2003–04.
- The Small Industries Development Bank of India (SIDBI) was set upin 1990 under an act of parliament—the SIDBI Act, 1989. The charterestablishing SIDBI envisaged SIDBI to be 'the principal financialinstitution for the promotion, financing and development of industriesin the small-scale sector and to coordinate the functions of otherinstitutions engaged in similar activities.' SIDBI offers a chain offinancial products covering micro-finance, business, incubation, venturecapital, project finance, assistance for technology developmentand marketing of small scale industries products, export finance, billsfinance, factoring, and guarantees for loans. SIDBI also provides supportservices such as training, market information, and advice forenhancing the inherent strength of small scale units. SIDBI is amongtop 30 development banks of the world.
- Infrastructure Development Finance Company Limited (IDFC) wasset up on the recommendations of the Expert Group on Commercializationof Infrastructure Projects. IDFC was set up to facilitatethe flow of private finance to commercially viable infrastructure projects.Initially, IDFC focused on power, roads, ports, and telecommunications.Now it has broadened this focus to the framework ofenergy, telecommunications and information

technology, integratedtransportation, urban infrastructure, and food and agri-business infrastructure.

- The Export Import Bank of India is wholly owned by the Governmentof India and was set up for the purpose of financing, facilitating, and promoting foreign trade in India. Exim Bank is the principalfinancial institution in the country for coordinatingworking ofinstitutions engaged in financing exports and imports.
- NABARD is an apex institution set up for providing and regulatingcredit and other facilities for the promotion and development of agriculture,small scale industries, cottage and village industries, handicraftsand other rural crafts, and other allied economic activities inrural areas with a view to promoting integrated rural developmentand securing prosperity of rural areas and for matters connectedtherewith or incidental thereto. The functions of NABARD are tofacilitate credit flow for agriculture and rural development, promoteand support policies, practices and innovations conducive to ruraldevelopment, strengthen rural credit delivery system through institutionaldevelopment, and supervise rural financial institutions suchas cooperative banks and regional rural banks.

15.7 Keywords

Development Bank: It is defined as 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.

Financial Institution: The institution which distributes its share capital, debentures to people and collects funds, which are used for giving loans.

Joint Financing: The provision of funds for a project etc. from two or more sources.

Refinance: Refinancing is the replacement of an existing debt obligation with another debt obligation under different terms

Bank: An institution primarily engaged in accepting deposits and giving loans is called a bank.

NABARD:NABARD is a development bank focusing primarily on the rural sector of the country.

IFCI: This development bank provides assistance to the industrial sector to meet their medium and long-term financial needs.

SIDBI: SIDBI is an independent body of its own that focuses mainly on the financing of the Small, Micro and Medium Enterprise (MSME) Sectors of the economy.

EXIM Bank: The bank set up by the government to provide financial support to importers and exporters.

State Finance Corporations:SFC promotes small and medium industries of the states. Besides, SFC helps in ensuring balanced regional development, higher investment, more employment generation and broad ownership of various industries.

States Industrial Development Corporations:SIDCs act as an instrument to speed up the process of industrialization in the respective states. To achieve this process, they provide loans, guarantees, subscription of shares, etc to the companies.

ICICI:ICICI is incorporated for developing medium and small industries of the private sector.

IDBI: The purpose of setting up the IDBI is to financial and other credit facilities to struggling industries.

MUDRA Bank: *It was established* to extend affordable loans to the non-corporate, non-farm micro and small enterprises to cater to their funding needs.

The Industrial Investment Bank of India: This bank not only provides loan assistance but it thoroughly reviews the position of sick industrial units and helps in their restructuring and rehabilitation.

15.8 Self-Assessment Test

1. Define Development Banks. How do you differentiate between Commercial Banks and Development Banks?
2. What is the objective of Development Banks? How development bank helps to boost the economy of the nation?
3. Describe in detail the functions of Development Banks.
4. Classify the Development Banks in India with their functions.
5. Write an essay on recent developments in Development Banking in India.

15.9 Answer to Check Your Progress

1. False
2. False
3. False
4. True
5. True
6. True
7. False
8. True
9. False
10. False
11. False
12. False
13. True
14. False

15. False; NABARD also focuses on development through other functions such as Resource Management Programs, Tribal Development Programs, associating with various SHG's, educating farmers about new innovations etc.
16. IDBI provides its services not only to industrial customers but also serves individuals who look out for loans to start up a business. If a person is willing to develop its agriculture plot of land, IDBI provides loans for such purposes. Also, there exists a variety of Government set up accounts for women and children benefits.
17. a) 1990
18. a) New Delhi
19. b) 28
20. d) State Industrial Development Corporation
21. The important objectives of the ICICI are:

    (i) To provide loans to various industrial projects in the private sector.

    (ii) To stimulate the promotion of various new industries.

    (iii) To provide assistance the expansion and modernization of existing industries.

    (iv) To provide Technical and managerial aid to increase production of industries.

15.10 References/Suggested Readings

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