ज्ञानगंगा घरोघरी

Yashwantrao Chavan Maharashtra Open University

FMG 302

Finance Group

Indian Financial System and Management of Financial Institutions

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Introduction

Financial System of a country play an important role in its economic development. The role of financial system is to efficient allocation of funds thereby creating capital that helps in achieving the ultimate goal of economic development. A vibrant financial system is considered fundamental to the growth and development of a country. The working of a financial system is facilitated by the existence of an efficient financials service sector. In addition, financial market, financial institutions and financial instruments together contribute to the functioning of the financial system. In the post liberalisation and globalisation era, the finance sector has been witnessing a complete metamorphosis.

Deregulation measures have included freeing up of direct control over ownership, liberalising interest rates, deregulation foreign exchange transactions controls, liberal policies for the entry of new firms and expanding the base of banking system both for nationals and international business ventures. At the same time, non-banking financial institutions, securities market and money market have developed to mobilise and allocate savings. Therefore, the objective of this book is to acquaint the students with the intricacies of financial system. As per the title, the book has been written to provide adequate information exclusively on components of financial system and risk management in financial institutions.

Any suggestions for improvement of book will be appreciated.

- Dr. Satish Kumar

Message from the Vice-Chancellor

Dear Students,

Greetings!!!

I offer cordial welcome to all of you for the Master's degree programme of Yashwantrao Chavan Maharashtra Open University.

As a post graduate student, you must have autonomy to learn, have information and knowledge regarding different dimensions in the field of Commerce & Management and at the same time intellectual development is necessary for application of knowledge wisely. The process of learning includes appropriate thinking, understanding important points, describing these points on the basis of experience and observation, explaining them to others by speaking or writing about them. The science of Education today accepts the principle that it is possible to achieve excellence and knowledge in this regard.

The syllabus of this course has been structured in this book in such a way, to give you autonomy to study easily without stirring from home. During the counseling sessions, scheduled at your respective study centre, all your doubts will be clarified about the course and you will get guidance from some experienced and expert professors. This guidance will not only be based on lectures, but it will also include various techniques such as question-answers, doubt clarification. We expect your active participation in the contact sessions at the study centre. Our emphasis is on 'self study'. If a student learns how to study, he will become independent in learning throughout life. This course book has been written with the objective of helping in self-study and giving you autonomy to learn at your convenience.

During this academic year, you have to give assignments and complete the Project work wherever required. You have to opt for specialization as per programme structure. You will get experience and joy in personally doing above activities. This will enable you to assess your own progress and thereby achieve a larger educational objective.

We wish that you will enjoy the courses of Yashwantrao Chavan Maharashtra Open University, emerge successful and very soon become a knowledgeable and honorable Master's degree holder of this university.

Best Wishes!

- Vice-Chancellor

Indian Financial System and Management of Financial Institutions

SYLLABUS

UNIT 1 : INTRODUCTION TO INDIAN FINANCIAL SYSTEM

- Concept of finance
- Saving and investment
- Introduction to the financial system
- Functions of financial system
- Structure of Indian financial system
- Regulatory framework of the Indian financial system

UNIT 2 : REFORMS IN INDIAN FINANCIAL SYSTEM

- Financial system and economic growth in India
- Reforms in financial sector

UNIT 3 : DEVELOPMENT FINANCIAL INSTITUTIONS

- Structure of various financial institutions e.g. IFCI, IDBI, ICICI, NABARD, SIDCs, SIDBI
- Concept of development banks
- Development financial institutions in India
- Changing role of development financial institutions
- Functions of various financial institutions

UNIT 4 : STATE FINANCIAL CORPORATIONS (SFCs)

- State Financial Corporations
- Functions of State Financial Corporations
- Types of State Financial Corporations
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UNIT 5 : OTHER FINANCIAL INSTITUTIONS

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- Other financial institutions e.g. DICGC, ECGC

UNIT 6 : BANKING INSTITUTIONS IN INDIA

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- Functions of commercial banks
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- Performance of the co-operative banks

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UNIT 9 : BANKING INNOVATIONS

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- Significance of debt market
- Participants in Indian debt market

- Debt market instruments
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- Measures taken to develop corporate bond market

UNIT 15 : FINANCIAL INSTITUTIONS RISKS

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- Types of risks- Credit risk, Liquidity risk, Interest rate risk, Market risk, Foreign exchange risk, Technology risk, Operational risk

UNIT 16 : RISK MANAGEMENT IN FINANCIAL INSTITUTIONS

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- Asset liability management strategies
- Interest rate risk measurement techniques
- Interest rate risk management
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- Fund management: managing credit and investments
- ALM systems in banks: RBI guidelines
- Basel norms-original accord and Indian position

UNIT 1: INTRODUCTION TO INDIAN FINANCIAL SYSTEM

NOTES

Structure

1.0 Introduction
1.1 Unit Objectives
1.2 Concept of Finance
1.3 Meaning of Saving and Investment
1.4 Introduction to the Financial System
1.5 Functions of Financial System
1.6 Structure of Indian Financial System
1.7 Regulatory Framework of the Indian Financial System
1.8 Key Terms
1.9 Summary
1.10 Questions and Exercises
1.11 Further Readings and References

1.0 Introduction

Money and finance alone cannot lead to economic development. A system is a set of interrelated parts working together to achieve some purpose. With reference to 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 set of institutions and instruments which foster savings and channel them to their most efficient use. The Indian financial system consists of the many financial institutions and the mechanism which affects the generation, mobilisation and distribution of savings to the community among all those who demand the funds for investment purposes

1.1 Unit Objectives

After completing this unit students will be able to :

- Understand the concept, features and role of finance in an economy
- Describe the meaning, objectives and functions of the Financial System
- Learn the structure of the Indian Financial System
- Understand the nature and importance of various Financial Instruments
- Familiarise with the role of RBI, SEBI and IRDA in regulating the Indian Financial System

1.2 Concept of Finance

Finance is defined in numerous ways by different groups of people. Though it is difficult to give a perfect definition of Finance following selected statements will help you deduce its broad meaning.*"Finance is the management of money and other valuables, which can be easily converted into cash."*

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"Finance is a simple task of providing the necessary funds (money) required by the business of entities like companies, firms, individuals and others on the terms that are most favourable to achieve their economic objectives."

1.2.1 Features of Finance

The main characteristics or features of finance are depicted below.

1. Investment Opportunities

In Finance, Investment can be explained as an utilisation of money for profit or returns. Investment can be done by:-

- Creating physical assets with the money (such as development of land, acquiring commercial assets, etc.),
- Carrying on business activities (like manufacturing, trading, etc.), and
- Acquiring financial securities (such as shares, bonds, units of mutual funds, etc.).

Investment opportunities are commitments of monetary resources at different times with an expectation of economic returns in the future.

2. Profitable Opportunities

In Finance, Profitable opportunities are considered as an important aspiration (goal). Profitable opportunities signify that the firm must utilize its available resources most efficiently under the conditions of cut-throat competitive markets.

For example, business carried on with non-compliance of law, unethical ways of acquiring the business, etc., usually may result in huge short-term profits but may also hinder the smooth possibility of long-term gains and survival of business in the future.

3. Optimal Mix of Funds

Finance is concerned with the best optimal mix of funds in order to obtain the desired and determined results respectively.

Primarily, funds are of two types, namely,

1. Owned funds (Promoter Contribution, Equity shares, etc.), and
2. Borrowed funds (Bank Loan, Bank overdraft, Debentures, etc).

The composition of funds should be such that it shall not result in loss of profits to the Entrepreneurs (Promoters) and must recover the cost of business units effectively and efficiently.

4. System of Internal Controls

Finance is concerned with internal controls maintained in the organisation or workplace.

Internal controls are set of rules and regulations framed at the inception stage of the organisation, and they are altered as per the requirement of its business. However, these rules and regulations are monitored at various intervals to accomplish the same which have been consistently followed.

5. Future Decision Making

Finance is concerned with the future decision of the organisation. A "Good Finance" is an indicator of growth and good returns. This is possible only with the good analytical decision of the organisation. However, the decision shall be framed by giving more emphasis on the present and future perspective (economic conditions) respectively.

1.3 Meaning of Saving and Investment

Many people confuse the concepts of saving and investment. Saving takes place when people abstain from consumption, that is, when they consume less than their income. Investment takes place when we purchase new capital equipment or other assets that make for future productivity. Investment does not mean buying stocks or bonds. Here are some important facts:

- The motive for saving is one of deferring your consumption to a later day. We save when we consume only part of our income now and save for retirement, a rainy day, putting children through college, the summer home, etc.
- The motive for investment is to make money. Investment takes place when we purchase plants or equipment, which make workers and businesses more productive in the future.

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Check your progress

1. What do you mean by finance?
2. Difference between savings and investment.
3. Explain the financial system.

1.4 Introduction to the Financial System

The economic development of a nation is reflected by the progress of its various economic units, such as its corporate sector, government and household sector. These economic units can be classified into the following three categories:

- Saving surplus units, that is, those units whose savings are in excess of investments
- Saving deficit units whose investments exceed their savings and
- Neutral units, wherein savings are equal to investments

Thus, a financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the areas of deficit. A financial system comprises financial institutions, financial markets, financial instruments and services that help in the formation of capital by transferring of funds in the economy. It provides a mechanism by which savings are transformed into investment, and these investments are used for the economic development of the nation.

Van Horne defined a financial system as, "*the system to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption*". It is a complex, integrated set of subsystems. These sub-systems are Financial Institutions, Markets and Instruments.

According to Prasanna Chandra, *"financial system consists of a variety of institutions, markets and instruments related in a systematic manner and provide the principal means by which savings are transformed into investments"*.

1.5 Functions of Financial System

The financial system of a country performs various important functions for the economic development of the country. The main functions of a financial system are as follows:

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i. **Saving mobilisation:** An important function of a financial system is to mobilise savings and channelise them into productive activities. A financial system helps in obtaining funds from the savers or surplus units such as household individuals, business firms, public sector units, central government and state governments.

ii. **Liquidity:** In a financial system, liquidity means the ability to convert into cash. The financial market provides investors the opportunity to liquidate their investments, which are in instruments such as shares, debentures and bonds. The price of these instruments is determined daily according to the operations of the market force of demand and supply.

iii. **Payment function:** A financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in an economy. The cost and time of transactions are considerably reduced.

iv. **Capital formation:** This promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

v. **Risk protection:** Financial markets provide protection against life, health- and income-related risks. These risks can be covered through the sale of life insurance, health insurance and property insurance and various derivative instruments.

1.6 Structure of Indian Finacial System

The Indian financial system comprises financial institutions, financial markets, financial instruments and financial services that are continuously monitored by various regulatory authorities, namely, the Reserve Bank of India, Securities and Exchange Board of India and Insurance Regulatory and Development Authority. A description of the various components of the Indian financial system is given below:

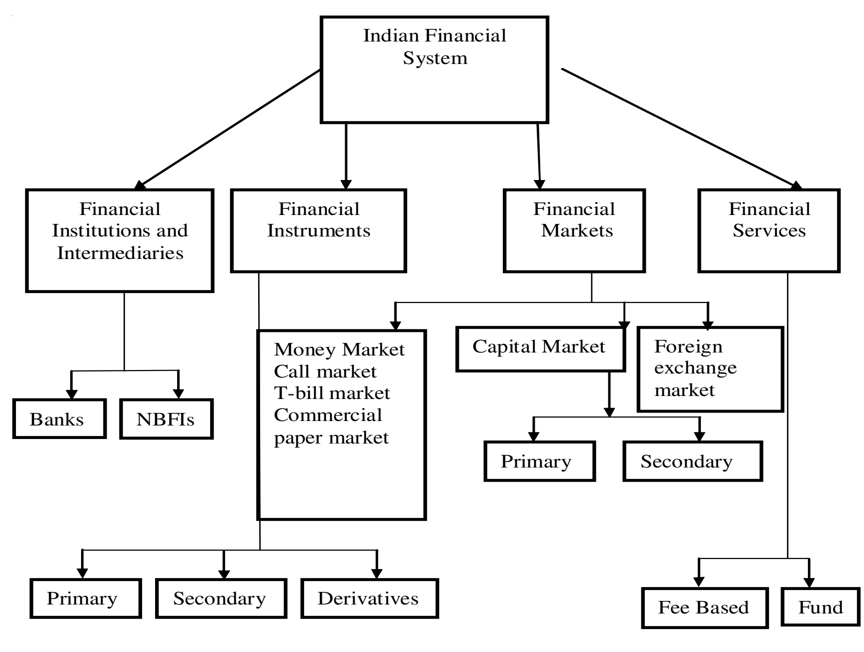

Figure 1.1: Structure of the Indian Financial System

1.6.1 Financial Institutions

These give a physical presence to the system and provide the financial infrastructure. They encourage savings and make for its optimal allocation. They make one type of contract with the borrowers and another type with the lenders. In other words, they perform the function of financial intermediation. The major financial institutions in India can be classified into Banking Institutions and Non-Banking Financial Institutions.

1.6.1.1 Banking Institutions

These institutions mobilize the savings of people. They provide a mechanism for the smooth exchange of goods and services. They extend credit while lending money. They not only supply credit but also create credit. There are three basic categories of banking institutions. They are commercial banks, cooperative banks and developmental banks. Commercial banks in India carry more than two-thirds of the assets of all financial institutions. Commercial banking can be further divided into four parts as follows:

I. Public sector banks
II. Private sector banks
III. Foreign banks
IV. Regional rural banks

1.6.1.2 Non-banking Institutions

Non-banking financial institutions (NBFIs) also mobilize financial resources directly or indirectly from people. They lend funds but do not create credit. Companies such as LIC, GIC,UTI, Development Financial Institutions, Organization of Pension and Provident Funds fall into this category. Non-banking financial institutions can be categorized as investment companies, housing companies, leasing companies, hire purchase companies, specialized financial institutions (EXIM Bank, etc.), investment institutions, state level institutions, etc. The largest component of NBFIs, can be distinguished from banks with regard to the degree and nature of regulatory and supervisory controls. Firstly, the regulations governing these institutions are relatively lighter as compared to those of banks. Secondly, they are not subject to certain regulatory prescriptions applicable to banks. Some of the NBFIs are as discussed below and the detailed description of NBFIs is given in unit 8.

i. **Tourism Finance Corporation of India Ltd. (TFCI):** The GoI had, pursuant to the recommendations of the National Committee on Tourism (i.e. the Yunus Committee set up under the aegis of Planning Commission), decided in 1988, to promote a separate All-India Financial Institution for providing financial assistance to tourism-related activities/projects.

ii. **General Insurance Corporation (GIC):** The entire general insurance business in India was nationalised by General Insurance Business (Nationalisation) Act, 1972 (GIBNA). The General Insurance Corporation of India (GIC) was formed in pursuance of Section 9(1) of GIBNA. It was incorporated on 22 November 1972 under the Companies Act, 1956, as a private company limited by shares. GIC was formed for the purpose of superintending, controlling and carrying on the busi-

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ness of general insurance. It has a number of need-based insurance schemes to meet the diverse and emerging needs of various segments of society.

iii. **Export-Import Bank of India (EXIM):** Export-Import Bank of India is the premier export finance institution of the country, set up in 1982 under the Export–Import Bank of India Act, 1981. The Government of India launched the institution with a mandate, not only to enhance exports from India but also to integrate the country's foreign trade and investment with the overall economic growth. For financing overseas investments, EXIM has put in place a Technology and Innovation Enhancement and Infrastructure Development (TIEID) for MSMEs by partnering with Banks/FIs.

iv. **National Bank for Agriculture and Rural Development (NABARD):** This is the apex institution in the country and it looks after the development of the cottage industry, small industry and village industry, and other rural industries. NABARD also reaches out to allied economies and supports and promotes integrated development. Against the backdrop of the massive credit needs of rural development and the need to uplift the weaker sections in rural areas, the National Bank for Agriculture and Rural Development was set up in 1982 under the National Bank for Agriculture and Rural Development Act 1981.

v. **National Housing Bank (NHB):** This was set up on 9 July 1988 under the National Housing Bank Act, 1987. It is wholly owned by the Reserve Bank of India, which contributed the entire paid-up capital. The Head Office of the NHB is in New Delhi. The NHB has been established to promote a sound, healthy, viable and cost-effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.

1.6.2 Financial Instruments

These instruments are another important constituent of the financial system. They represent a claim against the future income and wealth of others. It will be a claim against a person or an institution, for the payment of money at a specified future date. They fall into three broad categories - primary securities, indirect securities and derivatives.

1.6.2.1 Primary or direct instruments

Primary instruments or direct securities are issued directly by borrowers to lenders. Equity shares, preference shares and debentures are primary securities. Equity shares are ownership securities and risk capital. The owners of such securities are residual claimants on income and assets and participate in the management of the company. Debentures are creditor-ship securities. Their holders are entitled to a specified interest and first claim on the assets of the security. Preference shares are hybrid securities. The holders of such securities have preference rights over equity shareholders with regard to both a fixed dividend and return of capital.

1.6.2.2 Secondary or indirect instruments

Indirect securities are not directly issued by borrowers to lenders. These securities are issued via a financial intermediary to an ultimate lender. Indirect securities include mutual fund units, security receipts, securitized debt instruments.

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i. **Mutual Funds** pool the savings of many investors who share a common financial goal. Each scheme of a mutual fund can have different characteristics and objectives. Mutual funds issue units to investors, which represent an equitable right in the assets of the mutual fund.

ii. **Security Receipts** are bonds issued by Asset Reconstruction Companies to banks when they buy bad loans from them. Normally, when these companies buy bad assets from banks, they do not pay cash up front. They buy stressed assets through security receipts, which are essentially bonds that can be redeemed later. The bonds (SR) are issued up to a maximum period of seven years.

iii. **Securitized debt instruments** are products of securitization, which in turn is the process of passing debts on to entities that in turn break them into bonds and sell them. As of 2010, the most common form of securitized debt is mortgage-backed securities, but attempts are being made to securitize other debts, such as credit cards and student loans. Securitized debt instruments are created when the original holder (e.g. a bank) sells its debt obligation to a third party, called a Special Purpose Vehicle (SPV). The SPV pays the original lender the balance of the debt sold, which gives it greater liquidity. It then goes on to divide the debt into bonds, which are then sold on the open market.

1.6.2.3 Derivatives instruments

Derivatives are instruments whose value is derived from the value of one/more basic variables called the underlying asset. They are forwards, futures and options.

i. **Forward contracts** are agreements to exchange an asset, for cash, at a predetermined future date today. At the end of the contract, one can enter into an offsetting transaction by paying the difference in price.

ii. **Future contracts** are similar to forward contracts but are highly standardised traceable contracts unlike the latter. They are standardised in terms of size, expiry date and all other features.

iii. **Options** establish a contract between two parties concerning the buying or selling of an asset at a reference price. The buyer of the option gains the right, but not the obligation, to engage in some specific transaction on the asset, whereas the seller incurs the obligation to fulfil the transaction if requested by the buyer.

1.6.3 Financial Markets

A financial market is one in which financial assets are created or traded. Generally, there is no specific place or location to have/set up a financial market. Wherever a financial transaction takes place, it comes under the purview of the financial market. The financial market has two main components, namely (i) the Money Market, (ii) the Capital Market.

1.6.3.1 Money Market

This is a market for borrowing and lending of short-term funds. It deals in funds and financial instruments that have a maturity period of one day to one year. It is a mechanism through which short-term funds are loaned or borrowed and through which a large part of the financial transactions of a particular country or of the world is carried out. The most important feature of the money market instrument is its liquidity. It is characterized by a high degree of safety of principal. The following are instruments that are traded in the money market:

i. **Call and Notice Money Market:** This market functions only for an extremely short period. Here, funds are transacted on an overnight basis. The participants are mostly banks. Therefore, it is also called the Inter-Bank Money Market. In the notice money market, funds are transacted for 2 days and a 14-day period.

ii. **Treasury Bill Market (T-Bills):** This market deals in Treasury Bills of a short-term duration issued by the RBI on behalf of the Government of India. At present, three types of treasury bills are issued through auctions, namely, 91-day, 182-day and 364-day treasury bills.

iii. **Certificate of Deposits (CDs):** These are issued by Commercial banks and development financial institutions for funds deposited. CDs are unsecured, negotiable promissory notes issued at a discount to the face value. The scheme pertaining to CDs was introduced in 1989 by the RBI, to mainly enable commercial banks to raise funds from the market. At present, the maturity period of CDs ranges from 3 months to 1 year. They are issued in multiples of INR 25 lakhs subject to a minimum of INR 1 crore.

iv. **Commercial Papers (CPs):** Commercial Papersare unsecured money market instruments issued in the form of promissory notes or in demat form. These were introduced in January 1990. Commercial Papers can be issued by a listed company that has a working capital of not less than INR 5 crores. They could be issued in multiples of INR 25 lakhs. The minimum size of issue is INR 1 crore. At present, the maturity period of CPs ranges between 7 days and 1 year. CPs are issued at a discount to its face value and redeemed at its face value.

1.6.3.2 Capital Market

This is a market for financial assets, which have a long or indefinite maturity. Generally, it deals with long-term securities that have a maturity period of above one year.

i. Primary Market

This is a market for new issues or new financial claims. Hence, it is also called a New Issue Market. The primary market deals with those securities that are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, the primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market: (i) Public issue, (ii) Right issue and (iii) Private placement.

ii. Secondary Market

The market in which securities are traded after they are initially offered in the primary market is known as secondary market. Generally securities that have already been issued in the primary market are quoted in the stock exchange to provide a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government.

1.6.3.3 Foreign Exchange Market

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The market in which participants are able to buy, sell, exchange and speculate on currencies is the foreign exchange market. Foreign exchange markets are made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors. The forex market is considered to be the largest financial market in the world.

1.6.4 Financial Services

The development of a sophisticated and matured financial system in the country, especially after the early 1990s, led to the emergence of a new sector. This new sector is known as the financial services sector. Its objective is to intermediate and facilitate financial transactions of individuals and institutional investors. There are different types of financial services provided in financial markets. The financial service industry can be classified into two broad categories as Fee-based and Fund-based financial services.

1.6.4.1 Fee-based Financial Services

These services are provided by financial institutions/NBFCs to earn income by way of fee, dividend, commission, discount and brokerage. The major fee-based financial services are as follows:

i. Issue management and merchant banking
ii. Corporate advisory services
iii. Asset securitisation
iv. Credit rating

1.6.4.2 Fund-based Financial Services

In fund-based services, the financial service firm raises funds through equity, debt and deposits and invests the same in securities or lends this out to those who are in need of capital. The major fund-based services are as follows:

i. Leasing and hire purchase
ii. Venture capital
iii. Factoring and forfeiting

1.7 Regulatory Framework of The Indian Financial System

India's financial sector is diversified and is expanding rapidly. It comprises commercial banks, insurance companies, non-banking financial companies, cooperatives, pension funds, mutual funds and other smaller financial entities. This is why regulation and supervision of the financial system in India is carried out by different regulatory authorities. The financial system in India is regulated by independent regulators in the areas of banking, insurance, capital market, commodity market and pension funds. However, the Government of India plays a significant role in controlling the

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financial system in India and influences the roles of such regulators. Each regulator has its own rules on registration, code of conduct, commissions and fees to monitor product providers and distributors. The following are the main regulatory bodies of the financial system in India.

1.7.1 Reserve Bank of India

This is the apex monetary Institution of India and is also called the central bank of the country. The Reserve Bank of India regulates and supervises the major part of India's financial system. The RBI plays a supervisory role in commercial banks, urban cooperative banks (UCBs), some financial institutions and non-banking finance companies (NBFCs). The Banking Regulation Act, 1949, has given the RBI the power to regulate the banking system.

The Reserve Bank of India was established on 1 April 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The Central Office of the Reserve Bank was initially established in Calcutta but was permanently shifted to Mumbai in 1937.

1.7.1.1 Role of the RBI as a Regulator of the Indian Banking System

The RBI has been assigned the role of controlling and supervising the banking system in India. The RBI is responsible for controlling the overall operations of all banks in India. These banks may be Public sector banks**,** Private sector banks**,** Foreign banks**,** Cooperative banks and Regional rural banks. The controlling and supervisory roles of the Reserve Bank of India entail the following -

- **i.** **Issue of License:** Under the Banking Regulation Act, 1949, the RBI has been given the power to grant licences to commence new banking operations. The RBI also grants licences to open new branches of existing banks.
- **ii.** **Prudential Norms:** The RBI issues guidelines for credit control and management. The RBI is a member of the Banking Committee on Banking Supervision (BCBS). As such, they are responsible for implementation of international standards of capital adequacy norms and asset classification.
- **iii.** **Corporate Governance:** The RBI has the power to control the appointment of the chairman and directors of the banks in India. The RBI has powers to appoint additional directors in banks as well.
- **iv.** **KYC Norms:** To curb money laundering and prevent the use of the banking system for financial crimes, The RBI has issued "**Know Your Customer**" guidelines. Every bank has to ensure that KYC norms are applied before allowing customers to open an account.
- **v.** **Transparency Norms:** Every bank has to disclose their charges for providing services and the customers have the right to know these charges.
- **vi.** **Risk Management:** The RBI provides guidelines to banks for taking the necessary steps to mitigate risk. They do this through risk management in Basel norms.

vii. **Audit and Inspection:** Audit and inspection procedures are controlled by the RBI through an off-site and on-site monitoring system. On-site inspection is done by the RBI on the basis of "CAMELS" (Capital adequacy; Asset quality; Management; Earning; Liquidity; System and control).

viii. **Foreign Exchange Control:** The RBI plays a crucial role in foreign exchange transactions. It does this diligently for every foreign transaction, including the inflow and outflow of foreign exchange. It takes steps to stop the decrease in the value of the Indian Rupee.

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Check your progress

4. What are the main components of financial system?
5. What is the role of RBI as a regulator in Indian Financial system?

1.7.2 Securities and Exchange Board of India

The Securities and Exchange Board of India (SEBI) was first established in 1988 as a non-statutory body for regulating the securities market. It became an autonomous body in 1992 and acquired more powers in accordance with the provisions of the Securities and Exchange Board of India Act, 1992. Since then, it regulates the financial market through its independent powers. The SEBI regulates the securities market to protect the interest of investors in the primary market and the secondary market. The board has powers to regulate the functioning of stockbrokers, sub-brokers or other intermediaries, so that the investors' money cannot be lost by malpractices or in any other way.

1.7.2.1 Role of the SEBI as a Regulator of Indian Financial Markets

The SEBI plays an important role in protecting the interests of investors in securities and promoting the development of the securities market. The SEBI has the following powers for better regulating security markets:

i. Regulating the business in stock exchanges and any other securities markets.

ii. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and other such intermediaries who may be associated with securities markets in any manner.

iii. Promoting and regulating self-regulatory organisations.

iv. Prohibiting fraudulent and unfair trade practices relating to securities markets.

v. Promoting investors' education and training of intermediaries of securities markets.

vi. Prohibiting insider trading in securities.

vii. Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market.

1.7.3 Insurance Regulatory and Development Authority

The Insurance Regulatory and Development Authority (IRDA) is an autonomous apex statutory body that regulates and develops the insurance industry in India. It was constituted by a Parliament of India Act called Insurance Regulatory and De-

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velopment Authority Act, 1999, and duly passed by the Government of India. The agency operates from its headquarters in Hyderabad, Andhra Pradesh, where it shifted from Delhi in 2001. It protects the interests of the policyholders, regulates, promotes and ensures orderly growth of the insurance business and re-insurance business. The IRDA issues the applicant a certificate of registration, renews, modifies, withdraws, suspends or cancels such registrations and protects the interests of policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance.

1.7.4 Pension Fund Regulatory and Development Authority

The Pension Fund Regulatory and Development Authority (PFRDA) is a pension regulatory authority, which was established by the Government of India on 23 August 2003. The PFRDA is authorized by the Ministry of Finance, Department of Financial Services. The PFRDA promotes old age income security by establishing, developing and regulating pension funds and protects the interests of subscribers to schemes of pension funds and related matters.

1.8 Key Terms

- **Finance:** Finance is the science that describes the management, creation and study of money, banking, credit, investments, assets and liabilities. Finance consists of financial systems, which include the public, private and government spaces, and the study of finance and financial instruments, which can relate to countless assets and liabilities.
- **Investment:** In an economic sense, an investment is the purchase of goods that are not consumed today but are used in the future to create wealth. In finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or appreciate and be sold at a higher price.
- **Financial System:** A financial system can be defined at the global, regional or firm specific level. The firm's financial system is the set of implemented procedures that track the financial activities of the company. On a regional scale, the financial system is the system that enables lenders and borrowers to exchange funds. The global financial system is basically a broader regional system that encompasses all financial institutions, borrowers and lenders within the global economy.
- **Liquidity:** Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.
- **Financial Market:** A financial market is a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural products.
- **Financial Service:** Financial services are the economic services provided by the finance industry, which encompasses a broad range of businesses that manage money, including credit unions, banks, credit card companies, insurance

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companies, accountancy companies, consumer finance companies, stock brokerages, investment funds and some government-sponsored enterprises.

- **Commercial Paper:** Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days. The debt is usually issued at a discount, reflecting prevailing market interest rates.
- **Financial Instruments:** Financial instruments are assets that can be traded. They can also be seen as packages of capital that may be traded. Most types of financial instruments provide an efficient flow and transfer of capital all throughout the world's investors. These assets can be cash, a contractual right to deliver or receive cash or another type of financial instrument, or evidence of one's ownership of an entity.
- **Money Market:** A money market is a segment of the financial market in which financial instruments with high liquidity and very short maturities are traded. The money market is used by participants as a means for borrowing and lending in the short term, from several days to just under a year. Money market securities consist of negotiable certificates of deposit (CDs), bankers acceptances, U.S. Treasury bills, commercial paper, municipal notes, federal funds and repurchase agreements (repos).
- **Capital Market:** Capital markets are markets for buying and selling equity and debt instruments. Capital markets channel savings and investment between suppliers of capital such as retail investors and institutional investors, and users of capital like businesses, government and individuals. Capital markets are vital to the functioning of an economy, since capital is a critical component for generating economic output. Capital markets include primary markets, where new stock and bond issues are sold to investors, and secondary markets, which trade existing securities.
- **Foreign Exchange Market:** The foreign exchange market (forex, FX, or currency market) is a global decentralized market for the trading of currencies. This includes all aspects of buying, selling and exchanging currencies at current or determined prices. In terms of volume of trading, it is by far the largest market in the world.

1.9 Summary

- "Finance is a simple task of providing the necessary funds (money) required by the business of entities like companies, firms, individuals and others on the terms that are most favourable to achieve their economic objectives."
- Saving takes place when people abstain from consumption, that is, when they consume less than their income. Investment takes place when we purchase new capital equipment or other assets that make for future productivity. Investment does not mean buying stocks or bonds.
- A financial system comprises financial institutions, financial markets, financial instruments and services that help in the formation of capital by transferring of funds in the economy. It provides a mechanism by which savings are trans-

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formed into investment, and these investments are used for the economic development of the nation.

- The Indian financial system comprises financial institutions, financial markets, financial instruments and financial services that are continuously monitored by various regulatory authorities, namely, the Reserve Bank of India, Securities and Exchange Board of India and Insurance Regulatory and Development Authority.
- Non-banking financial institutions (NBFIs) also mobilize financial resources directly or indirectly from people. They lend funds but do not create credit. Companies such as LIC, GIC, UTI, Development Financial Institutions, Organization of Pension and Provident Funds fall into this category.
- Primary instruments or direct securities are issued directly by borrowers to lenders. Equity shares, preference shares and debentures are primary securities.
- Indirect securities are not directly issued by borrowers to lenders. These securities are issued via a financial intermediary to an ultimate lender. Indirect securities include mutual fund units, security receipts, securitized debt instruments.
- Derivatives are instruments whose value is derived from the value of one/more basic variables called the underlying asset. They are forwards, futures and options.
- The development of a sophisticated and matured financial system in the country, especially after the early 1990s, led to the emergence of a new sector. This new sector is known as the financial services sector.
- The Reserve Bank of India is the apex monetary Institution of India and is also called the central bank of the country. The Reserve Bank of India regulates and supervises the major part of India's financial system.

1.10 Questions and Exercises

1. What is a financial system? Discuss the components of a formal financial system.
2. What role does a regulator play in a financial system?
3. What are the different money market instruments in India?
4. Discuss the type of financial market and their interrelationship.
5. 'A market based financial system is preferable over bank based system.' Comment critically.

1.11 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.
2. Saha, S.S., ***"Indian Financial System and Markets",***TMH Education Private Limited.
3. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.

Web resources:

1. "Introduction to SEBI" available at www.**sebi**.gov.in/
2. "Overview of RBI" available at https://www.**rbi**.org.in/
3. "Structure of Indian Financial System" available at http://www.pondiuni.edu.in/storage/dde/downloads/finiii_ifs.pdf

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UNIT 2: REFORMS IN INDIAN FINANCIAL SYSTEM

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Structure

2.0 Introduction

2.1 Unit Objectives

2.2 Financial System and Economic Growth in India

2.3 Reforms in Financial Sector

2.4 Key Terms

2.5 Summary

2.6 Questions and Exercises

2.7 Further Readings and References

2.0 Introduction

Financial sector is the mainstay of any economy and it contributes immensely in the mobilisation and distribution of resources. Financial sector reforms have long been viewed as significant part of the program for policy reform in developing nations. Earlier, it was thought that they were expected to increase the efficiency of resource mobilization and allocation in the real economy to generate higher rates of growth. Recently, they are also seen to be critical for macroeconomic stability. It was due to the repercussion of the East Asian crisis, since weaknesses in the financial sector are broadly regarded as one of the major causes of collapse in that region.

The elements of the financial sector are Banks, Financial Institutions, Instruments and markets which mobilise the resources from the surplus sector and channelize the same to the different needy sectors in the economy.The process of accumulative capital growth through institutionalisation of savings and investment fosters economic growth. Reform of the financial sector was recognized, from the very beginning, as an integral part of the economic reforms initiated in 1991.

2.1 Unit Objectives

After completing this unit students will be able to :

- Understand the overview of economic growth in financial system
- Know the reforms in the financial sector

2.2 Financial System and Economic Growth in India

The global financial crisis has posed renewed concerns on the role of financial structures in fostering economic development. As the growth momentum slowed down globally, policy makers around the world have confronted with increasingly difficult challenges. Governments and monetary authorities have had to manage the balance between fiscal and monetary policies notwithstanding the conflict between

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each other in achieving high growth and price stability together. Globally, policy makers also resorted to various crisis intervention measures and regulatory reforms to prevent derailment of the growth process, which could have a crucial impact on the structure of the financial system. As a result, the changing financial structure could further affect economic growth, volatility and financial stability (IMF, 2012). The recent crisis also raised concerns about the threshold level of financial deepening beyond which its impact on economic development is negligible.

During the last four decades, particularly after the first phase of nationalization of banks in 1969, there have been distinct improvements in the banking activities which strengthened the financial intermediation process. The total number of offices of public sector banks which was merely at 8262 in June 1969 increased to 62,607 as of June 2011 (Table 2.1). Similarly, there have been many fold increases in aggregate deposits and credit indicating existence of a vibrant bank-based financial system.

Table 2.1: State-wise Distribution of Bank Offices, Aggregate Deposits and Total Credit of Public Sector Banks

	State/Union Territory	No. of offices at the end of		Deposits (Rs. crore) End of		Bank credit (Rs. crore) End of	
		June	June	June	June	June	June
		1969	2011	1969	2011	1969	2011
1.	Andaman & Nicober Islands	1	41	...	1677	...	668
2.	Andhra Pradesh	567	5251	121	230449	122	264748
3.	Arunachal Pradesh	...	65	...	4838	...	1174
4.	Assam	74	1012	33	51095	13	17352
5.	Bihar	273	2628	169	100349	53	26990
6.	Chandigarh	20	228	35	29681	64	48309
7.	Chhattisgarh	...	859	...	48871	...	24811
8.	Dadra & Nagar Haveli	...	21	...	1007	...	253
9.	Daman & Diu	...	18	...	1414	...	288
10.	Delhi	274	1887	360	478132	245	377803
11.	Goa	85	368	49	27226	20	7021
12.	Gujarat	752	3881	401	215358	195	138429
13.	Haryana	172	1905	49	89285	23	74296
14.	Himachal Pradesh	42	867	12	29796	3	11927
15.	Jammu & Kashmir	35	342	18	12193	1	3381
16.	Jharkhand	...	1442	...	67843	...	22792
17.	Karnataka	756	4165	188	246840	143	184120
18.	Kerala	601	2611	117	105657	77	80141
19.	Lakshadweep	...	12	...	470	...	45
20.	Madhya Pradesh	343	3016	107	122035	63	72363
21.	Maharashtra	1118	6413	903	925728	912	805525

22.	Manipur	2	52	1	2850	...	1123
23.	Meghalaya	7	147	9	8485	3	2022
24.	Mizoram	...	35	...	2031	...	830
25.	Nagaland	2	76	1	4279	...	1270
26.	Odisha	100	1960	29	85665	15	42993
27.	Puducherry	12	102	5	5585	5	3185
28.	Punjab	346	3142	185	134505	50	103498
29.	Rajasthan	364	2799	74	99778	38	96206
30.	Sikkim	...	73	...	2961	...	1135
31.	Tamil Nadu	1060	4700	233	234155	311	274421
32.	Tripura	5	117	4	6402	...	1573
33.	Uttar Pradesh	747	7217	337	317369	154	133102
34.	Uttarakhand	...	952	...	43957	...	14458
35.	West Bengal	504	4203	456	276778	526	158404
	All India	**8262**	**62607**	**3896**	**4014743**	**3036**	**2996655**

Source: Economic Survey 2011-12, Government of India. ...: Nil
Note: 1. Data include State Bank of India and its Associates, nationalized banks and IDBI Bank Limited.
2. Deposits exclude inter-bank deposits.
3. Bank credit excludes dues from banks but includes amount of bills rediscounted with RBI/financial institutions.

Some interesting insights could be drawn while examining various indicators of financial development in India (Table 2.2). First, an important indicator of bank-based financial deepening, *i.e.,* private sector credit has expanded rapidly in the past five decades thereby supporting the growth momentum. However, the domestic credit provided by the Indian banks still remains at an abysmally low as compared with major emerging market and developing economies (EDEs) and advanced economies (Table 2.3). Furthermore, the level of credit disbursement is also far below the world average levels. Therefore, there is scope for the Indian banks to expand their business to important productive sectors of the economy.

Table 2.2: Financial Development - Select Indicators

Item	1960s	1970s	1980s	1990s	2000s
Private Credit/Total Credit (%)	43.0	58.4	59.0	56.6	64.5
Private Credit/GDP (%)	9.5	18.8	28.7	28.6	43.0
Total credit/GDP (%)	22.2	32.0	48.8	50.6	66.2
M3/GDP (%)	21.2	28.4	40.8	49.9	73.5
M3 Velocity (times)	5.0	3.9	2.7	2.2	1.5
M1 Velocity (times)	7.0	6.7	7.1	6.4	5.4
Market Capitalization/GDP (%)	-	-	8.8	35.8	58.7
Per Capita Real GDP Growth (%)	1.6	0.5	3.2	3.7	5.4
Real GDP Growth (%)	4.0	2.9	5.6	5.8	7.2

Note: Domestic credit to the commercial sector is taken as proxy for private credit.
Source: Handbook of Statistics on Indian Economy, Reserve Bank India and Author's calculations.

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Table 2.3 : Domestic Credit Provided by Banking Sector

								(% of GDP)
Country/ Region	**1980**	**1990**	**2000**	**2005**	**2008**	**2009**	**2010**	**2011**
Brazil	43.0	87.6	71.9	74.5	96.9	95.8	95.2	98.3
China	53.3	89.4	119.7	134.3	120.8	145.1	146.3	145.5
Euro area	93.6	97.0	119.4	127.3	142.8	152.6	156.0	153.6
India	37.0	50.0	51.4	58.4	67.7	70.4	73.0	75.1
Japan	185.7	255.3	304.7	317.6	302.4	329.8	329.0	340.9
Russia	-	-	24.9	22.1	23.9	33.7	38.4	39.6
South Africa	76.4	97.8	152.5	178.5	173.8	184.2	182.4	167.0
South Korea	43.4	51.9	74.7	88.3	109.4	109.4	103.1	102.3
UK	36.2	118.2	130.2	161.9	213.5	229.2	222.6	213.8
US	120.2	151.0	198.4	225.4	222.0	234.9	232.9	233.3
World	93.5	130.6	158.9	162.1	154.7	169.1	167.4	165.3
Source: World Bank Data Base.								

Second, financial innovations have influenced velocity circulation of money by both reducing the transaction costs and enhancing the liquidity of financial assets. A relatively increasing value of velocity could be seen as a representative indicator of an efficient financial sector. Increasing monetization of the economy, which would be particularly relevant for EDEs, may imply falling money velocity. In Indian case, the velocity circulation of broad money has fallen since 1970s partly reflecting the fact that, in the midst of crisis, money injected to the system could not get distributed efficiently from the banking system to non-banks. Third, the market-based indicator of financial deepening, *i.e.,* market capitalization-to-GDP ratio has increased very sharply in the past two decades implying for a vibrant capital market in India (Table 2.2). Market capitalization as a ratio of GDP fell in 2008 reflecting the peak of the global financial market crisis during the year and sharp decline in major stock indices (Table 2.4). After a period of broader stability in the global financial markets for about two years, financial markets worldwide fell again in 2011 due to heightened sovereign debt crisis in the euro area. As a result, leading stock markets declined in 2011 and market capitalization fell. Various reform measures undertaken since the early 1990s by the Securities and Exchange Board of India (SEBI) and the

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Government of India have brought about a significant structural transformation in the Indian capital market. Although the Indian equity market has become modern and transparent, its role in capital formation continues to be limited. Unlike in some advanced economies, the primary equity and debt markets in India have not yet fully developed. The size of the public issue segment has remained small as corporates have tended to prefer the international capital market and the private placement market. The private corporate debt market is active mainly in the form of private placements.

Table 2.4: Market Capitalization of Listed Companies

(% of GDP)

Country/ Region	1990	2000	2005	2008	2009	2010	2011
Brazil	3.6	35.1	53.8	35.7	72.0	72.1	49.6
China		48.5	34.6	61.8	100.3	80.3	46.3
Euro area	21.1	86.9	62.7	38.1	49.6	52.1	41.9
India	11.8	31.2	66.3	52.7	86.6	95.9	54.9
Japan	94.1	66.7	103.6	66.4	67.1	74.7	60.3
South Africa	123.2	154.2	228.9	179.4	249.0	278.5	209.6
South Korea	42.1	32.2	85.0	53.1	100.3	107.3	89.1
Russia		15.0	71.8	23.9	70.5	67.5	42.9
United Kingdom	83.8	174.5	134.1	70.3	128.8	138.0	49.4
United States	53.2	152.6	135.1	82.5	108.8	118.6	103.6
World	47.3	101.3	96.6	58.7	83.8	88.8	66.3

Source: World Bank Data Base.

A comparison of bank-based indicator reported in Table 2.3 and market-based indicator in Table 2.4 provide some useful insights. In Table 2.3, it may be observed that credit provided by the banking sector as a percentage of GDP has increased steadily over the years from 37.0 percent in 1980 to 75.1percent in 2011. On the other hand, stock market capitalization as a percentage of GDP increased from 11.8 percent in 1990 to 54.9 percent in 2011 (Table 2.4). It may also be noticed that stock market capitalization as a percentage of GDP increased sharply in 2009 and 2010. These sharp gains in market capitalization to GDP ratio in 2009 could be attributed to valuation gains due to steep rise in share prices from a very low level in 2008 as the global financial crisis heightened. Furthermore, year-wise comparison of ratios in Table 2.3 and Table 2.4 reveals that barring a few years, credit to GDP ratio was higher than market capitalization to GDP ratio implying that financial system in India is more biased towards bank-based.

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Table 2.5: Economic indicators

Item	2015-16	2014-15		2015-16	
		Q3	Q4	Q3	Q4
	1	2	3	4	5
1 Real Sector (% Change)					
1.1 GVA at Basic Prices	7.2	6.7	6.2	6.9	7.4
1.1.1 Agriculture	1.2	-2.4	-1.7	-1.0	2.3
1.1.2 Industry	8.8	3.4	6.9	10.3	9.2
1.1.3 Services	8.2	11.7	8.3	8.5	8.1
1.1a Final Consumption Expenditure	6.6	5.3	1.6	7.4	7.6
1.1b Gross Fixed Capital Formation	3.9	3.7	10.0	1.2	-1.9
	2015-16	2015		2016	
		Mar.	Apr.	Mar.	Apr.
	1	2	3	4	5
1.2 Index of Industrial Production	0.1	2.5	3.0	0.1	-
2 Money and Banking (% Change)					
2.1 Scheduled Commercial Banks					
2.1.1 Deposits	9.9	11.4	11.8	9.3	9.3
2.1.2 Credit	11.3	9.5	9.8	10.9	9.2
2.1.2.1 Non-food Credit	11.3	9.8	10.1	10.9	9.3
2.1.3 Investment in Govt. Securities	6.0	13.2	14.0	5.4	5.1
2.2 Money Stock Measures					
2.2.1 Reserve Money (M0)	13.1	11.3	11.3	13.1	14.4
2.2.2 Broad Money (M3)	10.5	10.9	10.8	10.5	11.0
3 Ratios (%)					
3.1 Cash Reserve Ratio	4.00	4.00	4.00	4.00	4.00
3.2 Statutory Liquidity Ratio	21.50	21.50	21.50	21.50	21.50
3.3 Cash-Deposit Ratio	4.7	5.0	4.9	4.8	4.8
3.4 Credit-Deposit Ratio	77.6	76.5	75.4	77.7	75.8
3.5 Incremental Credit-Deposit Ratio	87.7	64.8	29.2	89.8	4.4
3.6 Investment-Deposit Ratio	28.1	29.2	29.5	28.1	28.2
3.7 Incremental Investment-Deposit Ratio	17.6	33.2	40.3	16.9	32.0
4 Interest Rates (%)					
4.1 Policy Repo Rate	6.75	7.50	7.50	6.75	6.50
4.2 Reverse Repo Rate	5.75	6.50	6.50	5.75	6.00
4.3 Marginal Standing Facility (MSF) Rate	7.75	8.50	8.50	7.75	7.00
4.4 Bank Rate	7.75	8.50	8.50	7.75	7.00
4.5 Base Rate	9.30/9.70	10.00/10.25	9.75/10.25	9.30/9.70	9.30/9.70
4.6 MCLR	-	-	-	-	8.90/9.15
4.7 Term Deposit Rate >1 Year	7.00/7.50	8.0/8.8	8.0/8.5	7.0/7.5	7.0/8.0
4.8 Savings Deposit Rate	4.00	4.00	4.00	4.00	4.00
4.9 Call Money Rate (Weighted Average)	7.35	7.36	7.51	7.35	6.49
4.10 91-Day Treasury Bill (Primary) Yield	7.27	8.27	7.94	7.27	6.81
4.11 182-Day Treasury Bill (Primary) Yield	7.17	8.14	7.90	7.17	6.91

4.12 364-Day Treasury Bill (Primary) Yield	7.11	7.98	7.91	7.11	6.91
4.13 10-Year Government Securities Yield	7.42	7.80	7.89	7.42	7.44
5 RBI Reference Rate and Forward Premia					
5.1 INR-US$ Spot Rate (? Per Foreign Currency)	66.33	62.59	63.40	66.33	66.52
5.2 INR-Euro Spot Rate (? Per Foreign Currency)	75.10	67.51	68.49	75.10	75.73
5.3 Forward Premia of US$ 1-month (%)	6.78	9.78	7.67	6.78	7.22
3-month (%)	6.63	8.50	7.51	6.63	6.80
6-month (%)	6.57	8.11	7.44	6.57	6.57
6 Inflation (%)					
6.1 All India Consumer Price Index	4.9	5.3	4.9	4.8	5.4
6.2 Consumer Price Index for Industrial Workers	5.6	6.3	5.8	5.5	5.9
6.3 Wholesale Price Index	-2.5	-2.3	-2.4	-0.9	0.3
6.3.1 Primary Articles	0.2	0.1	0.5	2.1	2.3
6.3.2 Fuel and Power	-11.6	-12.6	-13.0	-8.3	-4.8
6.3.3 Manufactured Products	-1.1	-0.2	-0.5	-0.1	0.7
7 Foreign Trade (% Change)					
7.1 Imports	-15.3	-13.5	-6.4	-23.8	-24.2
7.2 Exports	-15.9	-21.3	-14.4	-5.2	-6.6

Source: RBI

2.3 Reforms in Financial Sector

Until the early 1990s, the role of the financial system in India was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalization of large banks in 1969 and 1980, public ownership dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management system and the prudential standards were weak. All these resulted in poor asset quality and low profitability.

Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms.

In the insurance sector, there was little competition. The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz., the Unit Trust of India. Non-banking financial companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/participants between the market segments. Apart from inhibiting the development of the markets, this also affected their efficiency (RBI, 2003, 2004).

Against this backdrop, wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Financial sector reforms in India were grounded in the belief that competitive efficiency in the real sectors of the economy will not be realized to its full potential unless the financial sector was reformed as well. Thus, the principal objective of

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financial sector reforms was to improve the allocative efficiency of resources and accelerate the growth process of the real sector by removing structural deficiencies affecting the performance of financial institutions and financial markets.

The main thrust of reforms in the financial sector was on the creation of efficient and stable financial institutions and markets. Reforms in respect of the banking as well as non-banking financial institutions focused on creating a deregulated environment and enabling free play of market forces while at the same time strengthening the prudential norms and the supervisory system. In the banking sector, the focus was on imparting operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, imparting strength to the system and ensuring accountability and financial soundness. The restrictions on activities undertaken by the existing institutions were gradually relaxed and barriers to entry in the banking sector were removed. In the case of non-banking financial intermediaries, reforms focused on removing sector-specific deficiencies. Thus, while reforms in respect of DFIs focused on imparting market orientation to their operations by withdrawing assured sources of funds, in the case of NBFCs, the reform measures brought their asset side also under the regulation of the Reserve Bank. In the case of the insurance sector and mutual funds, reforms attempted to create a competitive environment by allowing private sector participation.

Reforms in financial markets focused on removal of structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions, improvement in trading, clearing and settlement practices, more transparency, *etc*. Reforms encompassed regulatory and legal changes, building of institutional infrastructure, refinement of market microstructure and technological upgradation. In the various financial market segments, reforms aimed at creating liquidity and depth and an efficient price discovery process.

Reforms in the commercial banking sector had two distinct phases. The first phase of reforms, introduced subsequent to the release of the Report of the Committee on Financial System, 1992 (Chairman: Shri M. Narasimham), focused mainly on enabling and strengthening measures. The second phase of reforms, introduced subsequent to the recommendations of the Committee on Banking Sector Reforms, 1998 (Chairman: Shri M. Narasimham) placed greater emphasis on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with international best practices.

2.3.1 Banking Sector Reforms

Reforms made to improve the performance of banking sector in India are as follows:

- Allowing private domestic and foreign players to enter banking, insurance and mutual funds sectors.
- Increasing the maximum coupon rates on government securities and reducing the maximum maturity period from 30 to 20 years.
- Reducing the statutory liquidity ratio to 25 % and effecting a progressive reduction in cash reserve ratio.
- De-regulating interest rates.

- Introducing capital adequacy norms to reduce non-performing assets of banks.
- Setting up the board for financial supervision, within the Reserve Bank to implement uniform accounting practices with respect to income recognition, asset classification and provision for bad debt.
- Setting up special tribunals to speed up the process of recovery of loans.
- Current account convertibility was allowed for the Rupee in accordance with IMF conditions.
- Nationalised banks were allowed to raise funds from the capital markets to strengthen their capital base.
- The lending rates for commercial banks was deregulated, thereby freeing them to lend more or as they saw fit.
- banks were allowed to fix their own interest rates on domestic term deposits that matures within two years.
- Customers were encouraged to move away from physical cash, as RBI issued guidelines to the banks pertaining to the issuance of debit cards and smart cards.
- The process of introducing computerisation in all branches of banks began in 1993 in line with the Committee on Computerisation in Banks' recommendations, which had been submitted in 1989.
- FII (Foreign Institutional Investors) were allowed to invest in dated Government Securities.
- The Foreign Exchange Management Act (FEMA) was enacted in 1999 and effectively repudiated the Foreign Exchange Regulation Act (FERA) of 1973.
- FEMA enabled the development and maintenance of the Indian foreign exchange markets and facilitated external trade and payments.
- The NSE (National Stock Exchange) began its operations in 1994.
- RBI began the practise of auctioning Treasury Bills spanning 14 days and 28 days.

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Check your progress

1. What are the major economic indicators?
2. What do you understand by economic growth of a country?
3. Explain the banking sector reforms in India after 1991.

2.3.2 Capital Market Reforms

The government has taken several measures to develop the capital market in the post-reform period, with which the capital market reached new heights. Some of the important measures are as follows:

- The Securities and Exchange Board of India was set up in early 1988 as a non-statutory body under an administrative arrangement. It was given statutory powers in January 1992 through the enactment of the SEBI Act, 1992, for regulating the securities market.
- The Capital Issues (Control) Act, 1947, was repealed in May 1992, and it allowed issuers of securities to raise capital from the market without requiring the consent of any authority either for floating an issue or pricing it.
- Foreign institutional investors have been allowed to invest in the Indian capital market since 1993.

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- Various new instruments including 182-day Treasury bills, certificate of deposits, commercial papers and inter-bank participation certificates were made available.
- The Indian stock exchanges were modernised in the 1990s, with Computerised Screen Based Trading System (SBTS). This cuts down time, cost, risk of error and fraud and thereby leads to improved operational efficiency. The trading system also provides complete online market information through various inquiry facilities.
- Demat of shares has been introduced in all the shares traded on the secondary stock markets and those issued to the public in the primary markets. Even bonds and debentures are allowed in demat form.
- Rolling settlement is an important measure to enhance the efficiency and integrity of the securities market. Under the rolling settlement, all trades executed on a trading day (T) are settled after certain days (N). This is called the T + N rolling settlement. Since 1 April 2002, trades are settled under the T + 3 rolling settlement. In April 2003, the trading cycle has been reduced to T + 2 days. The shortening of the trading cycle has reduced undue speculation on stock markets.
- Various credit rating agencies such as Credit Rating Information Services of India Ltd. (CRISIL – 1988), Investment Information and Credit Rating Agency of India Ltd. (ICRA – 1991) were set up to meet the emerging needs of the capital market.
- Trading on stock exchanges is allowed through the internet, and investors can place orders with registered stockbrokers through the internet. This enables stockbrokers to execute the orders faster.
- Derivatives trading in equities started in June 2000. At present, there are four equity derivative products in India Stock Futures, Stock Options, Index Futures and Index Options.
- To strengthen the "Know your client" norms and to have a sound audit trail of transactions in the securities market, PAN has been made mandatory with effect from 1 January 2007.

2.4 Key Terms

- **Banks:** A bank is a financial institution that accepts deposits from the public and creates credit. Lending activities can be performed either directly or indirectly through capital markets. Due to their importance in the financial system and influence on national economies, banks are highly regulated in most countries.
- **Fiscal policy**: Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.
- **Monetary policy:** Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting

an inflation rate or interest rate to ensure price stability and general trust in the currency.

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- **Economic indicators:** Economic indicators can potentially be anything the investor chooses, but specific pieces of data released by government and non-profit organizations have become widely followed - these include: The Consumer Price Index (CPI) Gross Domestic Product (GDP) Unemployment figures.
- **Developing economies:** A developing country, also called a less developed country or underdeveloped country, is a nation with a less developed industrial base, and a low Human Development Index (HDI) relative to other countries.
- **Financial innovations:** Financial innovation can be defined as the act of creating and then popularising new financial instruments as well as new financial technologies, institutions and markets. It includes institutional, product and process innovation.
- **Market capitalization:**Market capitalization (market cap) is the market value at a point in time of the shares outstanding of a publicly traded company, being equal to the share price at that point of time times the number of shares outstanding.
- **GDP:** The gross domestic product (GDP) is one of the primary indicators used to gauge the health of a country's economy. It represents the total dollar value of all goods and services produced over a specific time period; you can think of it as the size of the economy.
- **Cash Reserve Ratio:**Cash Reserve Ratio (CRR) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. CRR is set according to the guidelines of the central bank of a country.
- **Statutory Liquidity Ratio:** Statutory Liquidity Ratio refers to the amount that the commercial banks require to maintain in the form of cash, or gold or govt. approved securities before providing credit to the customers. Here by approved securities we mean, bond and shares of different companies.
- **Cash- deposit ratio:** Cash Deposit ratio (CDR) is the ratio of how much a bank lends out of the deposits it has mobilised. It indicates how much of a bank core funds are being used for lending, the main banking activity.
- **Credit deposit ratio:** It is the ratio of how much a bank lends out of the deposits it has mobilised. It indicates how much of a bank's core funds are being used for lending, the main banking activity.

2.5 Summary

- The global financial crisis has posed renewed concerns on the role of financial structures in fostering economic development. As the growth momentum slowed down globally, policymakers around the world have confronted with increasingly difficult challenges.

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- During the last four decades, particularly after the first phase of nationalization of banks in 1969, there have been distinct improvements in the banking activities which strengthened the financial intermediation process.
- Financial innovations have influenced velocity circulation of money by both reducing the transaction costs and enhancing the liquidity of financial assets. A relatively increasing value of velocity could be seen as a representative indicator of an efficient financial sector.
- Until the early 1990s, the role of the financial system in India was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years.
- Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms.
- The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz., the Unit Trust of India.
- Against this backdrop, wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Financial sector reforms in India were grounded in the belief that competitive efficiency in the real sectors of the economy will not be realized to its full potential unless the financial sector was reformed as well.
- Reforms in financial markets focused on removal of structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions, improvement in trading, clearing and settlement practices, more transparency, *etc*.

2.6 Questions and Exercises

1. State the major changes in Indian financial system after 1991.
2. How does a financial system influence the economic development of a country?
3. How are the macro - economic developments linked to financial Institutions ?
4. Write short notes on:

   (i) Banking Sector Reforms

   (ii) Capital Market Reforms

2.7 Further Readings and References

Books:

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4. Suresh, Padmalatha and Paul, Justin 2010. ***"Management of Banking and Financial Services",*** New Delhi: Dorling Kindersley (India) Pvt. Ltd.

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UNIT 3: DEVELOPMENT FINANCIAL INSTITUTIONS

NOTES

Structure

3.0 Introduction
3.1 Unit Objectives
3.2 Structure of Various Financial Institutions
e.g. IFCI, IDBI, ICICI, NABARD, SIDCs, SIDBI
3.3 Concept of Development Banks
3.4 Development Financial Institutions in India
3.5 Changing Role of Development Financial Institutions
3.6 Functions of Various Financial Institutions
3.7 Key Terms
3.8 Summary
3.9 Questions and Exercises
3.10 Further Readings and References

3.0 Introduction

A typical structure of financial system in any economy consists of financial institutions, financial markets, financial instruments and financial services.An efficient and robust financial system acts as a powerful engine of economic development by mobilising resources and allocating the same to their productive uses. It reduces the transaction cost of the economy through provision of an efficient payment mechanism, helps in pooling of risks and making available long-term capital through maturity transformation. The functional, geographic and sectorial scope of activity or the types of ownership are some of the criteria which are often used to classify the large number and variety of financial institutions which exist in the economy. Financial institutions were established to provide medium and long term financial assistance to various industries to setting up new projects and for the development and modernization of existing facilities. They also provide development services that can aid in the accelerated growth of business. These institutions provide various facilities like loans, underwriting and direct subscription to shares, debentures and guarantees. These financial institutions are classified in to different categories on the basis of geographical functional area.

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3.1 Unit Objectives

After completing this unit students will be able to:

- Understand the structure of financial institutions in India
- Develop an understanding of the concept, Meaning and objectives of development financial Institutions
- Familiarise with the changing role of development financial institutions
- Know the functions of development financial institutions

3.2 Structure of Financial Institutions in India

The financial institutions in India can be classified in to three categories: (a) All India Financial Institutions (b) State level Institutions (c) Other Institutions.

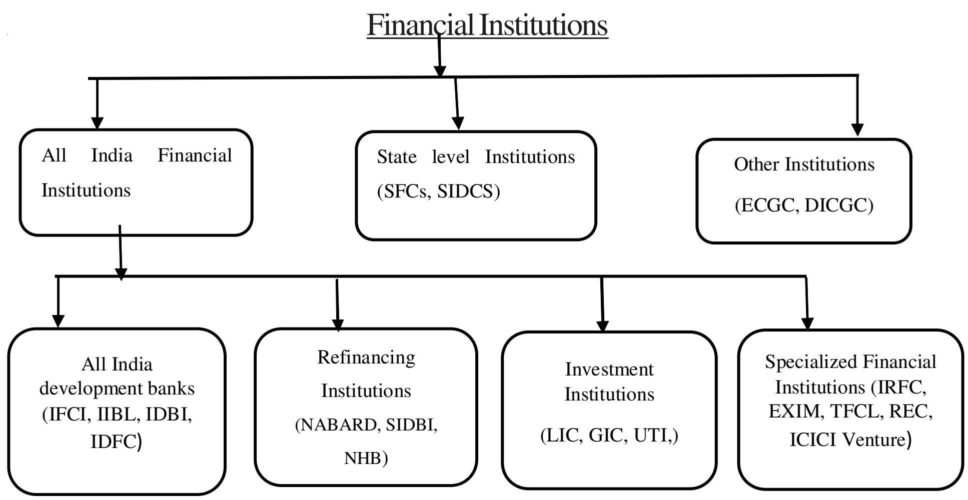

Figure 3.1: All India Financial Institutions

3.2.1 All-India Financial Institutions

Functionally, all-India financial institutions can be classified as:

3.2.1.1 All-India Development Banks/ Term-lending Institutions

IFCI Ltd., IDBI, IDFC Ltd., IIBI Ltd. provides long-term and medium term finance to different industrial sectors as well help in promotion and development of small scale industrial units.

- Industrial Finance Corporation of India Ltd (IFCI Ltd) was the first development finance institution set up in 1948 under the IFCI Act in order to pioneer long-term institutional credit to medium and large industries. It aims to provide financial assistance to industry by way of rupee and foreign currency loans, underwrites/subscribes the issue of stocks, shares, bonds and debentures of industrial concerns, etc.

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- Industrial Development Bank of India (IDBI) was established in July 1964 as an apex financial institution for industrial development in the country. It caters to the diversified needs of medium and large scale industries in the form of financial assistance, both direct and indirect.
- Industrial Investment Bank of India Ltd (IIBI) was set up in 1985 under the Industrial reconstruction Bank of India Act, 1984, as the principal credit and reconstruction agency for sick industrial units. It was converted into IIBI on March 17, 1997, as a full-fledged development financial institution. It assists industry mainly in medium and large sector through wide ranging products and services.

3.2.1.2 Refinancing Institutions

These institutions were established to extend refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sectors. Major refinancing institutions in India are as follows:

- National Bank for Agriculture and Rural Development (NABARD) was established in July 1982, under an act of parliament. It is an apex bank set up for providing credit and other facilities for the promotion and development of agriculture, small- scale industries, cottage and village industries and handicrafts.
- National Housing Bank was set up in July 1988, under the provision of National Housing Bank Act 1987. It is a refinancing institution as wholly owned subsidiary of RBI.
- Small Industries Development Bank of India (SIDBI) was set up by the Government of India in April 1990, as a wholly owned subsidiary of IDBI. It is the principal financial institution for promotion, financing and development of small scale industries in the economy.

3.2.1.3 Investment Institutions

These institutions are the most popular form of financial intermediaries, which particularly catering to the needs of small savers and investors. They deploy their assets largely in marketable securities.

- Life Insurance Corporation of India (LIC) was established in 1956, under the Life Insurance Corporation Act, 1956 as a wholly-owned corporation of the Government of India. The main objective of LIC was to spread life insurance much more widely and in particular to the rural area. It also extends assistance for development of infrastructure facilities like housing, rural electrification, water supply, sewerage, etc. In addition, it extends resource support to other financial institutions through subscription to their shares and bonds, etc.
- Unit Trust of India (UTI) was set up as a body corporate under the UTI Act, 1963, with a view to encourage savings and investment. It mobilises savings of small investors through sale of units and channelizes them into corporate investments mainly by way of secondary capital market operations. Thus, its primary objective is to stimulate and pool the savings of the middle and low income groups and enable them to share the benefits of the rapidly growing industrialisation in the country.

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- General Insurance Corporation of India (GIC) was established in pursuance of the General Insurance Business Nationalisation Act, 1972 (GIBNA), for the purpose of superintending, controlling and carrying on the business of general insurance or non-life insurance.

3.2.1.4 Specialised Financial Institutions

These are the institutions which have been set up to serve the increasing financial needs of commerce and trade in the area of venture capital, credit rating and leasing, etc.

- Export-Import Bank of India is the premier export finance institution of the country, set up in 1982 under the Export-Import Bank of India Act 1981. Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. It is commencing its operations as a purveyor of export credit, like other Export Credit Agencies in the world.
- IFCI Venture Capital Funds Ltd (IVCF) formerly known as Risk Capital & Technology Finance Corporation Ltd (RCTC), is a subsidiary of IFCI Ltd. It was promoted with the objective of broadening entrepreneurial base in the country by facilitating funding to ventures involving innovative product/process/technology.
- ICICI Venture Funds Ltd formerly known as Technology Development & Information Company of India Limited (TDICI), was founded in 1988 as a joint venture with the Unit Trust of India. Subsequently, it became a fully owned subsidiary of ICICI. It is a technology venture finance company, set up to sanction project finance for new technology ventures.
- Tourism Finance Corporation of India Ltd. (TFCI) is a specialised financial institution set up by the Government of India for promotion and growth of tourist industry in the country. Apart from conventional tourism projects, it provides financial assistance for non-conventional tourism projects like amusement parks, ropeways, car rental services, ferries for inland water transport, etc.

3.2.2 State Level Institutions

Several financial institutions have been set up at the State level which supplements the financial assistance provided by the all India institutions. They act as a catalyst for promotion of investment and industrial development in the respective States. They broadly consist of 'State financial corporations' and 'State industrial development corporations'.

- State Financial Corporations (SFCs) are the State-level financial institutions which play a crucial role in the development of small and medium enterprises in the concerned States. They provide financial assistance in the form of term loans, direct subscription to equity/debentures, guarantees, discounting of bills of exchange and seed/ special capital, etc. There are 18 State Financial Corporations (SFCs) in the country.
- State Industrial Development Corporations (SIDCs) have been established under the Companies Act, 1956, as wholly-owned undertakings of State Govern-

ments. They have been set up with the aim of promoting industrial development in the respective States and providing financial assistance to small entrepreneurs. They are undertaking a variety of promotional activities such as preparation of feasibility reports; conducting industrial potential surveys; entrepreneurship training and development programmes; as well as developing industrial areas/estates.

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Check your progress

1. Discuss the structure of financial institution in India.
2. Explain the functions of various financial institutions.

3.2.3 Other Institutions

The other institutions are; Export Credit and Guarantee Corporation (ECGC) (1957) and Deposit Insurance and Credit Guarantee Corporation (DICGC) (1962).

3.3 Concept of Development Banks

In post- colonial era for the development efforts various difficulties and challenges has been faced. Most of the developing economies were searching for funds and had very restricted resources in their financial system. Therefore, to resolve these difficulties financial institutions emerged.It is noteworthy that many of the industrialised and new industrialised country of Asia, DFIs have played important role in past. The vehicle for extending development finance is called development financial institution (DFI) or development bank. A DFI is defined as "an institution promoted or assisted by Government mainly to provide development finance to one or more sectors or sub-sectors of the economy. The institutions emphasize the "project approach" - meaning the viability of the project to be financed – against the "collateral approach". Apart from provision of long-term loans, equity capital, guarantees and underwriting functions, a development bank normally is also expected to upgrade the managerial and the other operational pre-requisites of the assisted projects. Its insurance against default is the integrity, competence and resourcefulness of the management, the commercial and technical viability of the project and above all the speed of implementation and efficiency of operations of the assisted projects.

Thus, the basic emphasis of a DFI is on long-term finance and on assistance for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear. DFIs may also play a large role in stimulating equity and debt markets by (i) selling their own stocks and bonds; (ii) helping the assisted enterprises float or place their securities and (iii) selling from their own portfolio of investments.

3.4 Development Financial Institutions in India

DFIs are created in developing countries to resolve market failures, especially in regard to financing of long-term investments. In India, the need for development financial institutions was felt very strongly immediately after the independence. The country needed a strong goods capital sector to support and accelerate the rate of development. RBI was entrusted with the task of developing an appropriate financial construction through institution building so as to mobilise and direct resources to preferred sectors as per the plan priorities. While the reach of the banking system was expanded to mobilise resources and extend working capital finance on an ever-increasing scale, to different sectors of the economy, the DFIs were established mainly to cater to the demand for long-term finance by the industrial sector.

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The first step towards development of DFIs was established in 1948 by establishing Industrial Finance Corporation of India (IFCI) followed by setting up of State Financial Corporations (SFCs) at the State level after passing of the SFCs Act, 1951.

i. Financial Institutions set up between 1948 and 1974

Besides IFCI and SFCs, in the early phase of planned economic development in India, a number of other financial institutions were set up, which included the following. ICICI Ltd.was established in 1955, LIC in 1956, Refinance Corporation for Industries Ltd. in 1958 (later taken over by IDBI), Agriculture Refinance Corporation (precursor of ARDC and NABARD) in 1963, UTI and IDBI in 1964, Rural Electrification Corporation Ltd. and HUDCO Ltd. in 1969-70, Industrial Reconstruction Corporation of India Ltd. in 1971 and GIC in 1972.

ii. DFIs set up after 1974 and Notification of certain institutions as Public Financial Institutions

Another important change that took place in 1974 was the insertion of Section 4A to the Companies Act, 1956 where under certain existing institutions were categorised as 'Public Financial Institutions' (PFI) and the powers of Central Government to notify any other institution as PFI were laid down. In exercise of these powers Government of India has been notifying from time to time certain institutions as PFIs. As on date, under the Section 4A, six specified institutions are regarded as PFI Besides these institutions, GOI has been notifying, from time to time, certain other FIs as PFIs and as on date additional 46 institutions have been so notified. Therefore, total 52 institutions have been categorised as PFIs.

The FIs set up after 1974 have been as follows. NABARD was set up in 1981, EXIM Bank (functions carved out of IDBI) in 1982, SCICI Ltd. in 1986 (set up by ICICI Ltd. in 1986 and later merged into ICICI Ltd. in 1997), PFC Ltd. and IRFC Ltd. in 1986, IREDA Ltd. in 1987, RCTC Ltd. and TDICI Ltd. (later known as IFCI Venture Capital Funds Ltd. and ICICI Venture Funds Management Ltd.) in 1988, NHB in 1988, TFCI Ltd. (set up by IFCI) in 1989, SIDBI (functions carved out of IDBI) in 1989, NEDFi Ltd. in 1995 and IDFC Ltd. in 1997.

Over the years, a wide variety of DFIs have come into existence and they perform the developmental role in their respective sectors. Apart from the fact that they cater to the financial needs of different sectors, there are some significant differences among them. While most of them extend direct finance, some extend indirect finance and are mainly refinancing institutions viz., SIDBI, NABARD and NHB which also have a regulatory / supervisory role.

3.5 Changing Role of Development Financial Institutions

Even though the world is becoming richer and more globalised, developing countries in particular are increasingly facing global challenges that are setting a new context for development and growth. Development finance institutions (DFIs) can help tackle the effects of a growing number of global challenges on poor countries, for example climate change, financial crises and global security.

Development bank plays a very important role in economic development of our country. Since independence they have contributed a lot to the inception of industrialization and all other technological innovations.

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Check your progress

3 what do you mean by Development banks?

4. Discuss the need of Development Financial Institutions in India.

While banks have traditionally met short-term working capital requirements of industry, development finance institutions (DFIs) have mainly catered to the medium to long-term financing requirements. They tend to lend not only for working capital purposes, but to finance long-term investment as well, including in capital-intensive sectors. DFIs were extended funds at concessional rates in the form of Long-Term Operations Fund of the RBI and government guaranteed bonds on a long-term basis, with their maturity ranging from 10-15 years. Generally, lending begins at the stage of the formulation of project itself, DFIs are also involved in decisions such as choice of technology, scale and location. This require more than just financial expertise, so that development financial institutions build a team of technical, financial and managerial experts, who are involved in the decisions related to lending and therefore to the nature of the investment.

The DFIs also provide merchant banking services to firms they lend to, taking firms to market to mobilise equity capital by underwriting equity issues. If the issue is not fully subscribed the shares would devolve on the underwriter, increasing the equity exposure of the bank. Between the period 1993 to 1998, DFIs took several measures such as offering innovative products and diversification of activities into new areas of business viz. investment banking, stock broking and custodial services to cope with the increased competition.

The intensification of global financial crisis and consequent liquidity crunch in the domestic financial system led the RBI to take a slew of measures in order to provide liquidity support to DFIs. For instance, the RBI provided refinance facility of Rs 160 bn (includes Rs 70 bn for SIDBI, Rs 50 bn for EXIM Bank and Rs 40 bn for NHB) to DFIs to facilitate on-lending to Housing Finance Companies (HFCs), NBFCs, mutual funds and exporters. Under the refinance facility, Rs 213.98 bn were drawn up to June 26, 2009, while total disbursements amounted to Rs 153.12 bn (up to June 26, 2009). The refinance facility had as many as 5,283 beneficiaries including 33 State Finance Corporation & Banks, 22 NBFCs and 14 HFCs. In addition to this, the ceiling on aggregate resources mobilised by SIDBI, NHB and EXIM Bank was raised to 12 times of net owned funds (NOF) for SIDBI & NHB and 13 times of NOF for EXIM Bank. This led to a 9.1% increase in resource mobilisation by DFIs during FY09.

3.6 Major Financial Institutions and their Functions

3.6.1 Industrial Finance Corporation of India Limited

The Industrial Finance Corporation of India (IFCI) was established on July 1, 1948, as the first Development Financial Institution in the country to cater to the long-term finance needs of the industrial sector. In 1970, with the consultation of other all-India financial institutions, viz., the IDBI, the LIC and ICICI, the Corporation an-

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nounced certain concessions to eligible industrial concerns that may be located in the notified districts in the less developed States/areas. In 1972, The Industrial Financial Corporation Act, 1948 was amended to enable private limited companies to seek financial assistance from the Corporation. In 1975, The Risk Capital Foundation was sponsored by IFCI, for offering service to first generation of new entrepreneurs by providing their interest-free personal loans, more or less in the form of venture capital assistance. In 1987, The Company was converted into a company known as "Risk Capital & Technology Finance Corporation, Ltd.During 1994, IFCI was converted into a joint-stock company and came out with a public issue of shares. In 1996 , The Corporation handled 79 merchant banking assignments, of which 25 related to Issue Management, 32 Project Counselling Appraisal and 22 Debenture Trusteeship. With a view to competitive repositioning of IFCI, the Corporation undertook to harness organisational strength by concentrating on continuous improvement of core competence. It was proposed to make entry into new business areas such as stock broking, asset management, investor services, insurance etc. In 1999, the name of the Company has been changed from "The Industrial Finance Corporation of India Ltd." to IFCI Ltd. From August 2007 onwards, it is being regulated as a non-banking financial company. Some sectors that have directly benefited from IFCI include:

- Agro-based industry (textiles, paper, sugar)
- Service industry (hotels, hospitals)
- Basic industry (iron & steel, fertilizers, basic chemicals, cement)
- Capital & intermediate goods industry (electronics, synthetic fibres, synthetic plastics, miscellaneous chemicals) and Infrastructure (power generation, telecom services)

3.6.1.1 Functions of Industrial Finance Corporation of India Limited

Initially, The IFCI started to cater the long term financial need of industries. Over a period of time it has involved into many other activities. It is offering a wide range of services including project financing, financial services and corporate advisory services etc.

- **Project Financing:** IFCI customizes the product-mix to maximize customer satisfaction. Financial assistance is provided to meet the fund requirements of Greenfield projects expansions and modernisation projects etc. across all industry and infrastructure sectors. It also provides the short term credit to meet the immediate requirements of corporates for meeting temporary gaps in working capital, mismatch in cash flow, short term miscellaneous requirements, investment requirement in group companies and subsidiaries, subscribing warrants, Rights issues, Initial Public Offerings, acquisitions, refinancing of existing debt, preoperative expenses of projects etc.

- **Project Development:** IFCI established the Project Development Group as IFCI's infrastructure development arm to provide end-to-end solutions to infrastructure sector that includes conceiving, techno economic viability study, financial advisory, monitoring of implementation and commercial production of the projects in sectors like Power Generation (Thermal, Hydro, Wind, Solar, Biomass etc). It also provide assistance in the form of Underwriting, Syndication, Equity, CCD, OCD, Mezzanine products, Debt (Both senior and sub) etc.

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- **Financial Services:** IFCI provides specially designed schemes to meet specific needs of corporates. The fund based services offered are equipment finance, equipment credit, leasing, hire purchase, working capital term loans, short term loans, instalment credit and others. The fee- based services offered by it are guarantees and letters of credit.
- **Corporate Advisory Services:** IFCI Corporate Advisory Group offers a host of consultancy services which entails providing complete financial solutions to diversified business entities. IFCI provides advisory services in the areas of projects, infrastructure, mergers and acquisition, disinvestment, bid process management, joint venture, corporate restructuring, bidding advisory. IFCI also provides a range of services to the prospective foreign investors.
- **Nodal Agency for Monitoring of Sugar Development Fund (SDF) Loans:** IFCI has been the Nodal Agency for monitoring of Sugar Development Fund (SDF) loans for projects related to modernization and expansion, co-generation of power and production of alcohol/ethanol in the private sector. As a nodal agency, it undertakes loan documentation, creation of security, recommendations to GOI for disbursement of funds, monitoring the progress of projects during implementation and operations, recovery of SDF dues and furnishing clarifications to queries of SDF.

3.6.1.2 Subsidiaries of Industrial Finance Corporation of India Limited

- With the passing of time IFCI has diversified its business by establishing subsidiaries. Currently, it has the following subsidiaries:
- IFCI Infrastructure Development Ltd., IFCI Factors Limited, IFCI Financial Services Ltd., IFCI Venture Capital Funds Ltd., MPCON.
- IFCI has also some associates like Assets Care and Reconstruction Enterprise Ltd, Tourism Finance Corporation of India Ltd., HIMCON, NITCON, HARDICON.

3.6.2 Industrial Development Bank of India Limited

Industrial Development bank of India (IDBI) was constituted under Industrial Development bank of India Act, 1964 as a Development Financial Institution and came into being as on July 1964, vide GoI notification dated June 22, 1964. It was regarded as a Public Financial Institution in terms of the provisions of Section 4A of the Companies Act, 1956. It continued to serve as a DFI for 40 years till the year 2004 when it was transformed into a Bank.

In February 16, 1976, RBI transferred the ownership of the company to the Government of India by RBI. The company was made the principal financial institution for coordinating the activities of institutions engaged in financing, promoting and developing industry in the country. In the year 1982, the company transferred their International Finance Division to Export-Import Bank of India.

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In the year 1993, they formed one wholly owned subsidiary company, namely IDBI Capital Market Services Ltd for providing broad range of financial products and services. In June 7, 1995, the company made their Initial Public Offer (IPO), which brought down GOI holding to below 100%. In March 2000, the company set up one wholly owned subsidiary company, namely IDBI Intech Ltd for providing Information Technology (IT) related activities of the organization.

In March 2001, they incorporated IDBI Trusteeship Services Ltd to take over the entire debenture business and assist to the subscribers and issuers of debentures by the way of up-to-date information and efficient professional services. In March 2003, the Bank made an exit from their asset management activity by divesting their entire shareholding in IDBI Principal Asset Management company Ltd, IDBI Principal Trustee Company Ltd and all Trust Corpus rights of IDBI Mutual Fund in favour of their joint venture partner Principal Financial Services Inc USA, with a view to concentrate on their core business activities. They also divested their entire stake in Discount & Finance House of India Ltd (DFHI) in favour of SBI.

In October 2004, the company was transformed into a banking company to undertake all kind of banking activities while continuing to play their secular Development Financial Institution role. Also, they changed their name to Industrial Development Bank of India Ltd.

In 2005, Industrial Development Bank of India Ltd merged their banking subsidiary IDBI Bank with themselves. In October 2006, United Western Bank Ltd was amalgamated with the Bank as a part of the inorganic growth strategy. In December 2006, the company incorporated a wholly owned subsidiary in the name of IDBI Gilts Ltd. for carrying on primary dealership business. In July 2007, the Bank entered into fourth tie-up for trading in carbon credits with Sumitomo of Japan. During the year 2007-08, the Bank came up with two innovative products Wealthsurance and Homesurance. In March 2008, IDBI Bank entered into a joint venture with Federal Bank and Fortis Insurance International to form IDBI Fortis Life Insurance, of which IDBI Bank owns 48%. Also, the name of the bank was changed to IDBI Bank Ltd with effect from May 07, 2008. An April 2011, two wholly-owned subsidiaries viz. IDBI Home Finance Ltd and IDBI Gilts Ltd were amalgamated with the Bank with effect from January 01, 2011.

3.6.2.1 Functions of Industrial Development Bank of India Limited

IDBI is vested with the responsibility of co-coordinating the working of institutions engaged in financing, promoting and developing industries. IDBI plays a role of catalyst to industrial development encompass a wide spectrum of activities. It also undertakes wide-ranging of promotional activities including entrepreneurship development programmes for new entrepreneurs, provision of consultancy services for small and medium enterprises, up gradation of technology and programmes for economic upliftment of the deprived. Along with the direct assistance, IDBI also provides assistance to industries through other financial institutions and banks. Thus the assistance provided by IDBI fell in two broad categories viz.

(a) Direct finance to large and medium enterprises; and (b) Indirect finance through other financial institutions.

(a) Direct Finance: IDBI provides financial assistance to the large and medium enterprises without intervention of other financial institutions. It can be offered in the following manner:

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- **Project Finance:** It provides project finance for new projects and for expansion, diversification and modernization of existing projects. Project finance is provided by way of; Term loans in Indian rupees and foreign currencies, Underwriting, Direct subscription to equity capital and, deferred payments guarantees. The term loans are secured by a first charge on the movable and immovable fixed assets of industrial concerns. These loans are repayable in quarterly instalments depending upon the projected cash flows of the borrower.

- **Discounting of Bills:** IDBI directly discounts the bills of exchange drawn by financially sound companies which have been in operation for at least 3 years and have not defaulted to financial institutions, in connection with sale of machinery equipment. IDBI fixes annual limit of discounting of bills which are repayable over period of 2 to 7 years.

- **Equipment Finance:** This facility is also provided in rupees and foreign currencies for acquiring specific machinery equipment. The net worth of company must be above Rs 5 crore.The eligible borrowing concern must be financially sound companies and should have been in operation for least 5 years. It should have earned profits during the last 3 years and must have dividend paying capacity of not less than 2 years.

- **Medium and Short Term Financing for Corporates:** Such type of loans are granted to meet the long term and short term working capital requirement of the companies. IDBI provides these loans to the financially sound companies with net worth of not less than Rs 10 crore and having been in commercial operations for 5 years and making profit consistently for last 3 years.

(**b) Indirect Finance:** IDBI provides indirect finance to the industrial concerns through other financial institutions like SFCs and SIDCs. Further these financial institutions are required to repay the dues to the IDBI Ltd. indirect finance to the industrial concern is provided through the following schemes:

- **Refinance of Term Loan:** It provides the refinance facilities to the SFCs, and SIDCs against their loans provided to the industrial units.

- **Rediscounting of Bills:** IDBI introduced bill rediscounting schemes in the year 1965, with an objective that by providing deferred payments facilities to the manufactures they can enable them to push up the sales of their products by offering their prospective purchaser.

(c) Other Financial Services:

- **Merchant Banking:** IDBI also provides merchant banking by considering various activities like: Issue management, corporate advisory services, Credit syndication, Valuation and corporate structuring etc.

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Check your progress

5. Explain the functions of IFCI Ltd.
6. Discuss the role and Subsidiaries of IDBI Ltd.

- **Debenture/Mortgage Trusteeship:** IDBI also offers this facility in which they used to accept these assignments in respect of bonds and debentures issued by companies. They also act as mortgage trustee agent to foreign lenders as part of corporate trustee services.

- **Forex Services:** For import of capital goods and services, IDBI opens letters of credit and effects foreign currency remittances on behalf of its borrowers. The bank also disburses foreign currencies loans towards domestic projects related rupee expenditure.

3.6.2.2 Subsidiariesof Industrial Development Bank of India Limited

IDBI is a pioneer Institution in Nation building. To cater to its ever-expanding needs, IDBI has formed subsidiaries across diverse areas of Banking & Financial System. Currently, IDBI has the following subsidiaries:

- IDBI Capital Market Services Limited (ICMS), IDBI Intech Limited (IIL), IDBI Asset Management Limited (IAML), IDBI MF Trustee Company Limited (IMTCL), IDBI Trusteeship Services Ltd (ITSL).

3.6.3 Industrial Credit and Investment Corporation of India Limited (ICICI)

The Industrial Credit and Investment Corporation of India was established as a private limited company in 1955. It was set up as a private sector development bank to assist and promote private industrial concerns in the country. The main objective was to provide assistance in the creation, expansion and modernisation of private concerns. The Corporation started with the authorised capital of Rs. 25 crore. At the end of June 1986, the authorised capital was Rs. 100 crore and the paid-up capital was 49.5 crore. Various sources of financial resources of the Corporation are Indian banks, insurance companies and foreign institutions, including the World Bank, and the public. The government and the IDBI have also provided loans to the Corporation. During 1977, ICICI sponsored the formation of Housing Development Finance Corporation.

In 1982, ICICI became the first ever Indian borrower to raise European Currency Units and commenced its leasing business. During 1987, ICICI, along with UTI, set up Credit Rating Information Services of India Limited, India's first professional credit rating agency. In 1994, ICICI Bank was established by the Industrial Credit and Investment Corporation of India, as a wholly owned subsidiary. In 1996, ICICI was the first Indian financial company to raise Global Depository Receipts (GDR). In May 2002, ICICI, ICICI Capital services and ICICI Personal Financial services amalgamated with ICICI Bank Ltd.

Merger of ICICI with ICICI bank

After consideration of various corporate structuring alternatives in the context of the emerging competitive scenario in the Indian banking industry, and the move towards universal banking, the managements of ICICI and ICICI Bank formed the view that the merger of ICICI with ICICI Bank would be the optimal strategic alternative for both entities, and would create the optimal legal structure for the

ICICI group's universal banking strategy. In October 2001, the Boards of Directors of ICICI and ICICI Bank approved the merger of ICICI and two of its wholly-owned retail finance subsidiaries, ICICI Personal Financial Services Limited and ICICI Capital Services Limited, with ICICI Bank. The merger was approved by shareholders of ICICI and ICICI Bank in January 2002, by the High Court of Gujarat at Ahmedabad in March 2002, and by the High Court of Judicature at Mumbai and the Reserve Bank of India in April 2002. Consequent to the merger, the ICICI group's financing and banking operations, both wholesale and retail, have been integrated in a single entity.

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3.6.3.1 Functions of Industrial Credit and Investment Corporation of India Limited

The primary function of ICICI is to act as a channel for providing development finance to industry. ICICI performs the following functions-

- Originally, the ICICI was established to provide financial assistance to industrial concerns in the private sector. But, recently, its scope has been widened by including industrial concerns in the public, joint and cooperative sectors.
- ICICI provides financial assistance in the form of medium and long-term loans in Indian and foreign currency for importing capital equipment and technical services.
- It subscribes to new issues of shares, generally by underwriting them.
- It guarantees loans raised from private sources including deferred payment.
- ICICI is providing special attention to financing riskier and non-traditional industries, such as chemicals, petrochemicals, heavy engineering and metal products. These four categories of industries have accounted for more than half of the total assistance.
- It provides technical and managerial assistance to industrial units.
- It provides assets on lease to industrial concerns. In other words, assets are owned by ICICI but allowed to be used by industrial concerns for a consideration called lease rent.
- It provides project consultancy services to industrial units for new projects.
- ICICI also provides assistance to the small scale industries and the projects in backward areas.
- Along with other financial institutions, the ICICI actively participates in conducting surveys to examine industrial potential in various states.

3.6.3.2 Subsidiaries of Industrial Credit and Investment Corporation of India Limited

Consequent to the merger of ICICI with ICICI Bank, ICICI's subsidiary companies have become subsidiaries of bank. ICICI bank has the following domestic and international subsidiaries:

- **Domestic Subsidiaries:** ICICI Prudential Life Insurance Company Limited, ICICI Lombard General Insurance Company Limited, ICICI Prudential Asset

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Management Company Limited, ICICI Prudential Trust Limited, ICICI Securities Limited, ICICI Securities Primary Dealership Limited, ICICI Venture Funds Management Company Limited, ICICI Home Finance Company Limited ICICI Investment Management Company Limited, ICICI Trusteeship Services Limited, ICICI Prudential Pension Funds Management Company Limited.

- **International Subsidiaries:** ICICI Bank UK PLC, ICICI Bank Canada, ICICI Bank Eurasia Limited Liability Company, ICICI Securities Holdings Inc., ICICI Securites Inc., ICICI International Limited.

3.6.4 The Small Industries Development Bank of India (SIDBI)

Small Industries Development Bank of India (SIDBI) was established in 1990 by Government of India under the Small Industries Development Bank of India Act, 1989 (SIDBI Act) as a wholly owned subsidiary of the IDBI. SIDBI serves as the principal financial institution for promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in promoting, financing or developing industry in the small scale sector. SIDBI aim at enhancing the capabilities of enterprises in the small sector and is carried out through involvement of institution like TOCS Institutions of Entrepreneurship Development, Technology/Management Institutions, industry Association etc. SIDBI has introduced Single Window Scheme were the Refinance is extended for term loans as well as working capital from same agency against its assistance to SSD units for new, modernisation, and diversification, technology up gradation and rehabilitation projects. In 1992, Deep Discount Bonds (Series I) was introduced which has a face value of Rs 1,00,000 and which is issued at a deep discounted price of Rs 2,500 with a monthly period of 25 years from the date of allotment i.e. 1.2.1993

During 1995, a joint venture between SIDBI and Asian & Pacific centre for transfer of technology a United Nation outfit Technology give rise to Bureau for Small Enterprises for providing effective services, in technology information, match making services and finance specification to small scale sector in the company.During 1996, the International Finance Department was set up to cater to the needs of the SSIs such as pre shipment credit in foreign currency, letters of credit, foreign currency loans for import of capital equipment and other related services. In 1997, SIDBI entered into a MOU with CII for mutually supplementing and consolidating the efforts of SIDBI and CII towards realisation of the common goal around at development of SSIs in the country.

In 2000, SIDBI has set up the National Fund for Software and Information Technology (NSFIT) and 10 regional funds for providing venture capital support to the IT sector in collaboration with the Union Ministry of IT and IDBI. In 2001, SIDBI has entered into a memorandum of understanding with the Mauritius-based venture fund Intech Venture Group to launch a $50 million fund for investments in software and knowledge-based projects in the Silicon Valley, US.

In 2003, SIDBI enters into an alliance with Oriental Bank to jointly work on projects in the field of small-scale, infrastructure and service areas. In 2004, Small Industries Development Bank of India (SIDBI) has set up Rs 10,000 crore fund for the small-scale industries (SSI) sector in 2005, SIDBI sets up SME growth fund. SIDBI signed MoU with IOB for co-financing projects in the SME segment.

Four basic objectives are set out in the SIDBI Charter. They are:

- Financing
- Promotion
- Development
- Co-ordination for orderly growth of industry in the small scale sector.

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The Charter has provided SIDBI considerable flexibility in adopting appropriate operational strategies to meet these objectives. The activities of SIDBI, as they have evolved over the period of time, now meet almost all the requirements of small scale industries which fall into a wide spectrum constituting modern and technologically superior units at one end and traditional units at the other

3.6.4.1 Functions of Small Industries Development Bank of India

SIDBI provides assistance to the small-scale industries sector in the country through the existing banking and other financial institutions, such as, State Financial Corporations, State Industrial Development Corporations, commercial banks, cooperative banks and RRBs. etc. The major functions of SIDBI are given below:

- It refinances loans and advances provided by the existing lending institutions to the small-scale units.
- It discounts and rediscounts bills arising from sale of machinery to and manufactured by small-scale industrial units.
- It extends seed capital/soft loan assistance under National Equity Fund, Mahila Udyam Nidhi and MahilaVikas Nidhi and seed capital schemes.
- It grants direct assistance and refinance loans extended by primary lending institutions for financing exports of products manufactured by small-scale unit.
- It provides financial services like factoring, leasing, etc. to small units.
- It extends financial support to State Small Industries Corporations for providing scarce raw materials to and marketing the products of the small-scale units.
- It provides financial support to National Small Industries Corporation for providing; leasing, hire pur-chase and marketing help to the small-scale units.
- It promotes state level venture funds in association with respective state government.
- It takes initiative for setting up of incubation center under its National Programme for innovation and incubation for small industries with a view to harnessing the entrepreneurial talents.
- It finances projects relating to transport, health care and tourism sectors and also to the professional and self-employed persons setting up small- sized professional ventures.

3.6.4.2 Promotional & Developmental Support of Small Industries Development Bank of India

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SIDBI adopts a 'Credit Plus' approach wherein, besides credit, the Bank also provides grant support for the promotion and development of the sector to make it strong, vibrant and competitive in the international markets. During FY 2011-12, the ongoing Rural Industries Programme (RIP) was comprehensively redesigned and renamed as Micro Enterprises Promotion Programme so as to make it more aligned with the business objectives of the Bank. The Promotional & Developmental (P&D) activities of the Bank are designed towards creation and strengthening of enterprises. Some of the major initiatives are given below:-

- **Strengthening Rural Enterprises:** Micro Enterprises Promotion Programme (MEPP) (erstwhile Rural Industries Programme) is the flagship programme of the Bank, for creation of rural employment through the use of comprehensive enterprise support services for the benefit of rural entrepreneurs. It aims at promoting viable rural enterprises leading to employment generation in rural areas through use of local resources. MEPP has been implemented in 121 districts in 24 States as on March 31, 2012. Cumulatively, more than 38,000 enterprises have been promoted, including over 1180 units during the year.
- **Enterprise Development:** Enterprises Development Programme (EDPs) aim at building and nurturing a reservoir of entrepreneurs. Most of these EDPs have been conducted in the semi-urban/rural areas. As on March 31, 2012, the total number of EDPs supported by the Bank, since inception, for various target groups was 2,894, covering more than 72,850 participants. During the year, 63 EDPs were supported by the Bank in which 2,024 beneficiaries were trained.
- **Skill Development:** With a view to strengthening the technical and managerial capacities of the MSME entrepreneurs, the Bank supports reputed management / technology institutions to offer certain structured management / skill development programmes, viz. Skill - cum - Technology Up gradation Programme [STUP] and Small Industries Management Programme [SIMAP]. STUP aims at enhancing technology profile of MSME units and SIMAP targets qualified unemployed as well as industry-sponsored candidates, with the overall objective of providing competent managers to the MSME sector.
- **Cluster Development:** SIDBI has supported more than 75 Cluster Development Programmes (CDPs) in various clusters all over India. The paradigm shift in supporting CDPs during the last few years is basically from technology centric to a more comprehensive cluster development approach which includes management practices, establishment of marketing linkages, product/design development, skill up gradation in different technical trades, etc. Besides enabling MSMEs to achieve economies of scale through the cluster financing approach, cluster centric approach also facilitates development of infrastructure.
- **Minority Cell:** As per the recommendations of Sachar Committee, a Minority Cell has been established at the Bank's Head Office. The field offices have been advised to cover maximum number of participants from minority communities under various P&D activities. The MEPP in the Government notified

minority focused district of Kishanganj in Bihar is under implementation, wherein about 55 units were set up during the year. Further, the Bank has extended assistance for conduct of exclusive training programmes on dress making, embroidery, electrical, artificial jewellery, etc. during FY 2011-12.

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Check your progress

7. what are the major functions of ICICI Ltd.?
8. Explain the objectives for the establishment of SIDBI.

3.6.4.3 Subsidiaries & Associates of Small Industries Development Bank of India

SIDBI has the following subsidiaries and associates:

• **Subsidiaries:** SIDBI Venture Capital limited, SIDBI Trustee Company Limited,

• **Associates:** Credit Guarantee Fund Trust for Micro and Small Enterprises, India SME Technology Services ltd., SME rating agency of India Ltd. (SMERA), India SME Asset Reconstruction Company Ltd (ISARC).

3.6.5 National Bank for Agriculture and Rural Development (NABARD)

Government of India Reserve Bank of India (RBI), constituted a committee to review the arrangements for institutional credit for agriculture and rural development (CRAFICARD) on 30 March 1979, under the Chairmanship of Shri B.Sivaraman, former member of Planning Commission, Government of India to review the arrangements for institutional credit for agriculture and rural development. The Committee, in its interim report, submitted on 28 November 1979, felt the need for a new organisational device for providing undivided attention, forceful direction and pointed focus to the credit problems arising out of integrated rural development and recommended the formation of National Bank for Agriculture and Rural Development (NABARD). The bank came into existence on 12 July 1982 by transferring the agricultural credit functions of RBI and refinance functions of the Agricultural Refinance and Development Corporation (ARDC).

NABARD was set up with an initial capital of Rs.100 crore. Consequent to the revision in the composition of share capital between Government of India and RBI, the paid up capital as on 31 March 2013, stood at Rs 4000 crore with Government of India holding Rs.3,980 crore (99.50%) and Reserve Bank of India 20.00 crore (0.50%).

NABARD recorded high levels of performance in purveying rural credit during 2012-13. The aggregate assets held by NABARD rose to 2,13,170 crore as on 31 March 2013, an increase of 30,700 crore (17 %) compared to the position as on 31 March 2012.

3.6.5.1 Objectives of National Bank for Agriculture and Rural Development

NABARD was established in terms of the Preamble to the Act, "for providing credit for the promotion of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting IRDP and securing prosperity of rural areas and for matters connected therewith in incidental thereto".The main objectives of the NABARD as stated in the statement of objectives while placing the bill before the Lok Sabha were categorized as under:

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- The National Bank will be an apex organisation in respect of all matters relating to policy, planning operational aspects in the field of credit for promotion of Agriculture, Small Scale Industries, Cottage and Village Industries, Handicrafts and other rural crafts and other allied economic activities in rural areas.
- The Bank will serve as a refinancing institution for institutional credit such as long-term, short-term for the promotion of activities in the rural areas.
- The Bank will also provide direct lending to any institution as may approved by the Central Government.
- The Bank will have organic links with the Reserve Bank and maintain a close link with it.

3.6.5.2 Functions of National Bank for Agriculture and Rural Development

NABARD accomplishes main three type of functions, namely; (i) Financial Function (ii) Development & Promotional Function and (iii) Supervisory Functions.

i) Financial Function: These functions cover planning, dispensation and monitoring of credit. This activity involves mainly refinance and direct finance facilities are discussed below:

a) Refinance

- **Short and medium term loans:** Modern agriculture involves substantial investment of recurring nature for using high yielding varieties of seeds, fertilisers, insecticides and costly agricultural implements.Production Credit Department (PCD) deals with short term refinance facilities, for various types of production, marketing and procurement activities, being provided to client institutions.
- **Long term loans:** Investment credit leads to capital formation through asset creation. It induces technological up gradation resulting in increased production, productivity and incremental income to farmers and entrepreneurs. This is a long-term refinance facility. The credit is normally provided for a period of 3 to 15 years. It is intended to create income generating assets in the following sectors:
  a.) Agriculture and allied activities
  b.) Artisans, small scale industries, Non-Farm Sector (Small and Micro Enterprises), handicrafts, handlooms, power looms, etc.
  c.) Activities of voluntary agencies and self-help groups working among the rural poor.

b) Direct Finance

- **NABARD Warehousing Scheme (NWS) 2013- 14:** NABARD has formulated a scheme viz., NABARD Warehousing Scheme 2013- 14 (NWS), which envisages extension of loans to Public and Private Sectors for construction of warehouses, silos, cold storages and other cold chain infrastructure.
- **Credit Facilities to Marketing Federations:**To support Producers Organizations in carrying out business activities, NABARD has set Producer

Organization Development Fund (PODF) during 2011-12.

- **Direct Lending to Cooperative Banks:** NABARD has traditionally provided refinance support to central cooperative banks (CCBs) through State Co-operative Banks (SCBs). NABARD has designed a Short Term Multi-purpose Credit Product for financing directly to CCBs.

- **Financing and Supporting Producer Organisations:** It has taken an initiative for supporting producer organizations, adopting a flexible approach to meet the needs of producers. In order to give a special focus, the "Producers Organization Development Fund" (PODF) has been set up wef. 01 April 2011, with an initial corpus of Rs 50 crore.

- **NABARD Infrastructure Development Assistance (NIDA):** NIDA is designed to fund State owned institutions/ corporations on both on-budget as well as off-budget for creation of rural infrastructure outside the ambit of RIDF borrowing.

ii) Development & Promotional Function: These functions are concerning with reinforcement of the credit functions and making credit more productive.

- **Institutional Development:** This facility includes the institutional building of Regional rural banks, co-operative banks, capacity building of co-operative banks and the institutional development.

- **Farm Sector :** For the development of the farm sector NABARD offers various schemes that includes; Village Adoption/Village development Plan, Backward Blocks, Bamboo Farming, Bio Fuels, Crop Insurance, Agriculture Commodities, Farm Mechanisation, Land Purchase, Capacity Building for Adoption of Technology (CAT) and Contract Farming etc.

- **Non- Farm Sector:** NABARD also provides various schemes for the development of non-farm sectors that includes; rural innovation, area development programme, marketing and technology, support to women, entrepreneur and skill development and environmental promotional assistance schemes.

- **Financial Inclusion:** It is "the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost." Financial Inclusion Fund (FIF) and Financial Inclusion Technology Fund (FITF). The two funds have been established with NABARD, which is the coordinating agency of Financial Inclusion initiative with Financial Inclusion Department (FID) as the nodal department.

- **Research & Development:** This facility is established by the Bank, in accordance with the provisions of the NABARD Act 1981, the Research and Development (R&D) Fund aims at acquiring new insights into the problems of agricultural and rural development through in-depth studies and applied research.

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iii) Supervisory Functions: Apart from the above mentioned two functions NARABD has been taking initiative in certain supervisory functions to conduct inspection of State Cooperative Banks (SCBs), Central Cooperative Banks (CCBs) and Regional Rural Banks (RRBs). Following are the objectives of supervision.

- To protect the interest of the present and future depositors
- To ensure that the business conducted by these banks is in conformity with the provisions of the relevant Acts/Rules, regulations/Bye-Laws
- To ensure observance of rules, guidelines, etc., formulated and issued by NABARD / RBI/ Government
- To examine the financial soundness of the banks and
- To suggest ways and means for strengthening the institutions so as to enable them to play more efficient role in purveying rural credit

3.6.6 State Industrial Development Corporations (SIDCs)

The State Industrial Development Corporations were incorporated under the companies Act 1956, as wholly owned companies in different states for promoting industrial development in their respective states. They have been set up with the aim of providing financial assistance to small entrepreneurs. They are also involved in setting up of medium and large industrial projects in the joint sector/assisted sector in collaboration with private entrepreneurs or wholly-owned subsidiaries.With a view to providing infrastructural facilities for the establishment of industrial units, SIDCs are involved in the setting up of industrial growth centres. To keep pace with the hanging economic environment, SIDCs have initiated various measures to expand the scope of their activities and have entered into various fee based activities. These SIDCs spread financial assistance in the form of rupee loans, underwriting subscriptions to shares/debentures, guarantees, inter corporate de also opens letters of credit on behalf of its borrowers.

There are 28 SIDCs in the India. Out of the various SIDCs in the country, those in Andaman & Nicobar, Arunachal Pradesh, Daman & Diu and Dadra & Nagar Haveli, Goa, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Pondicherry and Sikkim also act as SFCs to provide assistance to small and medium enterprises and act as promotional agencies for this sector.

3.6.6.1 Resources for State Industrial Development Corporations

SIDCs do not generally have large resources to meet the growing demand of industry within their regions. They raise resources by issue of share capital, issue of bonds and debenture guaranteed by State Governments. Additional resources are raised by accepting deposits from public and by borrowings from State Governments.

Other main resource available to these state level institutions is refinance from Industrial Development Bank of India/Small Industries Development Bank of India. Liberal refinance facilities ranging from 75% to 100% of the loans granted by these institutions to various borrowers under different schemes are available. The funds thus available from IDBI/SIDBI help these institutions to play an effective development role in promoting industries within their regions.

Small Industrial Development Bank of India provides refinance under two different schemes knowing as normal scheme and automatic refinance scheme. Automatic refinance scheme is applicable to loans granted for smaller projects and for composite loans to SC/ST and physically handicapped entrepreneurs etc. Individual approval of each project under the automatic scheme is not required. Under the normal scheme, each project is required to he approved from SIDBI for availing refinance.

SIDCs confine their activities in promoting the industrial projects in small scale and medium scale sectors and projects costing up to Rs. 10 crore can normally be financed by these institutions. Projects where cost exceeds Rs. 10 crore are required to approach all India institutions for financial assistance.

SIDCs can avail refinance from IDBI up to 150 Lakhs. The cost of project of the assisted unit should not exceed Rs. 5 crore and it should be medium scale industrial unit.

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Check your progress

.9. What are the major functions of NABARD?

10. Discuss the objectives of state level financial institutions.

3.7 Key Terms

- **Development Banks:** An institution promoted or assisted by Government mainly to provide development finance to one or more sectors or sub-sectors of the economy.
- **State level institutions:** Those financial institutions which have been set up at the State level to supplement the financial assistance provided by the all India institutions. They act as a catalyst for promotion of investment and industrial development in the respective States.
- **Term lending institutions :** which is primarily engaged in the business activities like loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase,
- **Refinancing institutions:** Those institutions which extend refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sectors.
- **Refinance:** It may be defined as paying off an existing loan with the proceeds from a new loan, usually of the same size, and using the same property as collateral. In order to decide whether this is worthwhile, the savings in interest must be weighed against the fees associated with refinancing.
- **Investment Institutions:** An investment institution is defined as an investment company or an investment fund.
- **Specialized Financial Institutions:** Those financial institutions which serve the increasing financial needs of commerce and trade in the area of venture capital, credit rating and leasing, etc.
- **Universal Banking:** A banking system in which banks provide a wide variety of financial services, including both commercial and investment services. Universal banking is common in some European countries, including Switzerland. In the United States, however, banks are required to separate their commercial and investment banking services.

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- **Merchant banking:** Merchant Banking is a combination of Banking and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters. Consultancy means to provide advice, guidance and service for a fee.

- **Financial Services:** Services and products provided to consumers and businesses by financial institutions such as banks, insurance companies, brokerage firms, consumer finance companies, and investment companies all of which comprise the financial services industry.

- **Project Finance:** The financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project.

- **Wholly owned subsidiary:** A company whose common stock is 100% owned by another company, called the parent company. A company can become a wholly owned subsidiary through acquisition by the parent company or spin off from the parent company. In contrast, a regular subsidiary is 51 to 99% owned by the parent company. One situation in which a parent company might find it helpful to establish a subsidiary company is if it wants to operate in a foreign market.

3.8 Summary

- A DFI is defined as "an institution promoted or assisted by Government mainly to provide development finance to one or more sectors or sub-sectors of the economy. The institutions emphasize the "project approach" - meaning the viability of the project to be financed – against the "collateral approach".

- The basic emphasis of a DFI is on long-term finance and on assistance for activities or sectors of the economy where the risks may be higher than that the ordinary financial system is willing to bear.

- In India, the need for development financial institutions was felt very strongly immediately after the independence. RBI was entrusted with the task of developing an appropriate financial construction through institution building so as to mobilise and direct resources to preferred sectors as per the plan priorities.

- The first step towards development of DFIs was established in 1948 by establishing Industrial Finance Corporation of India (IFCI) followed by setting up of State Financial Corporations (SFCs) at the State level after passing of the SFCs Act, 1951.

- Development finance institutions (DFIs) have mainly catered to the medium to long-term financing requirements. They tend to lend not only for working capital purposes, but to finance long-term investment as well, including in capital-intensive sectors. DFIs were extended funds at concessional rates in the form of Long-Term Operations Fund of the RBI and government guaranteed bonds on a long-term basis.

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- Between the period 1993 to 1998, DFIs took several measures such as offering innovative products and diversification of activities into new areas of business viz. investment banking, stock broking and custodial services to cope with the increased competition.
- The Industrial Finance Corporation of India (IFCI) was established on July 1, 1948, as the first Development Financial Institution in the country to cater to the long-term finance needs of the industrial sector. In 1970, with the consultation of other all-India financial institutions, viz., the IDBI, the LIC and ICICI, the Corporation announced certain concessions to eligible industrial concerns that may be located in the notified districts in the less developed States/areas.
- Industrial Development bank of India (IDBI) was constituted under Industrial Development bank of India Act, 1964 as a Development Financial Institution and came into being as on July 1964. It continued to serve as a DFI for 40 years till the year 2004 when it was transformed into a Bank.
- IDBI is vested with the responsibility of co-coordinating the working of institutions engaged in financing, promoting and developing industries. It also undertakes wide-ranging of promotional activities including entrepreneurship development programmes for new entrepreneurs, provision of consultancy services for small and medium enterprises, up gradation of technology and programmes for economic upliftment of the deprived.
- The Industrial Credit and Investment Corporation of India was established as a private limited company in 1955. It was set up as a private sector development bank to assist and promote private industrial concerns in the country. In October 2001, the Boards of Directors of ICICI and ICICI Bank approved the merger of ICICI and two of its wholly-owned retail finance subsidiaries, ICICI Personal Financial Services Limited and ICICI Capital Services Limited, with ICICI Bank.
- Small Industries Development Bank of India (SIDBI) was established in 1990 by Government of India under the Small Industries Development Bank of India Act, 1989 (SIDBI Act) as a wholly owned subsidiary of the IDBI.
- SIDBI provides assistance to the small-scale industries sector in the country through the existing banking and other financial institutions, such as, State Financial Corporations, State Industrial Development Corporations, commercial banks, cooperative banks and RRBs. etc.
- National Bank for Agriculture and Rural Development (NABARD) came into existence on 12 July 1982, by transferring the agricultural credit functions of RBI and refinance functions of the Agricultural Refinance and Development Corporation (ARDC).
- The State Industrial Development Corporations were incorporated under the companies Act 1956, as wholly owned companies in different states for promoting industrial development in their respective states. They have been set up with the aim of providing financial assistance to small entrepreneurs.
- The Central Government approved the State Financial Corporation Act of 28th

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September, 1951 which empowered the state government to establish financial corporation to operate within the state. State Financial Corporations play a vital role in the development of small and medium enterprises in their concerned States.

3.9 Questions and Exercises

1. Give a brief outline of financial institutions in India.
2. Discuss the changing role of development financial institutions in India.
3. Explain the major Refinancing institutions operating in India and their role in Indian Financial system.
4. State the role and functions State Financial Corporations (SFCs) in India.
5. Give the brief idea of All India development banks and their functions.
6. Discuss the objectives of State level Institutions.
7. Differentiate between Development banks and commercial banks.
8. Explain the financial functions of NABARD and their importance in rural areas.

3.10 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.
2. Saha, S.S., ***"Indian Financial System and Markets",*** TMH Education Private Limited.
3. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.

Web resources:

1. "Introduction and Historical Background of DFIs" available at http://www.rbi.org.in
2. "Functions of IFCI Ltd" available at www.ifciltd.com
3. "Promotional work of SIDBI" available at http://www.sidbi.in/
4. "History and functions of NABARD" available at https://www.nabard.org
5. "Functions of IDBI Ltd." available at www.idbi.com
6. "Historical background and functions of ICICI" available at www.icicibank.com

UNIT 4: STATE FINANCIAL CORPORATIONS (SFCs)

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Structure

4.0 Introduction
4.1 Unit Objectives
4.2 State Financial Corporations
4.3 Functions of State Financial Corporations
4.4 Types of State Financial Corporations
4.5 Performance of State Financial Corporations
4.6 Key Terms
4.7 Summary
4.8 Questions and Exercises
4.9 Further Readings and References

4.0 Introduction

The State Finance Corporations (SFCs) are the integral part of institutional finance structure in the country. SFCs promote small and medium industries of the states. Besides, SFCs are helpful in ensuring balanced regional development, higher investment, more employment generation and broad ownership of industries. At present there are 18 state finance corporations (out of which 17 SFCs were established under SFC Act 1951). Tamil Nadu Industrial Investment Corporation Ltd. established under Company Act, 1949, is also working as state finance corporation. SFCs provide long term finance to small and medium scale industrial concerns formed as public or private limited companies, corporations, forms or proprietary concerns repayable within a period of 20 years.

4.1 Unit Objectives

After completing this unit students will be able to:

- Understand the meaning and functions of State financial Corporation
- Learn the types of State Financial Corporations in India
- Explain the performance of State Financial Corporations in India

4.2 State Financial Corporations

A Central Industrial Finance Corporation was set up under the Industrial Finance Corporation Act, 1948, which fall outside the normal activities of Commercial Banks. The main objective of the Central Industrial Finance Corporation was to provide

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medium and long term credit to industrial concerns. The State Governments demanded that similar Corporations should also be set up in the States to supplement the work of the Industrial Finance Corporation. With this view, the Central Government approved the State Financial Corporation Act of 28th September, 1951 which empowered the state government to establish financial corporation to operate within the state.

State Financial Corporations play a vital role in the development of small and medium enterprises in their concerned States. They provide financial assistance in the form of term loans, direct subscription to equity/debentures, guarantees, discounting of bills of exchange and seed/ special capital, etc. SFCs have been set up with the objective of catalysing higher investment, generating greater employment and widening the ownership base of industries. They have also started providing assistance to newer types of business activities like floriculture, tissue culture, poultry farming, commercial complexes and services related to engineering, marketing, etc. There are 18 State Financial Corporations (SFCs) in the country.

4.2.1 Objectives of State Financial Corporations

- To establish uniformity in regional industries
- To provide incentive to new industries
- To bring efficiency in regional industrial units
- To provide finance to small-scale, medium sized and cottage industries in the state
- To develop regional financial resources

4.2.2 Resources

- **Share Capital:** The State Financial Corporation can have share capital ranging from Rs. 50 lakhs to Rs. 5 crores. It can be increased up to Rs. 10 crores with the prior sanction of the Central Government.
- **Bond and Debentures:** The State Financial Corporation can issue bonds and debentures to a maximum of ten times the amount of its paid-up capital and reserve fund.
- **Public Deposits:** The State Financial Corporation can accept public deposits for a maximum period of 5 years. However, the total amount received by way public deposits should not exceed twice its paid-up capital.
- **Other Sources:** Borrowings from the state government and the Reserve Bank.

4.3 Functions of State Financial Corporations

Following are the various functions of SFCs-

- To provide loans for a period not exceeding 20 years to industrial units.
- To underwrite the issue of shares, debentures and bonds for a period not exceeding 20 years of industrial units.

- To give guarantee to loans taken by industrial units for a period not exceeding 20 years.
- To make payment of capital goods purchased in India by these industrial units.
- To subscribe to the share capital of the industrial units, in case they wish to raise additional capital.
- To do all such acts as may be incidental of its duties under this Act.

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4.4 Types of State Financial Corporations

At present there are 18 state finance corporations (out of which 17 SFCs were established under SFC Act 1951).

4.4.1 Andhra Pradesh State Financial Corporation (APSFC)

Andhra Pradesh State Financial Corporation (APSFC) is a term lending Institution established in 1956 for promoting small and medium scale industries in Andhra Pradesh under the provisions of the Sate Financial Corporation' Act, 1951.The corporation has many entrepreneur - friendly schemes to provide term loans, working capital term loans, special and seed capital assistance to suit the needs of various categories of entrepreneurs. The Corporation has 45 years of expertise in industrial financing engaged in the business of financing tiny, small and medium scale sector units and thriving for balanced reginal development of the state.

4.4.2 Assam Financial Corporation (AFC)

Assam Financial Corporation (AFC) was established under the Central Act, viz., The State Financial Corporations Act, 1951, with the basic objective of promoting and developing small scale and medium scale industries in the State with a special focus on spreading industrial culture in the rural, semi-urban and backward areas of the States. The corporation is owned by the Assam state government jointly with IDBI and is functioning under the administrative control of the state government.

The Chairman and Managing Directors of AFC are senior IAS officers appointed by the state government in consultation with IDBI. The Board of Directors of AFC are highly professional in character and consist of senior executives of the state government, a representative each from RBI, IDBI and SIDBI, besides other interests like Co-operatives, Life Insurance, entrepreneurs are also represented on the Board. AFC employs highly professional and technical personnel to carry on the business operations such as M.B.As., C.As., engineers, marketing experts, etc.

Assam Financial Corporation caters to the requirements of the entrepreneurs. It provides term loan to small and medium scale industries for creation of assets, viz., land, building and machinery. It also provide working capital term loan to the industrial units on competitive terms.The Corporation also provides Non Fund based services like Merchant Banking, Under-Writing of Public Issues, Project Counselling, Bill Discounting, Leasing and Hire-Purchase. It is operating a number of financial assistance schemes for the benefit of the entrepreneurs such as assistance for marketing activities, equipment finance, special schemes for assistance to ex-servicemen, single window scheme, etc.

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4.4.3 Bihar State Financial Corporation (BSFC)

Bihar State Financial Corporation (BSFC) is the main state level institution providing term lending facilities to industrial entrepreneurs. Banks have also shown increasing interest in term lending to industrial units. BSFC will be restructured and strengthened to meet the growing financial and mercantile needs of entrepreneurs. Although the Government has nominated representatives of Associations of industrial enterprises and Chambers of Commerce in the Board of this institution a need has been felt to further strengthen the Board with induction of greater number of competent professionals and representative of Chambers and Industries with proven track record. Specific criteria will be laid down for choosing professionals. Representatives of Financial Institutions will also be inducted in the Board of BSFC. BSFC will also provide services such as financial leasing, loan syndication, consultancy, Merchant Banking, entrepreneurial skill development and support for technology upgradation to the industries in the State. The corporation would also be encouraged to establish a Venture Capital Fund for the entrepreneurs in the state.

4.4.4 Delhi Financial Corporation (DFC)

The Delhi Financial Corporation has been rendering service to small scale entrepreneurs in Delhi and Chandigarh. It has made finance available to existing and prospective entrepreneurs at very reasonable terms.The corporation has devised suitable schemes for catering the needs of different categories of entrepreneurs.

4.4.5 Gujarat State Financial Corporation (GSFC)

Gujarat State Financial Corporation (GSFC) incorporated under the State Financial Corporations Act of 1951, is a trend setter and path breaker in the field of industrial finance. It plays a major role in the development and industrialization of Gujarat by extending credit assistance to suit individual requirements.Gujarat State Financial Corporation established with main object for development activities to contribute to social upliftment, regional dispersal of industrial activities and to adding to Gross Stock Domestic Products. Also for promoting economic growth, balanced regional development and widening of entrepreneurial base by financing small enterprises. GSFC is a premier regional development bank set up by Government of Gujarat, to provide finance to new industrial units, for acquisition of Fixed Assets, Expansion, Modernization, Diversification, Renovation etc. The Industrial concern must set up in the state of Gujarat and the Union Territories of Diu, Dadra and Nagar Haveli.

4.4.6 Haryana Financial Corporation (HFC)

Haryana Financial Corporation (HFC) has been set up under an Act of Parliament known as State Financial Corporation's Act. 1951 and the working is governed by this Act. The Head Office of the Corporation is at Chandigarh and branch offices at each district headquarter of Haryana. HFC meets the credit needs of small/medium scale industrial units by advancing term loans & working Capital. The loans are advanced primarily for acquiring fixed assets such as land, building, plant & machinery, raw material etc.

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4.4.7 Himachal Pradesh Financial Corporation (HPFC)

Himachal Pradesh Financial Corporation (HPFC) was established in the State under the Central Act, viz. The State Financial Corporations Act, 1951, with the basic objective of promoting and developing small scale and medium scale industries in the State with a special focus on spreading industrial culture in the rural, semi-urban and backward areas of the State. The Corporation is owned by the State Government jointly with IDBI and is functioning under the administrative control of the State Government.

4.4.8 Jammu & Kashmir State Financial Corporation (J&KSFC)

The Jammu & Kashmir State Financial Corporation (J&KSFC) was established to act as a Regional Development Bank with the aim of boosting economic development in the State for providing financial assistance in the shape of loans to prospective entrepreneurs for development of Industries. It was incorporated under The SFCs Act 1951 on 2nd December 1959 as a Development Bank for promotion of Small Scale Industries, hotels, houseboats and transport sector in Jammu & Kashmir. The Board of J&K SFC is headed by Honourable Finance Minister, Shri Mohd. Shafi. The Board has been from time to time assessing the performance of institution with a view to achieve the objectives for which it was instituted.

4.4.9 Karnataka State Financial Corporation (KSFC)

The focus of Karnataka State Financial Corporation (KSFC) has always been on the small scale sector, artisans, tiny units and disadvantaged groups. KSFC has been the main term lending institution in most of the districts for first generation entrepreneurs.

4.4.10 Kerala Financial Corporation (KFC)

Kerala Financial Corporation (KFC) was established in the State under the Central Act, viz.. The State Financial Corporations Act, 1951, with the basic objective of promoting and developing small scale and medium scale industries in the state with a special focus on spreading industrial culture in the rural, semi-urban and backward areas of the State. The Corporation is owned by the State Government jointly with IDBI and is functioning under the administrative control of the State Government.

The Chairman and Managing Director of KFC is a senior IAS officer appointed by the State Government in consultation with IDBI. The Board of Directors are highly professional in character and consist of senior executives of the state government, a representative each from RBI, IDBI and SIDBI, besides other interests like Co-operatives, Life Insurance, entrepreneurs are also represented on the Board. Highly professional and technical personnel are employed to carry on the business operations such as M.B.As, C.As., engineers, marketing experts, etc. KFC caters to the requirements of the entrepreneurs by providing term-loan to small and medium scale industries for creation of assets, viz., land, building and machinery. It also provides working capital term-loan to the industrial units on competitive terms.

Kerala Financial Corporation also provide non-fund based services like merchant banking, under-writing of public issues, project counselling, bill discounting, leasing and hire-purchase. It is operating a number of financial assistance schemes for the benefit of

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the entrepreneurs such as assistance for marketing activities, equipment finance, special schemes for assistance to ex-servicemen, single window scheme, etc.

4.4.11 Madhya Pradesh Financial Corporation (MPFC)

Madhya Pradesh Financial Corporation (MPFC) is the premier institution of the State engaged in providing financial assistance and related services to small to medium sized industries. It is registered as Category-I Merchant Banker with Securities Exchange Board of India and setup a separate Merchant Banking Division in the name of MPFC Capital Markets.

MPFC is incorporated in the year 1955, under the State Financial Corporation Act, 1951 (No. LXIII of 1951). It works under the control of the Board of Directors, consisting of representatives from State Government, Industrial Development Bank of India, Small Scale Industrial Development Bank of India, Reserve Bank of India, Scheduled Banks, Insurance Companies, Co-operative Banks and other shareholders. MPFC is a well-knit organisation with its headquarters at Indore - the industrial hub of Madhya Pradesh. It has zonal offices at Raipur, Jabalpur, Bhopal, Gwalior, Indore, Satna, and various branches at different places; making a total of eighteen offices throughout Madhya Pradesh.

4.4.12 The Maharashtra State Financial Corporation (MSFC)

The Maharashtra State Financial Corporation (MSFC) has been set up under the State Financial Corporations Act, 1951. The Corporation operates in State of Maharashtra from 1962 and in State of Goa and Union Territory of Daman & Diu since 1964.The main function of the Corporation is to meet the term loan requirements of small and medium scale industries for acquisition of fixed assets like land, building, machinery and equipment. The loans are given for setting up new industrial units as well as for expansion and modernisation of the existing units.The objective of the Corporation is to promote more industries in backward and developing areas of Maharashtra, Goa and Union Territory of Daman & Diu.

The Corporation is a highly decentralised organisation and has network of offices in all the districts of Maharashtra and Goa except Gadchiroli. There are nine Regional Offices and twenty Branch Offices.

4.4.13 Orissa State Financial Corporation (OSFC)

The Orissa State Financial Corporation (OSFC) is the primary state level financing institution incorporated in the year 1956 under the State Financial Corporations Act, 1951. The Corporation extends term loan for acquiring fixed assets like land, building, plant and machinery, equipment and margin money for working capital for setting up of industries. OSFC also provides working capital assistance under Single Window Scheme. Priority is given to small and tiny sector industrial units in backward areas.

4.4.14 Punjab Financial Corporation (PFC)

The Punjab Financial Corporation (PFC) has been established under the State Financial Corporation Act, 1951, for providing medium and long term loans to small and medium scale industrial undertakings in the State of Punjab. It generally grants term loans for creation/ acquisition of fixed assets like land, building, plant & machinery, provides guarantee against deferred payments for the purchase of capital goods and offers underwriting facility on issue of stocks and shares to companies. The Corporation also provides financial assistance for setting up of hotels, nursing homes/small hospitals, development of industrial estates and purchase of transport vehicles, etc.

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4.4.15 Rajasthan Financial Corporation (RFC)

Since its very inception, the Rajasthan Financial Corporation (RFC) has been striving incessantly towards its goal- that of extending a helping hand to a varied entrepreneurial section of society for their financial requirements. A goal, ultimately aimed at sparring the process of industrialization of its parent State.

For the fulfillment its prime objective, it operates various loan schemes for tiny, small and medium scale industries, many of them tailor-made for specific entrepreneurial classes.

4.4.16 Uttar Pradesh Financial Corporation (UPFC)

Uttar Pradesh Financial Corporation (UPFC) was established in 1954 under the State Financial Corporation Act, 1951 with its Head Office at Kanpur. The UPFC took a humble step for the industrial development of the State of Uttar Pradesh by providing term loan assistance to small and medium scale units. Several units nurtured by UPFC have now become large enterprises.

4.4.17 West Bengal Financial Corporation (WBFC)

West Bengal Financial Corporation (WBFC) was established under the State Financial Corporation Act, 1951. The WBFC provides loans, assistance and term finance to small and medium scale industries.Technical guidance is given to entrepreneurs for project formulation and organisation, restructuring etc. WBFC has formed Entrepreneurs Assistance Cell which holds regular meetings with commercial banks, WBSEB, WBSIC, SISI, WEBCON etc. to render services to the units seeking working capital assistance. The Cell also renders other services like arranging for various inputs like power, industrial sheds, working capital finance etc. Short term finance by way of Working Capital Term Loan to seasonal industries vis. Tea gardens, rice mills, cold storages etc. These loans are self-liquidating in character and do not qualify for refinance from SIDBI, IDBI.

The Corporation is mainly engaged in providing term finance to Small & Medium Scale Industries. However, during the last few years there has been a phenomenal change in the role of Commercial Banks and Financial Institutions. Bank & Financial Institutions are making inroads into each other's specified territory. This means that the Commercial Banks are judiciously extending the net of the terms-finance and Financial Institutions are also providing Short Term finance to the industries. The line of distinction between Commercial Banks and Financial Institutions is getting blurred. In the case of State Financial Corporations, the average cost of funds is high in comparison to that of for commercial banks and the forces of the competition are forcing them to squeeze the operating margin by reducing the spread.

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Check your progress

1. What do you understand by SFCs?
2. What is the major role of SFCs?
3. How many SFCs are in India?

Along with this the mounting financial expenses for servicing the refinance/ borrowings taken earlier as also the increasing administrative expenditure on account of the salary rent, are posing a threat to our business growth and profitability.

4. 5 Performance of State Financial Corporations

4.5.1 Performance of Andhra Pradesh State Financial Corporation (APSFC)

During the Financial Year 2014-15, the Corporation sanctioned Rs. 694.59 crores and disbursed Rs. 673.86 crores as against Rs. 1315.34 crore and Rs. 882.76 crore respectively during the previous financial year 2013-14. The lower performance is due to uncertainties prevailing in both the states on account of Re-organization and delay in framing of respective industrial polices, and APSFC concentrated on consolidation and was selective in lending projects. During the Financial Year 2014-15, the Corporation earned an operating profit of Rs. 80.95 crore against Rs. 93.58 crore earned in the previous year. The Corporation has earned a net profit of Rs. 38.53 crore during current year, after making necessary provisions towards provision for NPAs etc. The Capital Adequacy Ratio (CAR) stood at 15.37%, average cost of borrowings stood at 9.79% as at 31.03.2015. The net NPAs have gone up to Rs. 155.49 crore as on 31.03.2015 from Rs. 135.14 crore as on 31.03.2014. The Corporation has initiated the process of Re-organising the Corporation consequent upon bifurcation of the state. The Corporation already created two divisions viz., Andhra Division and Telangana Division to look after the operational and administrative aspects in the State of Andhra Pradesh and Telangana State respectively. Both the divisions are functioning satisfactorily. The Corporation also tentatively allocated the employees to Andhra and Telangana Divisions based on the nativity of the employees.

4.5.2 Performance of Assam Financial Corporation (AFC)

During the FY 2014-15 the Corporation continued its effort to maximize recovery of dues. The total recovery was 1514.89 lakhs as against 1563.54 lakhs in the previous year. The total principal collections during the year are 802.98 lakhs as against the previous year principal collections of 994.78 lakhs. The interest recovery rose to 689.13 lakhs during the year under review from 543.92 lakhs in the previous year registering a growth of 26.70 % over the previous year. In addition to the above the Corporation could recover an amount of 22.78 lakhs out of prudentially written off loan accounts as against the previous year recovery of 24.84 lakhs. The Corporation has been able to maintain its profit earning trend for 9 consecutive years by earning a nominal profit of 2.31 lakhs during the year 2014-15 in comparison to the previous year profit of 5.17 lakhs. However, this profit has not been adequate to absorb the adjustment made on account of past liabilities resulting into increase of the accumulated loss to 337.32 lakhs during the year. The net profit in the current year has been decreased due to revision of pay to employees and additional provisioning on account of slippage of loan accounts. The Net worth of the Corporation has been declined to 3081.54 lakhs as on 31.03.2015 from 3370.47 lakhs as on 31.03.2014 due to increase in accumulated loss. The Capital to Risk Weighted Assets Ratio stands at 50.42 % as on 31.03.15 compared to 60.78% as on 31.03.14.

4.5.3 Performance of Bihar State Financial Corporation (BSFC)

Table 4.1: Performance of Bihar State Financial Corporation

							Rs. in Crores
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Sanction							
Disbursement	4.34	1.57					
Recovery	16.57	17.41	10.50	9.75	31.21	67.80	28.02

Source: http://bsfc.bih.nic.in/

4.5.4 Performance of Delhi Financial Corporation (DFC)

Table 4.2: Performance of Delhi Financial Corporation

							Rs. in Crores
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Sanction	77.47	25.80	88.37	36.38	38.79	19.78	10.55
Disbursement	60.30	20.93	66.03	23.26	27.25	16.15	10.00
Recovery	59.98	72.50	59.35	64.37	60.89	50.59	42.16

Source: http://www.dfcdelhi.nic.in/profilef.htm

4.5.5 Performance of Haryana Financial Corporation (HFC)

In 2008-09, 2009-10, 2010-11, the loan sanctions and disbursement reduced year by year. There were no sanctions in 2011-12 and the disbursement in the same year was for the previous year's loan.

Table 4.3: Performance of Haryana Financial Corporation

					Rs. in Crores
	2008-09	**2009-10**	**2010-11**	**2011-12**	**2012-12**
Sanction	64.57	23.48	1.16	0.00	11.39
Disbursement	23.94	21.38	3.22	2.37	11.92
Recovery	73.73	58.34	62.03	45.98	39.36

Source: www.hfcindia.org

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4.5.6 Performance of Gujarat State Financial Corporation (GSFC)

Table 4.4: Performance of Gujarat State Financial Corporation

(Rs. in crores)

Sr. No.	Particulars		1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	Since inception
1	2		3	4	5	6	7	8	9	10	11	12	13
(A)	Assistance												
	1. Flow of Applications	No.	632	597	629	640	–	–	–	–	–	–	61756
	Term Loans	Rs.	271.60	375.56	254.16	157.77	–	–	–	–	–	–	5385.60
	2. Loan Sanctioned												
	a. Term Loan	No.	405	444	474	535	21	–	–	–	–	–	46646
		Rs.	157.90	274.40	241.93	86.99	3.18	–	–	–	–	–	3732.10
	b. Lease Finance	No.	4	–	–	–	–	–	–	–	–	–	41
		Rs.	3.97	–	–	–	–	–	–	–	–	–	28.62
	c. Short Term Finance	No.	63	4	13	3	–	–	–	–	–	–	299
		Rs.	45.01	2.16	14.19	1.24	–	–	–	–	–	–	219.48
	d. Line of Credit	No.	–	–	–	–	–	–	–	–	–	–	11
		Rs.	–	–	–	–	–	–	–	–	–	–	80.00
	e. Bill discounting	No.	17	18	–	–	–	–	–	–	–	–	130
		Rs.	111.84	12.35	–	–	–	–	–	–	–	–	227.96
	f. Working Capital	No.	46	94	43	7	–	–	–	–	–	–	225
	Term Loan	Rs.	39.38	75.92	22.17	4.56	–	–	–	–	–	–	174.73
	g. N.H.F.D.C.	No.	–	–	631	298	114	34	538	113	16	–	1744
		Rs.	–	–	2.81	1.07	0.73	0.17	2.00	0.35	0.04	–	7.17
	h. Fund Based Merchant	No.	–	–	–	–	–	–	–	–	–	–	20
	Banking Activity	Rs.	–	–	–	–	–	–	–	–	–	–	26.29
	i. Small Scale Units (SSI)	No.	369	427	442	525	21	–	–	–	–	–	45178
		Rs.	128.77	189.96	175.99	64.48	3.18	–	–	–	–	–	3000.59
	j. Backward District	No.	192	202	165	313	–	–	–	–	–	–	18168
		Rs.	61.29	136.73	72.93	29.17	–	–	–	–	–	–	1482.14
	k. Backward Talukas	No.	146	141	137	19	–	–	–	–	–	–	9759
		Rs.	46.49	102.11	42.17	1.31	–	–	–	–	–	–	1574.47
	l. Rural Areas	No.	201	144	207	282	6	–	–	–	–	–	13589
		Rs.	91.25	144.59	95.81	47.92	1.16	–	–	–	–	–	1935.50
	m. Tribal Area/Talukas	No.	59	52	27	8	–	–	–	–	–	–	4479
	Pockets	Rs.	29.28	32.63	10.55	1.44	–	–	–	–	–	–	652.30

Source: http://gsfc.gujarat.gov.in/RTI/Perfomance.pdf

4.5.7 Himachal Pradesh Financial Corporation (HPFC)

With the passage of time, there is a significant change in the role of SFCs and competition made worse for the survival of SFCs. **Himachal Pradesh Financial Corporation** is not an exception to competition and was compelled to discontinue its lending activity since 2008. With almost all good accounts having been settled and closed, recovery is required to be effected from sticky units and stubborn loanees, which is a herculean task (inspite of adverse circumstances, Corporation earned interest income of Rs.5.23 crore during the year 2014-15 under reference as against Rs. 4.91 crore earned in last year). Total recoveries for the year stood at Rs.10.51 crore which were Rs.16.39 crore in the last year i.e. 2013-14. Corporation has reduced total expenditure to Rs.6.75 crore during the year 2014-15 under reference from Rs.9.29 crore in 2013-14. Since the recovery is dwindling and expenditure is stagnant, the loss for the year stood at Rs.1.09 crore as against Rs.16.49 crore registered last year. The Corporation has carried an accumulated loss of Rs.145.01 crore to balance sheet till the year under reference. Corporation has made payments of Rs. 8.75 crore to SIDBI under OTS. The State Government has provided financial support for redemption of Bonds along with interest of Rs 12.86 crores.

KFC is largely dependent on bulk funds borrowed from other financial institutions for lending to its customers. KFC has successfully borrowed Rs 600 crore from the market through non-SLR bonds during the period 2011-14 including Rs.200 crore raised during 2014-15. Despite stiff competition from commercial banks and changes in government policies affecting the business, Corporation has managed to register a 13.21% increase in its overall loan portfolio and adding new clients, especially young entrepreneurs. However the Corporation had to make increased provisions which have adversely affected the profitability. The Corporation is examining the challenges and opportunities in the wake of changing economic scenario prevailing in the state and emphasis is being laid on the quality of its advances and containing NPAs.

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Table 4.5: Financial highlights of Kerala Financial Corporation

			Rs. in Crores
	2012-13	**2013-14**	**2014-15**
Sanction	661.39	989.62	947.45
Disbursements	475.94	754.73	657.09
Recovery	540.22	565.13	684.27

Source: http://www.kfc.org/financial-results.php

4.5.8 Madhya Pradesh Financial Corporation (MPFC)

During the year, the corporation received 346 applications for Rs. 530.52 crore as against 285 applications for Rs. 465.86 crore received last year. Out of total 346 applications received and 33 applications pending at the beginning of the year, 326 applications of Rs. 490.29 crore were sanctioned. The MSME sector continues to occupy a significant proportion in the total sanctions of the Corporations, out of the total sanction of Rs 490.29 crore, an amount of Rs. 258.37 crore was for MSME sector which is 53% of the total sanctions. The sanction in backward areas amounts to Rs 222.10 crore which represents 455 of the total sanctions.

Table 4.6: Financial highlights of Madhya Pradesh Financial Corporation

		Rs. in Crores
	2013-14	**2014-15**
Sanction	403.53	490.29
Disbursements	287.79	336.77
Recovery	226.58	273.45

Source: http://www.mpfc.org/annualrep1415.pdf

4.6 Key Terms

- **State financial Corporation:** The State Finance Corporations (SFCs) are the integral part of institutional finance structure in the country. SEC promotes small and medium industries of the states. Besides, SFCs are helpful in ensuring balanced regional development, higher investment, more employment generation and broad ownership of industries.
- **Share Capital:** Share capital consists of funds raised by issuing shares in return for cash or other considerations. The amount of share capital a company has can change over time because each time a business sells new shares to the public in exchange for cash, the amount of share capital will increase. Share capital can be composed of both common and preferred shares
- **Public Deposits:** Public deposits are an important source of financing the medium-term and long-term requirements of a company. The term 'public deposit' implies any money received by a company through the deposits or loans collected from the public.

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- **Merchant Bank:** A merchant bank is a financial institution providing capital to companies in the form of share ownership instead of loans. A merchant bank also provides advisory on corporate matters to the firms in which they invest. In the United Kingdom, the historical term "merchant bank" refers to an investment bank.
- **Small & Medium Scale Industries:** The MSMED Act, 2006 defines the Micro, Small and Medium Enterprises based (i) on the investment in plant and machinery for those engaged in manufacturing or production, processing or preservation of goods and (ii) on the investment in equipment for enterprises engaged in providing or rendering of Services.
- **Capital Adequacy Ratio:** Capital Adequacy Ratio (CAR), also known as Capital to Risk (Weighted) Assets Ratio (CRAR), is the ratio of a bank's capital to its risk. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory Capital requirements.
- **NPA:** A nonperforming asset (NPA) refers to a classification for loans on the books of financial institutions that are in default or are in arrears on scheduled payments of principal or interest. In most cases, debt is classified as nonperforming when loan payments have not been made for a period of 90 days. While 90 days of non-payment is the standard period of time for debt to be categorized as nonperforming, the amount of elapsed time may be shorter or longer depending on the terms and conditions set forth in each loan.
- **Lease finance:** Lease financing is one of the important sources of medium- and long-termfinancing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee.
- **Term loans:** A term loan is a monetary loan that is repaid in regular payments over a set period of time. Term loans usually last between one and ten years, but may last as long as 30 years in some cases. A term loan usually involves an unfixed interest rate that will add additional balance to be repaid.

4.7 Summary

- A Central Industrial Finance Corporation was set up under the Industrial Finance Corporation Act, 1948, which fall outside the normal activities of Commercial Banks. The main objective of the Central Industrial Finance Corporation was to provide medium and long term credit to industrial concerns.
- At present there are 18 state finance corporations (out of which 17 SFCs were established under SFC Act 1951). Tamil Nadu Industrial Investment Corporation Ltd. established under Company Act, 1949, is also working as state finance corporation.
- Andhra Pradesh State Financial Corporation (APSFC) is a term lending Institution established in 1956 for promoting small and medium scale industries in Andhra

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Pradesh under the provisions of the Sate Financial Corporation' Act, 1951.

- Assam Financial Corporation (AFC) was established under the Central Act, viz., The State Financial Corporations Act, 1951, with the basic objective of promoting and developing small scale and medium scale industries in the State with a special focus on spreading industrial culture in the rural, semi-urban and backward areas of the States.
- Bihar State Financial Corporation (BSFC) is the main state level institution providing term lending facilities to industrial entrepreneurs. Banks have also shown increasing interest in term lending to industrial units.
- The Delhi Financial Corporation has been rendering service to small scale entrepreneurs in Delhi and Chandigarh. It has made finance available to existing and prospective entrepreneurs at very reasonable terms.
- Gujarat State Financial Corporation (GSFC) incorporated under the State Financial Corporations Act of 1951, is a trend setter and path breaker in the field of industrial finance. It plays a major role in the development and industrialization of Gujarat by extending credit assistance to suit individual requirements.
- Haryana Financial Corporation (HFC) has been set up under an Act of Parliament known as State Financial Corporation's Act. 1951 and the working is governed by this Act. The Head Office of the Corporation is at Chandigarh and branch offices at each district headquarter of Haryana.
- Himachal Pradesh Financial Corporation (HPFC) was established in the State under the Central Act, viz. The State Financial Corporations Act, 1951, with the basic objective of promoting and developing small scale and medium scale industries in the State with a special focus on spreading industrial culture in the rural, semi-urban and backward areas of the State.
- The Jammu & Kashmir State Financial Corporation (J&KSFC) was established to act as a Regional Development Bank with the aim of boosting economic development in the State for providing financial assistance in the shape of loans to prospective entrepreneurs for development of Industries.
- The focus of Karnataka State Financial Corporation (KSFC) has always been on the small scale sector, artisans, tiny units and disadvantaged groups.
- Kerala Financial Corporation (KFC) was established in the State under the Central Act, viz.. The State Financial Corporations Act, 1951, with the basic objective of promoting and developing small scale and medium scale industries in the state with a special focus on spreading industrial culture in the rural, semi-urban and backward areas of the State.
- Madhya Pradesh Financial Corporation (MPFC) is the premier institution of the State engaged in providing financial assistance and related services to small to medium sized industries.
- The Maharashtra State Financial Corporation (MSFC) has been set up under the 'State Financial Corporations Act, 1951. The Corporation operates in State

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of Maharashtra from 1962 and in State of Goa and Union Territory of Daman & Diu since 1964.

- The Orissa State Financial Corporation (OSFC) is the primary state level financing institution incorporated in the year 1956 under the State Financial Corporations Act, 1951. The Corporation extends term loan for acquiring fixed assets like land, building, plant and machinery, equipment and margin money for working capital for setting up of industries.
- The Punjab Financial Corporation (PFC) has been established under the State Financial Corporation Act, 1951, for providing medium and long term loans to small and medium scale industrial undertakings in the State of Punjab.
- The Rajasthan Financial Corporation (RFC) has been striving incessantly towards its goal- that of extending a helping hand to a varied entrepreneurial section of society for their financial requirements.
- Uttar Pradesh Financial Corporation (UPFC) was established in 1954 under the State Financial Corporation Act, 1951 with its Head Office at Kanpur. The UPFC took a humble step for the industrial development of the State of Uttar Pradesh by providing term loan assistance to small and medium scale units.
- West Bengal Financial Corporation (WBFC) was established under the State Financial Corporation Act, 1951. The WBFC provides loans, assistance and term finance to small and medium scale industries.

4.8 Questions and Exercises

1. Give a brief profile of the state financial corporation.
2. Discuss the main objectives and resources of SFCs.
3. Writ short note on:
   (i) Assam Financial Corporation
   (ii) Gujarat State Financial Corporation
   (iii) Kerala Financial Corporation
4. Highlight the performance of State Financial Corporation.

4.9 Further Readings and References

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UNIT 5: OTHER FINANCIAL INSTITUTIONS

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Structure

5.0 Introduction
5.1 Unit Objectives
5.2 Specialised Financial Institutions
5.2.1 The Export Import Bank of India (EXIM)
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5.0 Introduction

In the previous unit we have discussed development banks, refinancing institutions and state level institutions. But as we know for an effective and efficient financial system financial institutions play a vital role. In this unit we are discussing the specialised and other financial institutions. With the continuous growth in economy the above mentioned financial institutions are not able to accomplish the financial needs of the businesses and industries. With this view to cater the increasing financial requirement of the commerce and trade these specialised financial institutions were established. These institutions provide medium and long term financial resources to the industry. Moreover other financial institutions were also established that provide various functions related to the guarantee cover to the loans and advances granted by the credit institutions and insurance to the exporters against the export credit.

5.1 Unit Objectives

After completing this unit students will be able to:

- Understand role and functions of specialised financial institutions
- Know the need and importance for the development of specialised financial institutions
- Learn the structure of other financial institutions

- Know the role and objectives of Deposit Insurance and Credit Guarantee Corporation in India
- Explain functions of Export Credit Guarantee Corporation (ECGC) in India

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5.2 Specialized Financial Institutions

Specialised financial institutions are those financial institutions which serve the increasing financial needs of commerce and trade in the area of venture capital, credit rating and leasing, etc. These are as follows:

5.2.1 The Export Import Bank of India (EXIM)

Export-Import Bank of India is the premier export finance institution of the country, set up in 1982 under the Export-Import Bank of India Act 1981. Government of India launched the institution with a mandate to not just enhance exports from India, but also to integrate the country's foreign trade and investment with the overall economic growth. Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of export credit, like other Export Credit Agencies in the world, Exim Bank of India has evolved into an institution that plays a major role in partnering Indian industries, particularly the Small and Medium Enterprises. It offers a wide range of products and services at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.

5.2.1.1 Functions of The Export Import Bank of India

Exim Bank provides a wide range of financial assistance to Indian Companies, commercial banks and overseas companies. Exim bank offers a wide range of lending programmes, namely, non-funded and funded lending programme. Financial products and services offered by Exim bank are as follows:

1. **Overseas Investment Finance Programme:** Exim Bank encourages Indian companies to invest abroad for, inter alia, setting up manufacturing units and for acquiring overseas companies to get access to the foreign market, technology, raw material, brand, IPR etc. For financing such overseas investments, Exim Bank provides:
   a) Term loans to Indian company's up to 80% of their equity investment in overseas JV/ WOS.
   b) Term loans to Indian companies towards up to 80% of loan extended by them to the overseas JV/ WOS.
   c) Term loans to overseas JV/ WOS towards part financing- capital expenditure towards acquisition of assets, working capital, equity investment in another company, acquisition of brands/ patents/ rights/ other IPR, acquisition of another company, any other activity that would otherwise be eligible for finance from Exim Bank had it been an Indian entity.

d) Guarantee facility to the overseas JV/ WOS for (i) raising term loan/ working capital.

2. **Project Exports:** Projects involve activities like engineering, procurement, construction (civil, mechanical, electrical or instrumental), including provision of all desired and specified equipment and / supplies, construction and building materials, consultancy, technical know-how, technology transfer, design, engineering (basic or detailed), commissioning with other all such related services.

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Exim Bank extends funded and non-funded facilities for overseas turnkey projects, civil construction contracts, technical and consultancy service contracts as well as supplies.

a) Funded facilities

- **Pre-Shipment Credit:**This facility is provided in Indian Rupees and Foreign Currency provides access to finance at the manufacturing stage - enabling exporters to purchase raw materials and other inputs.
- **Post-Shipment Credit:** It finances the export bill after shipment has been made. This facility enables Indian exporters to extend term credit to importers (overseas) of eligible goods at the post-shipment stage, Construction/turnkey projects.
- **Export Project Cash Flow Deficit Finance (EPCDF):** It is provided to Indian Project exporters executing project export contract overseas. The facility (INR/FC) enables project exporters to take care of temporary deficits in their cash-flow during contract execution period.

b) Non-Funded facilities

Indian companies can avail of these facilities to secure & facilitate execution of export contracts or deemed export contracts.

- **Advance Payment Guarantee (APG):** It is issued to project exporters to secure a project mobilization advance as a percentage (10-20%) of the contract value, which is generally recovered on a pro-rata basis from the progress payment during project execution.
- **Performance Guarantee (PG):** IPG for up to 5-10% of contract value is issued valid until completion of maintenance period and/or grant of Final Acceptance Certificate (FAC) by the overseas employer/ client.
- **Retention Money Guarantee (RMG):** This enables the exporter to obtain the release of retained payments from the client prior to issuance of Project Acceptance Certificate (PAC)/ Final Acceptance Certificate (FAC).

3. **Line of Credit (LOC):** It is a financing mechanism through which Exim Bank extends support for export of projects, equipment, goods and services from India. Exim Bank extends LOCs on its own and also at the behest and with the support of Government of India. Exim Bank extends Lines of Credit to Foreign Governments or their nominated agencies such as central

banks, state owned commercial banks, National or regional development banks, overseas financial institutions, Commercial banks abroad, other suitable overseas entities.

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Check your progress

1. Discuss the specialised financial institutions in India.
2. Explain different functions of EXIM bank in Indian Financial system.

4. **Corporate Banking:** The Bank offers a number of financing programmes for Export Oriented Units (EOUs), importers and for companies making overseas investments. The financing programmes cater to the term loan requirements of Indian exporters for financing their new project, expansion, modernization, and purchase of equipment, R&D, overseas investments and also the working capital requirements.
5. **Buyer's Credit:** Overseas buyers/importers can avail this facility for import of eligible goods and services from India on deferred payment terms. The facility enables exporters/contractors to expand abroad and into non-traditional markets.
6. **Research & Analysis:** Exim Bank's Research & Analysis Group (RAG) offers a vast range of research products. The Bank's team of experienced economists and strategists provide insights on aspects of international economics, trade and investment through qualitative and quantitative research techniques.
7. **Marketing Advisory Services:** Exim Bank through its Marketing Advisory Services [MAS] helps Indian exporting firms in their globalisation efforts by proactively assisting in locating overseas distributor(s)/buyer(s)/ partner(s) for their products and services. The Bank assists in identification of opportunities overseas for setting up plants or projects or for acquisition of companies overseas.
8. **Export Advisory Services:** The Export Advisory Services Group [EAS] offers a diverse range of information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness. Value added information and support services are provided to Indian projects exporters on the projects funded by multilateral agencies.

5.2.2 Power Finance Corporation (PFC)

PFC was established on 16th July 1986 as a Financial Institution dedicated to Power Sector financing and committed to the integrated development of the power and associated sectors. During 1990, the PFC was notified as a Public Financial Institution under Companies Act, 1956. The Reserve Bank of India (RBI) registered the corporation as a non-banking financial company. In year 2010, PFC has entered in its silver Jubilee year. It is a Schedule-A, Nav-Ratna CPSE (conferred by Govt. of India on 22nd June, 2007) in the Financial Service Sector, under the administrative control of the Ministry of Power. Its Registered and Corporate Offices are at New Delhi.

5.2.2.1 Objectives of Power Finance Corporation

1. To provide financial resources and encourage flow of investments to the power and associated sectors.
2. To ensure optimum utilization of available resources.
3. To mobilize various resources from domestic and international sources at competitive rates.

4. To work as a catalyst to bring about institutional improvements in restructuring the functions of its borrowers in financial, technical and managerial areas.

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5.2.2.2 Functions of Power Finance Corporation

PFC is engaged in various functions by providing financial products and services to the power and other related sectors. It also acts as a catalyst for the coordination and to accelerate the growth of industrial units. Various financial products and services offered by the PFC are as follows:

i) Financial products

a) Fund based

- **Asset Acquisition Scheme:** Under this scheme PFC provides finance to an entity acquiring assets of another entity to increase volume and competitiveness in its operations, expand operations / business and upgrade the existing technology.
- **Buyers' Line of Credit Scheme:** PFC provides this facility to actual users in power sector for purchases of machinery, equipment and other capital goods on deferred payment basis (Up to 10 years).
- **Project Term Loans:** PFC facilitates financing to eligible borrowers in power and allied sectors for a variety of projects viz. Generation, transmission, distribution, renovation and modernization, metering etc.
- **Corporate Loan:** This facility is provided to the power sector borrower whether government or private so that they can infuse in new power project or can acquire of an existing power project.
- **Debt Refinancing:** PFC provides this facility to refinancing existing debt/ guarantee including forward/backward linkage to power projects.
- **Rupee Short Term Loan Scheme (1 Year):** This facility is provided to meet the immediate requirement of funds. The Rupee Short Term Loan (STL) scheme is available to all existing government sector borrowers that are in the business of generation / transmission / distribution of power.

b) Non- Fund based

- **Deferred Payment Guarantee:** PFC may issue guarantees on behalf of projects to guarantee their payment obligations. Such guarantees may enable projects to secure financing from a wider spectrum of sources at more competitive rates, including borrowings from commercial banks, foreign lenders and the debt capital markets.
- **Guarantee for Credit Enhancement:** The facility will provide credit enhancement of bonds issued in the domestic market by a power project SPV/holding company. This will help in channelizing funds(other than for working capital) for power projects from long term institutional investors, such as insurance and pension funds, through bond markets to financing of power projects at competitive interest rate.

ii) Services

PFC also provides technical, advisory and consultancy services related activities through its subsidiary company namely PFC Consulting Limited.

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5.2.2.3 Government of India Initiatives

- **Ultra Mega Power Projects (UMPPs):** PFC has been entitled as the nodal agency by Ministry of Power (MoP), Government of India (GoI), for development of Ultra Mega Power Projects (UMPPs), with a capacity of at least 3,500 MW each under Tariff based competitive bidding route. These projects will meet the power needs of the country through transmission of power on regional and national grids.

- **Restructured Accelerated Power Development and Reform Programme (RAPDRP):** In July 2008, Ministry of Power, Government of India, has launched the Restructured Accelerated Power Development and Reforms Programme (R-APDRP). It focuses on establishment of base line data, fixation of accountability, reduction of AT&C losses up to 15% level through strengthening & up-gradation of Sub Transmission and Distribution network and adoption of Information Technology during XI Plan. PFC has been designated as the nodal agency to operationalize the programme and shall act as a single window service under R-APDRP.

- **Independent Transmission Projects (ITPs):** Ministry of Power has also initiated Tariff Based Competitive Bidding Process for development and strengthening of Transmission system through private sector participation.

- **Distribution Reforms, Upgrades & Management (DRUM (APDRP):** DRUM addresses the critical development challenge of providing commercially viable and dependable power. PFC has been appointed as Principal Financial Intermediary responsible for technical assistance and training under DRUM components. The roles and responsibilities of PFC for DRUM project are to i) provide management and implementation support, ii) co-ordinate with all stakeholders, iii) act as a financial intermediary and banker for controlling and directing funds (loans and grants) and iv) design mechanism for leveraging resources of other FIs/ Bankers.

- **Delivery through Decentralised Management (DDM):** DDM is a scheme sponsored by Ministry of Power with the objective of showcasing participatory models of excellence in distribution predominantly in rural area, which are sensitive to the local aspirations and requirements. PFC has been appointed as carrier agency for successful implementation of DDM Schemes.

5.2.2.4 Performance Highlight of Power Finance Corporation

During the financial year 2012-13 the PFC has earned net profit of Rs. 4,420 Crore registering a growth of 46%. The Total Income of the Company was Rs. 17,273 Crore registering an increase of 33% over last year.

5.2.2.5 Subsidiaries of Power Finance Corporation

Currently PFC has the following subsidiaries-

PFC Consulting Limited, Coastal Karnataka Power Limited, Coastal Maharashtra Mega Power Limited, Coastal Maharashtra Mega Power Limited, Coastal Tamilnadu Power Limited, Orissa Integrated Power Limited, Sakhigopal Integrated Power Company Limited, Ghogharpalli Integrated Power Company Limited, Tatiya Andhra Mega Power Limited, PFC Green Energy Limited, PFC Capital Advisory Services Limited, Power Equity Capital Advisors Private Limited, Deoghar mega power Limited.

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Check your progress

3. What are the major functions of Power Finance corporation in India.
4. Discuss the objectives of PFC in brief.
5. Explain the need to establish the IRFC in India.

5.2.3 Indian Railway Financial Corporation (IRFC)

Indian Railway Financial Corporation was incorporated on December 12, 1986 under the Companies Act, 1956 as a public limited company. The Government of India, Ministry of Railways incorporated the company as a financial arm of the Indian Railways for the purpose of raising the necessary resources for meeting the developmental needs of the Indian Railways. IRFC is 100% owned by the President of India acting through the Ministry of Railways.

The borrowing programme of IRFC is guided by the requirements projected by Ministry of Railways. IRFC has successfully met the targeted borrowings year after year, through issue of both taxable and tax-free Bonds, term loans from banks/ financial institutions and through off shore borrowings. IRFC also makes use of innovative financial instruments to diversify the debt portfolio and to minimize the cost. Its contribution to infrastructure build-up in Railways is very significant. Till 31st March, 2013, Rolling Stock assets- Locomotives, Coaches and Wagons- valued at Rs. 97,482 crore have been added to the asset base of the Indian Railways with funding assistance from IRFC. IRFC's funding has support technology infusion in the Railways and has enabled Ministry of Railways to purchase new generation Locomotives from General Motors (USA) along with transfer of technology and new generation Coaches from Germany for use in high speed/Shatabdi trains.

5.2.3.1 Performance Highlights of Indian Railway Financial Corporation

Since its inception, IRFC has consistently earned profits and paid dividend adding upto Rs. 1668 crore till 31-03-2012 on a paid up capital of Rs. 500 crore which has been increased to Rs. 800 crore from 2nd June, 2009 and further to Rs. 1,091 crore during 2009-10. The networth of the Company stood at Rs. 5,699.8 crore as on 30.09.2012. Dividend payments for the year 2005-06, 2006-07, 2007-08, 2008-09, 2009-10, 2010-11 and 2011-12 are Rs. 150 crore, Rs. 160 crore, Rs. 100 crore, Rs. 100 crore, Rs. 100 crore and Rs. 100 crore respectively and are the highest ever paid by a Railway PSU. The networth of IRFC as on 30-09-2012 stood at 5,699.8 crore.

The Company's performance has been rated excellent for eleven years in a row by the Department of Public Enterprises. Specially worth mentioning is the ranking of IRFC among the top ten Government Undertakings for the last four years in succession.

5.2.3.2 Future plans of the Indian Railway Financial Corporation

To focus on its existing business and further consolidate its position as a low-cost funding source for MOR.

a) To establish it's pre-eminence as the only market borrowing arm of MoR by providing funding support to Ministry of Railways (MOR) for induction of new technologies in areas of rolling stock, etc.

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b) To diversify its activities through funding financially viable and remunerative railway projects involving port connectivity or specific industry based new lines/gauge conversion projects.

c) To engage in advisory services in financial structuring.

d) To mobilize funds through loans from multilateral agencies such as ADB and World Bank so as to diversify sources of funds and ensure access to desired pool of resources at the most optimum cost.

5.3 Other Financial Institutions

5.3.1 Deposit Insurance and Credit Guarantee Corporation

The Deposit Insurance Corporation (DIC) Bill was introduced in the Parliament on August 21, 1961 by the Parliament. After the passing of the Bill, it got the approval of the President on December 7, 1961 and the Deposit Insurance Act, 1961 came into force on January 1, 1962. The Deposit Insurance Scheme was initially extended to functioning commercial banks only. This included the State Bank of India and its subsidiaries, other commercial banks and the branches of the foreign banks operating in India.

Since 1968, with the enactment of the Deposit Insurance Corporation (Amendment) Act, 1968, the Corporation was required to register the 'eligible co-operative banks' as insured banks. Further, the Government of India, in consultation with the Reserve Bank of India, introduced a Credit Guarantee Scheme in July 1960. The Reserve Bank of India was entrusted with the administration of the Scheme, as an agent of the Central Government and was designated as the Credit Guarantee Organization (CGO) for guaranteeing the advances granted by banks and other Credit Institutions to small scale industries. The Reserve Bank of India operated the scheme up to March 31, 1981.

The Reserve Bank of India also promoted a public limited company on January 14, 1971, named the Credit Guarantee Corporation of India Ltd. (CGCI). The Credit Guarantee Corporation of India Ltd. introduced the Credit Guarantee Schemes. The purpose of these schemes was to encourage the commercial banks to cater to the credit needs of the previously neglected sectors, particularly the weaker sections of the society engaged in non-industrial activities. They provided the guarantee cover to the loans and advances granted by the credit institutions to small and needy borrowers covered under the priority sector.

With a view to integrating the functions of deposit insurance and credit guarantee, the above two organizations (DIC & CGCI) were merged and the present Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence on July 15, 1978. Consequently, the title of Deposit Insurance Act, 1961 was changed to 'The Deposit Insurance and Credit Guarantee Corporation Act, 1961 '. The Head Office of the Corporation is at Mumbai.

Effective from April 1, 1981, the Corporation extended its guarantee support to credit granted to small scale industries also, after the cancellation of the Government of India's credit guarantee scheme. With effect from April 1, 1989, guarantee cover was extended to the entire priority sector advances, as per the definition of the Reserve Bank of India.

5.3.1.1 Functions of Deposit Insurance and Credit Guarantee Corporation

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DICGC is involved mainly in the functions of insurance of deposits and guaranteeing of credit facilities and for other matters connected therewith or incidental thereto. Each depositor in a bank is insured maximum up to Rs.1,00,000 of its deposits by the DICGC. Till 2167 banks are insured under the DICGC.

- **Deposit Insurance**

  Banks covered by Deposit Insurance Scheme

  i. All commercial banks including the branches of foreign banks functioning in India, Local Area Banks and Regional Rural Banks.

  ii. All eligible co-operative banks as defined in Section 2(gg) of the DICGC Act are covered by the Deposit Insurance Scheme. All State, Central and Primary co-operative banks functioning in the States/Union Territories which have amended their Co-operative Societies Act as required under the DICGC Act, 1961.

- **Types of Deposits Covered**

  DICGC insures all bank deposits, such as saving, fixed, current, and recurring, etc. except the following types of deposits.

  i. Deposits of foreign Governments;

  ii. Deposits of central/state Governments;

  iii. Inter-bank deposits;

  iv. Deposits of the State Land Development Banks with the State co-operative banks;

  v. Any amount due on account of and deposit received outside India;

  vi. Any amount which has been specifically exempted by the corporation with the previous approval of the RBI.

- **Returns**

  Every insured bank is required to furnish to the Corporation as soon as possible, after the commencement of each calendar half-year, but not in any event later than the last day of the first month of the half-year, a statement (Form DI Return) in duplicate, showing the basis on which the premium payable by that bank has been calculated and the amount of premium payable by that bank for that half-year. The statement should be certified as correct by two officials authorised by the bank for this purpose and it has to furnish to the Corporation specimen signatures of the officers authorised to sign the statements and returns under the DICGC Act, 1961.

- **Supervision and Inspection of Insured Banks**

  The Corporation is empowered to have free access to the records of an insured bank and to call for copies of such records. On Corporation's request, the RBI is required to undertake / cause the inspection / investigation of an insured bank.

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- **Accounts**

  The Corporation maintains the following Funds:
  a. Deposit Insurance Fund
  b. Credit Guarantee Fund
  c. General Fund

The first two are funded respectively by the insurance premium and guarantee fees received and are utilised for settlement of the respective claims.The General Fund is utilised for meeting the establishment and administrative expenses of the Corporation.The surplus balances in all the three Funds are invested in Central Government securities which is the only investment permissible under the Deposit Insurance and Credit Guarantee Corporation Act, 1961 and the income derived out of such investments is credited to the respective Funds

5.3.2 Export Credit Guarantee Corporation

Export Risk Insurance Corporation (ERIC) was registered on 30th July 1957 in Mumbai as a Private Ltd. Company, entirely state owned, under the Companies Act with an authorized capital of Rs. 5 crores and paid up capital of Rs. 25 lakhs. After introduction of insurance covers to banks during the period 1962-64, ERIC's name was changed to Export Credit & Guarantee Corporation Ltd in 1964. To bring Indian identify in the name, ECGC was renamed as Export Credit Guarantee Corporation of India Ltd in the year 1983.

Export Credit Guarantee Corporation of India Ltd. (ECGC) is a Government of India Enterprise which provides export credit insurance facilities to exporters and banks in India. It functions under the administrative control of Ministry of Commerce & Industry, and is managed by a Board of Directors comprising representatives of the Government, Reserve Bank of India, banking, insurance and exporting community. Over the years, it has evolved various export credit risk insurance products to suit the requirements of Indian exporters and commercial banks. ECGC is the seventh largest credit insurer of the world in terms of coverage of national exports. The present paid up capital of the Company is Rs. 1000 Crores and the authorized capital is Rs. 1000 Crores.

ECGC is essentially an export promotion organization, seeking to improve the competitive capacity of Indian exporters by giving them credit insurance covers comparable to those available to their competitors from most other countries. It keeps its premium rates at the lowest level possible.

5.3.2.1 Objectives of Export Credit Guarantee Corporation

The ECGC has set the following objectives:

- To encourage and facilitate globalization of India's trade.
- To assist Indian exporters in managing their credit risks by providing timely information on worthiness of the buyers, bankers and the countries.
- To protect the Indian exporters against unforeseen losses, which may arise due to failure of the buyer, bank or problems faced by the country of the buyer by providing cost effective credit insurance covers in the form of Policy, Factoring and Investment Insurance Services comparable to similar covers available to exporters in other countries.

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- To facilitate availability of adequate bank finance to the Indian exporters by providing surety insurance covers for bankers at competitive rates.
- To achieve improved performance in terms of profitability, financial and operational efficiency indicators and achieve optimum return on investment.
- To develop world class expertise in credit insurance among employees and ensure continuous innovation and achieve the highest customer satisfaction by delivering top quality service.
- To educate the customers by continuous publicity and effective marketing.

National Export Insurance Account (NEIA)

The National Export Insurance Account has been set up by the Government of India (GOI) and operated by ECGC. It provides adequate credit insurance cover to protect long and medium term exporters against both, political and commercial risks of the overseas country and the buyer/bank concerned. The NEIA trust also provides covers to banks for Buyer's Credit transactions which facilitates foreign buyer to pay for project exports from India.

5.3.2.2 Functions of Export Credit Guarantee Corporation

ECGC provides various functions namely- export credit insurance for exporter, export credit insurance for banks and other functions.

5.3.2.2.1 Export credit insurance for exporter

ECGC provides insurance to the exporter against the goods exported on the credit. It can be to two type-

i) **Short term:** ECGC provides insurance in respect of goods exported on short-term credit. Under the short term insurance there are various schemes or policies offered by the ECGC. These are as follows-

- **Shipments Comprehensive Risks Policy:** Shipments (Comprehensive Risks) Policy, commonly known as the Standard Policy, is the one ideally suited to cover risks in respect of goods exported on short-term credit, i.e. credit not exceeding 180 days. This policy covers both commercial and political risks from the date of shipment.
- **Small Exporters Policy (SEC):** It is issued to exporters whose anticipated export turnover for the period of one year does not exceed Rs.50 lacs.
- **Export Turnover Policy:** The turnover policy envisages projection of the export turnover of the exporter for a year and the initial determination of the premium payable on that basis, subject to adjustment at the end of the year based on actual.
- **Consignment Exports Policy (CEP):** consignment exports where the goods are shipped and held in stock overseas ready for sale to overseas buyers, as and when orders are received. The Consignment Policy cover protects the Indian Exporters from possible losses when selling goods to ultimate buyers.
- **Buyer Exposure Policy (BEP):** In this policy premium would be charged on the basis of the expected level of exposure. Two types of exposure policies – one for covering the risks on a specified buyer and another for covering the risks on all buyers- are offered.

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Check your progress

6. Discuss the functions of DICGC in India.
7. What is NEIA?
8. Explain the main objectives to establish the EGCG.

- **IT-enabled Services Policy:** IT-enabled Services Policy is issued to cover the commercial and political risks involved in rendering IT-enabled services to a particular customer.

ii) **Medium and long term:** ECGC provides insurance in respect of goods exported on medium and long term credit. The time period for the risk covering is 1 year or more than 1 year. Following are the schemes that ECGC provides under the medium term and long term insurance.

- **Construction Works Policy:** Construction Works Policy is designed to provide cover to an Indian contractor who executes a civil construction job abroad.
- **Specific Policy for Supply Contract:** The Standard Policy is a whole turnover policy designed to provide a continuing insurance for the regular flow of an exporter's shipments for which credit period does not exceed 180 days.
- **Specific Shipment Policy:** Specific Shipments Policy can be obtained by exporters that have secured contract for supply of capital goods such as machinery or equipment on deferred terms of payment. The cover provides protection against non-receipt of payments due to commercial and /or political risks.

5.3.2.2.2 Export credit insurance for banks

i) **Short term:** ECGC offers following schemes under the short term insurance.

- **Individual Packing Credit (INPC):** A bank or a financial institution authorized to deal in foreign exchange can obtain the Individual Packing Credit Cover for each of its exporter clients who has been classified as a standard asset and whose CR is acceptable to ECGC.
- **Whole Turnover Packing Credit (WTPC):** In it protection is offered against losses that may be incurred in extending packing credit advances due to protracted default or insolvency of the exporter-client.
- **Individual Post -Shipment (ECIB -INPS):** Any bank or financial institution who is an authorized dealer in foreign exchange can obtain the Individual Post-shipment Export Credit Cover in respect of its exporter client who is holding the appropriate Comprehensive Risks Policy of ECGC but with specific exclusions. Maximum period of cover under this scheme is 12 months.

ii) **Medium and long term :** Following are the schemes offered by ECGC under medium and long term insurance-

- **Individual Packing Credit (INPC):** Packing credit cover can be obtained by the bank that provides advances/credit facilities to the exporters for the purposes of manufacturing, processing, purchasing and/ or packing of goods.
- **Individual Post Shipment (INPS):** Any bank or financial institution who is an authorized dealer in foreign exchange that provides post-shipment finance to the exporter by way of purchase, negotiation or

discount of export bills after the shipment has been affected pertaining to a particular project. The maximum period of cover under this scheme is also 1 year.

- **Export Credit Insurance for Banks- Surety Cover (ECIB-SC):** ECIB (SC) can be considered to those banks whose exporter clients have Standard Asset Classification with an acceptable credit rating weightage/marks/score of 50% and above.

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5.4 Key Terms

- **Specialized Financial Institutions:** Those financial institutions which serve the increasing financial needs of commerce and trade in the area of venture capital, credit rating and leasing, etc.
- **Letter of Credit:** A letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.
- **Credit rating:** An assessment of the credit worthiness of a borrower in general terms or with respect to a particular debt or financial obligation. A credit rating can be assigned to any entity that seeks to borrow money – an individual, corporation, state or provincial authority, or sovereign government.
- **Bank Guarantee:** A bank guarantee enables the customer (debtor) to acquire goods, buy equipment, or draw down loans, and thereby expand business activity.
- **Insurance:** A contract (policy) in which an individual or entity receives financial protection or reimbursement against losses from an insurance company. The company pools clients' risks to make payments more affordable for the insured.
- **Import:** A good or service brought into one country from another. Along with exports, imports form the backbone of international trade. The higher the value of imports entering a country, compared to the value of exports, the more negative that country's balance of trade becomes.
- **Export:** A function of international trade whereby goods produced in one country are shipped to another country for future sale or trade. The sale of such goods adds to the producing nation's gross output.
- **Deposits:** A transaction involving a transfer of funds to another party for safe keeping or a portion of funds that is used as security or collateral for the delivery of a good.
- **Deferred Payment:** A loan arrangement in which the borrower is allowed to start making payments at some specified time in the future. Deferred payment arrangements are often used in retail settings where a person

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buys and receives and item with a commitment to begin making payments at a future date.

- **Corporate Banking:** Corporate banking, also known as business banking, refers to the aspect of banking that deals with corporate customers.
- **Retail Banking:** Retail banking refers to the division of a bank that deals directly with retail customers also known as consumer banking or personal banking. Retail banking is the visible face of banking to the general public, with bank branches located in abundance in most major cities.

5.5 Summary

- Export-Import Bank of India is the premier export finance institution of the country, set up in 1982 under the Export-Import Bank of India Act 1981. Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment.
- EXIM bank offers a wide range of products and services at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.
- PFC was established on 16th July 1986 as a Financial Institution dedicated to Power Sector financing and committed to the integrated development of the power and associated sectors. During 1990, the PFC was notified as a Public Financial Institution under Companies Act, 1956.
- Indian Railway Financial Corporation was incorporated on December 12, 1986 under the Companies Act, 1956 as a public limited company. The Government of India, Ministry of Railways incorporated the company as a financial arm of the Indian Railways for the purpose of raising the necessary resources for meeting the developmental needs of the Indian Railways.
- The IRFC's performance has been rated excellent for eleven years in a row by the Department of Public Enterprises. Specially worth mentioning is the ranking of IRFC among the top ten Government Undertakings for the last four years in succession.
- Deposit Insurance Corporation & Credit Guarantee Corporation of India Ltd. were merged and the present Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence on July 15, 1978.
- DICGC is involved mainly in the functions of insurance of deposits and guaranteeing of credit facilities and for other matters connected therewith or incidental thereto.
- Export Credit Guarantee Corporation of India Ltd. (ECGC) is a Government of India Enterprise which provides export credit insurance facilities to exporters and banks in India.

- ECGC is the seventh largest credit insurer of the world in terms of coverage of national exports. The present paid up capital of the Company is Rs. 1000 Crores and the authorized capital is Rs. 1000 Crores.

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5.6 Questions and Exercises

1. Discuss the need to establish the specialised financial institutions.
2. Explain the role and importance of EXIM bank in Indian financial system.
3. Discuss the objectives to establish the Indian Railway Financial Corporation in India.
4 Give an overview of Power Finance Corporation and its functions.
5. Discuss the various products and services offered by the Export Credit Guarantee Corporation of India Ltd.
6. Brief the role and functions of Deposit Insurance Corporation & Credit Guarantee Corporation of India Ltd.

5.7 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.
2. Saha, S.S., ***"Indian Financial System and Markets",***TMH Education Private Limited.
3. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.

Web resources:

1. "Overview and functions of Power Finance Corporations" available at http://www.pfcindia.com/
2. "History and performance of Indian Railway Financial Corporation" available at irfc.nic.in
3. "Overview of Deposit Insurance and Credit Guarantee Corporation" available at http://www.dicgc.org.in/English/index.html
4. "History of Export Credit Guarantee Corporation" available at www.ecgc.in

UNIT 6: BANKING INSTITUTIONS IN INDIA

NOTES

Structure

6.0 Introduction
6.1 Unit Objectives
6.2 Structure of the Indian Banking Industry
6.3 Functions of Commercial Banks
6.4 Performance of Commercial Banks in India
6.5 Recent Developments in Commercial Banking in India
6.6 History and Structure of the Co-operative Banks
6.7 Performance of the Co-operative Banks
6.8 Key Terms
6.9 Summary
6.10 Questions and Exercises
6.11 Further Readings and References

6.0 Introduction

In the previous unit we have discussed introduction to financial system, role of finance in an economy and financial sector reforms in India. But as we know for an effective and efficient financial system financial institutions play a vital role. In this unit we are discussing the banking institutions in India. Nowadays, the banking sector acts as the backbone of modern businesses. The development of any country mainly depends upon its banking system. In simple words, Banking can be defined as a business activity in which money owned by individuals and entities is accepted and safeguarded, and then lent out to earn a profit. However, with the passage of time, the activities covered by a banking business have widened, and banks now offer various other services. Today, banking services include issue of debit and credit cards; providing safe custody of valuable items, lockers, ATM services and online transfer of funds across the country and world.

6.1 Unit Objectives

After completing this unit students will be able to:

- Understand the structure of Indian Banking Industry
- Explain the functions of commercial banks
- Familiarise with performance of commercial banking in India
- Know recent development in commercial banking in India
- Understand history of the co-operative banks
- Discuss the performance of the co-operative banks in India

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6.2 Structure of The Indian Banking Industry

The banking industry plays a dynamic role in the economic development of a country. The growth of an economy depends on the development of its banking industry. Banks act as the backbone of a country's financial system. They accept deposits from individuals and corporates and lend them to businesses. They use the deposits collected for productive purposes for helping in the capital formation in the country. In India, the central banking authority is the Reserve Bank of India. It is also referred to as the Apex Bank. It functions under an act called The Reserve Bank of India Act, 1934. All the banks operating in India are monitored and controlled by the RBI. The RBI controls the banking sector in India through an Act called "The Banking Regulations Act, 1949".

6.2.1 Scheduled Banks

Scheduled commercial banks are those banks that are included in the second schedule of the RBI Act, 1934, and which carry out the normal business of banking such as accepting deposits, giving loans and other banking services. For a bank to be included in the second schedule (a) it must have paid up a capital and reserves of not less than INR 5 lakh, (b) it must also convince the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors. Scheduled banks are required to maintain a certain amount of reserves with the RBI and in return, they enjoy the facility of financial accommodation and remittance facilities at concessional rates from the RBI. Scheduled banks can be further divided into the following categories: Schedule Commercial banks, Schedule Co-operative banks.

6.2.1.1 Commercial Banks

Commercial banks form a significant part of the country's Financial Institution System. Commercial Banks are those profit-seeking institutions that accept deposits from the general public and advance money to individuals including households, entrepreneurs and businessmen with the prime objective of earning a profit in the form of interest, commission, etc. The operations of all these banks are regulated by the Reserve Bank of India. Commercial banks in India can be divided into the following categories:

1. **Public Sector Banks:** In these banks, the majority stake is held by the Government of India or the Reserve Bank of India. The public sector in Indian banking emerged to its present position in three stages. First, the conversion of the existing Imperial Bank of India into the State Bank of India in 1955, followed by the taking over of the seven state-associated banks as its subsidiary banks. Later on, the State Bank of Indore and State Bank of Saurashtra were merged with the State Bank of India. In the second stage, the nationalization of 14 major commercial banks took place on 19 July 1969. In the third stage, 6 more commercial banks were nationalized on 15 April 1980. In 1993, the New Bank of India was merged with the Punjab National Bank. The public sector accounts for 90 percent of the total banking business in India and the State Bank of India is the largest commercial bank in terms of the volume of all commercial banks.

There are currently 27 public sector banks in India. They include the SBI and its 5 associate banks, 19 nationalized banks (e.g. Allahabad Bank and Canara Bank), IDBI Bank Ltd. and Bhartiya Mahila Bank.

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2. **Private sector Banks:** In the case of private sector banks, the majority of the share capital of the bank is held by private individuals. These banks are registered as companies with limited liability. In 1994, the Reserve Bank of India issued a policy of liberalization to license limited number of private banks, which resulted in New Generation tech-savvy banks. Global Trust Bank was, thus, the first private bank after liberalization; it was later amalgamated with Oriental Bank of Commerce (OBC). Later the Housing Development Finance Corporation Limited (HDFC) became the first (still existing) institution to receive an 'in principle' approval from the Reserve Bank of India (RBI) to set up a bank in the private sector. At present, Private Banks in India includes leading banks, namely, ICICI Bank, ING Vysya Bank, Jammu & Kashmir Bank, Karnataka Bank, Kotak Mahindra Bank.
3. **Foreign Banks:** These banks are registered and have their headquarters in a foreign country but operate their branches in India. The number of foreign banks operating in India has increased since the financial sector reforms of 1991. To operate in India, foreign banks have to obtain a licence from the Reserve Bank of India. As of December 2014, there are 43 foreign banks from 26 countries operating as branches in India and 46 banks from 22 countries operating as representative offices in India. Apart from that, few foreign banks have entered into India via the NBFC route. There are 334 foreign bank branches in India. This strength is less than 1% of the total branch network in the country. However, they account for approximately 7% of the total banking sector assets and around 11% of the profits. Most of the foreign banks in India are niche players and their business is usually focused on trade finance, external commercial borrowings, wholesale lending, investment banking and treasury services. Some of the foreign banks operating in India are Hong Kong and Shanghai Banking Corporation (HSBC), Citibank, American Express Bank and Standard Chartered Bank.
4. **Regional Rural Banks:** Regional Rural Banks (RRBs) were first established in October 2, 1975 and are playing a pivotal role in the economic development of rural India. Rural banks have been established to meet the needs of the weaker sections of society. The main goal of establishing Regional Rural Banks in India is to provide credit to the rural people who are not economically strong enough, especially the small and marginal farmers, artisans, agricultural labour and even small entrepreneurs. The Narasimham Committee conceptualized the foundation of regional rural banks in India. The Committee felt the need of 'regionally oriented rural banks' that would address the problems and requirements of the rural people with local feel, yet with the same level of professionalism of commercial banks. The rural banks had the legislative backing of the Regional Rural Banks Act 1976. This Act allowed the government to set up banks from time to time wherever it considered necessary. Regional Rural Banks were conceived as low cost institutions having a rural ethos, local feel and

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pro-poor focus. Every bank was to be sponsored by a Public Sector Bank. Initially on 2 October 1975, five regional rural banks were set up with a total authorized capital of INR 1 crore, which was later augmented to INR 5 crore. There were five commercial banks, viz. Punjab National Bank, State Bank of India, Syndicate Bank, United Bank of India and United Commercial Bank, which sponsored the regional rural banks. Regional Rural Banks are regulated by National Bank for Agriculture and Rural Development (NABARD). The RRBs were owned by three entities with their respective shares as follows:

- Central Government 50%
- State government 15%
- Sponsor bank 35%

The working and affairs of the RRB are directed and managed by a Board of Directors comprising of a Chairman, three directors to be nominated by the Central Government, and not more than two directors to be nominated by the State Government concerned, and not more than 3 directors to be nominated by the sponsoring bank. The Chairman is appointed by the Central Government and his term of office does not exceed five years.

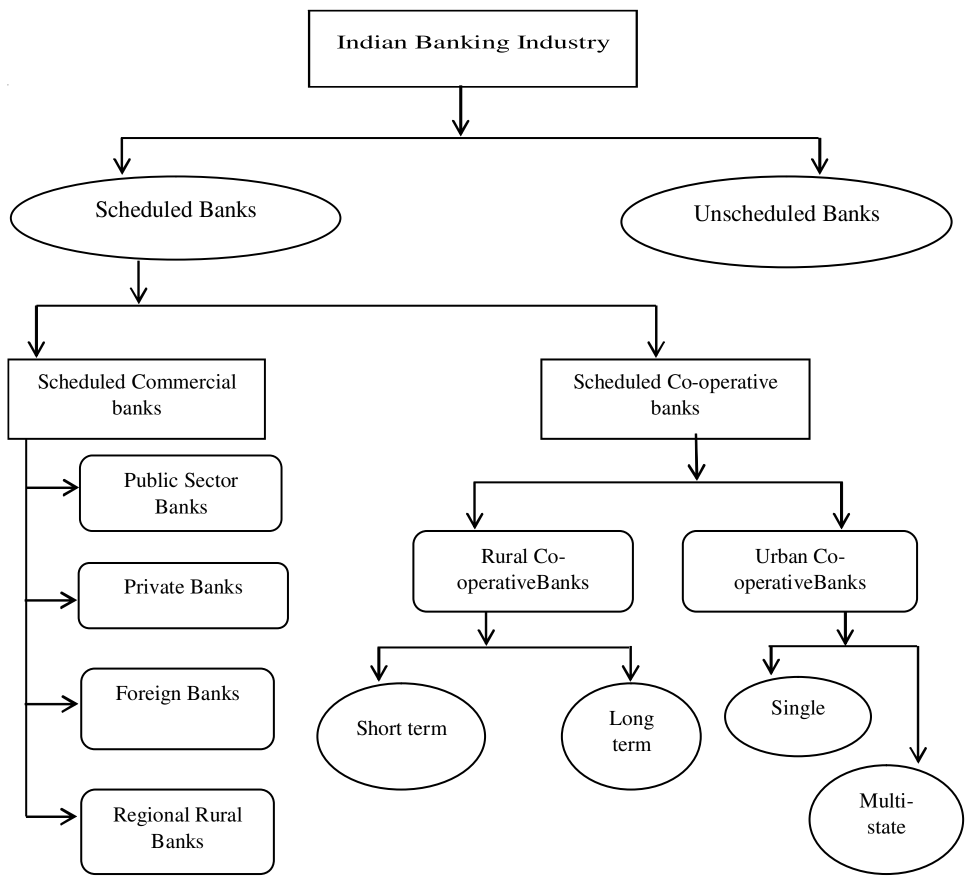

Figure 6.1: Structure of Indian Banking Industry

Source: D&B Industry research service

6.2.1.2 Co-operative Banks

Co-operative banks have become an integral part of the success of the Indian Financial inclusion story. They have achieved many landmarks since their creation and have helped a normal rural Indian to feel empowered and secure. A co-operative bank is a financial entity that belongs to its members, who are also the owners and the customers of their bank. Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest. Co-operative banks have been set up under various Co-operative Society Acts enacted by the State Governments. Hence, the State Governments regulate these banks. In 1966, there was a need to regulate banking activities to ensure their soundness and to protect the interests of depositors. Consequently, certain provisions of the Banking Regulation Act, 1949, were made applicable to co-operative banks as well. Indian cooperative structures are one of the largest such networks in the world with more than 200 million members. It has about 67% penetration in villages and fund 46% of the total rural credit. It also stands for 36% of the total distribution of rural fertilizers and 28% of rural fair price shops.

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Check your progress

1. What do you mean by scheduled banks?
2. Explain the types of commercial banks.
3. Differentiate between public sector banks and private banks.

6.2.2 Unscheduled Banks

These also function in the Indian banking space, in the form of Local Area Banks (LABs). At the end of March 2009, there were only four LABs operating in India. Local area banks are banks that are set up under the scheme announced by the Government of India in August 1996. One bank was amalgamated with the Bank of Baroda in 2004 due to its weak financial position. RBI approved established of only 10 Local Area Banks but out of them only 4 are into existence as of 2015.The intention of the government was to set up new private local banks with jurisdiction over two or three contiguous districts. The objective of establishing the local area banks was to enable to mobilization of the rural savings by local institutions and make them available for investments in local areas.

6.3 Functions of Commercial Banks

In the modern economy, banks play an important role in the financial sector. A Bank is an institution dealing in money and credit. The strength of an economy of any country basically depends on a sound and solvent banking system. They render many valuable services. The important functions of Commercial banks can be divided into the primary and secondary functions.

6.3.1 Primary Functions

Commercial banks have two important banking functions: one is accepting deposits and the other is advancing loans.

6.3.1.1 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 these amounts in banks. Depending upon the nature of deposits, funds deposited in these banks also earn interest. Deposits are accepted by banks in various forms.

i. **Fixed Deposits or Term Deposits:**These are used by the customers to save money for a specific period of time, ranging from 7 days to 3 years or

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more. The rate of interest is related to the period of deposit. For example, a fixed deposit with a maturity period of 3 years will give a higher rate of return than a deposit with a maturity period of 1 year but money cannot be usually withdrawn before the due date. Some banks also impose penalty if the fixed deposits are withdrawn before the due date. However, the customer can obtain a loan from the bank against the fixed deposit receipt.

ii. **Recurring Deposits:** Here, the customer opens an account and de-posits a certain sum of money every month. After a certain period, say 1 year, 3 years or 5 years, the accumulated amount along with the interest is paid to the customer. This is very helpful to people from the middle and poor sections of the society.

iii. **Savings Account Deposits:** These deposits can only be held by individuals and non-profit institutions. The rate of interest paid on savings deposits is lower than that of time deposits. The savings account holder gets the advantage of liquidity and small income in the form of interest. Savings bank account-holder is required to maintain a minimum balance in his account to avail of cheque facilities.

iv. **Current Account Deposits:** These accounts are maintained by people who need to have a liquid balance. A current account offers high liquidity. No interest is paid on cur-rent deposits, and there are no restrictions on withdrawals from the current account. If the customer overdraws the account, he may be required to pay interest to the bank. Cash credit facility is allowed in the current account.

6.3.1.2 Grant of Loans and Advances

The second important function of a commercial bank is to grant loans and advances. The deposits received by banks are not allowed to remain idle. So, after keeping certain cash reserves, the balance is given to needy borrowers and interest is charged from them, which is the main source of income for these banks. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than is 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.

i. **Cash Credit:** This is an arrangement whereby the bank allows the borrower to draw amounts upto a specified limit. A credit limit is sanctioned and the amount is credited in his account. The borrower may withdraw any amount within his credit limit and interest is charged on the amount actually withdrawn. Cash Credit is granted as per the agreed terms and conditions informed to the customers.

ii. **Demand Loans:** Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the account and interest is payable on the entire sum.

iii. **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 dishonoured on the due date, the bank can recover the amount from the customer.

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6.3.2 Secondary Functions

Banks offer various services to the public. Such services are termed non-banking or secondary functions. The secondary functions can be classified under two heads, namely, agency functions and general utility functions.

6.3.2.1 Agency Functions

Banks perform certain functions on behalf of their customers. While performing these services, banks act as agents to their customers; hence, these are called agency services. Important agency functions are as follows:

i. **Collection and Payment of Various Items:** Commercial banks collect cheques, drafts, bills, promissory notes, dividends, subscriptions, rents and any other receipts that are to be received by the customer. For these services, banks charge a nominal amount. Banks also make payments of taxes, insurance premium, etc. on standing instructions of their clients. For such services, banks charge a commission.

ii. **Purchase and Sale of Foreign Exchange:** Some commercial banks are authorized by the central bank to deal in foreign exchange. They buy and sell foreign exchange on behalf of their customers and help in promoting international trade.

iii. **Income-Tax Consultant:** Commercial banks act as income-tax consultants. They prepare and finalise the income tax returns of their clients.

iv. **Sale and Purchase of Financial Assets:** As per the customers' instructions, banks undertake sale and purchase of securities, shares and any other financial assets. Banks charge only nominally for these services.

6.3.2.2 General Utility Services:

Modern Commercial banks render certain general utility services for the community, such as

i. **Letter of Credit:** Banks also deal in foreign trade. They issue a letter of credit and provide guarantee to foreign traders for the soundness of their customers.

ii. **Discounting of Bill of Exchange:** Banks also provide short term financing to business firms by discounting their bills of exchange.

iii. **Transfer of Funds:** Banks arrange transfer of funds cheaply and safely from one place to another. Transfer can be in the form of a Demand draft, Mail transfer, Travellers cheques, etc.

iv. **Guarantor:** Banks offer a guarantee of payment on behalf of the importer to facilitate imports with deferred payments.

v. **Underwriting:** This facility is provided to Joint Stock Companies and to the government to enable them to raise funds. Banks guarantee the purchase of a certain proportion of shares, if not sold in the market.

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vi. **Locker Facility:** Safe Lockers are provided to customers, so that they can deposit their valuables including Jewellery, Securities, Shares and other documents.

vii. **Referee:** Banks may act as referees with respect to financial standing, business reputation and respectability of customers.

6.4 Performance of Commercial Banks

The banks are the lifelines of the economy and play a catalytic role in activating and sustaining economic growth. The slowdown in growth in the balance sheets of banks witnessed since 2011-12 continued during 2014-15. The moderation in assets growth of scheduled commercial banks (SCBs) was mainly attributed to tepid growth in loans and advances to below 10 per cent (figure 6.2). Growth in investments also slowed down marginally. The decline in credit growth reflected the slowdown in industrial growth, poor earnings growth reported by the corporates, risk aversion on the part of banks in the background of rising bad loans and governance related issues. Further, with the availability of alternative sources, corporates also switched part of their ûnancing needs to other sources such as external commercial borrowings (ECBs), corporate bonds and commercial papers. On the liabilities side, growth in deposits and borrowings also declined significantly. Bank-group wise, public sector banks (PSBs) witnessed deceleration in credit growth in 2014-15; private sector banks (PVBs) and foreign banks (FBs), however, indicated higher credit growth.

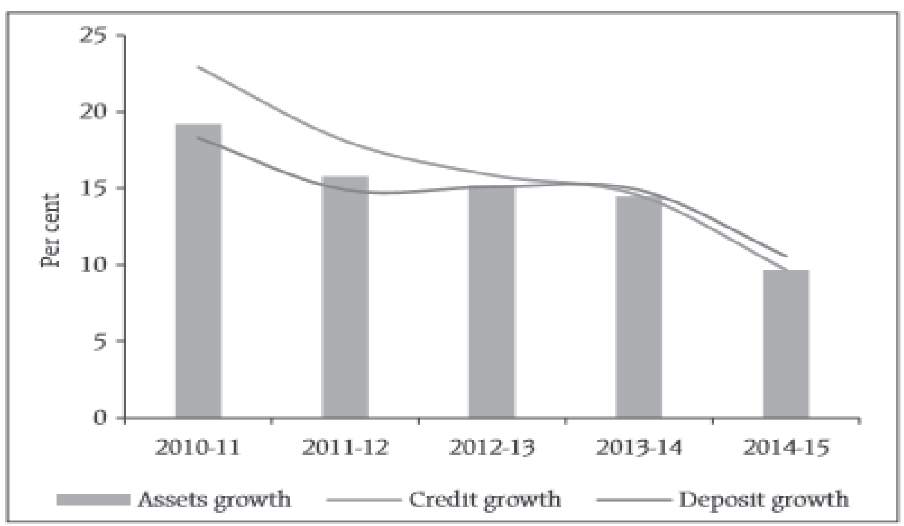

Figure 6.2: Movements in assets, credit and deposit growth of the SCBs

Source: Annual accounts of banks and RBI staff calculations

6.4.1 Current Accounts and Saving Account Deposits

Growth in current account and saving account (CASA) deposits moderated due to decline in saving deposits which in turn got reflected in deceleration in overall deposit growth (Figure 6.3). Bank-group wise, Public Sector Banks recorded decline in CASA deposits while Private Banks and Foreign Banks recorded higher growth during 2014-15.

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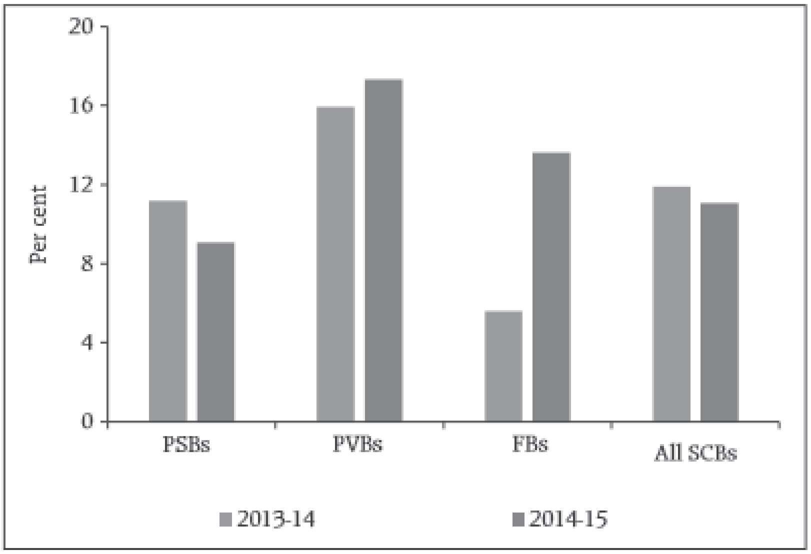

Figure 6.3: Growth in CASA deposits growth of the SCBs

Source: Annual accounts of banks and RBI staff calculations

6.4.2 Credit-Deposit Ratio

Credit-Deposit (C-D) ratio of the SCBs stood at around 78 per cent, same as that of previous year. Among the bank-groups, the C-D ratio of the private sector banks improved marginally with the other constituents recording a decline.

6.4.3 Maturity Profile of Liabilities and Assets

The maturity profile of liabilities of the SCBs witnessed an improvement during 2014-15 as the proportion of short-term liabilities declined and that of long-term liabilities increased. On the assets side, share of long-term assets declined and the share of short-term assets increased marginally. This can be seen in the light of risk aversion on the part of banks in the backdrop of rising share of nonperforming loans. The proportion of long-term loans and advances declined to 27.3 per cent in 2014-15 from 28.9 per cent in the previous year. The Public Sector Banks, however, had 52 per cent of their investments in more than 5 year maturity bracket during 2014-15 while investments of the Private Banks and Foreign Banks in that tenor, aggregated 30.4 per cent and 5.6 per cent, respectively.

6.4.4 Financial Performance of the SCBs

Both interest earnings and interest expended recorded a lower growth during 2014-15 as compared to the previous year. However, decline in interest income was marginally higher than interest expended. As a result, net interest income grew less than the previous year despite an improvement in the operating expenses (through reduction in the growth of wage bill). Also, the pace of increase in provisions and contingencies due to delinquent loans declined sharply. This led to an increase in net profits at the aggregate level by 10.1 per cent during 2014-15 as against a decline in net profits during the previous year. Following the trend in the recent past, both net interest margin (NIM) and spread (difference between return and cost of funds) witnessed marginal decline. During 2014-15, return on assets (RoA) remained at the same level as previous year, however, return on equity (RoE) dipped marginally

(Table 6.1). At the bank-group level, the RoA of Public sector banks declined though that of Private banks and Foreign banks showed an improvement.

Table 6.1: ROA and ROE of SCBs – Bank-group wise

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Check your progress
4. What are the primary functions of the commercial bank?
5. Explain the cash credit.

(Per cent)

S.No.	Bank group	Return on assets		Return on equity	
		2013-14	**2014-15**	**2013-14**	**2014-15**
1	Public sector banks	0.50	0.46	8.47	7.76
	1.1 Nationalised banks	0.45	0.37	7.76	6.44
	1.2 State bank group	0.63	0.66	10.03	10.56
2	Private sector banks	1.65	1.68	6.22	15.74
3	Foreign banks	1.54	1.87	9.03	10.24
4	All SCBs	0.81	0.81	10.68	10.42

Notes: Return on Assets = Net profit/Average total assets.
Return in Equity= Net profit/Average total equity.
*Nationalised banks include IDBI Bank Ltd.
Source: Annual accounts of banks and RBI staff calculations

6.4.5 Credit Growth

Following the overall trend, credit growth to priority sector also declined during 2014-15 and this decline was spread over all the subsectors with growth in credit to agriculture declining to 12.6 per cent from 30.2 per cent in the previous year. Credit to priority sectors by Public sector banks and private banks and Foreign banks was 38.2 per cent, 43.2 per cent and 32.2 per cent (of adjusted net bank credit (ANBC)/ credit equivalent of off-balance sheet exposure, whichever is higher) respectively, during the year. Thus, PSBs indicated a shortfall from the overall target of 40 per cent. Within priority sector credit, both Public sector banks (16.5 per cent) and Private sector banks (14.8 per cent) had a shortfall in advances to agricultural sector against the target of 18 per cent.

Retail loan portfolio of the banks continued to grow at around 20 per cent during 2014-15 even though there was deceleration in the total credit growth of banks. Housing loans (constituted around half of the total outstanding retail loans) and credit card receivables grew by more than 20 per cent. Auto- loans also recorded a recovery.

Capital market, real estate market and commodities market have been classified as sensitive sectors as flctuations in prices of underlying assets in these sectors could adversely affect the asset quality of banks. In 2014-15, sensitive sectors accounted for 18.5 per cent of the total loans and advances of banks. Within these sensitive sectors, more than 90 per cent comprised lending to real estate market. However, in line with overall trend, credit growth to sensitive sectors also witnessed a decline on account of lower growth in lending to real estate market. Nevertheless, lending to capital market recorded higher growth during 2014-15. At the bank group level, in both the sectors, Foreign banks' exposure was highest followed by Private sector banks.

6.5 Recent Development in Commercial Banking in India

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The Banking Industry has evolved tremendously over a period of time. Nowadays, modern banking sector is doing away with its traditional methods and shifting focus to a more advanced and digitally connected network. While many countries are still struggling to get basic banking facilities, there are others that are growing not only in number but facing fierce competition from non-banks. As we all know, banking, in recent years, is not all about depositing and taking loans but much more. With many new technologies, we focus on a few developments that we could see the rise of a more innovative banking industry in 2015.

6.5.1 Digital Revolution

Undoubtedly, this technology surpasses most of the recent developments in banking history. Traditional banking is becoming practically non-existent, as banks get more and more digitally equipped. The revolution will surpass even the trouble of taking out cash through ATMs.

6.5.2 Growth in Automated Teller Machines (ATMs)

The banks increased their penetration further with the total number of ATMs reaching 0.18 million in 2015. However, there was a decline in growth of ATMs of both Public sector banks as well as Public sector banks. Public sector banks recorded a growth of 16.7 per cent during 2014-15 maintaining a share of around 70 per cent in total number of ATMs. Foreign banks continued to record a negative growth in number of ATMs.

6.5.3 Population Group-wise Distribution of ATMs

In recent years, the shares of ATMs in rural and semi-urban area have been rising, though urban and metropolitan centres still dominate. In 2015, about 44 per cent of the ATMs were located in rural and semi-urban centres.

6.5.4 Off-site ATMs

The share of off-site ATMs in total ATMs increased to 50.9 per cent as at end-March 2015 from 47.9 per cent in the previous year. The increase in share of off-site ATMs of public sector banks played a major role, which increased to 45.7 per cent in 2015 from 40.3 per cent in 2014. The share of private sector and foreign banks was already more than 60 per cent.

6.5.5 White Label ATMs

Looking at the effciency and cost-effectiveness of off-site ATMs, non-bank entities were allowed to own and operate ATMs called ‘White Label ATMs (WLA)’ by the Reserve Bank in 2012. As on October 31, 2015, 10,983 WLAs were installed

6.5.6 Debit Cards and Credit Cards

Issuance of debit cards is much higher as compared to credit cards and they remain a preferred mode of transactions. In 2012, there were 6.3 credit cards for every 100 debit cards, which declined to 3.8 in 2015. Public sector banks maintained a lead over Private sector banks and foreign banks in issuing debit cards. As on

March 31, 2015 approximately 83 per cent of the debit cards were issued by Public sector banks, while around 80 per cent of the credit cards were issued by the Private sector banks (57.2 per cent) and foreign banks (22.4 per cent).

6.5.7 Prepaid Payment Instruments

Pre-paid payment instruments (PPIs) are payment instruments that facilitate purchase of goods and services, including funds transfer, against the value stored on such instruments. The value stored on such instruments represents the value paid for by the holders by cash, by debit to a bank account, or by credit card. In the past few years, PPIs have emerged as an easy alternative to cash for performing day to day small value payment transactions. Value of PPIs has increased from 79.2 billion in 2012-13 to 213.4 billion in 2014-15. Among the PPI instruments, PPI card has been the most popular one, with non-bank PPIs having fuelled most of this growth.

6.5.8 Financial Inclusion

The Reserve Bank continued its efforts towards universal fiancial inclusion. Given the boost provided by the Pradhan Mantri Jan Dhan Yojana (PMJDY) during the period, considerable banking penetration has occurred, particularly in rural areas. However, significant numbers of banking outlets operate in branchless mode through business correspondents (BCs)/facilitators. Dominance of BCs in the rural areas can be gauged from the fact that almost 91 per cent of the banking outlets were operating in branchless mode as on March 31, 2015. As on December 9, 2015, 195.2 million accounts have been opened and 166.7 million RuPay debit cards have been issued under PMJDY. The scheme was launched on 28th August, 2014 with the objectives of providing universal access to banking facilities, providing basic banking accounts with overdraft facility and RuPay Debit card to all households, conducting financial literacy programmes, creation of credit guarantee fund, micro-insurance and unorganised sector pension schemes. The objectives are expected to be achieved in two phases over a period of four years up to August 2018. Banks are also permitted to avail of Reserve Bank's scheme for subsidy on rural ATMs. The objectives of the financial inclusion plan (FIP), spearheaded by the Reserve Bank and PMJDY are congruent to each other.

6.6 History and Structure of Co-operative Banks

6.6.1 History of Co-operative Banks

Co-operatives started out as small grass roots organizations in Western Europe, North America and Japan in the middle of the 18th century. The idea spread when the continent was faced with economic turmoil which led large populations to live at subsistence level without any economic security. People were forced to poverty and deprivation. It was the idea of Hermann Schulze (1808-83) and Friedrich Wilhelm Raiffeisen (1818-88) which took shape as cooperative banks of today across the world. They started to promote the idea of easy availability of credit to small businesses and for the poor segment of society. It was similar to the many microfinance institutions which have become highly popular in developing economies today. These movements were supported by governments of the respective countries. This success was achieved due to the failure of the commercial banks to fund and support the needs of small business owners and ordinary people who were outside the network of formal banking. Cooperative banks helped in overcoming the vital market imperfections and serviced the poorer layers of society.

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Indian Cooperative Banks were also born out of distress prevalent in Indian society.

- The Cooperative Credit Societies Act, 1904 led to the formation of Cooperative Credit Societies in both rural and urban areas. The act was based on recommendations of Sir Frederick Nicholson (1899) and Sir Edward Law (1901). Their ideas in turn were based on the pattern of Raiffeisen and Schulze respectively.
- The Cooperative Societies Act, 1912 further gave recognition to the formation of non-credit societies and the central cooperative organizations. In independent India, with the onset of planning, the cooperative organizations gained more leverage and role with the continued government's support.
- In 1915, Machlagan Committee highlighted the deficiencies of cooperative societies which were aroused due to lack of proper education to the masses. He also laid down the importance of Central Assistance by the Government to support the movement.
- The Royal Commission on Agriculture (1928) enumerated the importance of education of members/staff for effective implementation of cooperative movement.
- In 1945, Saraiya Committee further recommended the setting up of a Cooperative Training College in every state and a Cooperative Training Institute for Advanced Study and Research at the Central level.
- In 1953, Central Committee for Cooperative Training was constituted by RBI for establishing Regional Training Centres. Rural Credit Survey Committee, 1954 was the first committee formed till then to first delve into the problems of rural credit and other financial issues of rural society. The cooperative movement and banking structures soon spread and resonated with the unexpressed needs of the rural Indian and small scale businesses. Since, 1950s, they have come a long way to support and provide assistance in activities like credit, banking, production, processing, distribution/marketing, housing, warehousing, irrigation, transport, textiles, dairy, sugar etc. to households.

6.6.2 Structure of Co-operative Banks

The structure of cooperative banks in India can be divided into 2 broad segments, namely, Urban Cooperative Banks and Rural Cooperatives.

6.6.2.1 Urban Co-operatives

The term Urban Co-operative Banks (UCBs), though not formally defined, refers to primary cooperative banks located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. They essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably. Urban Co-operatives can be further divided into scheduled and non-scheduled. Both the categories are further divided into multi-state and single-state. Majority of these banks fall in to the non-scheduled and single-state category.

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Check your progress

6. Discuss the financial inclusion.
7. What do you mean by Co-operative banks?
8. Explain the types of Co-operative banks.

- Banking activities of Urban Cooperative Banks are monitored by RBI.
- Registration and Management activities are managed by Registrar of Cooperative Societies (RCS). These RCS operate in single-state and Central RCS (CRCS) operate in multiple state.

6.6.2.2 Rural Co-operatives

The rural cooperatives are further divided into short-term and long-term structures. The short-term cooperative banks are three tiered operating in different states. These are

i. **State Cooperative Banks:** This is a federation of central co-operative bank and acts as a watchdog of the co-operative banking structure in the state. Its funds are obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India. The state co-operative banks lend money to central co-operative banks and primary societies and not directly to farmers.

ii. **District Central Cooperative Banks:** These are the federations of primary credit societies in a district and are of two types – those having a membership of primary societies alone and those having a membership of societies and individuals. The bank funds consist of share capital, deposits, loans and overdrafts from state co-operative banks and joint stocks. These banks finance member societies within the limits of the borrowing capacity of societies. They also conduct all the business of a joint stock bank.

iii. **Primary Agricultural Credit Societies:** The Primary Co-operative Credit Society (PACSs) is an association of borrowers and non-borrowers residing in a particular locality. The funds of the society are derived from the share capital and deposits of members and loans from central co-operative banks. The borrowing powers of the members as well as of the society are fixed. Loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, implements etc. The main functions of the PACSs are to provide short and medium term credit; supply agricultural and other production requirements and undertake marketing of agricultural produce. In addition, the co-operatives help in formulating and implementing a plan for agricultural production for the village and undertake such educative, advisory and welfare functions as the members might be willing to take up.

Likewise, the long-term structures are further divided into –

i. **State Cooperative Agriculture and Rural Development Banks (SCARDS) -** These operate at state-level.

ii. **Primary Cooperative Agriculture and Rural Development Banks (PCARDBS)-**They operate at district/block level.

The rural banking cooperatives have a complex monitoring structure as they have a dual control which has led to many problems. A Forum called State Level Task Force on Cooperative Urban Banks (TAFCUB) has been set-up to look into issues related to duality in control. All banking activities are regulated by a shared arrangement between RBI and NABARD. All management and registration activities are managed by RCS.

6.7 Performance of Co-operative Banks

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As at end-March 2015, India's co-operative banking sector comprised of 1,579 Urban Co-operative Banks (UCBs) and 94,178 Rural Co-operative Credit Institutions, including short-term and long-term credit institutions. During 2014-15, the UCBs witnessed a moderation in their asset growth and an increase in their net profits. During 2013-14, the balance sheets of all rural co-operative banks, except the short-term State Co-operative Banks (StCBs), witnessed either deceleration or reversal in growth. The state level short term and long-term rural co-operatives witnessed a decline in net profits.

6.7.1 Urban Co-operative banks

The consolidation of the UCBs continued as the number of UCBs came down from 1,606 in 2013 to 1,579 in 2015. The Reserve Bank had ordered closure of six UCBs in September 2014 on account of charges of money laundering.

- Growth in assets of UCBs witnessed moderation during 2014-15 as compared to the previous year (Figure 6.4). Slowdown in growth of assets was led by lower growth in 'other assets' of UCBs. Loan & advances grew by about 12 per cent and contributed significantly to the total increase in assets in 2014-15.

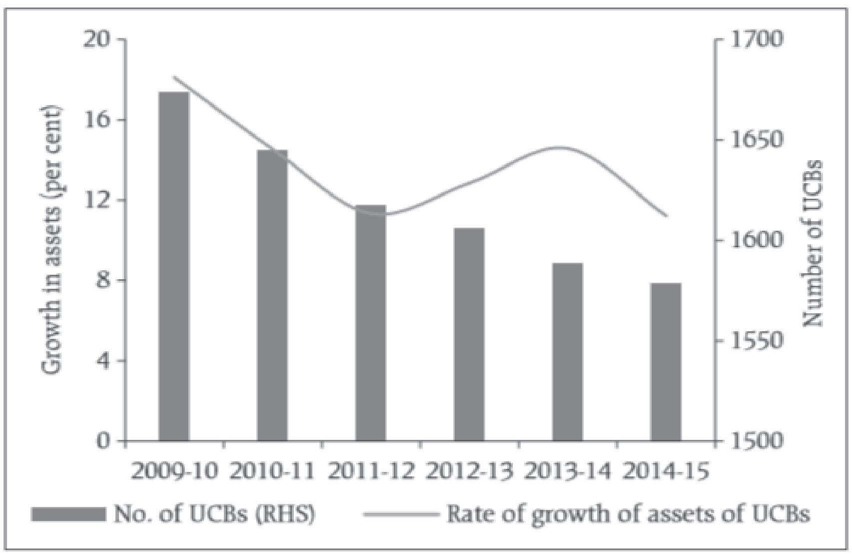

Figure 6.4: Total number and growth in assets of UCBs

Source: RBI supervisory returns and staff calculations

- The UCBs performed well in terms of return on equity (RoE). Net interest margin (NIM), however, marginally moderated (Figure 6.5). There was a deceleration in growth of both interest income and interest expense while the growth in other income and other operating expenses increased during 2014-15.

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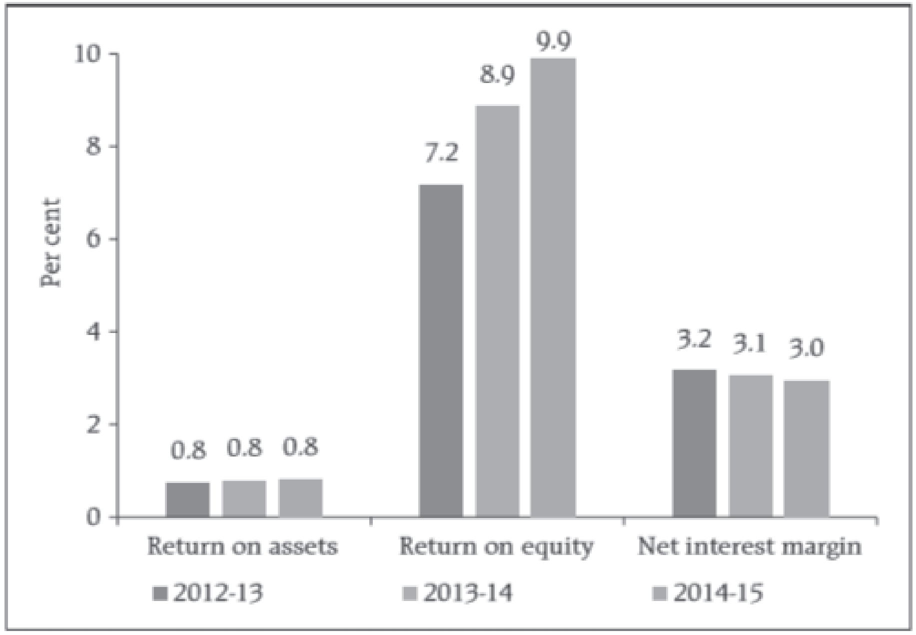

Figure 6.5 : Select indicators of profitability of UCBs

Source: RBI supervisory returns and staff calculations

- The gross non-performing advances (GNPAs) ratio witnessed an increase in 2014-15 over the previous year with the GNPA ratio rising to 6.0 per cent at end-March 2015 from 5.7 per cent at end-March 2014. Net NPA ratio also increased from 2.2 per cent to 2.7 per cent during the same period. At end-March 2015, provisions grew at a lower rate than the increase in gross NPAs resulting in a lower provisioning coverage ratio as compared to the previous years.

6.7.2 Rural Co-operative banks

The share of short-term credit co-operatives, comprising State Co-operative Banks (StCBs), District Central Co-operative Banks (DCCBs) and Primary Agricultural Credit Societies (PACS) stood at about 93 per cent of the total assets of the rural co-operative credit institutions as on March 31, 2014 while the long-term credit co-operatives accounted for the remaining.

6.7.2.1 Short term rural credit – StCBs and DCCBs

The balance sheet of state and district co-operatives expanded during 2013-14, however, the expansion slowed down in 2013-14 for the DCCBs. This moderation has been on account of a fall in reserves. Income of StCBs in 2013-14 grew by 9.7 per cent as against an increase of 13 per cent in their expenditure during the same period. Major component that contributed to the variation in expenditure was a steep increase in provisioning and contingencies. The growth in net profts of DCCBs has decelerated sharply during 2013-14 on account of growth in both interest and non-interest expenses. The NPAs of DCCBs increased during the year 2013-14. In terms of financial stability indicators, the StCBs outperformed the DCCBs.

During 2013-14, the NPA ratio of StCBs fell across all regions except the southern region. The southern region showed an increase in NPA ratio (4.3 to 5.4

per cent) although the recovery ratio for the region increased as well.At the district level, the DCCBs in the southern region saw a marginal increase in NPA ratio in 2013-14 and the recovery ratio at the district level also declinedduring the year. During 2013-14, the recovery ratio fell at the district level across all regions except western (71.4 to 75.2 per cent) and central regions (63.5 to 70.8 per cent).

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6.7.2.2 Primary agricultural credit societies (PACS)

After witnessing a growth in credit outstanding in 2012-13, the rate of credit growth of PACS slowed down in 2013-14.The overall borrower to member ratio, which is a useful indicator of access to credit from PACS, continued to fall from 2011-12 levels. Farmers – small and marginal–remain the majority members of the PACS and also have the highest borrower to member ratio among all groups. The borrower-member ratio has declined over the previous three years.

During 2013-14, the percentage of loss-making PACS remained stable and the percentage of PACS making profits increased marginally to 46.6 per cent. The eastern region, followed by the north-eastern region, continues to remain the weakest performing region with the loss-making PACS outnumbering the profit-making PACS (figure 6.6). The northern and the central region continue to remain the strongest as the number of profit-making PACS are much higher than that of the loss-making PACS.

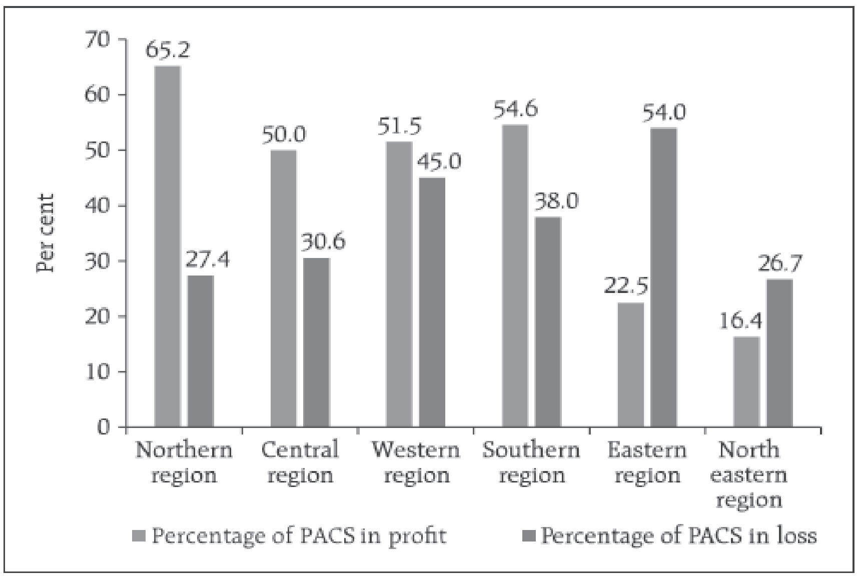

Figure 6.6: Percentage of PCAS in profit and loss- regional level as on March 31, 2014

Source: NAFSCOB

6.7.2.3 Long term rural credit – state co-operative agriculture and rural development banks (SCARDBs)

Balance sheet growth for SCARDBs decelerated from eight per cent in 2012-13 to about one per cent in 2013-14. The growth in reserves and loans and advances has been outweighed by negative growth in 'other liabilities' and 'other assets'. Among expenses, the share of operating expenses has fallen on account of fall in non-wage expenses that has off-set the increase in the wage expenses.

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6.7.2.4 Long term rural credit – primary co-operative agriculture and rural development banks (PCARDBs)

The balance sheet contraction in 2013-14 as opposed to balance sheet expansion during 2012-13, was broad based on account of fall in 'other liabilities', loans and advances and 'other assets'. In 2013-14, income of PCARDBs increased at a higher rate than their expenditure. The NPA ratio of SCARBDs declined marginally while that of PCARDBs remained almost stable in 2013-14.

6.8 Key Terms

- **Scheduled commercial banks:** The scheduled commercial banks are those banks which are included in the second schedule of RBI Act 1934 and which carry out the normal business of banking such as accepting deposits, giving out loans and other banking services.
- **Public sector banks:** Public Sector Banks (PSBs) are banks where a majority stake (i.e. more than 50%) is held by a government. The shares of these banks are listed on stock exchanges. There are a total of 27 PSBs in India [21 nationalized banks + 6 State bank group (SBI + 5 associates)].
- **Foreign banks:** A foreign bank is a bank with head office outside the country in which it is located. Foreign banks are obligated to follow the regulations of both the home and host countries.
- **Co-operative banks:** A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest. Co-operative banks generally provide their members with a wide range of banking and financial services (loans, deposits, banking accounts).
- **Financial inclusion:** Financial inclusion is the delivery of financial services at affordable costs to vast sections of disadvantaged and low income groups (for example "no frill accounts").
- **ATM:** An automated teller machine (ATM) is an electronic banking outlet, which allows customers to complete basic transactions without the aid of a branch representative or teller.
- **Fixed deposit:** A fixed deposit (FD) is a financial instrument provided by banks which provides investors with a higher rate of interest than a regular savings account, until the given maturity date.
- **Discounting of bills:** Trading or selling a bill of exchange prior to the maturity date at a value less than the par value of the bill. The amount of the discount will depend on the amount of time left before the bill matures, and on the perceived risk attached to the bill.
- **Recurring deposit:** Recurring Deposit is a special kind of Term Deposit offered by banks in India which help people with regular incomes to deposit a fixed amount every month into their Recurring Deposit account and earn interest at the rate applicable to Fixed Deposits.

6.9 Summary

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- In India, the central banking authority is the Reserve Bank of India. It is also referred to as the Apex Bank. It functions under an act called The Reserve Bank of India Act, 1934. All the banks operating in India are monitored and controlled by the RBI. The RBI controls the banking sector in India through an Act called "The Banking Regulations Act, 1949".
- Scheduled commercial banks are those banks that are included in the second schedule of the RBI Act, 1934, and which carry out the normal business of banking such as accepting deposits, giving loans and other banking services.
- In Public sector banks, the majority stake is held by the Government of India or the Reserve Bank of India. There are currently 27 public sector banks in India. They include the SBI and its 5 associate banks, 19 nationalized banks (e.g. Allahabad Bank and Canara Bank), IDBI Bank Ltd. and Bhartiya Mahila Bank.
- In the case of private sector banks, the majority of the share capital of the bank is held by private individuals. These banks are registered as companies with limited liability. In 1994, the Reserve Bank of India issued a policy of liberalization to license limited number of private banks, which resulted in New Generation tech-savvy banks.
- Regional Rural Banks (RRBs) were first established in October 2, 1975 and are playing a pivotal role in the economic development of rural India. Rural banks have been established to meet the needs of the weaker sections of society.
- A co-operative bank is a financial entity that belongs to its members, who are also the owners and the customers of their bank. Co-operative banks are often created by persons belonging to the same local or professional community or sharing a common interest.
- Local area banks are banks that are set up under the scheme announced by the Government of India in August 1996. One bank was amalgamated with the Bank of Baroda in 2004 due to its weak financial position. RBI approved established of only 10 Local Area Banks but out of them only 4 are into existence as of 2015.
- Commercial banks have two important banking functions: one is accepting deposits and the other is advancing loans.
- Public Sector Banks recorded decline in CASA deposits while Private Banks and Foreign Banks recorded higher growth during 2014-15.
- During 2014-15, return on assets (RoA) remained at the same level as previous year, however, return on equity (RoE) dipped marginally. The RoA of Public sector banks declined though that of Private Banks and Foreign banks showed an improvement**.**
- As at end-March 2015, India's co-operative banking sector comprised of 1,579 Urban Co-operative Banks (UCBs) and 94,178 Rural Co-operative Credit Institutions, including short-term and long-term credit institutions.
- During 2014-15, the UCBs witnessed a moderation in their asset growth and an increase in their net profits. During 2013-14, the balance sheets of all rural co-operative banks, except the short-term State Co-operative Banks

(StCBs), witnessed either deceleration or reversal in growth. The state level short term and long-term rural co-operatives witnessed a decline in net proûts.

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6.10 Questions and Exercises

1. Explain the various types of commercial banks operating in India.
2. Differentiate between time deposits and demand deposits.
3. Explain the role of commercial banks in the development of economy.
4. What are the recent developments in commercial banking in India?
5. Discuss the structure of co-operative banks in India.

6.11 Further Readings and References

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UNIT 7: RESERVE BANK OF INDIA

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Structure

7.0 Introduction
7.1 Unit Objectives
7.2 History of Reserve Bank of India
7.3 Organisation of Reserve Bank of India
7.4 Management and Functions of Reserve Bank of India
7.5 Risk Management Guidelines of Reserve Bank of India
7.6 Key Terms
7.7 Summary
7.8 Questions and Exercises
7.9 Further Readings and References

7.0 Introduction

Central banks all over the world have been playing a very crucial role in the national economy. In a developing, economy, they are likely to be called upon to assume wide responsibilities with a view to strengthening and broad- basing the financial structure, and ensuring efficient financial management and supervision of the economy. The Reserve Bank of India is the central bank of the country. The Reserve Bank of India was set up on the basis of the recommendations of the Hilton Young Commission. The Reserve Bank of India Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank, which commenced operations on April 1, 1935. As the apex institution, it has been guiding, monitoring, regulating, controlling and promoting the destiny of the IFS since its inception.

7.1 Unit Objectives

After completing this unit students will be able to:

- Understand history of Reserve Bank of India
- Know the organisations of Reserve Bank of India
- Explain the functions of Reserve Bank of India
- Familiarise with risk management guidelines of Reserve Bank of India

7.2 History of Reserve Bank of India

The genesis of Reserve Bank of India (RBI) started in 1926 when the Hilton-Young Commission or the Royal Commission on Indian Currency and Finance made recommendation to the British Government of India for creation of a central bank. To give effect to above recommendations, a bill was introduced in Legislative

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Assembly in 1927 but this bill was withdrawn because various sections of the people were not in agreement. The recommendation to create a reserve bank was made by White Paper on Indian Constitutional Reforms. Thus, a fresh bill was introduced and was enacted in 1935. The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. Its headquarters were in Kolkata in the beginning, but it was shifted to ShahidBhagat Singh Marg, Mumbai in 1937. The Reserve Bank of India has four zonal offices at Chennai, Delhi, Kolkata and Mumbai. It has 19 regional offices and 10 sub-offices. Prior to establishment of RBI, the functions of a central bank were virtually being done by the Imperial Bank of India, which was established in 1921 by merging three Presidency banks. It was mainly a commercial bank but also served as banker to the government to some extent.

Though, initially RBI was privately owned. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government. After independence, the government passed Reserve Bank (Transfer to Public Ownership) Act, 1948 and took over RBI from private shareholders after paying appropriate compensation. Thus, nationalisation of RBI took place in 1949 and from January 1, 1949, RBI started working as a government owned central bank of India.

Key landmarks in the journey of the Reserve Bank of India

- In 1926, the Royal Commission on Indian Currency and Finance recommended creation of a central bank for India.
- In 1927, a bill to give effect to the above recommendation was introduced in the Legislative Assembly, but was later withdrawn due to lack of agreement among various sections of people.
- In 1933, the White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
- In 1934, the Bill was passed and received the Governor General’s assent.
- In 1935, Reserve Bank commenced operations as India’s central bank on April 1 as a private shareholders’ bank with a paid up capital of rupees five crore.
- In 1942 Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
- In 1947, Reserve Bank stopped acting as banker to the Government of Burma.
- In 1948, Reserve Bank stopped rendering central banking services to Pakistan.
- In 1949, the Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.
- In 1949, Banking Regulation Act was enacted.
- In 1951, India embarked in the Planning Era.

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- In 1966, the Cooperative Banks came within the regulations of the RBI, Rupee was devaluated for the first time.
- In 1969, Nationalization of 14 Banks was a Turning point in the history of Indian Banking.
- In 1973, the Foreign Exchange Regulation act was amended and exchange control was strengthened.
- In 1974, the Priority Sector Advance Targets started getting fixed.
- In 1975, Regional Rural Banks started.
- In1985, the Sukhamoy Chakravarty and Vaghul Committee reports embarked the era of Financial Market Reforms in India.
- In 1991, India came under the Balance of Payment crisis and RBI pledged Gold to shore up reserves. Rupee was devaluated.
- In 1991-92, Economic Reforms started in India.
- In 1993, Exchange Rate became Market determined.
- In 1994, Board for Financial Supervision was set up.
- In 1997, the regulation of the Non-Banking Financial Companies (NBFC) got strengthened.
- In 1998, Multiple Indicator Approach for monetary policy was adopted for the first time.
- In 2000, the Foreign Exchange Management Act (FEMA) replaced the erstwhile FERA.
- In 2002, The Clearing Corporation of India Ltd Started operation.
- In 2003, Fiscal Responsibility and Budget Management Act (FRBMA) enacted.
- In 2004, Liquidity Adjustment Facility (LAF) started working fully.
- In 2004, Market Stabilization Scheme (MSS) was launched.
- In 2004 Real Time Gross Settlement (RTGS) started working.
- In 2006, Reserve Bank of India was empowered to regulate the money, forex, G-Sec and Gold related security markets.
- In 2007, Reserve bank of India was empowered to regulate the Payment systems.
- In 2008-09, world under the grip of Global Financial Slowdown, RBI Proactive.

7.3 Organisation of Reserve Bank of India

The power and responsibilities of the Reserve Bank of India flow from the RBI Act, 1934. The general superintendence and direction of the Bank's affairs is vested in the Central Board of Directors, comprising the Governor and not more than four Deputy Governors appointed by the Central Government. The Governor and Deputy Governors hold office for periods not exceeding five years (fixed by the Central

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Government) and are eligible for reappointment. In absence of the Governor, a Deputy Governor nominated by him functions as the chairman of the central board.

Meetings of the central board are required to be held not less than six times a year and at least once in every quarter. The bank usually follows the consensual approach to get the benefit of all shades of opinions in decision making. Senior management meeting, attended by the Governor, Deputy Governors, Executive Directors, select Chief General Managers and Regional Directors on a rotation basis, deliberates upon and takes decisions on important matters. The committee of Deputy Governors meets weekly and attends to the matters referred to it. The major policy decisions are taken at the level of Central Board, committee of the Board, the Governor, or the Deputy Governors. In other matters, decisions are taken at the levels of Executive Directors or Chief General Managers- in- charge of the Central Office Departments.

In the day-to-day administration and functioning of the departments of the bank, decisions are taken at the level of Heads of Departments (Chief GeneralManager-in-charge/ Chief General Managers/ General Managers) to junior most level of officers, i.e., Assistant Managers depending upon the nature of the matter or activity.

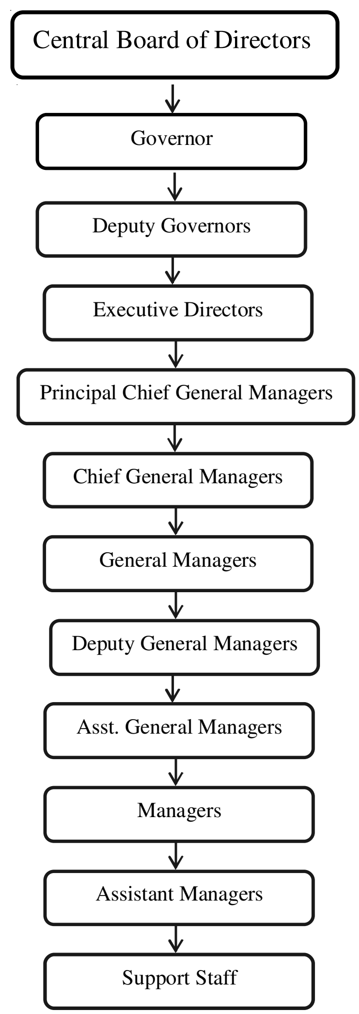

Figure 6.1 : Organisation Structure of RBI

Source: https://www.rbi.org.in

7.4 Functions of Reserve Bank of India

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The Reserve Bank of India performs all the typical functions of a good central bank. The main functions of the Reserve bank can be categorised as follows:

7.4.1 Monetary Management

One of the most important functions of central banks is formulation and execution of monetary policy. In the Indian context, the basic functions of the Reserve Bank of India as enunciated in the Preamble to the RBI Act, 1934 are: "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." Thus, the Reserve Bank's mandate for monetary policy flows from its monetary stability objective. Essentially, monetary policy deals with the use of various policy instruments for influencing the cost and availability of money in the economy. As macroeconomic conditions change, a central bank may change the choice of instruments in its monetary policy. The overall goal is to promote economic growth and ensure price stability.

7.4.2 Issuer of Currency

Management of currency is one of the core central banking functions of the Reserve Bank for which it derives the necessary statutory powers from Section 22 of the RBI Act, 1934. Along with the Government of India, the Reserve Bank is responsible for the design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes. In consultation with the Government, the Reserve Bank routinely addresses security issues and targets ways to enhance security features to reduce the risk of counterfeiting or forgery of currency notes.The Reserve Bank carries out the currency management function through its Department of Currency Management located at its Central Office in Mumbai, 19 Issue Offices located across the country and a currency chest at its Kochi branch. To facilitate the distribution of notes and rupee coins across the country, the Reserve Bank has authorised selected branches of banks to establish currency chests. There is a network of 4,281 Currency Chests and 4,044 Small Coin Depots with other banks. Currency chests are storehouses where bank notes and rupee coins are stocked on behalf of the Reserve Bank. The currency chests have been established with State Bank of India, six associate banks, nationalised banks, private sector banks, a foreign bank, a state cooperative bank and a regional rural bank.

7.4.3 Banker and Debt Manager to Government

Since its inception, the Reserve Bank has undertaken the traditional central banking function of managing the government's banking transactions. The Reserve Bank of India Act, 1934 requires the Central Government to entrust the Reserve Bank with all its money, remittance, exchange and banking transactions in India and the management of its public debt. The Government also deposits its cash balances with the Reserve Bank. The Reserve Bank may also, by agreement, act as the banker to a State Government. Currently, the Reserve Bank acts as banker to all the State Governments in India, except Jammu & Kashmir and Sikkim. It has limited agreements for the management of the public debt of these two State Governments.

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As a banker to the Government, the Reserve Bank receives and pays money on behalf of the various Government departments. As it has offices in only 27 locations, the Reserve Bank appoints other banks to act as its agents for undertaking the banking business on behalf of the governments. The Reserve Bank pays agency bank charges to the banks for undertaking the government business on its behalf. The Reserve Bank also undertakes to float loans and manage them on behalf of the Governments. It also provides Ways and Means Advances – a short-term interest bearing advance – to the Governments, to meet the temporary mismatches in their receipts and payments.

7.4.4 Banker to Banks

Banks are required to maintain a portion of their demand and time liabilities as cash reserves with the Reserve Bank, thus necessitating a need for maintaining accounts with the Bank. Further, banks are in the business of accepting deposits and giving loans. Since different persons deal with different banks, in order to settle transactions between various customers maintaining accounts with different banks, these banks have to settle transactions among each other. Settlement of inter-bank obligations thus assumes importance. To facilitate smooth operation of this function of banks, an arrangement has to be made to transfer money from one bank to another. This is usually done through the mechanism of a clearing house where banks present cheques and other such instruments for clearing. Many banks also engage in other financial activities, such as, buying and selling securities and foreign currencies. In order to meet the above objectives, in India, the Reserve Bank provides banks with the facility of opening accounts with itself. This is the 'Banker to Banks' function of the Reserve Bank, which is delivered through the Deposit Accounts Department (DAD) at the Regional offices.

7.4.5 Financial Regulation and Supervision

The Reserve Bank's regulatory and supervisory domain extends not only to the Indian banking system but also to the development financial institutions (DFIs), non-banking financial companies (NBFCs), primary dealers, credit information companies and select segments of the financial markets. As the regulator and the supervisor of the banking system, the Reserve Bank has a critical role to play in ensuring the system's safety and soundness on an ongoing basis. The objective of this function is to protect the interest of depositors through an effective prudential regulatory framework for orderly development and conduct of banking operations, and to maintain overall financial stability through various policy measures.

7.4.6 Foreign Exchange Reserves Management

The Reserve Bank, as the custodian of the country's foreign exchange reserves, is vested with the responsibility of managing their investment. The basic parameters of the Reserve Bank's policies for foreign exchange reserves management are safety, liquidity and returns. While safety and liquidity continue to be the twin-pillars of reserves management, return optimisation has become an embedded strategy within this framework. The Reserve Bank has framed policy guidelines stipulating stringent eligibility criteria for issuers, counterparties, and investments to be made with them to enhance the safety and liquidity of reserves. The Reserve Bank, in consultation with the Government, continuously reviews the reserves management strategies.

7.4.7 Foreign Exchange Management

The Reserve Bank oversees the foreign exchange market in India. It supervises and regulates it through the provisions of the Foreign Exchange Management Act, 1999. The Reserve Bank issues licences to banks and other institutions to act as Authorised Dealers in the foreign exchange market. In keeping with the move towards liberalisation, the Reserve Bank has undertaken substantial elimination of licensing, quantitative restrictions and other regulatory and discretionary controls. Apart from easing restrictions on foreign exchange transactions in terms of processes and procedure, the Reserve Bank has also provided the exchange facility for liberalised travel abroad for purposes, such as, conducting business, attending international conferences, undertaking technical study tours, setting up joint ventures abroad, negotiating foreign collaboration, pursuing higher studies and training, and also for medical treatment.

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Check your progress

1. Explain the functions of RBI?
2. What do you mean by bankers to bank?

7.4.8 Payment and Settlement Systems

The regulation and supervision of payment systems is being increasingly recognised as a core responsibility of central banks. Safe and efficient functioning of these systems is an important pre-requisite for the proper functioning of the financial system and the efficient transmission of monetary policy. The Reserve Bank, as the regulator of financial systems, has been initiating reforms in the payment and settlement systems to ensure efficient and faster flow of funds among various constituents of the financial sector.

7.4.9 Developmental Role

The Reserve Bank is one of the few central banks that has taken an active and direct role in supporting developmental activities in their country. The Reserve Bank's developmental role includes ensuring credit to productive sectors of the economy, creating institutions to build financial infrastructure, and expanding access to affordable financial services. Over the years, its developmental role has extended to institution building for facilitating the availability of diversified financial services within the country. The Reserve Bank today also plays an active role in encouraging efficient customer service throughout the banking industry, as well as extension of banking service to all, through the thrust on financial inclusion.

7.5 Risk Managment Guidelines of RBI

Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Thus, top management of banks should attach considerable importance to improve the ability to identify, measure, monitor and control the overall level of risks undertaken.

Risk Management is actually a combination of management of uncertainty, risk, equivocality and error. Uncertainty – where the outcomes cannot be estimated even randomly, arises due to lack of information and this uncertainty gets transformed

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into risk (where the estimation of outcome is possible) as information gathering progresses.

Initially, the Indian banks have used risk control systems that kept pace with legal environment and Indian accounting standards. But with the growing pace of deregulation and associated changes in the customer's behaviour, banks are exposed to mark-to-market accounting.Therefore, the challenge of Indian banks is to establish a coherent framework for measuring and managing risk consistent with corporate goals and responsive to the developments in the market. As the market is dynamic, banks should maintain vigil on the convergence of regulatory frameworks in the country, changes in the international accounting standards and finally and most importantly changes in the clients' business practices.

To evaluate the financial soundness of the Banks and for the risk management RBI used the tools called CAMELS. CAMELS is the collective tool of six components namely

- Capital Adequacy
- Asset Quality
- Management
- Earnings Quality
- Liquidity
- Sensitivity to Market risk

The CAMEL was recommended for the financial soundness of bank in 1988 while the sixth component called sensitivity to market risk (S) was added to CAMEL in 1997. In India, the focus of the statutory regulation of commercial banks by RBI until the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements.

RBI in 1999 recognised the need of an appropriate risk management and issued guidelines to banks regarding assets liability management, management of credit, market and operational risks. The entire supervisory mechanism has been realigned since 1994 under the directions of a newly constituted Board for Financial Supervision (BFS), which functions under the aegis of the RBI, to suit the demanding needs of a strong and stable financial system.

7.6 Key Terms

- **Real Time Gross Settlement:**Real-time gross settlement systems (RTGS) are specialist funds transfer systems where transfer of money or securities 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.
- **Monetary policy:**Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency.

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- **Foreign Exchange:**In finance, an exchange rate (also known as a foreign-exchange rate, forex rate, FX rate or Agio) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency.
- **Risk:**The chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment. A high standard deviation indicates a high degree of risk.
- **Capital Adequacy:** The capital adequacy ratio (CAR) is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures.
- **Sensitivity to Market risk:** Sensitivity to market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or capital.
- **Assets liability management:** Asset Liability Management (ALM) can be defined as a mechanism to address the risk faced by a bank due to a mismatch between assets and liabilities either due to liquidity or changes in interest rates. Liquidity is an institution's ability to meet its liabilities either by borrowing or converting assets.

7.7 Summary

- The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. Its headquarters were in Kolkata in the beginning, but it was shifted to ShahidBhagat Singh Marg, Mumbai in 1937. The Reserve Bank of India has four zonal offices at Chennai, Delhi, Kolkata and Mumbai.
- Though, initially RBI was privately owned. It started with a Share Capital of Rs. 5 Crore, divided into shares of Rs. 100 each fully paid up. In the beginning, this entire capital was owned by private shareholders. Out of this Rs. 5 Crore, the amount of Rs. 4,97,8000 was subscribed by the private shareholders while Rs. 2,20,000 was subscribed by central government.
- The power and responsibilities of the Reserve Bank of India flow from the RBI Act, 1934. The general superintendence and direction of the Bank's affairs is vested in the Central Board of Directors, comprising the Governor and not more than four Deputy Governors appointed by the Central Government. The Governor and Deputy Governors hold office for periods not exceeding five years (fixed by the Central Government) and are eligible for reappointment. In absence of the Governor, a Deputy Governor nominated by him functions as the chairman of the central board.
- One of the most important functions of central banks is formulation and execution of monetary policy. In the Indian context, the basic functions of the Reserve Bank of India as enunciated in the Preamble to the RBI Act, 1934 are: "to regulate the issue of Bank notes and the keeping of reserves

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with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

- Management of currency is one of the core central banking functions of the Reserve Bank for which it derives the necessary statutory powers from Section 22 of the RBI Act, 1934. Along with the Government of India, the Reserve Bank is responsible for the design, production and overall management of the nation's currency, with the goal of ensuring an adequate supply of clean and genuine notes.
- Banks are required to maintain a portion of their demand and time liabilities as cash reserves with the Reserve Bank, thus necessitating a need for maintaining accounts with the Bank. Further, banks are in the business of accepting deposits and giving loans. Since different persons deal with different banks, in order to settle transactions between various customers maintaining accounts with different banks, these banks have to settle transactions among each other.
- Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks viz., credit, interest rate, foreign exchange rate, liquidity, equity price, commodity price, legal, regulatory, reputational, operational, etc. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories.
- Risk Management is actually a combination of management of uncertainty, risk, equivocality and error. Uncertainty – where the outcomes cannot be estimated even randomly, arises due to lack of information and this uncertainty gets transformed into risk (where the estimation of outcome is possible) as information gathering progresses.

7.8 Questions and Exercises

1. What are the important functions of Reserve Bank of India?
2. "Reserve Bank of India acts as a promoter of the financial system." Justify.
3. Discuss the risk management guidelines of Reserve Bank of India.

7.9 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.
2. Saha, S.S., ***"Indian Financial System and Markets",***TMH Education Private Limited.
3. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.

Web resources:

1. "Organisation and funcitons of RBI" available at www.Rbi.org.in

UNIT 8 : NON BANKING FINANCIAL INSTITUTIONS

NOTES

Structure

8.0 Introduction

8.1 Unit Objectives

8.2 Concept of Non Banking Financial Institutions

8.3 Type of NBFCs

8.4 Importance of NBFCs

8.5 Classification of NBFCs

8.6 Performance of NBFCs

8.7 Regulatory Framework for NBFCs

8.8 Key Terms

8.9 Summary

8.10 Questions and Exercises

8.11 Further Readings and References

8.0 Introduction

Non Banking Financial Companies (NBFCs) are the integral part of Indian Financial System. NBFCs are heterogeneous group of diverse institutions providing a range of financial services and have emerged as specialised financial institutions. These firms play an expanded role to accelerate the pace of growth of the financial market. NBFCs play a key role in the direction of savings and investment and also bridge the credit gaps in several sectors. NBFCs assume significance in the small business segment as they primarily cater to the credit requirements of the unorganised sector such as wholesale & retail traders, small-scale industries and small borrowers at the local level, performing a wide range of activities like hire-purchase finance, vehicle financing, equipment lease finance, personal loans, working capital loans, consumer loans, housing loans, loans against shares and investment, etc. NBFCs play a pivotal role in economic development by mobilising savings, bridging credit gaps, channelizing investments and by influencing money market. The segment has witnessed considerable growth in the last few years and is now being recognised as complementary to the banking sector due to implementation of innovative marketing strategies, introduction of tailor-made products, customer-oriented services, attractive rates of return on deposits and simplified procedures, etc.

8.1 Unit Objectives

After completing this unit students will be able to:

- Understand Concept of NBFCs
- Comprehend the Classification of NBFCs

- Describe Structure of NBFCs
- Explain the Significance of NBFCs
- Discuss the Performance of NBFCs
- Familiarise with the Recent Regulatory Changes for NBFCs

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Check your progress

1. Define NBFC as per RBI guidelines
2. What do you mean by 50-50 test?
3. Explain the statement "Financial activity as a principal business" in terms of NBFCs

8.2 Concept of NBFC

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has ***principal business*** of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company). Financial activity as ***principal business*** is when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term 'principal business' is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as ***50-50 test*** and is applied to determine whether or not a company is into financial business.

Section 45I of the Reserve Bank of India Act, 1934 defines ''non-banking financial company'' as–

(i) A financial institution which is a company;

(ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

Hence in short an NBFC may be defined as a company registered under the Companies Act, 2013 or any previous Act and also registered under the provisions of Section 45-IA of the Reserve Bank of India Act, 1934 and which provides banking services without meeting the legal definition of bank such as holding a banking license.

8.3 Type of NBFCs

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The categories of NBFCs depend on the nature of their main activities. NBFCs are categorized on the basis of following points listed below-

(a) Type of liabilities into Deposit and Non-Deposit accepting NBFCs,

(b) Non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and

(c) Kind of activity performed by them

Within this broad categorization the different types of NBFCs are as follows:

i. Asset Finance Company (AFC) : An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising there from is not less than 60% of its total assets and total income respectively.

ii. Investment Company (IC): IC means any company which is a financial institution carrying on as its principal business, the acquisition of securities.

iii. Loan Company (LC): LC means any company which is a financial institution carrying on as its principal business, the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

iv. Infrastructure Finance Company (IFC): IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of Rs 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.

v. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:-

a. It holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;

b. Its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its total assets;

c. It does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;

d. It does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the RBI act, 1934 except investment in bank deposits, money market instruments, government securities, loans to

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and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

e. Its asset size is Rs 100 crore or above and

f. It accepts public funds

vi. **Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC):** IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

vii. **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI):** NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

a. Loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs 1,00,000 or urban and semi-urban household income not exceeding Rs 1,60,000

b. Loan amount does not exceed Rs 50,000 in the first cycle and Rs 1,00,000 in subsequent cycles

c. Total indebtedness of the borrower does not exceed Rs 1,00,000

d. Tenure of the loan not to be less than 24 months for loan amount in excess of Rs 15,000 with prepayment without penalty

e. Loan to be extended without collateral

f. Aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs

g. Loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

viii. **Non-Banking Financial Company – Factors (NBFC-Factors):** NBFC-Factor is a non deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

ix. **Mortgage Guarantee Companies (MGC):** MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is Rs 100 crore.

x. **NBFC- Non-Operative Financial Holding Company (NOFHC):** It is a financial institution through which promoter / promoter groups will be permitted to set up a new bank . It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.

8.4 Importance of NBFCs

A thriving, healthy, and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive economy. NBFCs perform a diversified range of functions and offer various financial services to individuals, corporates and institutional clients. These companies have been helping to bridge the credit gaps in several sectors which traditional institutions such as banks are unable to fulfil. Financial intermediaries play a very important role in the saving – investment process by raising the level of savings and investment and by allocating more efficiently the scarce savings among most productive investments. Commercial banks which are one of the oldest financial intermediaries often fall short of the diversified requirements of the ultimate savers and investors. This creates a favourable climate for the emergence and growth of the NBFCs. New and specialised types of financial intermediaries are established to meet the demand for increasing specialization.

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Check your progress

4. Discuss different types of NBFCs in India
5. List out the qualifying assets for NBFC-MFI
6. Define Systematically Core Investment NBFCs.

NBFCs aid in economic development in the following ways –

- Mobilization of Resources – It converts savings into investments
- Capital formation – Aids to increase capital stock of a company
- NBFC's provide long term credit and specialized credit
- Aid in employment generation
- Help in development of financial markets
- Help in attracting foreign grants
- Helps in breaking the vicious circle of poverty by serving as government's instrument

As recognized by the RBI the specific roles of a Non Banking Financial Company are-

- Development of sectors like transport and infrastructure
- Substantial employment generation
- Help and increase wealth creation
- Broad base economic development
- To finance economically weaker section
- Huge contribution to state exchequer
- Irreplaceable supplement to bank credit in rural segments, major thrust on semi-urban, rural areas and first time users.

8.5 Structure of NBFCs

The role of NBFC sector in the Indian financial system has become critical in terms of its size, spread and niche areas of operations. Many of the larger NBFCs have grown bigger and become more connected with other financial entities, necessitating periodical review of the regulatory framework for this sector. During the year, the Reserve Bank, with a view to addressing the regulatory gaps, arbitrage and risks associated with NBFCs, initiated a host of measures to strengthen regulation and supervision of NBFCs and harmonise their regulations with those of the banks in a phased manner as also to foster financial stability.

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Check your progress

7. Write the functions of NBFCs.
8. Discuss the classification criteria's' of NBFCs in India?

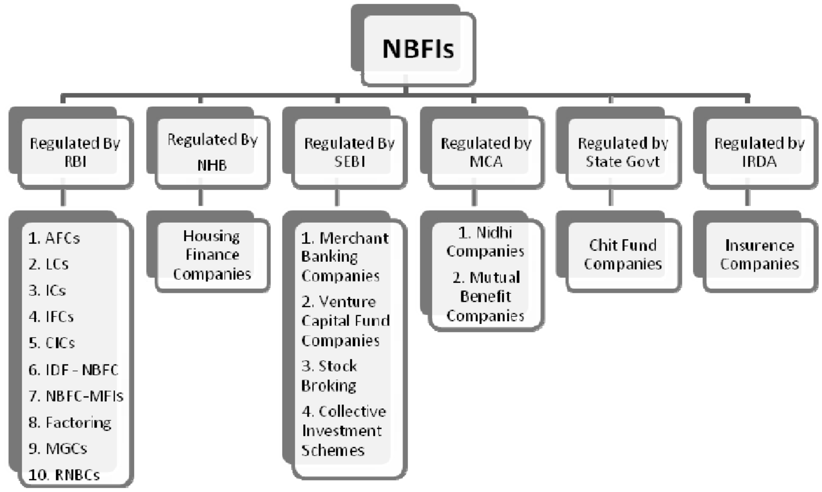

Figure 8.1: Classification of NBFCs in India

As depicted above, RBI classifies NBFCs into ten categories namely Asset Finance Companies(AFCs), Loan Companies(LCs), Investment Companies(ICs), Infrastructure Finance Companies(IFCs),Core Investment Companies(CICs), Infrastructure Debt Funds(IDF-NBFCs), NBFC-Microfinance Institutions(NBFC-MFIs), Factoring companies(FCs), Mortgage Guarantee Companies(MGCs) and Residuary Non-Banking Companies (RNBCs).

Based on their liability structure, the NBFCs are classified into two broad categories: (a) Deposit taking NBFCs, and (b) Non-deposit taking NBFCs. As on March 31, 2015, there were 11,842 NBFCs registered with the Reserve Bank; out of which 220 were deposit-taking (NBFCs-D) and 11,622 were non-deposit taking (NBFCs-ND) entities. The two existing residual Non-Banking Finance Companies (RNBCs) are in the process of winding up their businesses.

8.6 Performance of NBFCs

The NBFC sector has been gaining systemic importance in the recent years and the share of NBFC has steadily grown from 10.7% of banking assets in 2009 to 14.3% of banking assets in 2014. NBFCs typically have several advantages over banks due to their focus on niche segment, expertise in the specific asset classes and deeper penetration in the rural and unbanked markets. However, on the flip side, they depend to a large extent on bank borrowings, leading to high cost of borrowings and face competition from banks which have lower cost of funds.

The growing asset size of the NBFC sector has increased the need for risk management in the sector due to growing interconnectedness of NBFCs with other financial sector intermediaries. The Reserve Bank of India (RBI) has been in the recent past trying to strengthen the risk management framework in the sector, simplify the regulations and plug regulatory gaps so as to prevent regulatory arbitrage between banks and NBFCs.

Table 8.1: Public Deposits in NBFCs & RNBCs from 1997-98 to 2014-15

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NBFCs generally operate in niche products and segments where, due to their specialised skill sets, they are more efficient than banks. While they generally have higher and volatile credit costs, higher rated entities operate at large buffers both in terms of pre-provision operating profits and capital (lower leverage).

8.6.1 Key Performance Trends in NBFC Sector

i. Capital Adequacy Ratio

n Total d 20% ortably d 7.5% m Tier couple er, due d debt tal has sector AR by

(Amount in ₹ Billion)

Year (End-March)	NBFCs		RNBCs		Total Public Deposits (3+5)
	No. of Reporting Companies	Public Deposits	No. of Reporting Companies	Public Deposits	
1	2	3	4	5	6
1997-98	1420	135.72	9	102.49	**238.20**
1998-99	1536	97.85	11	106.44	**204.29**
1999-00	996	83.38	9	110.04	**193.42**
2000-01	974	64.59	7	116.25	**180.85**
2001-02	905	59.33	5	128.89	**188.22**
2002-03	870	50.35	5	150.65	**201.00**
2003-04	774	43.17	3	153.27	**196.44**
2004-05	700	39.26	3	166.00	**205.26**
2005-06	428	24.48	3	201.75	**226.23**
2006-07	401	20.77	3	226.22	**246.99**
2007-08	364	20.42	2	223.58	**244.00**
2008-09	336	19.71	2	195.95	**215.66**
2009-10	308	28.31	2	145.21	**173.52**
2010-11	297	40.98	2	79.02	**120.00**
2011-12	271	57.35	2	42.65	**100.00**
2012-13	254	70.85	2	38.17	**109.02**
2013-14	240	108.08	2	35.82	**143.90**
2014-15 P	220	275.04	2	31.83	**306.87**

NBFC : Non-Banking Financial Company RNBC : Residuary Non-Banking Company P : Provisional

Note : NBFCs here include Deposit taking NBFCs (NBFCs-D), Mutual Benefit Financial Companies (MBFCs)/ Notified Nidhis, Mutual Benefit Companies (MBCs)/ Potential Nidhis,*etc.* till 2004-05 and only NBFCs-D thereafter.

Source : Reserve Bank of India.

NBFCs have witnessed a stress in asset quality during the last two-three years due to weak operating environment and economic downturn. Sectors which are directly linked to economic activities like commercial vehicle, construction equipment and infrastructure financing have witnessed sharp deterioration in asset quality. Gold loan NBFCs have also witnessed asset quality concerns on account of regulatory uncertainties, correction in gold prices and funding constraints.

Deposit accepting NBFCs have seen higher deterioration in asset quality as compared to non-deposit accepting NBFCs as major deposit accepting NBFCs are operating in commercial vehicle financing. However, deposit accepting NBFCs have better provision coverage of around 60%.

During financial year i.e. FY15 (refers to period April 01, 2014 to March 31, 2015), delinquencies for NBFCs remained at elevated levels due to no pick-up in industrial activity. However, the industrial activity is expected to see recovery during later part of the year.

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iii. Profitability impacted on account of slowdown in growth and asset quality pressure

During FY13, overall profitability remained stable as compared to FY12 levels. The Return on Total Assets (ROTA) for FY13 was at 2.57% as compared to 2.58% for FY12.

During FY14, due to hardening of interest rates and rising delinquencies, the NBFC sector has seen pressure on net interest margins and increase in credit cost. Increase in NPAs has dual effect – (1) not earning of interest and (2) reversal of interest income which was booked in earlier period. Due to which the profitability has taken a hit which is visible from ROTA declined from 2.57% for FY13 to 2.06% for FY14.

iv. Resource profile

Borrowings through capital market including NCDs, subordinated debt, preference shares, perpetual debt continued to be the major source of funding for NBFCs as it accounted for 34% of total borrowings in FY14 followed by banks funding which accounted for 31% of their total borrowings. Overall borrowing mix in FY14 has remained in-line with FY13. Dependency on *NBFC* short term borrowings like commercial paper is less at around 7% which helps them to manage their asset liability mismatches.

Revised guidelines on securitization and priority sector lending made NBFCs to re-look at their business model. Direct loans given to NBFCs are now not classifying as priority sector lending except for NBFC-MFIs. Lending via securitization route through direct assignment without credit enhancement or through Pass Through Certificates (PTCs) can be classified as priority sector lending criteria.

Change in above guidelines has made NBFCs to explore channel business tie-ups and direct assignment i.e. securitization without credit enhancement with banks to save their capital cost and overcome fund raising constraints.

8.7 Regulatory Framework of NBFCs in India

The NBFC (Non-Banking Finance Company) sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into newer areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are as exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system. There is therefore, a felt need to address the risks, without impeding the dynamism displayed by NBFCs in delivering innovation and last mile connectivity for meeting the credit needs of the productive sectors of the economy. Therefore, a review of the entire regulatory framework for the NBFC sector has been undertaken with a view to transitioning, over time, to an activity based regulation of NBFCs. As a first step in this direction, certain changes to the regulatory framework are sought to be made to a) address risks wherever they exist, b) address regulatory gaps and arbitrage arising from differential regulations, both within the sector as well as vis-a-vis other financial institutions, c) harmonise and simplify regulations to facilitate a smoother compliance culture among NBFCs, and d) strengthen governance standards. In doing so, certain important recommendations made by the Working Group on Issues and Concerns in the NBFC Sector (Chairperson: Smt. Usha Thorat) and the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households (Chairman: Dr. Nachiket Mor), have been drawn upon.

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The recent changes introduced to the regulatory framework are delineated below-

i. Requirement of Minimum Net Owned Fund (NOF) of Rs. 200 lakh

NBFCs are required to obtain a Certificate of Registration (CoR) from the Bank to commence/carry on business of NBFI in terms of Section 45-IA of the RBI Act, 1934. The said section also prescribes the minimum Net Owned Fund (NOF) requirement. In terms of Notification No.DNBS.132/CGM(VSNM)-99 dated April 21, 1999, the minimum NOF requirement for new companies applying for grant of CoR to commence business of an NBFC is stipulated at Rs. 200 lakh. Although the

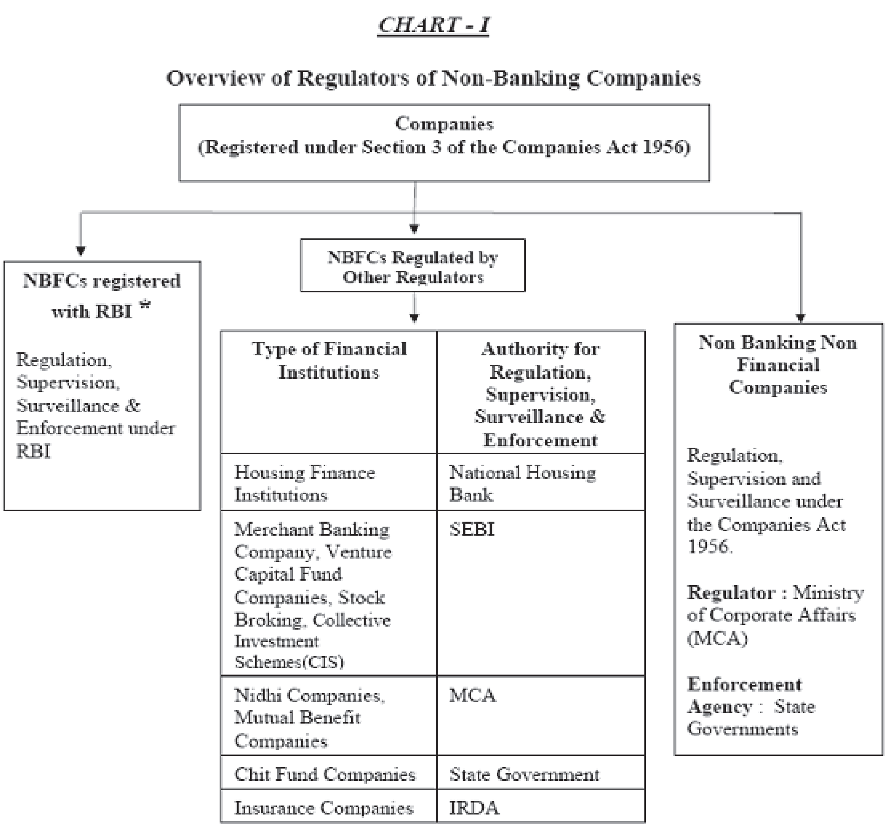

Figure 8.2: Regulatory Framework of NBFCs

Source: Reserve Bank of India

requirement of minimum NOF at present stands at Rs. 200 lakh, the minimum NOF for companies that were already in existence before April 21, 1999 was retained at Rs. 25 lakh. Given the need for strengthening the financial sector and technology adoption, and in view of the increasing complexities of services offered by NBFCs, it shall be mandatory for all NBFCs to attain a minimum NOF of Rs. 200 lakh by the end of March 2017, as per the milestones given below:

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- Rs. 100 lakh by the end of March 2016
- Rs. 200 lakh by the end of March 2017

It will be incumbent upon such NBFCs, the NOF of which currently falls below Rs. 200 lakh, to submit a statutory auditor's certificate certifying compliance to the revised levels at the end of each of the two financial years as given above. NBFCs failing to achieve the prescribed ceiling within the stipulated time period shall not be eligible to hold the CoR as NBFCs. The Bank will initiate the process for cancellation of CoR against such NBFCs.

ii. Deposit Acceptance

As per extant NBFCs Acceptance of Public Deposit (Reserve Bank) Directions, 1998, an unrated Asset Finance Company (AFC) having NOF of Rs. 25 lakh or more, complying with all the prudential norms and maintaining capital adequacy ratio of not less than fifteen per cent, is allowed to accept or renew public deposits not exceeding one and half times of its NOF or up to Rs. 10 crore, whichever is lower. AFCs which are rated and complying with all the prudential regulations are allowed to accept deposits up to 4 times of their NOF. In order to harmonise the deposit acceptance regulations across all deposit taking NBFCs (NBFCs-D) and move over to a regimen of only credit rated NBFCs-D accessing public deposits, existing unrated AFCs shall have to get themselves rated by March 31, 2016. Those AFCs that do not get an investment grade rating by March 31, 2016, will not be allowed to renew existing or accept fresh deposits thereafter. In the intervening period, i.e. till March 31, 2016, unrated AFCs or those with a sub-investment grade rating can only renew existing deposits on maturity, and not accept fresh deposits, till they obtain an investment grade rating. It has been decided to harmonise the limit for acceptance of deposits across the sector by reducing the same for rated AFCs from 4 times to 1.5 times of NOF, with effect from the date of this circular. While AFCs holding deposits in excess of the revised limit should not access fresh deposits or renew existing ones till they conform to the new limit, the existing deposits will be allowed to run off till maturity. It must be mentioned here that the data available with the Reserve Bank indicates that most AFCs are already complying with the revised norms and very few NBFCs have deposits in excess of 1.5 times of the NOF. Also, in cases where this limit is exceeded, the excess is not substantial. It is therefore expected, that this harmonization measure will not be disruptive.

iii. Systemic Significance

Currently, NBFCs are categorized into three groups for the purpose of administering prudential regulations namely, NBFCs-D, non-deposit taking NBFCs (NBFCs-ND) with assets less than Rs.100 crore and NBFCs-ND-SI with assets Rs.100 crore

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and above, (categorised as non–deposit taking systemically important NBFCs.. The current prudential regulation mainly comprises the following elements:

a) Norms relating to Income Recognition, Asset Classification and Provisioning norms;

b) Capital to Risk Weighted Assets Ratio (CRAR); and

c) Credit Concentration Norms [norms at b) and c) are applicable to only NBFCs–D and NBFCs-ND-SI].

The threshold for defining systemic significance for NBFCs-ND has been revised in the light of the overall increase in the growth of the NBFC sector. NBFCs-ND-SI will henceforth be those NBFCs-ND which have asset size of Rs. 500 crore and above as per the last audited balance sheet. With this revision in the threshold for systemic significance, NBFCs-ND shall be categorized into two broad categories viz.,

- NBFCs-ND (those with assets of less than Rs. 500 crore) and
- NBFCs-ND-SI (those with assets of Rs. 500 crore and above).

iv. Multiple NBFCs

NBFCs that are part of a corporate group or are floated by a common set of promoters will not be viewed on a standalone basis. The total assets of NBFCs in a group including deposit taking NBFCs, if any, will be aggregated to determine if such consolidation falls within the asset sizes of the two categories mentioned above. Regulations as applicable to the two categories will be applicable to each of the NBFC-ND within the group. For this purpose, Statutory Auditors would be required to certify the asset size of all the NBFCs in the Group. However, NBFC-D, within the group, if any, will be governed under the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Direction 1998 and Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 and other applicable Directions.

The definition of the word “group” will be the same as per Accounting Standards. “Companies in the Group”, shall mean an arrangement involving two or more entities related to each other through any of the following relationships:

- Subsidiary – parent (defined in terms of AS 21),
- Joint venture (defined in terms of AS 27),
- Associate (defined in terms of AS 23),
- Promoter – romote [as provided in the SEBI (Acquisition of Shares and Takeover) Regulations, 1997],
- For listed companies, a related party (defined in terms of AS 18), common brand name, and investment in equity shares of 20% and above.

v. Prudential Norms

One of the main objectives of prudential regulation is to address systemic risks. The systemic risks posed by NBFCs functioning exclusively out of their own funds and NBFCs accessing public funds cannot be equated and hence cannot be subjected to the same level of regulation. Hence, as a principle, enhanced prudential regulations shall be made applicable to NBFCs wherever public funds are accepted and conduct of business regulations will be made applicable wherever customer interface is involved. In conformity with the above principles, the regulatory approach in respect of NBFCs-ND with an asset size of less than Rs. 500 crore will be as under:

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a. They shall not be subjected to any regulation either prudential or conduct of business regulations viz., Fair Practices Code (FPC), KYC, etc., if they have not accessed any public funds and do not have a customer interface.

b. Those having customer interface will be subjected only to conduct of business regulations including FPC, KYC etc., if they are not accessing public funds.

c. Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.

d. Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.

e. Irrespective of whichever category the NBFC falls in, registration under Section 45 IA of the RBI Act will be mandatory. All of the above will also be subjected to a simplified reporting system which shall be communicated separately.

All NBFCs-ND with assets of Rs. 500 crore and above, irrespective of whether they have accessed public funds or not, shall comply with prudential regulations as applicable to NBFCs-ND-SI. They shall also comply with conduct of business regulations if customer interface exists.

1. Prudential Regulations Applicable to NBFCs-ND with Assets less than Rs. 500 crore

Consequent to the redefining of 'systemic significance' the NBFCs-ND with asset size of less than Rs. 500 crore, are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms. A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities/ Owned Funds.

2. Prudential Regulations Applicable to NBFCs-ND-SI (asset of Rs. 500 crore and above) and all NBFCs-D

I. Tier 1 Capital: At present, all NBFCs-D and NBFCs-ND with asset size of Rs.100 crore and above are required to have minimum CRAR of 15%. Consequently, Tier 1 capital cannot be less than 7.5%. For Infrastructure Finance Companies (IFCs), however, Tier 1 capital cannot be less than 10%. Similarly, NBFCs primarily engaged in lending against gold jewellery have to maintain a minimum Tier 1 capital of 12% w.e.f. April 01, 2014. Given the business activities of NBFCs, being generally 'niche' in nature, concentration risk associated with such businesses, and on account of the re-definition of systemic importance, all NBFCs-ND which have an asset size of Rs. 500 crore and above, and all NBFCs-D, shall maintain minimum

Tier 1 Capital of 10%. The compliance to the revised Tier 1 capital will be phased in as follows:

- 8.5% by end of March 2016.
- 10% by end of March 2017.

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II. Asset Classification: At present, an asset is classified as Non-Performing Asset when it has remained overdue for a period of six months or more for loans; and overdue for twelve months or more in case of lease rental and hire purchase instalments, as compared to 90 days for banks. In the interest of harmonisation, the asset classification norms for NBFCs-ND-SI and NBFCs-D are being brought in line with that of banks, in a phased manner, as given below. Lease Rental and Hire-Purchase Assets shall become NPA:

- If they become overdue for 9 months (currently 12 months) for the financial year ending March 31, 2016;
- If overdue for 6 months for the financial year ending March 31, 2017; and
- If overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

Assets other than Lease Rental and Hire-Purchase Assets shall become NPA:

- If they become overdue for 5 months for the financial year ending March 31, 2016;
- If overdue for 4 months for the financial year ending March 31, 2017; and
- If overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, sub-standard asset would mean:

- An asset that has been classified as NPA for a period not exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;
- An asset that has been classified as NPA for a period not exceeding 14 months for the financial year ending March 31, 2017; and
- An asset that has been classified as NPA for a period not exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, doubtful asset would mean:

- An asset that has remained sub-standard for a period exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;
- An asset that has remained sub-standard for a period exceeding 14 months for the financial year ending March 31, 2017; and
- An asset that has remained sub-standard for a period exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

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For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted.

III. **Provisioning for Standard Assets:** At present, every NBFC is required to make a provision for standard assets at 0.25% of the outstanding. On a review of the same, the provision for standard assets for NBFCs-ND-SI and for all NBFCs-D, is being increased to 0.40%. The compliance to the revised norm will be phased in as given below:

- 0.30% by the end of March 2016
- 0.35% by the end of March 2017
- 0.40% by the end of March 2018

IV. **Credit / Investment Concentration Norms for AFCs:** As a step towards meeting the broad objective of harmonizing regulations to the extent possible within the NBFC sector, the credit concentration norms for AFCs are now being brought in line with other NBFCs. This will be applicable with immediate effect for all new loans excluding those already sanctioned. All existing excess exposures would be allowed to run off till maturity.

V. **Corporate Governance and Disclosure norms for NBFCs:** The need for adoption of good corporate governance practices continues to engage the regulator and stakeholder attention. The certain amendments to the Corporate Governance guidelines are made as given below:

i. NBFCs-D with deposits of Rs. 20 crore and above, and NBFCs-ND with asset size of Rs. 50 crore and above are required to constitute an Audit Committee; NBFCs-D with deposits of Rs. 20 crore and above, and NBFCs-ND with assets of Rs. 100 crore and above are advised to consider constituting Nomination Committee to ensure 'fit and proper' status of proposed/ existing Directors and Risk Management Committee. Further, NBFCs-D with deposits of Rs. 50 crore and above were advised that it was desirable that they stipulate rotation of partners of audit firms appointed for auditing the company every three years.

ii. Board Committees: As part of harmonisation, the constitution of the three Committees of the Board and instructions with regard to rotation of partners have now been made applicable to all NBFCs-ND-SI, as also all NBFCs-D. Other NBFCs are encouraged to observe such practices, if already being followed.

iii. Audit Committee of all NBFCs-ND-SI, as also all NBFCs-D must ensure that an Information Systems Audit of the internal systems and processes is conducted at least once in two years to assess operational risks faced by the company.

iv. Fit and Proper Criteria for Directors: With the increasing integration of NBFCs in the financial sector and their growing systemic significance, it has become important that the Directors and shareholders who are responsible for steering the affairs of the companies are fit and proper, besides having the necessary qualifications. In view of this, the following additional requirements are being put in place, which shall be applicable to all NBFCs-ND-SI, as also all NBFCs-D, with effect from March 31, 2015:

- NBFCs shall ensure that there is a policy put in place for ascertaining the fit and proper criteria at the time of appointment of Directors and on a continuing basis.
- A declaration and undertaking shall be obtained from the Directors by the NBFCs
- In addition, the Directors shall sign a Deed of Covenant
- NBFCs shall furnish to the Reserve Bank a quarterly statement on change of Directors certified by the auditors and a certificate from the Managing Director that fit and proper criteria in selection of directors have been followed. The statement must reach the Regional Office concerned of the Reserve Bank within 15 days of the close of the quarter.

v. Disclosures in Financial Statements – Notes to Account: A reference is invited under which NBFCs with assets of Rs. 100 crore and above were required to make additional disclosures in their balance sheets from the year ending March 31, 2009 relating to CRAR, exposure to real estate sector (both direct and indirect), and maturity pattern of assets and liabilities respectively. The above disclosures are now applicable for NBFCs-ND-SI (as redefined) and for all NBFCs-D. However, other NBFCs already disclosing the above are encouraged to continue to do so, in line with prudent practice.

vi. The extant disclosures are however far from comprehensive. There is need for greater transparency to provide enhanced information to the market and retain stakeholder confidence. It has hence been decided that in addition to the above disclosures, all NBFCs-ND-SI (as redefined), as also all NBFCs-D shall additionally disclose the following in their Annual Financial Statements, with effect from March 31, 2015:

- Registration/ licence/ authorisation obtained from other financial sector regulators;
- Ratings assigned by credit rating agencies and migration of ratings during the year;
- Penalties, if any, levied by any regulator;
- Information viz., area, country of operation and joint venture partners with regard to Joint Ventures and Overseas Subsidiaries; and
- Asset liability profile, extent of financing of parent company products, NPAs and movement of NPAs, details of all off-balance sheet exposures, structured products issued by them as also securitization/ assignment transactions and other disclosures .

VI. Off-Site Reporting: In view of the revised regulations, NBFCs-ND, with assets less than Rs. 500 crore, including investment companies, shall henceforth be required to submit only a simplified annual return, the details of which shall be separately communicated. Till such time, they may continue

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to submit the existing returns. NBFCs-ND-SI (as redefined), as also NBFCs-D, shall continue to submit the existing returns.

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8.8 Key Terms

- **Capital Adequacy Ratio:** The capital adequacy ratio (CAR) is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures
- **TIER 1 Capital:** Tier one capital is one which can absorb losses without a bank being required to cease trading,
- **TIER 2:** It can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors
- **Net owned Fund:** It consists of paid up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets
- **NBFC:** A Non-Banking Financial Company (**NBFC**) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance etc.

8.9 Summary

- Non banking financial institutions play a crucial role in extending financial services, enhancing competition and diversification of the financial sector. NBFCs form a diverse group not only in terms of size and nature of incorporation, but functionally as well. Apart from enhancing competition in the financial system, these institutions play a crucial role in broadening the cess of a vast section of the population to financial services by offering a variety of products and services. The overlap between products offered by banks and non banking institutions is increasing day by day, calling for closer coordination in the regulation of banks and non banks.
- Financially sound, prudently governed and effectively regulated NBFCs can contribute to the stability and soundness of an efficient financial system, as NBFCs participate actively in the financial sector and play a complementary role by offering varied financial products and dispersing risk.

8.10 Questions & Exercises

1. How a Non Banking Financial Companies aid in the economic development of the country?
2. Compare the similarities and differences between NBFCs and commercial banks

3. Discuss the recent regulatory changes adopted for the better governance of NBFCs in India.
4. Explain the significance of NBFCs with respect to small business.
5. Highlight the performance of NBFCs in India in the current context.
6. Give the structural detail of NBFCs in India.

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8.11 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.
2. Saha, S.S., ***"Indian Financial System and Markets",***TMH Education Private Limited.
3. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.
4. Vasant Desai, *"**Fundamentals of the Indian Financial System-New Challenges, New Initiatives**",* Himalaya Publishing House.

Web resources:

1. "Classification and regulatory framework of RBI" is available at www.rbi.org.in

UNIT 9: BANKING INNOVATIONS

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Structure

9.0 Introduction
9.1 Unit Objectives
9.2 Reforms in the Banking Sector in India
9.3 Universal Banking
9.4 Core Banking
9.5 Consortium Banking
9.6 New Technology in Banking
9.7 Debit Cards
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9.0 Introduction

In this unit we are discussing the innovations and the new technology in banking sector. Over the years, the banking sector in India has seen a number of changes. The rate of transformation was particularly high in the 1990s and 2000s, when a number of innovations changed the way banking was perceived and it was the result of autonomous and induced necessities of the environment. In the 1990s, the banking sector in India pronounced greater emphasis being placed on technology and innovation. Banks began to use technology to provide better quality of services at greater speed. Information technology has made it convenient for customers to do their banking from geographically diverse places which earlier remain uncovered. Banks no longer restricted themselves to traditional banking activities, but explored newer avenues to increase business and capture new markets.

9.1 Unit Objectives

After studying this unit, students will be able to:

- Explain new technology in banking sector
- Understand meaning of debit and credit card
- Understand the concept of Automated Teller Machine
- Discuss the methods of electronic funds transfer

9.2 Banking Sector Reforms in India

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- Capital base of the banks were strengthened by recapitalization, public equity issues and subordinated debt.
- Prudential norms were introduced and progressively tightened for income recognition, classification of assets, provisioning of bad debts, marking to market of investments.
- Pre-emption of bank resources by the government was reduced sharply.
- New private sector banks were licensed and branch licensing restrictions were relaxed.
- Detailed regulations relating to Maximum Permissible Bank Finance were abolished.
- Consortium regulations were relaxed substantially.
- Credit delivery was shifted away from cash credit to loan method.
- The enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 enabled the sale of financial assets to securitisation/ reconstruction companies.
- Credit Information Bureau (India) Ltd (CIBIL) was established in 2000 that paved the way for the enactment of the Credit Information Act in May 2005, for credit information of borrowers.
- FDI in the banking sector was brought under the automatic route, and the limit in private sector banks was raised from 49 percent to 74 percent in 2004.
- To boost infra financing CRR/SLR exemption announced for banks for funds raised via infra bonds
- RBI issues draft norms for payments and small banks; for the first time a process to issue differentiated licences initiated
- Prime Minister Narendra Modi launches Pradhan mantri Jan DhanYojana – a scheme for opening bank accounts to foster financial inclusion. More than 130 million accounts opened in a matter of five months
- Government issues ordinance to allow foreign firms to have 49 per cent stake in insurance companies, a decision that was stuck for several years.
- RBI brings out final guidelines on banks becoming insurance brokers.
- The government is mulling Indradhanush-II, expanding the scope of banking reforms to get rid of bad loans, manage risks better, bring millions of un-banked and under-banked people into the fold as well as create a holding company for the public sector banks (PSBs).

9.3 Universal Banking

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A universal bank is a financial service conglomerate combining retail, wholesale and investment banking services under one roof and reaping synergies between them. The notion is that they would benefit from economies of scale in information technology and access to capital to serve companies and retail customers around the world. Universal banking benefits both banks and their clients. The integration of retail and investment services benefits banks by providing them with more ways to generate revenue, while it benefits clients by providing them with the convenience of accessing a full range of banking services from a single provider presumably trust.

9.3.1 Universal Banking in India

The Narsimham Committee II suggested that Development Financial Institutions (DFIs) should convert ultimately into either commercial banks or non-bank finance companies. However, the concept of Universal Banking conceptualized in India after the RH Khan Committee recommended it as a different concept. The Khan Working Group held the view that DFIS should be allowed to become banks at the earliest. The RBI released a 'Discussion Paper' (DP) in January 1999 for wider public debate. The feedback on the discussion paper indicated that while the universal banking is desirable from the point of view of efficiency of resource use, there is need for caution in moving towards such a system by banks and DFIs. Major areas requiring attention are the status of financial sector reforms, the state of preparedness of the concerned institutions, the evolution of the regulatory regime and above all a viable transition path for institutions which are desirous of moving in the direction of universal banking.

9.3.2 Advantages of Universal Banking

Economies of Scale would result in greater economic efficiency in the form of lower cost, higher output and better products.

- Increased diversions and increased profitability
- Better Resource Utilization.
- Brand name leverage
- Existing clientele leverage
- Value added services
- 'One-stop shopping' saves a lot of transaction costs.

9.3.3 RBI Guidelines on Universal Banking

Some of the guidelines are as follows:

- Once the FI becomes a universal Bank, it would be compliant with the CRR and SLR requirements of the RBI.
- The activity which is permissible for the FI but not permissible for Bank would have to be stopped.
- Any immovable property acquired by the FI would have to be disposed of in 7 years. The composition of the Board of Directors would be required to be changed so that it is compliant with the Section 10 (A) of the Banking

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Regulation Act which requires at least 51% of the total number of directors to have special knowledge and experience.

- If there is any floating charge on any of its assets, it would have to be ratified by the RBI since a banking company is not allowed to create a floating charge on the undertaking or any property of the company unless duly certified by RBI as required under the Section 14 (A) of B R Act.
- If there is any subsidiary that is engaged in an activity which is not permissible under the B R Act, then the subsidiary will have to be delinked.
- Banks cannot hold shares in the companies in excess of 30% of the paid up share capital of that company or 30 per cent of its own paid-up share capital and reserves as per the B R act, so , the FI after becomes a Universal Bank shall divert the excess of the equity.
- Section 20 of the B. R. Act prohibits grant of loans and advances by a bank on security of its own shares or grant of loans or advances on behalf of any of its directors or to any firm in which its director/manager or employee or guarantor is interested.
- The compliance with these provisions would be mandatory after conversion of an FI to a universal bank.
- The FI would require obtaining a license from RBI to carry business of banking in India and has to comply with the applicable conditions.
- The FI would need to comply with the existing branch licensing policy of RBI which requires allotting at least 25 per cent of their total number of branches in semi-urban and rural areas. At the close of business on the last Friday of every quarter, the FI after becomes a Universal Bank, would make sure that its total assets held in India are not less than 75 per cent of its total demand and time liabilities in India, as required of a bank under Section 25 of the B R Act.
- Publishing annual financial reports as per requirements of the B R Act.

9.4 Core Banking

The word Core Banking is used to describe the various services being offered by the banking system to its customers and this is done by the whole banking core branches. This facility makes it possible for the banks to get transfer their funds and other transactions to other core branch offices in a very easy and quick manner. Now, there is no need to get deposit and withdrawal of your cash in the same branch. You can deposit from any branch and get it withdrawal easily from the other branch. This facility of core banking has been developed few years back and had led to the tremendous change in the banking system structure. It gives the freedom of choice to the customer to get done the transactions completed in his own way. The person is not bound to anyone.

The Core Banking solution from TCS BaNCS is an integrated solution that automates all aspects of core banking operations across entities, languages and currencies. A part of the universal banking suite, the core banking solution helps financial institutions introduce new products with ease and efficiently manage changes in existing ones.

- Entire range of banking products including savings, checking, overdraft and deposit accounts
- Entire range of lending products
- Complement of transactional services including remittance, foreign exchange, cards and trade finance
- Accessibility through multiple channels, including mobile banking and web
- Full integration of front-, middle-, and back-office processes
- Accurate, timely and actionable information about customer relations
- Single view between bank and customer
- "Anytime anywhere" banking

With world-class implementation and support expertise, the Core Banking solution from TCS BaNCS has been successfully deployed in leading banks across the world. State Bank of India, Taishin Bank, and Nova Ljubljanska Banks are among our success stories in the deployment of "anytime anywhere" banking. Our core banking solution automates banking processes and provides best-in-class customer service at reasonable cost, thereby maximizing operational efficiency and minimizing risks.

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9.5 Consortium Banking

As per the consortium lending approach, the group of banks would have a common agreement wherein a lead bank would assess the borrower's fund requirements, set common terms and conditions and disseminate information about borrower's performance to other lenders. Thus, the move is expected to keep a check on the high value frauds in the system as well, which ride high in case of multiple lending arrangements. It is not uncommon to find a borrower availing term loan as well as working capital limits from a number of financial institutions and commercial banks. A term loan to a borrower may be sanctioned jointly by all India financial institutions and banks. Similarly, working capital limits may also be availed by the borrower from a number of banks partly because of the large size of borrowing and partly to have a degree of flexibility in his operations with different banks.

The borrower may have a multiple banking relationship where he has independent arrangement with each bank, security offered to each bank is separate and no formal understanding exists between different banks financing the same borrower. Under this arrangement banks may not be exchanging information on the borrower and limits might have been sanctioned on different terms and conditions. This arrangement may be preferred by the borrower as it affords him a great flexibility in operating his accounts with different banks but goes contrary to the expectations of reserve bank which desires that a wholesome view of entire operations of a customer must be taken by the banks and the assessment of credit needs be also done in totality.

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The other arrangement for sanctioning of credit limit to such a Borrower may be to form a Consortium of Banks to take care of the entire needs, of the Borrower. No definite guidelines on formation of consortium of Banks, however, existed in past and it was generally left to the Borrower to decide this issue.

The first attempt in this regard was made by Reserve Bank of India while it constituted a study group in December, 1973, headed by Shri G. Lakshmmaryanan, which submitted its report in July, 1974. The report was accepted by Reserve Bank.

RBI Guidelines on Consortium Advances

The concept of Consortium Advance has since gone many changes and most of the large Borrowers are now being financed by Banks in consortium. Reserve Bank of India had also issued revised comprehensive guidelines in June 1987 on this subject. Reserve Bank of India further constituted a Committee in January, 1993 under the Chairmanship of Shri J.V. Setty, Chairman and Managing Director, Canara Bank, to review the extant guidelines on lending under Consortium arrangement and suggest measures for improving the efficiency of banking system in delivery of credit. Based upon the report submitted by the above Committee, Reserve Bank announced important changes in die existing guidelines. Guidelines applicable to Consortium advance are as follows:

1. The overall exposure to a single borrower should not exceed 25% of the net worth of the banking institution. For this purpose non fund based facilities shall be counted @ 50% of limits sanctioned and added to total fund based facilities to arrive at total exposure to the borrower.

2. Exposure limit to group has also now been stipulated. The overall exposure to a group should not exceed 50% (60% in case of infrastructure projects consisting of power, telecommunication, roads and ports) of the net worth of the banking institution.
   (a) The borrowers who are already having multiple banking arrangements and enjoy fund based credit limits of Rs. 50.00 crores or more must necessarily be brought under Consortium arrangements. The bank that is having the largest share in the credit facilities would automatically become the leader of Consortium and would ensure that Consortium arrangements are finalised immediately.
   (b) The borrowers who are already having multiple banking arrangements and enjoy fund based credit limits of less than Rs.50 crores should also be brought under formal Consortium arrangements at the time of further enhancements which would take the aggregate limits to Rs.50 crores or more. The enhancements in such cases would be considered jointly by the financing banks concerned and the bank which takes up the largest share of fund based limits shall be the leader of the Consortium.
   (c) These provisions would also be applicable to new units which approach more than one bank for sanctioning of working capital limits of Rs.50 crores or more.

The net effect of these provision amounts to that no borrower will be allowed to have multiple banking arrangement if the total fund based credit limit sanctioned to him amounts to Rs.50 crores or more. A formal Consortium will have to be constituted in such cases and the bank having largest share in fund based credit limits will automatically assume the status of the leader of the Consortium.

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3. There is no ceiling on number of banks in a Consortium, whether it is obligatory (fund based credit limits of Rs.50 crores and above from more than one bank) or voluntary (fund based credit limits below Rs.50 crores from more than one bank) in nature. However, the share of a bank as member of Consortium should be a minimum of 5 per cent of the fund based credit limits or Rs.1 crore whichever is more. This provision would itself restrict the number of banks in a Consortium.

4. The banks who have sanctioned term loans to a unit or who have also participated in term loans sanctioned in Consortium with term lending financial institution should also provide working capital facilities to such a unit. These banks may, however, associate other banks, if so warranted, to provide working capital Finance.

5. The borrower who is being financed under a formal Consortium arrangement should not avail any additional credit facility by way of bills limits/ guarantees/ acceptances, letters of credit etc. from any other bank outside the Consortium. It has been stipulated by Reserve Bank of India that any bank outside the Consortium should not extend any such facility or may not even open a current account without the knowledge and concurrence of the Consortium members. This stipulation is applicable to even those borrowers who are enjoying total fund based credit limits of above Rs.50 crores from a single bank or under syndication without a Consortium arrangement.

6. In case of borrowers enjoying aggregate fund based credit limits of Rs.1 crore and above but below Rs.50 crore from more than one bank, and where there is no formal Consortium arrangement, banks should obtain full details of the credit facilities (including ad hoc facilities) availed by such borrowers from the banking system, each time any fresh facility/ enhancement is sought. Also the banks should ensure timely exchange of information and co-ordinated approach in the interest of overall health of advance made to such borrowers. Further, in the case of borrower accounts enjoying fund based credit limits below Rs.50 crore from more than one bank, the concerned banks will be free to enter into a Consortium arrangement at their option.

7. Banks/consortia treat borrowers having multi division/ multi product companies as one single unit, unless there is more than one published balance sheet. Similarly, in the case of merger, the merged unit will be treated as a single unit. In case of split, the separated units will be treated as separate borrower accounts provided there is more than one published balance sheet.

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8. In case of borrowers enjoying fund based credit limits of Rs.50 crore and above, the concerned single bank and/or the leader of the existing Consortium, will be free to organise a 'syndication' of the credit limits.

9. In cases, where banks/consortia/syndicates are unable to adhere to the recommended maximum time frames for disposal of loan applications/ proposals, borrowers will be free to bring in a new bank or new banks to form/ to join a Consortium /syndicate. Within seven days of sanction of any credit facility, such new banks should inform the existing Consortium / syndicate/ regular banks/(s) and should not disburse the limit without obtaining 'no objection'. In case such 'no objection' certificate is not received within next ten days, it would be doomed that existing consortia/syndicates/ regular bank/(s) have no objection to the new bank/(s) joining/forming consortia/syndicates.

10. In the cases of existing consortia, if a member bank is unable to take up its enhanced share, such enhanced share in full or in part could be reallocated among the other existing willing members. In case other existing member banks are also unable to take up such enhanced share of an existing & member bank, a new bank willing to take up the enhanced share may be inducted into the Consortium in consultation with the borrowers.

11. While a member bank may be permitted not to take to up its enhanced/ incremental shares it cannot be permitted to leave a Consortium before expiry of at least two years from the date of its joining the Consortium. An existing member bank may be permitted to withdraw from the Consortium after two years provided other existing member banks and/or a new bank is willing to take its place by joining the Consortium.

12. In cases where the other existing member banks or a new bank an unwilling to take over the entire outstanding of an existing member desirous of moving out of the Consortium after the expiry of above mentioned period of two years, such bank may be permitted to leave the Consortium by selling its debt at a discount and/or furnishing an unconditional undertaking that the repayment of its dues would be deferred till the dues of other members are repaid in full.

13. Quite often non availability of data or submission of incorrect data or non-receipt of required financial statements results in banks/consortia being not able to take decisions within a stipulated period of time. These data/ statements include, among other, audited financial results for the last two years, estimated and projected results for the current and subsequent years respectively. More often than not borrowers require an average time of at least six months to obtain audited financial statements.

14. Further, individual banks/consortia/syndicates should review the borrower accounts during the first quarter of the current year on the basis of audited statements for the year before last, provisional statements (where audited statements are not available) for the last accounting year, provisional

estimates for the current accounting year and forecast for the next year. Consequently, individual banks/consortia/syndicates, at their discretion, may release 50 per cent of the additional credit requirement during or before the second quarter of the current accounting year. The remaining 50 per cent could be released consequent to submission of audited results provided there is no significant difference between the provisional estimates and the audited results.

15. No bank will be allowed to move out of the Consortium in case of sick/ weak units since in such cases all the banks are required to associate themselves with rehabilitation efforts.

16. The appraisal of credit proposals will be done by the lead bank. The customer has to submit all the necessary papers and data regarding appraisal of his limits to the lead bank who will in turn arrange for preparation of necessary appraisal note and its circulation to other member banks. Lead bank must complete the entire work relating to appraisal within the maximum time frame. Reporting to and attending to any correspondence with Reserve Bank of India shall also be the responsibility of lead bank.

17. There may sometimes be disagreement between the member banks on the quantum of permissible bank Finance, terms and conditions or any other matter. In such cases, decision of the Consortium will be binding on the lead bank as also other members. However, lead bank will enjoy the freedom to sanction an additional credit up to a pre-determined percentage in emergent situations. The lead bank should however, inform other members immediately together with their pro rata share.

18. There also exists a provision for forming steering committee consisting of leader bank and the bank with next highest share in the Consortium. Normally steering committee banks must have more than 51% share. Wherever Consortium fails to reach the consensus, other member banks shall follow the decision of the steering committee.

19. Earlier, the terms and conditions including rate of interest, margin etc. finalised at the Consortium meeting were uniformly applicable to all banks. Reserve Bank has however, relaxed the guidelines in this regard with freedom granted to banks to determine their own lending rates for advances above Rs.2 lacs. The banks in a Consortium will now be free to offer different rates of interest and other charges on their shares.

20. The ancillary and non-fund based business should also be passed on by the borrower to all the member banks in almost the same proportion in which funds based limits are shared. The inspection/verification of securities may be done by the lead bank or members in rotation as per arrangement which may be finalised in the Consortium.

21. The information regarding quarterly operating limits fixed in such a manner would be communicated by the lead bank to other member banks.

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Check your progress

1. Explain the Universal Banking?
2. What do you mean core banking solution?
3. What is consortium banking?

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9.6 New Technology in Banking

Banking today is a flourishing industry, focused on technological innovation. Internet banking has emerged as the biggest focus area in the "Digital Transformation" agenda of banks. Banks have changed in their operations and moved towards universal banking along with the increased usage of technology and technology-based services offering alternate channels such as smart cards, ATMs, usage of the internet, mobile and social banking. In 2012-13, Indian banks deployed technology-intensive solutions to increase revenue, enhance customer experience, optimize cost structure and manage enterprise risk. Majority of banks are insisting on cashless and paperless payment modes. However, there is a wide variation in the technology agendas and implementation capability across different players of the banking industry. Following are the salient features of banking on technology.

9.6.1 Internet Banking

The shift towards internet banking is fuelled by the changing dynamics in India. By 2020 the average age of India will be 29 years and this young consumer base is internet savvy and wants real time online information. Therefore, Indian banks need to aspire high and move toward implementing a world class internet banking capability.

9.6.2 Business Intelligence

India's banking industry is on the edge of a major transformation, with new banking licenses expected to bring more players in acompetitive environment. In such an environment, banks across India are increasingly adopting business intelligence (BI) and analytics to drive their overall profitability. RBI has also encouraged banks to adopt BI to increase transparency and control over the banking business. The Automated Data Flow (ADF) initiative has been a strategic step in this direction, seeking to ensure submission of correct and consistent data from banks' systems to the RBI without any manual intervention.

9.6.3 Risk Management and Information Security

The Indian Bank's Association (IBA) survey and EY analysis reveals that Core Banking System (CBS) is widely used across the banks for transaction management. However, its integration with risk management and other enterprise level applications is still at preliminary stages. Some key risk management methods include:

- Credit systems
- Enterprise Risk Management Systems
- Liquidity risk systems

With the advent of mobile computing, social media, cloud computing and increasing sophistication of hackers it is evident that the risk environment is changing. With more and more cases being registered under the IT Act 2000, banks can no longer ignore privacy of customers.

9.6.4 Technology in Training and E-learning

The last decade, which marks the era of liberalization and reforms in the country, has been an eventful one for the banking sector. The increase in investment on training and development by banks in India is caused by a variety of motives.These include - new technology adoption, productivity, responding to skills deficiencies, new hire inculcation, and staff performance management.

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9.6.5 Financial Inclusion

The spread of digital connectivity and mobile phones have created attractive opportunities in the Indian financial inclusion landscape. In particular, technology promises to enable hundreds of millions of people to access financial services for the first time due to its wide reach, convenience and low cost of delivery.

India is experimenting with several new ideas in financial inclusion in almost all areas requiring immediate focus - banking and payment channels, technology platforms, regulatory etc.

The six cornerstones pillars of financial inclusion

The six cornerstones pillars of financial inclusion	The ability of technology to bring services to people wherever they are and whenever they need them is the biggest driver of achieving comprehensive financial inclusion.
	Electronic payments are accelerating this drive, and new developments, including Big Data, ubiquitous internet access and cloud computing, are expected to have enormous impact.
	Regulators should consider relaxing restrictions in areas that disproportion ally affect unbanked customers, e.g., through KYC, agent banking and mobile banking.
	Interoperability can create value for customers to attract large volumes
	Keeping pace with technology changes in the financial inclusion space will require significant investments in the regulatory capacity and changes made in regulatory processes.
	Government can incentivize service providers to introduce technologyenhanced business models that improve last mile delivery by deploying their own resources, e.g., DBT payments and universal service funds.

9.6.6 Mobile Banking

Mobile banking continues to be a focus area for all banks in India. Our survey indicates that they are not only looking at this channel as a way to increase their customer engagement in urban areas, but also to reach out to new ones in rural regions.

9.6.7 Payment Systems

In the last decade, India has seen a shift from traditional payment methods, i.e., cash/paper-based payments to modern electronic payment systems. However, 97% of payment transactions for public sector banks are paper based as compared to

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60% for private sector banks. In the recent past, the RBI has taken multiple steps to promote electrification of payment instruments such as:

- Framing the Payment & Settlements Systems Act to provide for the regulation and supervision of payment systems in India.
- Providing robust RTGS/NEFT platform, establishing National Payments Corporation of India (NPCI) to act as an umbrella institution for all the retail payment systems.
- Regulation and promotion of acceptance channels including ATMs, POS and payment gateway policy.
- Issuance guidelines and security measures for all card transactions.

9.7 Debit Cards

A debit card is another way to make banking transactions electronically. In addition to using it at ATMs, you can use a debit card to pay for goods you purchase in many stores. You must have the money in your account at the time of purchase. The amount of your purchase is deducted from your account immediately. You will receive a regular statement from the bank, showing the total amount deducted from your account and your remaining balance.

A debit card looks just like a regular ATM card, and you can use it at ATMs. The difference is that a debit card has a Visa® or Mastercard® logo on its face. That means you can use a debit card wherever Visa® or Mastercard® debit cards are accepted, for example, department stores, restaurants, or online. ATM and debit cards are also a convenient way to make purchases without carrying cash that help you keep better track of the money you spend.

9.7.1 Parts of a Debit Card

Debit card is a powerful tool for spending. That little piece of plastic has everything you need to spend money overseas, in your hometown, and online. Let's look at each of the features on your card, starting with the front of your card.

9.7.1.1 Front of a debit card: It includes -

- **Bank branding:** Your card might simply show the bank name, or it might display a logo for a specific program (such as a rewards programthat your bank offers).
- **Debit card number:** It is one of the most important things on the card. It is the 16 digit number that points to your account with the card issuer, and those are the digits you will need to provide when making purchases online or by phone.
- **Cardholder's name:** It is the name of the person authorized to use the card. That person didn't necessarily open the account – they might simply have permission to spend from the account. Only authorized card users can make purchases with a debit card, and merchants are encouraged to ask for ID before accepting payment with a card.
- **Issue and Expiration date:** Issue date is the date on which your debit card was issued. Your card can only be used until the expiration date. A new card will be automatically sent to your address prior to the expiration date.

- **Payment network logo:** The logos that appear on your card indicate where it can be used. Common examples include MasterCard, Visa, and Discover. If making purchases online, there might be a drop-down menu that requires you to select which network your card belongs to.

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9.7.1.2 Back of a debit card: It includes -

- **Customer service number**: Call this toll-free number when you have questions about your account.
- **Magnetic stripe:** This black strip contains information about you and your card, which can be read by specialized devices known as *card readers*. Every time you swipe your card at a merchant, you're running the magnetic stripe through a card reader so that your card can be charged. Magnetic stripes provide your name, card number, expiration date, and other details. If that information is stolen (whether manually or by a card skimming device), it can be used to create a fake card – with a magnetic stripe that has the same information as your card.
- **Signature bar:** For your protection against fraud, be sure to sign here as soon as receive your card.
- **Card verification value (CVV):** This number is unique to your card. When you use your card to make purchases over the phone or Internet, some merchants may require you to supply this number to confirm that you have the card with you.
- **Network logos:** The logos that appear on your card indicate where it can be used. You can:
    1. Access any ATM that carries the same logos as your card.
    2. Make PIN-based purchases at merchants that display the same Point-of-Sale network.
    3. Make signature-based purchases at merchants that accept Visa or MasterCard debit cards.

9.7.2 Types of Debit Cards in India

- **Visa Debit Cards:**These debit cards are issued with the bank's tie-up with VISA payment services providing the Verified by Visa (VbV) platform for online transactions.
- **Visa Electron Debit Cards:** Visa Electron debit cards are very similar to Visa debit cards but these cards do not provide the overdraft feature.
- **MasterCard Debit Cards:** A MasterCard gives customers access to their funds worldwide and they can perform online transactions using their bank accounts on the MasterCard SecureCode platform.
- **Contactless Debit Cards:** Customers can make payments with just a tap or wave of their contactless debit cards near PoS terminals, with the cards working on Near Field Technology (NFC), thereby, making electronic payments safer.
- **RuPay Debit Cards:** These cards were introduced as a domestic card scheme by the NPCI.RuPay debit cards facilitate online purchases and

transactions on the Discover network and ATM transactions under the National Financial Switch network.

- **Maestro Debit Card:** Maestro from MasterCard is a premier, international debit card service that has been popularly adopted at over 13 million locations spread across 100+ countries around the world. Maestro, as easily identified by the signature logo on all partner cards, helps the customer gain immediate access to his/her money through a robust, international network of compatible ATMs, POS outlets and online resources.

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Check your progress

4. Explain the six cornerstones pillars of financial inclusion.
5. What do you mean by debit card?
6. What is card verification value?

9.8 Credit Cards

Credit is a method of selling goods or services without the buyer having cash in hand. A credit card is only an automatic way of offering credit to a consumer. A credit card is basically a plastic card with a magnetic strip invented with the intention to simplify the complicated banking process for an individual in case he/she is short of cash, be it something casual like shopping or something severe like an emergency situation.

The dictionary defines a credit card as ‘A card which can be used to obtain cash, goods or services up to a stipulated credit limit. The supplier is later paid by the credit card company which in due course is reimbursed by the credit card holder who will be charged interest at the end of the credit period if money is still owing.’

This means that using a credit card is effectively like taking-out a loan. That loan must be re-paid to the credit card company (the lender) within the credit cycle (billing is usually every 30 days and thus the credit period can vary from 7 days to 45 days depending on when the purchase was made). If the money is not repaid within this time an interest charge is levied (applied) to the remaining balance. All the credit card comes with a credit limit, a predetermined amount of money which its lender is offering as credit to a credit card holder to spend wherever he wants to. Before issuing a credit card to an individual, the bank or the financial institution has a look at his/her credit rating alongside verifying his/her credit history.

9.8.1 Features of Credit Cards

- **Alternative to cash:** Credit card is a better alternative to cash. It removes the worry of carrying various currency denominations to pay at the trade counters. It is quite easy and way fast to use a credit card rather than waiting for completion of cash transactions.As an alternative, credit card helps a cardholder to travel anywhere in the world without a need to carry an ample amount of cash. It also reduces the possible risk of money theft and gives its user a complete peace of mind.
- **Credit limit:** The credit cardholder enjoys the facility of a credit limit set on his card. This limit of credit is determined by the credit card issuing entity (bank or NBFC) only after analyzing the credit worthiness of the cardholder.The credit limit is of two types, viz., normal credit limit and revolving credit limit varies with the financial exposure of the credit cardholder.
- **Record keeping of all transactions:** Credit card issuing entities like banks or NBFCs keeps a complete record of all transactions made by their credit

cardholders. Such a record helps these entities to raise appropriate billing amounts payable by their cardholders, either on a monthly or some periodic basis.

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- **Grace period:** The grace period is referred to those minimum numbers of additional days within which a credit cardholder has to pay his credit card bill without any incurring interest or financial charges.
- **Additional charges for delay in payment:** The credit card payment is supposed to be made within a due date as mentioned on the bill of a credit card. If payment is not paid on time, then a credit-card issuer charges some additional costs, which are resulted due to delay in payment. These charges are charged to compensate (recover) the interest cost, administration cost and any other related costs bared by the credit card issuing entity.

9.8.2 Types of Credit Card

Credit cards now are of various types with different fees, interest rates and rewarding programs. When applying for a credit card, it is important to learn of their diverse types to know the one best suited to their lifestyle and financial status. Different types of credit cards available by banks and other companies/organizations are briefly described below.

- **Gold Credit Card:** Gold Credit cards made for higher income groups who also have higher credit rating. It is status symbol and it is considered prestigious. Cash withdrawal limit is higher. Credit limit is higher Provides one Add-on card which can be given to either, spouse, children or parents of the credit card holder Provides many privileges such as travel insurance, reward points, cash back offers etc.
- **Platinum or Titanium Card:** Platinum or Titanium Cards are similar to gold credit cards but they have few more additional benefits. Protections against credit card loss and theft, Protection against online fraud transactions, Protection against sickness and injury by an accident. There is no yearly fee.
- **Silver Credit Card:** Silver credit cards are standard credit cards available and most of the employed people with 4 or 5 years' experience can own this type of card, Lower membership fees, The applicant need not be a high-salaried person to buy silver card, The interest rate is 0% initially between 6-9 months when transferring account balance from one credit provider to another one.
- **Secured Credit Cards:** Secured credit cards are known as pay-as-you-go cards. Upon opening the account, the card holder deposits a few hundred to a couple of thousand dollars. This determines the card holder's credit line. This limit is often based on a percent of the deposit, which is usually 50-100% of what you put into the account. The cards have an annual fee and higher annual interest rates. Most often, these cards are used to re-establish credit. A person can use the card to make small purchases that they can easily repay. Getting a card with a conversion option makes it easier to switch to a standard credit card, which should be possible after several months of good payment history.

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- **Specialty Credit Cards:** Specialty cards typically are offered through affiliations, partnerships, major brand retailers or service providers. Many specialty credit cards share a partnership between organizations that support a social cause, professional organization or an alumni association. A small portion of the purchase goes toward the intended organization.

- **Prepaid Credit Cards:** Prepaid cards are not credit cards at all, but are used and accepted just like them. The advantages of prepaid cards is that there are no finance charges and they help you avoid debt since all purchases are paid for beforehand. With these cards you determine the credit line by transferring however much money you'd like to have available to spend to the card. This eliminates the risk of running up credit card debt and makes the budgeting process much easier. Although most prepaid cards do not charge finance fees, other fees may apply, including monthly fees, start-up or application fees, over-limit fees, ATM fees, reload fees and more. Be sure to thoroughly look over the terms and conditions for each specific card before applying for it.

- **Reward Cards:** Many credit cards have reward programs that can influence your spending. The perks may come in the form of cash, points or discounts. Points that accumulate, for instance, can be traded off for free hotel stays, merchandise, air travel car rentals and certificates. However, these credit cards can come with complex rules, limits and restrictions. The key is to try to make sure that annual fees don't end up eliminating all the benefits. Rewards cards are typically best for people who pay their balances off every month.

9.8.3 Global Player in Credit Card Market

- **Master Card:** Master Card is a product of MasterCard International and along with VISA are distributed by financial institutions around the world. Cardholders borrow money against a line of credit and pay it back with interest if the balance is carried over from month to month. Its products are issued by 23,000 financial institutions in 220 countries and territories.

- **VISA Card:** VISA cards is a product of VISA USA and along with MasterCard is distributed by financial institutions around the world. A VISA cardholder borrows money against a credit line and repays the money with interest if the balance is carried over from month to month in a revolving line of credit. Nearly 600 million cards carry one of the VISA brands and more than 14 million locations accept VISA cards.

- **American Express:** The world's favourite card is American Express Credit Card. More than 57 million cards are in circulation and growing and it is still growing further. Around US $ 123 billion was spent last year through American Express Cards and it is poised to be the world's No.1 card in the near future.

9.9 Internet Banking

Internet banking (or E-banking) means any user with a personal computer and a browser can get connected to his bank's website to perform any of the virtual banking functions. In internet banking system the bank has a centralized database that is web-enabled. All the services that the bank has permitted on the internet are displayed in menu. Any service can be selected and further interaction is dictated by the nature of service. Internet banking is assessable via a computer or mobile phone also known as online banking.

Internet banking through traditional banks enables customers to perform all routine transactions, such as account transfers, balance inquiries, bill payments and stop payment requests and some even offer online loan and credit card applications. Account information can be accessed anytime, day or night and can be done from anywhere. A few online banks update information in real time, while others do it daily. Once information has been entered, it doesn't need to be re-entered for similar subsequent checks and future payments can be scheduled to occur automatically.

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Check your progress

7. What is credit card?
8. Explain the types of credit card.
9. Discuss the features of credit card.

9.9.1 Internet Banking in India

The Reserve Bank of India constituted a working group on Internet Banking. The group divided the internet banking products in India into 3 types based on the levels of access granted. They are:

- **Information Only System:** General purpose information like interest rates, branch location, bank products and their features, loan and deposit calculations are provided on the banks website. They provide facilities for downloading various types of application forms. The communication is normally done through e-mail. There is no interaction between the customer and bank's application system. No identification of the customer is done. In this system, there is no possibility of any unauthorized person getting into production systems of the bank through internet.
- **Electronic Information Transfer System:** This system provides customer- specific information in the form of account balances, transaction details, and statement of accounts. The information is still largely of the 'read only' format. Identification and authentication of the customer is through password. The information is fetched from the bank's application system either in batch mode or off-line. The application systems cannot directly access through the internet.
- **Fully Electronic Transactional System:** This system allows bi-directional capabilities. Transactions can be submitted by the customer for online update. This system requires high degree of security and control. In this environment, web server and application systems are linked over secure infrastructure. It comprises technology covering computerization, networking and security, inter-bank payment gateway and legal infrastructure.

9.9.2 Services through E-Banking

Customers can avail following services through E-banking.

- **Bill payment service :** You can facilitate payment of electricity and telephone bills, mobile phone, credit card and insurance premium bills as

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each bank has tie-ups with various utility companies, service providers and insurance companies, across the country. To pay your bills, all you need to do is complete a simple one-time registration for each biller. You can also set up standing instructions online to pay your recurring bills, automatically. Generally, the bank does not charge customers for online bill payment.

- **Fund transfer:** You can transfer any amount from one account to another of the same or any another bank. Customers can send money anywhere in India. Once you login to your account, you need to mention the payee's account number, his bank and the branch. The transfer will take place in a day or so, whereas in a traditional method, it takes around three working days.
- **Credit card customers:** With Internet banking, customers can not only pay their credit card bills online but also get a loan on their cards. If you lose your credit card, you can report of lost card online.
- **Investing through Internet banking**: Anyone can now open an FD online through funds transfer. Now, investors with interlinked demat account and bank account can easily trade in the stock market and the amount will be automatically debited from their respective bank accounts and the shares will be credited in their demat account. Moreover, some banks even give you the facility to purchase mutual funds directly from the online banking system. Nowadays, most leading banks offer both online banking and demat account. However, if you have your demat account with independent share brokers, then you need to sign a special form, which will link your accounts
- **Recharging your prepaid phone:** Now just top-up your prepaid mobile cards by logging in to Internet banking. By just selecting your operator's name, entering your mobile number and the amount for recharge, your phone is again back in action within few minutes.
- **Shopping:** With a range of all kind of products, you can shop online and the payment is also made conveniently through your account. You can also buy railway and air tickets through Internet banking.

9.10 Automated Teller Machine (ATM)

An automated teller machine (ATM) is a computerised machine that permits bank customers to gain access to their accounts with a magnetically encoded plastic card and code number. It enables the customers to perform several banking, operations without the help of teller, such as to withdraw cash, make deposits, pay bills, obtain bank statements and cash transfers. It is also called automated banking machine or remote service unit.

There are two primary types of automated teller machines, or ATMs. The basic units allow the customer to only withdraw cash and receive a report of the account's balance. The more complex machines will accept deposits, facilitate credit card payments and report account information. To access the advanced features of the complex units, you will usually need to be a member of the bank that operates the machine.

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9.10.1 Advent of the ATM

The automated teller machine, or ATM, is such a complicated piece of technology that it does not have a single inventor. Instead, the ATMs we use today are an amalgam of several different inventions. Some of these proto-ATMs dispensed cash but did not accept deposits, while others accepted deposits but did not dispense cash. Today's ATMs are sophisticated computers that can do almost anything a human bank teller can, and have accompanied in a new era of self-service in banking.

By the end of the 1960s, however, times were changing, and a broader segment of the population was more comfortable with the idea of self-service and was more willing to trust unfamiliar technologies.

In 1967, a Scottish inventor named John Shepherd-Barron was sitting in the bathtub when he had a flash of genius; if vending machines could dispense chocolate bars, why couldn't they dispense cash? Barclays, a London bank, loved the idea, and Shepherd-Barron's first ATM was installed in a branch on Enfield High Street not long afterward. Unlike modern ATMs, Shepherd-Barron's did not use plastic cards. Instead, it used paper vouchers printed with radioactive ink so that the machine could read them. The customer entered an identification code and took her cash, a maximum of £10 at a time.

The first automated banking machine in the U.S. was devised by a Dallas engineer and former professional baseball player named Donald Wetzel. Wetzel's machine used plastic cards like the ones people use today (Instead of radioactive ink, the cards stored account information in magnetic strips). In September 1969, a Chemical Bank branch on Long Island installed the first of Wetzel's machines.The Hongkong and Shanghai Banking Corporation was the first bank to introduce the ATM concept in India way back in 1987. Now, most of the banks have their ATM outlets in India. The ATMs installed were from Diebold.

9.10.2 Growth in Automated Teller Machines (ATMs)

The banks increased their penetration further with the total number of ATMs reaching 0.18 million in 2015. However, there was a decline in growth of ATMs of both public sector banks as well as Private sector banks. Public sector banks recorded a growth of 16.7 per cent during 2014-15 maintaining a share of around 70 per cent in total number of ATMs. Foreign banks continued to record a negative growth in number of ATMs. In recent years, the shares of ATMs in rural and semi-urban area have been rising, though urban and metropolitan centres still dominate. In 2015, about 44 per cent of the ATMs were located in rural and semi-urban centres.

The share of off-site ATMs in total ATMs increased to 50.9 per cent as at end-March 2015 from 47.9 per cent in the previous year. The increase in share of off-site ATMs of public sector banks played a major role, which increased to 45.7 per cent in 2015 from 40.3 per cent in 2014. The share of private sector and foreign banks was already more than 60 per cent. Looking at the efficiency and cost-effectiveness of off-site ATMs, non-bank entities were allowed to own and operate ATMs called 'White Label ATMs (WLA)' by the Reserve Bank in 2012. As on October 31, 2015, 10,983 WLAs were installed.

NOTES

Check your progress

10. What do you mean by internet banking?
11. Explain the benefits of ATM.
12. What is White Label ATMs ?

9.11 Electronic Funds Transfer

With the emergence of internet and mobile banking and the emerging e-commerce opportunities, banks too have marched ahead with introducing the concept of electronic funds transfer, which is much more convenient and hassle free. Electronic funds transfer allows you to exchange funds between individuals as well as organizations via electronic gateways which can be accessed using internet, computers and smart phones. Funds can be transferred instantly from one account to another, either within the same bank or to a different bank network at any given time.

Electronic funds transfer is a much more preferred money transfer option as it allows customersto make money transfers at the comfort of their homes using integrated banking tools such as internet and mobile banking.

Besides being convenient, electronic transfer modes are considered to be safe, secure and make transferring money much simpler. Electronic transfers are processed immediately with the transferred amount being deducted from one account and credited to the other in real time, thus saving time and effort involved in physically transferring a sum of money. Opting for electronic transferring system also reduces the possibilities of any mistakes as a transaction is only authorized with complete details which include the correct account number of the beneficiary and the target bank's specific IFSC code.

9.11.1 Types of Electronic Funds Transfer

Following are the different types of electronic funds transfer

9.11.1.1 National Electronic Funds Transfer (NEFT)

The National Electronic Funds Transfer is a nation-wide money transfer system which allows customers with the facility to electronically transfer funds from their respective bank accounts to any other account of the same bank or of any other bank network. Not just individuals but also firms and corporate organizations may use the NEFT system to transfer funds to and fro.

Funds transfer through NEFT requires a transferring bank and a destination bank. With the RBI organizing the records of all the bank branches at a centralized database, almost all the banks are enabled to carry out an NEFT transaction. Before transferring funds via NEFT anyone has to register the beneficiary, for receiving the funds. For this people must possess information such as name of the recipient, recipient's bank name, a valid account number belonging to the recipient and his respective bank's IFSC code. These fields are mandatory for a funds transfer to be authorized and processed.

Any sum of money can be transferred using the NEFT system with a maximum cap of Rs. 10, Lakhs. NEFT transactions can be ordered anytime you want, even on holidays except for Sundays which are designated bank holidays. However, the transactions are settled in batches defined by the Reserve Bank of India depending upon specific time slots.

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The structure of charges that can be levied on the customer for NEFT is given below (as per RBI guidelines):

Inward transactions at destination bank branches (for credit to beneficiary accounts)	Free, no charges to be levied from beneficiaries
Outward transactions at originating bank branches – charges applicable for the remitter • For transactions up to Rs 10,000 For • transactions above Rs 10,000 up to Rs 1 lakh • For transactions above Rs 1 lakh and up to Rs 2 lakhs • For transactions above Rs 2 lakhs	- not exceeding Rs 2.50 (+ Service Tax) - not exceeding Rs 5 (+ Service Tax) - not exceeding Rs 15 (+ Service Tax) - not exceeding Rs 25 (+ Service Tax)

9.11.1.2 Real Time Gross Settlement (RTGS)

Real Time Gross Settlement as the name suggests is a real time funds transfer system which facilitates you to transfer funds from one bank to another in real time or on a gross basis. The transactions are not put on a waiting list and cleared out instantly. RTGS payment gateway, maintained by the Reserve Bank of India makes transactions between banks electronically. The transferred amount is instantly deducted from the account of one banks and credited to the other bank's account.

Users such as individuals, companies or firms can transfer large sums using the RTGS system. The minimum value that can be transferred using RTGS is Rs. 2 Lakhs and above. However there is no upper cap on the amount that can be transacted.

The remitting customer needs to add the beneficiary and his bank account details prior to transacting funds via RTGS. A beneficiary can be registered through your internet banking portal. The details required while transferring funds would be the beneficiary's name; his/her account number, receiver's bank address and the IFSC code of the respective bank. On successful transfer the Reserve Bank of India acknowledges the receiver bank and based on this the both the remitting bank as well as the receiving bank may/ may not notify the customers.

9.11.1.3 Immediate Payment Service (IMPS)

Majority of the funds transferred using electronic channels are processed via NEFT or RTGS. But as the funds could only be cleared in batches using these transfer gateways, the National Payments Corporation of India introduced a pilot mobile payment project also known as the Immediate Payment Service (IMPS). IMPS offers instant electronic transfer service using mobile phones. IMPS interbank transfer service is available 24X7 and allows you to use your mobile phones to access your account and to authorize transfer of funds between accounts and banks. The IMPS service also features a secure transfer gateway and an immediate confirmation on fulfilled orders.

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IMPS is offered on all the cellular devices via Mobile Banking or through SMS facility. For transferring money via IMPS route you must first register for the immediate payment services with your bank. On obtaining the Mobile Money Identifier (MMID) and MPIN from the bank you can login or make a request via SMS to transfer a certain amount to a beneficiary. Meanwhile the beneficiary must link his/her mobile number with his/her respective account and obtain the MMID from the bank to be able to receive money.

To initiate a transfer you must enter the beneficiary's mobile number, beneficiary MMID, the transfer amount and your MPIN while requesting the fund transfer. As soon as the transaction is cleared, you receive a confirmation SMS on deduction from your account and the money credited into the beneficiary's account. The transaction reference number can be noted for future reference. Thus, IMPS enables customers to use mobile instruments as an instant money transfer gateway, facilitating user convenience and saving time and effort involved in other modes of transfer.

9.12 Maganetic Ink Character Recognition

MICR stands for Magnetic Ink Character Recognition. It is a technology which allows machines to read and process cheques enabling thousands of cheque transactions in a short time.Actually, the MICR is the name given to the technology used in printing the code. In India in 1980 this unique system of MICR based cheque clearing system was introduced first time. Apart from being a security bar code to protect your transaction, the MICR code is also an indispensable part for online money transfers. Every bank branch is given a unique MICR code and this helps the RBI to identify the bank branch and speed up the clearing process. MICR code is usually a nine digit code comprising of some important information about the transaction and the bank.

The first three digits in the MICR code represent the city code that is the city in which the bank branch is located. In most cases it is in line with the PIN code of the postal addresses in India. ***The next three digits*** stand for the bank code while ***the last three digits*** represent the bank branch code.

For example, if you have an account with Axis Bank,New Delhi (Defence Colony) then its nine digit MICR code will be 110211004 where:

- 110, the first three digits representing the city code for New Delhi;
- 211, the next three digits representing the bank code for Axis bank;
- And 004, the last three digits representing the bank branch code for Defence Colony.

9.13 Key Terms

- **Internet banking:** Internet banking, also known as Online banking, e-banking or virtual banking is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website.
- **Universal banking:** Universal banking is a banking system in which banks provide a wide variety of financial services, including both commercial and investment services. Universal banking is common in some European countries, including Switzerland. In the United States, however, banks are required to separate their commercial and investment banking services. Proponents of universal banking argue that it helps banks better diversify risk.
- **Core banking system:** Core banking has historically meant the critical systems that provide the basic account management features and information about customers and account holdings. Elements of core banking include: Making and servicing loans, Opening new accounts, Processing cash deposits and withdrawals.
- **ATM:** An automated teller machine (ATM) is an electronic banking outlet, which allows customers to complete basic transactions without the aid of a branch representative or teller.
- **Electronic fund transfer:** An electronic funds transfer (EFT) is a transaction that takes place over a computerized network, either among accounts at the same bank or to different accounts at separate financial institutions.
- **NEFT:** National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporates can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme.
- **RTGS:** The acronym 'RTGS' stands for Real Time Gross Settlement, which can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis (without netting). 'Real Time' means the processing of instructions at the time they are received rather than at some later time; 'Gross Settlement' means the settlement of funds transfer instructions occurs individually (on an instruction by instruction basis). Considering that the funds settlement takes place in the books of the Reserve Bank of India, the payments are final and irrevocable.
- **MICR:** MICR stands for Magnetic Ink Character Recognition. It is a technology which allows machines to read and process cheques enabling thousands of cheque transactions in a short time. MICR code is usually a nine digit code comprising of some important information about the transaction and the bank.

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Check your progress

13. What is electronic fund transfer?
14. What do you mean by NEFT?
15. Difference between NEFT and RTGS
16. Explain the MICR.

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- **Mobile banking:** Mobile banking is the act of doing financial transactions on a mobile device (cell phone, tablet, etc.). This activity can be as simple as a bank sending fraud or usage activity to a client's cell phone or as complex as a client paying bills or sending money abroad. Advantages to mobile banking include the ability to bank anywhere and at any time. Disadvantages include security concerns and a limited range of capabilities when compared to banking in person or on a computer

- **Credit card:** A credit card is a card issued by a financial company giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short-term financing. Interest usually begins one month after a purchase is made and borrowing limits are pre-set according to the individual's credit rating.

- **Debit card:** A payment card that deducts money directly from a consumer's checking account to pay for a purchase. Debit cards eliminate the need to carry cash or physical checks to make purchases. In addition, debit cards, also called check cards, offer the convenience of credit cards and many of the same consumer protections when issued by major payment processors like Visa or MasterCard.

9.14 Summary

- Banks have changed in their operations and moved towards universal banking along with the increased usage of technology and technology-based services offering alternate channels such as smart cards, ATMs, usage of the internet, mobile and social banking.

- A debit card is another way to make banking transactions electronically. In addition to using it at ATMs, you can use a debit card to pay for goods you purchase in many stores. You must have the money in your account at the time of purchase. The amount of your purchase is deducted from your account immediately.

- A credit card is only an automatic way of offering credit to a consumer. A credit card is basically a plastic card with a magnetic strip invented with the intention to simplify the complicated banking process for an individual in case he/she is short of cash, be it something casual like shopping or something severe like an emergency situation.

- Internet banking (or E-banking) means any user with a personal computer and a browser can get connected to his bank -s website to perform any of the virtual banking functions. In internet banking system the bank has a centralized database that is web-enabled.

- An automated teller machine (ATM) is a computerised machine that permits bank customers to gain access to their accounts with a magnetically encoded plastic card and code number. It enables the customers to perform several banking, operations without the help of teller, such as to withdraw cash, make deposits, pay bills, obtain bank statements and cash transfers.

- The first automated banking machine in the U.S. was devised by a Dallas engineer and former professional baseball player named Donald Wetzel. Wetzel's machine used plastic cards like the ones people use today.
- The banks increased their penetration further with the total number of ATMs reaching 0.18 million in 2015. However, there was a decline in growth of ATMs of both public sector banks as well as Private sector banks. Public sector banks recorded a growth of 16.7 per cent during 2014-15 maintaining a share of around 70 per cent in total number of ATMs.
- Electronic funds transfer allows you to exchange funds between individuals as well as organizations via electronic gateways which can be accessed using internet, computers and smart phones. Funds can be transferred instantly from one account to another, either within the same bank or to a different bank network at any given time.
- The National Electronic Funds Transfer is a nation-wide money transfer system which allows customers with the facility to electronically transfer funds from their respective bank accounts to any other account of the same bank or of any other bank network.
- Real Time Gross Settlement as the name suggests is a real time funds transfer system which facilitates you to transfer funds from one bank to another in real time or on a gross basis. The transactions are not put on a waiting list and cleared out instantly.
- The National Payments Corporation of India introduced a pilot mobile payment project also known as the Immediate Payment Service (IMPS). IMPS offers instant electronic transfer service using mobile phones. IMPS interbank transfer service is available 24X7 and allows you to use your mobile phones to access your account and to authorize transfer of funds between accounts and banks.
- MICR stands for Magnetic Ink Character Recognition. It is a technology which allows machines to read and process cheques enabling thousands of cheque transactions in a short time.

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9.15 Questions and Exercises

1. Explain the major banking sector reforms after the liberalisation.
2. What are various innovative services provided by banks in current banking system? Explain.
3. How does the NEFT system operate?
4. Briefly describe the uses of internet banking.
5. What are the processing and service charges for NEFT transactions?
6. What is the importance of MICR code in banking industry?
7. Explain the different types of Electronic Funds Transfer.

NOTES

9.16 Further Readings and References

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UNIT 10: MONEY MARKET AND REGULATION

NOTES

Structure

10.0 Introduction
10.1 Unit Objectives
10.2 Overview of Money Market
10.3 Functions of Money Market
10.4 Structure of Indian Money Market
10.5 Regulatory Authorities of Money Market
10.6 Money Market Reforms in India
10.7 Government Securities Market
10.8 Key Terms
10.9 Summary
10.10 Questions and Exercises
10.11 Further Readings and References

10.0 Introduction

The financial Markets are the forefront in developing countries for speedy economic development. The financial market is mainly segmented in capital and money market. The efficiency of any financial system not only depends on developed capital market but also on the well-being of the money market. In India the money market is the major channel for transmitting the monetary policy impulses to the real sector of the economy. It is also important for ensuring stability in short-term interest rate and achieving balanced development of various market segments. Primarily money market deals with short-term investments and turnover of money in the economy.In this market short-term funds are borrowed and lent among participants permitted by RBI. It is the responsibility of Money Market to ensure that institutions which have surplus funds earn certain returns on the surplus. Otherwise these funds will be idle with the institutions. Similarly, the money market ensures funds for the needy at reasonable interest. This way liquidity posi-tion is assured by money market operations.

10.1 Unit Objectives

After studying this unit, students will be able to:

- Develop an understanding of the Basics of Money Market
- Know the functions of Money Market
- Understand the structure of Indian Money Market
- Develop an understanding of Money Market Instruments
- Understand legislations governing Indian Money Market

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10.2 Overview of Money Market

The money market is a mechanism that deals with the lending and borrowing of short term funds or debt securities and through which a large part of financial transactions of a particular country or of the world are cleared. It deals in funds and financial instruments having a maturity period of one day to one year. It is not a single market but a collection of markets for several instruments like call money market, Commercial bill market etc. The Reserve Bank of India is the most important constituent of Indian money market.

RBI describes money market as *"The centre for dealing mainly of short character, in monetary assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is a place where short term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government."*

The money market is generally considered as a place for safe investment with relatively low returns. The money market is also closely linked with the Foreign Exchange Market through the process of covered interest arbitrage in which the forward premium acts as a bridge between domestic and foreign interest rates.

10.3 Funtions of Money Market

A well-developed money market is an important part of any economy. It has very important role to play for the industrial and commercial development of a country. The major functions of money market are given below-

- **Provide self-sufficiency for Commercial Bank:** Developed money market helps the commercial banks to become self-sufficient. In the situation of emergency, when the commercial banks have scarcity of funds, they need not approach the central bank and borrow at a higher interest rate. On the other hand, they can meet their requirements by recalling their old short-run loans from the money market.
- **Provide profitable investment opportunity:** It provides a channel for commercial banks to invest their surplus reserves in profitable investment opportunities. Commercial banks can invest their surplus through money market in near-money assets *(e.g.* short-term bills of exchange) which are highly liquid and can be easily converted into cash.
- **Provide help to trade and industry:** Money market provides adequate finance to trade and industry. Money market helps the industries in securing short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc. Similarly it also provides facility of discounting bills of exchange for trade and industry.
- **Promote economic growth:** Money market can do this by making funds available to various units in the economy such as agriculture, small scale industries, etc.

- **Provide finance to government:** Money market provides non-inflationary sources of finance to government. It is possible by issuing treasury bills in order to raise short loans. However this does not leads to increases in the prices.

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10.4 Structure of Indian Money Market

The Indian Money Market involves a wide range of instruments and participants. In India money market Government, RBI, DFHI (Discount and finance House of India) Banks, Mutual Funds, Corporate Investors, Provident Funds, PSUs (Public Sector Undertakings), NBFCs (Non-Banking Finance Companies) etc. play very important role. The role and level of participation by each type of player differs from that of others. Indian money market is divided into two sectors: The organized sector and unorganized sector. Both of these sectors comprise several constituents. The following figure will help you in understanding the organizational structure of the Indian money market.

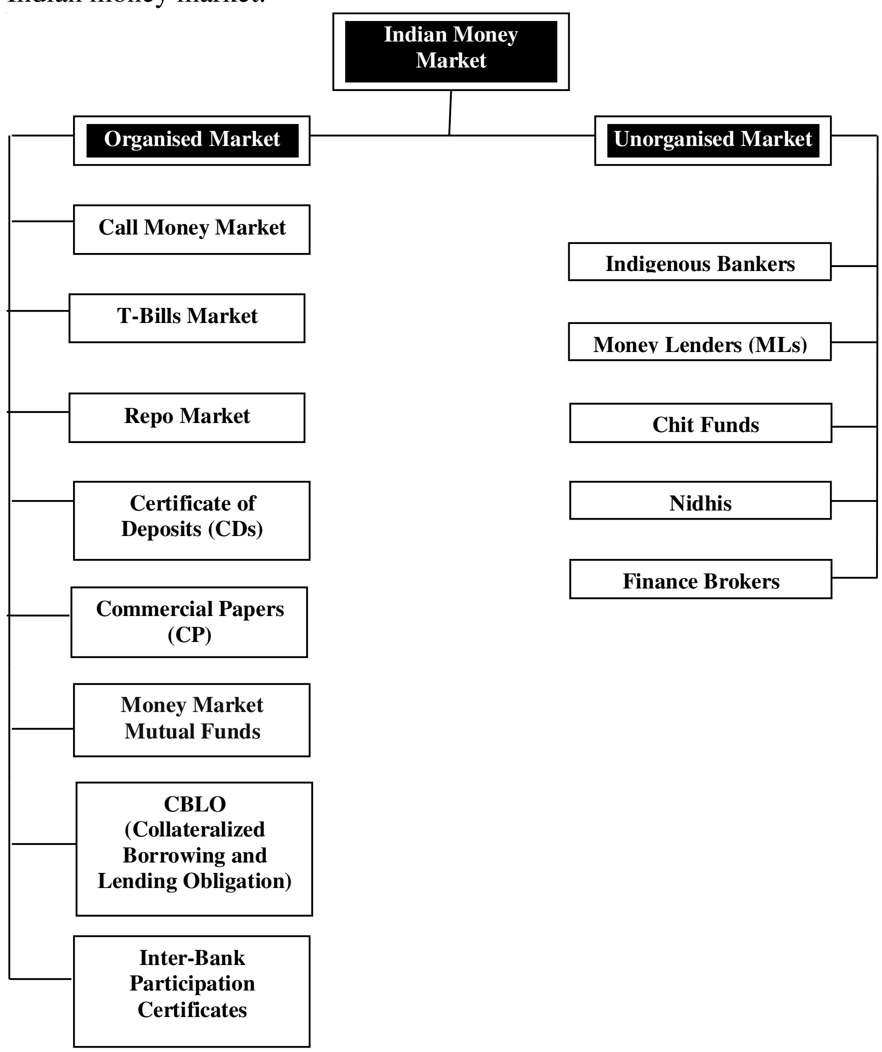

Figure 10.1: Structure of Indian Money Market

10.4.1 Organized Money Market

Organized Money Market is not a single market, it consists of number of markets. The most important feature of money market instrument is that it is liquid. It is characterized by high degree of safety of principal. The organized sector consists

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of the Reserve Bank of India, the State Bank of India with its five associates, twenty nationalized commercial banks, other scheduled and non-scheduled commercial banks, foreign banks, and Regional Rural Banks. It is called organized because its part is systemati-cally coordinated and regulated by the RBI. **Main constituents/components of organized money market in India are as follows:**

10.4.1.1 Call and Notice Money Market

It an important sub market of the Indian money market. The call/notice/term money market is a market for trading very short term liquid financial assets that are readily convertible into cash at low cost. The money market primarily facilitates lending and borrowing of funds between banks and entities like Primary Dealers. An institution which has surplus funds may lend them on an uncollateralized basis to an institution which is short of funds. The period of lending may be for a period of 1 day which is known as call money and between 2 days and 14 days. In this market the rate at which funds are borrowed and lent is called the call money rate. The call money rate is determined by demand and supply of short term funds. In call money market the main participants are commercial banks, co-operative banks and primary dealers. They participate as borrowers and lenders. This market is governed by the Reserve Bank of India which issues guidelines for the various participants in the call/notice money market.

Scheduled commercial banks are permitted to borrow to the extent of 125% of their capital funds in the call/notice money market, however their fortnightly average borrowing outstanding should not exceed more than 100% of their capital funds (Tier I and Tier II capital). At the same time SCBs can lend to the extent of 50% of their capital funds on any day, during a fortnight but average fortnightly outstanding lending should not exceed 25 per cent of their capital funds. Co-operative Banks are permitted to borrow up to 2% of their aggregate deposits as end of March of the previous financial year in the call/notice money market. Primary Dealers can borrow on average in a reporting fortnight up to 225% of the total net owned funds (NOF) as at end-March of the previous financial year and lend on average in a reporting fortnight up to 25% of their NOF.

The average daily turnover in the call money market is around Rs. 12,000-16,000 Cr every day and trading occurs between 9 am to 5 pm on Monday to Friday and 9 am to 2 pm on Saturday.

10.4.1.2 Treasury Bill Market (T – Bills)

This is a market for sale and purchase of short term government securities primarily Treasury Bills. Treasury Bills are short-term promissory notes issued by RBI on behalf of Central Government for raising funds to meet shortfalls in revenue collections, i.e., to meet revenue expenditure at present three types of treasury bills are issued through auctions, namely 91 day, 182 day and 364 day treasury bills. State government does not issue any treasury bills. Interest is determined by market forces. Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples of Rs. 25,000. Periodic auctions are held for their Issue. T-bills are highly liquid, readily available; there is absence of risk of default. In India T-bills have narrow market and are undeveloped. Commercial Banks, Primary Dealers, Mutual Funds, Corporates, Financial Institutions, Provident or Pension Funds and Insurance Companies can participate in T-bills market.

10.4.1.3 Repo Market

Repo was introduced in December 1992. Repo is a repurchase agreement. It means selling a security under an agreement to repurchase it at a predetermined date and rate. The seller of the security receives funds while the buyer of the security receives collateral for the funds he has lent. The rate at which the security will be repurchased in the 2nd leg of the repo is derived from the rate of interest payable on the funds lent and is known as repo rate. At present repoable securities include Central Government dated securities, Treasury Bills, State Development Loans and Govt of India Special Securities like Oil bonds, Food bonds, and Fertilizer bonds. The entities permitted to undertake repo transactions include Scheduled Commercial Banks, Co-operative Banks, Primary Dealers, Mutual Funds, Insurance Companies and corporate entities.

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In November 1996, RBI introduced Reverse Repo. 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. In March 2003, to broaden the Repo market, RBI allowed NBFCs, Mutual Funds, Housing Finance and Companies and Insurance Companies to undertake REPO transactions.

10.4.1.4 Market for Certificate of Deposits (CDs)

It is again an important segment of the Indian money market. Certificate of deposit is a negotiable money market instrument issued in dematerialized form or as a Usance Promissory Note by scheduled commercial banks excluding Regional Rural Banks (RRBs) and local Area Banks (LABs); and select all-India Financial Institutions that have been permitted by RBI to raise short-term resources. CDs are discounted instruments and are issued at a discounted price and redeemed at par value. CDs issued by banks should not have the maturity less than seven days and not more than one year. In 1992, RBI allowed four financial institutions ICICI, IDBI, IFCI and IRBI to issue CDs with a maturity period of one year to three years. They normally give a higher return than Bank term deposit, and are rated by approved rating agencies (e.g. CARE, ICRA, CRISIL, and FITCH). They are issued in multiples of Rs. 25 lakh subject to a minimum size of Rs. 1 crore. CDs can be issued at discount to face value. They are freely transferable but only after the lock-in-period of 45 days after the date of issue. There exists an active secondary market for CDs which witnesses an average volume of Rs 200-300 crore per day with demand and supply determined by by the liquidity conditions in the market.

10.4.1.5 Market for Commercial Paper

Commercial Paper is a money-market security issued (sold) by large banks and corporations to get money to meet short term debt obligations. Commercial Papers were introduced by RBI in January 1990 to enable corporate borrowers to diversify their sources of short-term borrowing and also provide an additional instrument to investors. A Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. Since it is not backed by collateral, only firms with excellent credit ratings from a recognized rating agency will be able to sell their commercial paper at a reasonable price. Commercial paper is usually sold at a discount from face value, and carries shorter repayment dates than bonds. CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. The longer the maturity on a note, the higher the interest rate the issuing institution must pay. CPs can be issued in denominations of Rs.5 lakh or multiples thereof.

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A corporate would be eligible to issue CP provided:

1. The minimum tangible net worth of the company to be at least Rs. 4 crores.
2. The CP receives a minimum rating of A-2 or such other rating from recognized rating agencies like CRISIL, CARE, ICRA, Fitch Ratings, etc.
3. The company has been sanctioned working capital limit by bank/s or all-India FIs.

10.4.1.6 Money Market Mutual Funds (MMMFs)

A Scheme of MMMFs was introduced by RBI in 1992. The goal was to provide an additional short-term avenue to individual investors. In November 1995 RBI made the scheme more flexible. The existing guidelines allow banks, public financial institutions and also private sector institutions to set up MMMFs. The ceiling of Rs. 50 crores on the size of MMMFs stipulated earlier, has been withdrawn. MMMFs are allowed to issue units to corporate enterprises and others on par with other mutual funds. Resources mobilised by MMMFs are now required to be invested in call money, CD, CPs, Commercial Bills arising out of genuine trade transactions, treasury bills and government dated securities having an unexpired maturity up to one year. Since March 7, 2000 MMMFs have been brought under the purview of SEBI regulations. At present there are 3 MMMFs in operation.

10.4.1.7 CBLO (Collateralized Borrowing and Lending Obligation)

CBLO (Collateralized Borrowing and Lending Obligation) Introduction was announced in year 2002-03 by RBI. It a money market instrument similar to REPO. CBLO is another money market instrument operated by the Clearing Corporation of India Ltd. (CCIL), for the benefit of the entities that have either no access to the inter-bank call money market or have restricted access in terms of ceiling on call borrowing and lending transactions. CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (up to one year as per RBI guidelines). In order to enable the market participants to borrow and lend funds, CCIL provides the Dealing System through Indian Financial Network (INFINET), a closed user group to the Members of the Negotiated Dealing System (NDS) who maintain Current account with RBI and through Internet for other entities who do not maintain Current account with RBI. Membership to the CBLO segment is extended to entities who are RBI-NDS members, viz., Nationalized Banks, Private Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, etc. Associate Membership to CBLO segment is extended to entities who are not members of RBI- NDS, viz., Co-operative Banks, Mutual Funds, Insurance companies, NBFCs, Corporates, Provident/ Pension Funds, etc.

10.4.1.8 Inter-Bank Participation Certificates

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Inter-Bank Participation Certificates or simply Participation Certificates (PC) are short-term papers issued by scheduled commercial banks to raise funds from other banks against big loan portfolios. When banks are short of liqui-dity to carry on their immediate operations and need short-term funds, they may approach other banks to share/participate in their lending portfolios. In other words, part of the specified loans and advances of the borrowing bank will be passed on to the lender-bank against cash. This will have the effect of reducing the exposure of borrower-bank on its particular loan portfolio and increase in the portfolio of lender-bank when the participa-tion is without recourse basis. Borrower-banks can have access to the facility only, up to certain percentage (currently 40%) of their standard or performing assets, i.e., Loans and Advances which are being serviced without default. PCs can be issued only for a maxi-mum period of 180 days and not less than a 90-day period.

10.4.2 Unorganized Money Market

The unorganized money market mostly finances short-term financial needs of farmers and small businessmen. The main constituents of unorganized money market are-

10.4.2.1 Indigenous Bankers (IBs)

The IBs are individuals or private firms who receive deposits and give loans and thereby they operate as banks. Unlike moneylenders who only lend money, IBs accept deposits as well as lend money. They operate mostly in urban areas, especially in western and southern regions of the country. Over the years, IBs faced stiff competition from cooperative banks and commercial banks. Borrowers are small manufacturers and traders, who may not be able to obtain funds from the organised banking sector, may be due to lack of security or some other reason.

10.4.2.2 Money Lenders (MLs)

MLs are important participants in unorganised money markets in India. There are professional as well as non-professional MLs. They lend money in rural areas as well as urban areas. They normally charge an invariably high rate of interest ranging between 15% p.a. to 50% p.a. and even more. The borrowers are mostly poor farmers, artisans, petty traders, manual workers and others who require short term funds and do not get the same from organised sector.

10.4.2.3 Chit Funds and Nidhis

They collect funds from the members for the purpose of lending to members (who are in need of funds) for personal or other purposes. The chit funds lend money to its members by draw of chits or lots, whereas Nidhis lend money to its members and others.

10.4.2.4 Finance Brokers

They act as middlemen between lenders and borrowers. They charge commission for their services. They are found mostly in urban markets, especially in cloth markets and commodity markets.

NOTES

Check your progress
1. What do you mean by money market?
2. Differentiate between organised and unorganised money market.
3. Explain the T-bills.
4. Discuss the repo rate.

Table 10.1: Interest Rate in the Money Market

(Percent per annum: Annual Averages)								
	Repo Rate	Call Rate	CBLO Rate	Market Repo Rate	91 day T-Bills	364-day T Bills	CP Rate	CD Rate
1	2	3	4	5	8	9	6	7
2000-01	11.2	9.1	-	-	9.0	9.8	10.8	9.6
2001-02	8.5	7.2	-	-	7.0	7.3	9.2	8.0
2002-03	7.7	5.9	-	-	5.8	5.9	7.7	6.6
2003-04	7.0	4.6	-	-	4.6	4.7	6.1	5.3
2004-05	6.0	4.7	-	-	4.9	5.2	5.8	5.0
2005-06	6.2	5.6	5.3	5.4	5.7	6.0	6.7	6.1
2006-07	7.0	7.2	6.2	6.3	6.6	7.0	8.5	7.9
2007-08	7.8	6.1	5.2	5.5	7.1	7.5	9.3	9.1
2008-09	7.4	7.1	6.1	6.5	7.1	7.2	10.7	9.2
2009-10	4.8	3.2	2.7	2.8	3.6	4.4	5.3	5.4
2010-11	5.9	5.7	5.4	5.5	6.2	6.6	8.7	7.7
2011-12	8.0	8.1	7.8	7.9	8.4	8.4	10.1	9.6
2013-14 (so far)	8.0	8.1	7.9	8.0	8.2	8.1	9.3	9.0

Source: RBI (http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=761)

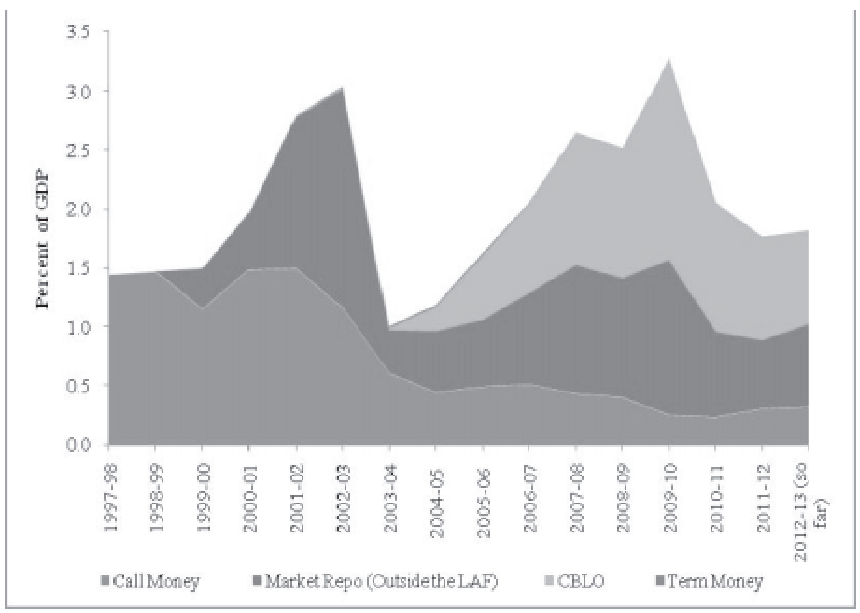

Figure 10.2: Average daily turnover in the money market

Source: RBI (http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=761

10.5 Regulatory Authorities of Money Market

The Reserve Bank of India is the most important constituent of the money market. The Reserve Bank of India (RBI) plays a key role of regulator and controller of money market. The money market comes within the direct preview of the Reserve Bank of India regulations. The intervention of RBI is varied – curbing crisis situations by reducing key policy rates or curbing inflationary situations by rising key policy rates such as Repo, Reverse Repo and CRR etc. The aims of the Reserve Bank's operations in the money market are:

- To ensure that liquidity and short term interest rates are maintained at level consistent with the monetary policy objectives of maintaining price stability.
- To ensure an adequate flow of credit to the productive sector of the economy and
- To bring about order in the foreign exchange market.

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The Reserve Bank of India has, from time to time, issued a number of guidelines/ instructions/directives to banks and the Primary Dealers in regard to call/notice money market. Scheduled commercial banks (excluding RRBs), co-operative banks (other than Land Development Banks) and Primary Dealers (PDs), are permitted to participate in call/notice money market both as borrowers and lenders.

10.5.1 Prudential Limits

- The prudential limits in respect of both outstanding borrowing and lending transactions in call/notice money market for scheduled commercial banks, co-operative banks and PDs are as follows-

Sr. No.	Participant	Borrowing	Lending
1.	Scheduled Commercial Banks	On a fortnightly average basis, borrowing outstanding should not exceed 100 per cent of capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 per cent of their capital funds on any day, during a fortnight.	On a fortnightly average basis, lending outstanding should not exceed 25 per cent of their capital funds. However, banks are allowed to lend a maximum of 50 per cent of their capital funds on any day, during a fortnight.
2.	Co-operative Banks	Outstanding borrowings of State Co-operative Banks/District Central Co-operative Banks/ Urban Co-operative Banks in call/notice money market, on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end March of the previous financial year.	No limit.
3.	PDs	PDs are allowed to borrow, on average in a reporting fortnight, up to 225 per cent of their net owned funds (NOF) as at end-March of the previous financial year.	PDs are allowed to lend in call/notice money market, on average in a reporting fortnight, up to 25 per cent of their NOF.

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- Banks/PDs/ Co-operative banks may, with the approval of their Boards, arrive at the prudential limits for borrowing/lending in Call/Notice Money Market in terms of guidelines given in paragraph above. The limits so arrived at may be conveyed to the Clearing Corporation of India Ltd. (CCIL) for setting of limits in NDS-CALL System, under advice to Financial Markets Regulation Department (FMRD), Reserve Bank of India.
- Non-bank institutions (other than PDs) are not permitted in the call/notice money market.

10.5.2 Interest rate

- Eligible participants are free to decide on interest rates in call/notice money market.
- Calculation of interest payable would be based on the methodology given in the Handbook of Market Practices brought out by the Fixed Income Money Market and Derivatives Association of India (FIMMDA).

10.5.3 Dealing Session

- Deals in the Call/Notice/Term money market can be done from 9:00 am to 5:00 pm on weekdays and from 9:00 am to 2:00 pm on Saturdays or as specified by RBI from time to time.

10.5.4 Documentation

- Eligible participants may adopt the documentation suggested by FIMMDA from time to time.

10.5.5 Reporting Requirement

- All dealings in Call/Notice/Term money executed on the Negotiated Dealing System-Call, i.e. NDS-Call (a screen –based, negotiated, quote-driven system), do not require separate reporting.
- It is mandatory that all the OTC Call/Notice/Term money deals be reported over the reporting platform of NDS-Call by the parties who are having NDS-Call membership.
- Such OTC deals should be reported within 15 minutes on NDS-Call reporting platform, irrespective of the size of the deal or whether the counterparty is a member of the NDS-Call or not.
- Parties who are not having NDS-Call membership are advised to report the deals to Financial Markets Regulation Department, RBI in the reporting format given in Annex I of this master circular.
- The reporting time for all OTC Call/Notice/Term money deals on NDS-Call is up to 5:00 pm on weekdays and 2:00 pm on Saturdays or as decided by RBI from time to time.
- In case of any misreporting or repeated reporting of OTC deals by a party, the same should be immediately brought to the notice of Financial Markets Regulation Department either through e-mail or through fax (022-22702290).
- In case the situation so warrants, the Reserve Bank may call for information in respect of money market transactions of eligible participants.

10.6 Money Market Reforms in India

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Financial reforms in India began in the early 1990s. However, various segments of domestic financial markets, viz., money market, debt market and forex market underwent significant shifts mainly from the 1990s. Earlier, the Indian money market was characterized by paucity of instruments, lack of depth and distortions in the market micro-structure. It mainly consisted of uncollateralized call market, treasury bills, commercial bills and participation certificates. Various committees have been formed to review and reform money market. Following the recommendations of the Chakravarty Committee (1985), the Reserve Bank adopted a monetary targeting framework. At the same time, efforts were made to develop the money market following the recommendations of Vaghul Committee (1987). For the rapid development of money market, Narasimham Committee was formed in 1998. Comprehensive recommendations of this committee are as follow-

- Setting up of the Discount and Finance House of India (DFHI) in 1988 to impart liquidity to money market instruments and help the development of secondary markets in such instruments.
- Introduction of instruments such as certificate of deposits (CDs) in 1989 and commercial papers in 1990 and inter-bank participation certificates with and without risk in 1988 to increase the range of instruments; and
- Freeing of call money rates by May 1989 to enable price discovery. However, the functioning of the market continued to be hindered by a number of structural rigidities such as skewed distribution of liquidity and the prevalence of administered deposit and lending rates of banks.
- Money Market Mutual Funds were introduced in 1992. The objective of the scheme was to provide an additional short-term avenue to the individual investors. In 1995, RBI modified the scheme to allow private sector organisation to set up MMMFs.
- Introduction of auctions in treasury bills.
- Gradual move away from the cash credit system to a loan-based system. Maturities of other existing instruments such as CP and CDs were also gradually shortened to encourage wider participation. Most importantly, the *ad hoc* treasury bills were abolished in 1997 thereby putting a stop to automatic monetisation of fiscal deficit. This enhanced the instrument independence of the Reserve Bank.
- In order to facilitate the phasing out of corporate and the non-banks from the call money market, new instruments such as market repos and collateralised borrowing and lending obligations (CBLO) were introduced to provide them avenues for managing their short-term liquidity.
- In order to improve transparency and efficiency in the money market, reporting of all call/notice money market transactions through negotiated dealing system (NDS) within 15 minutes of conclusion of the transaction was made mandatory. Furthermore, a screen-based negotiated quote-driven system for all dealings in the call/notice and the term money markets (NDS-

CALL), developed by the Clearing Corporation of India Limited (CCIL), was operationalised in September 2006 to ensure better price discovery.

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10.7 Government Securities Market

Government needs enormous amount of money to perform its functions. Government generates revenue in the form of taxes and income from ownership of assets. Besides theses, it borrows extensively from banks, financial institutions, and the public to finance its expenditures. One of the important sources of borrowing funds is government security market. This market is also known as gilt-edged securities market. The Government securities market consists of securities issued by the State government and the Central government. Government securities include Central Government securities, Treasury bills and State Development Loans. They are issued in order to finance the fiscal deficit and managing the temporary cash mismatches of the Government. All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, and even individuals are eligible to purchase Government Securities.

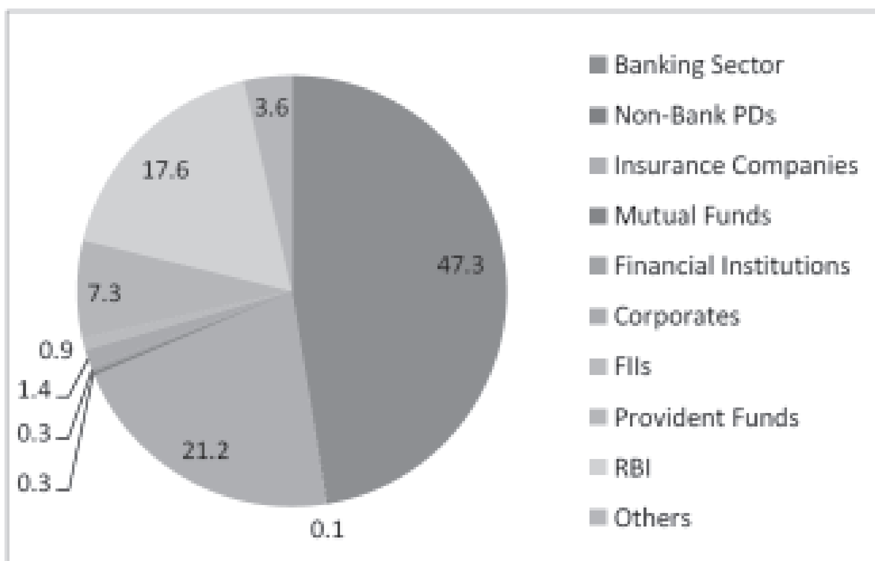

Figure10.3: Share of market participants in Government securities in India (End-June 2012)

Source: http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/RSDAP210912F.pdf

The Government securities market has witnessed significant changes during the past decade. Introduction of an electronic screen based trading system, dematerialized holding, straight through processing, establishment of the Clearing Corporation of India Ltd. (CCIL) as the central counterparty (CCP) for guaranteed settlement, new instruments, and changes in the legal environment are some of the major aspects that have contributed to the rapid development of the market

Government securities are highly liquid instruments available both in the primary and secondary market.

10.7.1 Primary Market for Government Securities

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In the primary market Government securities are issued through auctions (yield based or price based auctions) which are conducted by the Reserve Bank of India. There is a scheme of non-competitive bidding in these auctions wherein retail investors can participate for small amounts ranging from Rs 10,000 to Rs 2 cr face value. The tenor of these securities ranges from 1 year to 30 years.

State Development Loans are securities issued by the State Governments to finance their expenditures. These securities are generally issued by auction technique which is carried out by the Reserve Bank of India. They also pay half-yearly interest at the coupon rate.

Table 10.2: Market Borrowing of Central and state government

Type of Government	Gross Borrowings				Net Borrowings			
	2010-11 (₹ bn)	2010-11 US $ bn	2011-12 (₹ bn)	2011-12 (US $ bn)	2010-11 (₹ bn)	2010-11 (US $ bn)	2011-12 (₹ bn)	2011-12 (US $ bn)
Central	4,795	107	6,004	117	3,264	73	4,843	95
State	1,040	23	1,588	31	883	20	1,368	27
Total	**5,835**	**131**	**7,592**	**148**	**4,147**	**93**	**6,211**	**121**

Source: RBI

10.7.2 Secondary Market for Government Securities

The secondary market consists of both a telephonic market wherein brokers provide quotes to market participants and the electronic trading system operated by the

Table 10.3: Secondary Market Transactions in Government Securities

Month/ Year	SGL Non-Repo Transactions				Share in Non-Repo Turnover (in percent)	
	GOI Securities	Treasury Bills	Total	Total	GOI Securities	T-Bills
	(₹ mn)			(US $ mn)		
2000-01	5,120,836	600,620	5,721,456	122,673	89.5	10.5
2001-02	11,446,342	673,316	12,119,658	248,354	94.4	5.6
2002-03	13,155,989	767,845	13,923,834	293,133	94.5	5.5
2003-04	15,813,076	1,200,556	17,013,632	392,110	92.9	7.1
2004-05	9,897,351	2,711,314	12,608,665	288,198	78.5	21.5
2005-06	4,986,040	2,094,107	12,066,187	270,482	41.3	17.4
2006-07	2,747,384	1,235,603	3,982,988	91,374	69.0	31.0
2007-08	3,541,760	1,461,287	5,003,047	125,170	70.8	29.2
2008-09	5,427,749	1,217,740	6,645,488	130,432	81.7	18.3
2009-10	6,304,237	2,714,149	9,018,385	199,787	69.9	30.1
2010-11	5,137,117	1,945,950	7,083,067	158,635	72.5	27.5
2011-12	**5,363,758**	**2,438,708**	**7,802,466**	**152,496**	**68.7**	**31.3**

Source: NSE

NOTES

Check your progress

5. What is the role of RBI in money market?
6. Discuss the government securities market.

Reserve Bank of India known as Negotiated Dealing System Order Matching (NDS-OM). The instruments traded on the NDS OM include G-secs, T-Bills and SDLs. The membership of this electronic system is open to most institutional players including banks, primary dealers, insurance companies and financial institutions. The settlement of all such trades takes place through the Clearing Corporation of India which guarantees the settlements. The market trades from 9 a.m to 5 p.m. from Monday to Friday.

10.8 Key Terms

- **Certificates of Deposit (CDs):** Certificates of Deposit (CDs) are short-term tradable deposits, issued by banks that pay a fixed rate of interest.
- **Repo:** Repurchase Agreements (Repos) are instruments under which the funds sell portfolio securities and at the time of sale agree to repurchase those securities at a mutually agreed time and price including interest payment. This is usually on an overnight basis.
- **Credit rating:** An assessment of the credit worthiness of a borrower in general terms or with respect to a particular debt or financial obligation. A credit rating can be assigned to any entity that seeks to borrow money – an individual, corporation, state or provincial authority, or sovereign government.
- **Primary dealer:** A primary dealer is a firm that buys government securities directly from a government, with the intention of reselling them to others, thus acting as a market maker of government securities.
- **Call Money / Notice Money / Term Money:** The money market primarily facilitates lending and borrowing of funds between banks and entities like Primary Dealers (PDs). Banks and PDs borrow and lend overnight or for the short period to meet their short term mismatches in fund positions. This borrowing and lending is on unsecured basis. 'Call Money' is the borrowing or lending of funds for 1day. Where money is borrowed or lend for period between 2 days and 14 days it is known as 'Notice Money'. And 'Term Money' refers to borrowing/lending of funds for period exceeding 14 days.

10.9 Summary

- The money market is a mechanism that deals with the lending and borrowing of short term funds or debt securities and through which a large part of financial transactions of a particular country or of the world are cleared. It deals in funds and financial instruments having a maturity period of one day to one year.
- The Indian Money Market involves a wide range of instruments and participants. In India money market Government, RBI, DFHI (Discount and finance House of India) Banks, Mutual Funds, Corporate Investors, Provident

Funds, PSUs (Public Sector Undertakings), NBFCs (Non-Banking Finance Companies) etc. play very important role. The role and level of participation by each type of player differs from that of others. Indian money market is divided into two sectors: The organized sector and unorganized sector.

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- The organized sector consists of the Reserve Bank of India, the State Bank of India with its five associates, twenty nationalized commercial banks, other scheduled and non-scheduled commercial banks, foreign banks, and Regional Rural Banks. It is called organized because its part is systematically coordinated and regulated by the RBI.
- The unorganized money market mostly finances short-term financial needs of farmers and small businessmen.
- The Reserve Bank of India is the most important constituent of the money market. The Reserve Bank of India (RBI) plays a key role of regulator and controller of money market.
- The Government securities market consists of securities issued by the State government and the Central government. Government securities include Central Government securities, Treasury bills and State Development Loans. They are issued in order to finance the fiscal deficit and managing the temporary cash mismatches of the Government. All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, and even individuals are eligible to purchase Government Securities.
- In the primary market Government securities are issued through auctions (yield based or price based auctions) which are conducted by the Reserve Bank of India. There is a scheme of non-competitive bidding in these auctions wherein retail investors can participate for small amounts ranging from Rs 10,000 to Rs 2 cr face value. The tenor of these securities ranges from 1 year to 30 years.
- The secondary market consists of both a telephonic market wherein brokers provide quotes to market participants and the electronic trading system operated by the Reserve Bank of India known as Negotiated Dealing System Order Matching (NDS-OM). The instruments traded on the NDS OM include G-secs, T-Bills and SDLs. The membership of this electronic system is open to most institutional players including banks, primary dealers, insurance companies and financial institutions.

10.10 Questions and Exercises

1. What is money market? Explain the organization and working of Indian money market.

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2. What do you mean by call money market?
3. What are the important features of Indian money market?
4. Explain the various institutional development in Indian money market
5. Give a brief of government securities market.
6. Differentiate between primary and secondary market for the government securities.

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UNIT 11: CAPITAL MARKET

Structure

NOTES

11.0 Introduction
11.1 Unit Objectives
11.2 Meaning of Capital Market
11.3 Structure of Indian Capital Market
11.4 Significance of Capital Market
11.5 Capital Market V/S Money Market
11.6 Primary Market
 11.6.1 Features of Primary Market
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11.0 Introduction

In a market economy, the role of the capital market is very important. The good functioning of the capital market is vital in the contemporary economy, in order to achieve an efficient transfer of monetary resources from those who save money toward those who need capital and who succeed to offer it a superior utilization. The present day capital market plays an encouraging and supporting force to the entrepreneurs, corporate sectors and the investors. The recent modifications of the Indian capital market environment have emerged the various financial institutions as the major sources of finance for the organizations. Governments and Companies use Capital Markets to raise money for their long-term investments. Dealers in the securities segment of the capital market include banking institutions, stockbrokers, investment and merchant bankers and venture capitalists that intermediate between the market and the public.

11.1 Unit Objectives

After studying this unit, students will be able to:

- Understand the basics of Indian capital Market
- Know the structure of Indian Capital Market
- Distinguish between primary and secondary markets

- Familiarise with the Functioning of SEBI
- Understand legislations governing Indian Capital Market

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11.2 Meaning of Capital Market

Capital Market is one of the significant aspects of every financial market. Broadly speaking the capital market is a market for financial assets which have a long or indefinite maturity. It is an institutional arrangement to borrow and lend money for a longer period of time. It consists of financial institutions like IDBI, ICICI, UTI, LIC, etc. These institutions play the role of lenders in the capital market. Business units and corporate are the borrowers in the capital market. Capital market involves various instruments which can be used for financial transactions. Capital market provides long term debt and equity finance for the government and the corporate sector. Capital market can be divided into two segments viz. primary and secondary. The primary market is mainly used by issuers for raising fresh capital from the investors by making initial public offers or rights issues or offers for sale of equity or debt. The secondary market provides liquidity to these instruments, through trading and settlement on the stock exchanges.

11.3 Structure of Capital Market

Broadly speaking the capital market is classified in to two categories. They are the Primary market (New Issues Market) and the Secondary market (Old (Existing) Issues Market). This classification is done on the basis of the nature of the instrument brought in the market. However, on the basis of the types of institutions involved in capital market, it can be classified into various categories such as the Government Securities market or Gilt-edged market, Industrial Securities market, Development Financial Institutions (DFIs) and financial intermediaries. All of these components have specific features to mention. The structure of the Indian capital market has its distinct features. These different segments of the capital market help to develop the institution of capital market in many dimensions. The primary market helps to raise fresh capital in the market. In the secondary market, the buying and selling (trading) of capital market instruments takes place. The following chart will help us in understanding the organizational structure of the Indian Capital market.

1. Government Securities Market: This is also known as the Gilt-edged market. This refers to the market for government and semi-government securities backed by the Reserve Bank of India (RBI).

2. Industrial Securities Market: This is a market for industrial securities i.e. market for shares and debentures of the existing and new corporate firms. Buying and selling of such instruments take place in this market. This market is further classified into two types such as the New Issues Market (Primary) and the Old (Existing) Issues Market (secondary). In primary market fresh capital is raised by companies by issuing new shares, bonds, units of mutual funds and debentures. However in the secondary market already existing i.e. old shares and debentures are traded. This trading takes place through the registered stock exchanges. In

India we have three prominent stock exchanges. They are the Bombay Stock Exchange (BSE), the National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI).

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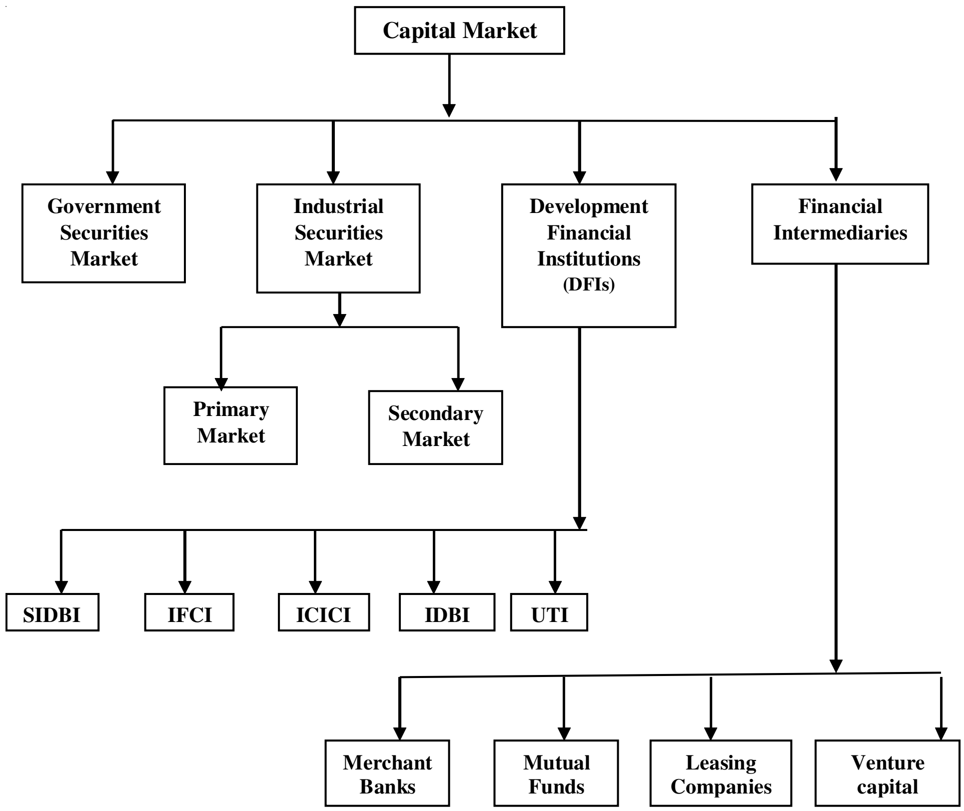

Figure 11.1: Structure of Indian capital market

Source: http://kalyan-city.blogspot.com/2010/09/organizational-structure-of-indian.html

3. Development Financial Institutions (DFIs): This is yet another important segment of Indian capital market. This comprises various financial institutions. These can be special purpose institutions like IFCI, ICICI, SFCs, IDBI, IIBI, UTI, etc. These financial institutions provide long term finance for those purposes for which they are set up.

4. Financial Intermediaries: The fourth important segment of the Indian capital market is the financial intermediaries. This comprises various merchant banking institutions, mutual funds, leasing finance companies, venture capital companies and other financial institutions

11.4 Significance of Capital Market

Capital market is also very important. It plays a significant role in the national economy. A developed, dynamic and vibrant capital market can immensely contribute for speedy economic growth and development.

Let us get acquainted with the important functions and role of the capital market.

- **Mobilization of Savings:** Capital market is an important source for mobilizing idle savings from the economy. It mobilizes funds from people

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for further investments in the productive channels of an economy. In that sense it activates the ideal monetary resources and puts them in proper investments.

- **Capital Formation:** Capital market helps in capital formation. Capital formation is net addition to the existing stock of capital in the economy. Through mobilization of ideal resources it generates savings; the mobilized savings are made available to various segments such as agriculture, industry, etc. This helps in increasing capital formation.
- **Provision of Investment Avenue:** Capital market raises resources for longer periods of time. Thus it provides an investment avenue for people who wish to invest resources for a long period of time. It provides suitable interest rate returns also to investors. Instruments such as bonds, equities, units of mutual funds, insurance policies, etc. definitely provides diverse investment avenue for the public.
- **Speed up Economic Growth and Development:** Capital market enhances production and productivity in the national economy. As it makes funds available for long period of time, the financial requirements of business houses are met by the capital market. It helps in research and development. This helps in, increasing production and productivity in economy by generation of employment and development of infrastructure.
- **Proper Regulation of Funds:** Capital markets not only helps in fund mobilization, but it also helps in proper allocation of these resources. It can have regulation over the resources so that it can direct funds in a qualitative manner.
- **Service Provision:** As an important financial set up capital market provides various types of services. It includes long term and medium term loans to industry, underwriting services, consultancy services, export finance, etc. These services help the manufacturing sector in a large spectrum.
- **Continuous Availability of Funds**: Capital market is place where the investment avenue is continuously available for long term investment. This is a liquid market as it makes fund available on continues basis. Both buyers and seller can easily buy and sell securities as they are continuously available. Basically capital market transactions are related to the stock exchanges. Thus, marketability in the capital market becomes easy.

11.5 Money Market V/S Capital Money

When it comes to business, each business at a certain point has to borrow money in order to keep running business. There are multiple ways that a company can borrow money, including issuing bonds, shares or taking up a loan. There are two different components of the financial market; known as Money Market and Capital Market. These terms are more commonly come across in business and economics. Money market is a component of financial market where short-term borrowing can be issued. This market includes assets that deal with short-term borrowing, lending, buying and selling. The short-term ensures that the borrowing and lending period has a lease of less than one year. In Money Markets, Trading is usually done over the counter using instruments such as Treasury bills, commercial paper, bankers' acceptances, deposits, certificates of deposit, bills of exchange, repurchase agreements and asset-backed securities. The money market was created as some businesses have a surplus of cash, while the other businesses were looking for loans.

Money market is distinguished from capital market on the basis of the maturity period, credit instruments and the institutions:

- **Maturity Period:** The money market deals in the lending and borrowing of short-term finance (i.e. for one year or less), while the capital market deals in the lending and borrowing of long-term finance (i.e. for more than one year).
- **Credit Instruments:** The main credit instruments of the money market are call money, collateral loans, acceptances, bills of exchange. On the other hand, the main instruments used in the capital market are stocks, shares, debentures, bonds, securities of the government.
- **Nature of Credit Instruments:** The credit instruments dealt with in the capital market are more heterogeneous than those in money market. Some homogeneity of credit instruments is needed for the operation of financial markets. Too much diversity creates problems for the investors.
- **Institutions:** Important institutions operating in the' money market are central banks, commercial banks, acceptance houses, nonbank financial institutions, bill brokers, etc. Important institutions of the capital market are stock exchanges, commercial banks and nonbank institutions, such as insurance companies, mortgage banks, building societies, etc.
- **Purpose of Loan:** The money market meets the short-term credit needs of business; it provides working capital to the industrialists. The capital market, on the other hand, caters the long-term credit needs of the industrialists and provides fixed capital to buy land, machinery, etc.
- **Risk:** The degree of risk is small in the money market. The risk is much greater in capital market. The maturity of one year or less gives little time for a default to occur, so the risk is minimised. Risk varies both in degree and nature throughout the capital market.
- **Basic Role:** The basic role of money market is that of liquidity adjustment. The basic role of capital market is that of putting capital to work, preferably to long-term, secure and productive employment.
- **Relation with Central Bank:** The money market is closely and directly linked with central bank of the country. The capital market feels central bank's influence, but mainly indirectly and through the money market.
- **Market Regulation:** In the money market, commercial banks are closely regulated. In the capital market, the institutions are not much regulated.

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Check your progress

1. What do you understand by capital market?
2. Discuss the types of the capital market.
3. What is the government securities market?

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11.6 Primary Market

The primary market plays an important role in the securities market by forming a link between the savings and investments. The primary market is a market for fresh capital. *The Primary Market is, hence, the market that provides a channel for the issuance of new securities by issuers (Government companies or corporate) to raise capital.* The primary market comprises the public issues and the private placement market. A public issue consists of a company entering the market to raise funds from all types of investors; its debut is known as the initial public offer (IPO). In case of private placement, there are only a few select subscribers to the issue. The securities can be issued at a face value, or at a discount/premium; they may take a variety of forms such as equity, debt or some hybrid instrument.

11.6.1 Features of Primary Market

i. This is the market for new long term capital. The primary market is the market where the securities are sold for the first time. Therefore it is also called New Issue Market (NIM).

ii. In a primary issue, the securities are issued by the company directly to investors.

iii. The company receives the money and issue new security certificates to the investors.

iv. Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.

v. The primary market performs the crucial function of facilitating capital formation in the economy.

vi. The new issue market does not include certain other sources of new long term external finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital; this is known as 'going public'

11.6.2 Methods of Floating New Issue

A company can raise the required capital in the primary market by the following methods:

- **Public issue through prospectus:** When a company raises funds by selling (issuing) its shares (or debenture / bonds) to the public through issue of offer document (prospectus), it is called a public issue. Initial Public Offer (IPO): When a (unlisted) company makes a public issue for the first time and gets its shares listed on stock exchange, the public issue is called as initial public offer (IPO). Follow-on public offer (FPO): When a listed company makes another public issue to raise capital, it is called follow-on offer (FPO).
- **Offer for sale:** Institutional investors like venture funds, private equity funds etc., invest in unlisted company when it is very small or at an early stage. Subsequently, when the company becomes large, these investors sell their

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shares to the public, through issue of offer document and the company's shares are listed in stock exchange. This is called as **offer for sale.** The proceeds of this issue go the existing investors and not to the company.

- **Private Placement:** The sale of securities to a relatively small number of select investors for raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market.
- **Issue of Indian Depository Receipts (IDR):** A foreign company which is listed in stock exchange abroad can raise money from Indian investors by selling (issuing) shares. These shares are held in trust by a foreign custodian bank against which a domestic custodian bank issues an instrument called Indian depository receipts (**IDR**). IDR can be traded in stock exchange like any other shares and the holder is entitled to rights of ownership including receiving dividend.
- **Rights issue (RI):** When a company raises funds from its existing shareholders by selling (issuing) those new shares / debentures, it is called as **rights issue**. The offer document for a rights issue is called as the **Letter of Offer** and the issue is kept open for 30-60 days. Existing shareholders are entitled to apply for new shares in proportion to the number of shares already held.
- **Bonus Issue:** The company issues new shares to its existing shareholders. As the new shares are issued out of the company's reserves (accumulated profits), shareholders need not pay any money to the company for receiving the new shares.

Table 11.1 Total Resources Mobilised by Corporate Sector (Amount in crore)

Month	Equity Issues			Debt Issues			Total Resource Mobilisation (4+7)
	Public & Rights	Private Placements	Total (2+3)	Public	Private Placements	Total (5+6)	
1	2	3	4	5	6	7	8
2014-15	9,789	57,362	67,151	9,413	4,04,136	4,13,492	4,80,643
2015-16	9,822	20,663	30,484	710	1,41,624	1,42,334	1,72,818
Apr-15	8,890	11,517	20,406	710	84,807	85,517	1,05,923
May-15	493	6,133	6,626	0	20,692	20,692	27,318
Jun-15	439	3,013	3,452	0	36,125	36,125	39,577

Notes: 1. Private placement of Equity includes, amount raised through preferential allotments, QIP and IPP mechanism, 2. Public Equity Issues includes IPO, FPO & Rights issues of common equity shares.

Source: SEBI

11.6.3 Parties Involved in the New Issue

- **Managers to the issue:** Lead managers are appointed by the company to manage the public issue programmers. Their main duties are (a) drafting of prospectus (b) preparing the budget of expenses related to the issue (c) suggesting the appropriate timings of the public issue (d) assisting in marketing the public

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issue successfully (e) advising the company in the appointment of registrars to the issue, underwriters, brokers, bankers to the issue, advertising agents etc. and (f) directing the various agencies involved in the public issue.

- **Registrar to the issue:** In consultation with the lead manager, the Registrar to the issue is appointed. Quotations containing the details of the various functions they would be performing and charges for them are called for selection. Among them the most suitable one is selected. It is always ensured that the registrar to the issue has the necessary infrastructure like computer, internet and telephone. The Registrars to the issue normally receive the share application from various collection centers. They recommend the basis of allotment in consultation with the Regional Stock Exchange for approval. They arrange for the dispatching of the share certificates. They handover the details of the share allocation and other related registers to the company.
- **Underwriters:** Underwriter is a person/organization who gives an assurance to the issuer to the effect that the former would subscribe to the securities offered in the event of non-subscription by the person to whom they were offered. They stand as back-up supporters and underwriting is done for a commission. Underwriting provides an insurance against the possibility of inadequate subscription. Some of the underwriters are financial institutions, commercial banks, merchant bankers, members of the stock exchange, Export and Import Bank of India etc.
- **Bankers to the issue:** The responsibility of collecting the application money along with the application form is on bankers to the issue. The bankers charge commission besides the brokerage, if any. Depending upon the size of the public issue more than one banker to the issue is appointed. When the size of the issue is large, three or four banks are appointed as bankers to the issue. The number of collection centers is specified by the central government. The bankers to the issue should have branches in the specified collection centers.
- **Advertising agents:** Advertising a public issue is very essential for its promotion. Hence, the past track record of the advertising agency is studied carefully. Tentative program of each advertising agency along with the estimated cost are called for. After comparing the effectiveness and cost of each program with the other, a suitable advertising agency is selected in consultation with the lead managers to the issue. The advertising agencies take the responsibility of giving publicity to the issue on the suitable media. The media may be newspapers /magazines/ hoardings/press release or a combination of all.
- **The financial institutions:** The function of underwriting is generally performed by financial institutions. Therefore, normally they go through the draft of prospectus, study the proposed program for public issue and approve them. IDBI, IFCI, ICICI, LIC, GIC and UTI are the some of the financial institutions that underwrite and give financial assistance. The lead manager sends copy of the draft prospectus to the financial institutions and includes their comments, if any in the revised draft.

- **Regulatory bodies:** The various regulatory bodies related with the public issue are:
    1. Securities Exchange Board of India
    2. Registrar of companies
    3. Reserve Bank of India (if the project involves foreign investment)
    4. Stock Exchanges where the issue is going to be listed
    5. Industrial licensing authorities
    6. Pollution control authorities (clearance for the project has to be stated in the prospectus)
- **Collection centres:** There should be at least 20 mandatory collection centres inclusive of the places where stock exchanges are located. If the issue is not exceeding Rs. 10 cr (excluding premium if any) the mandatory collection centres are the four metropolitan centres viz. Mumbai, Delhi, Calcutta and Chennai and at all such centres where stock exchanges are located in the region in which the registered office of the company is situated.

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Check your progress

4. Differentiate between money market and capital market.
5. What is primary market?
6. What are the methods of floating of new issue?

11.7 Secondary Market

The securities market has two interdependent and inseparable segments, namely, the new issues (primary) market and the stock (secondary) market. The primary market provides the channel for the creation and sale of new securities, while the secondary market deals in the securities that were issued previously. The secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risks and returns. Once new securities are issued in the primary market, they are traded in the stock (secondary) market. Growth of the primary market depends on the secondary market. The health of the economy is reflected by the growth of the stock market. The secondary market operates through two mediums, namely, the over-the-counter (OTC) market and the exchange-traded market. The OTC markets are informal markets where trades are negotiated. Most of the trades in government securities take place in the OTC market.

11.7.1 Relationship between the Primary and Secondary Markets

- The new issue market cannot function without the secondary market. The secondary market or the stock market provides liquidity for the issued securities.
- The stock exchanges through their listing requirements, exercise control over the primary market. The company seeking for listing on the respective stock exchange has to comply with all the rules and regulations given by the stock exchange.
- The primary market provides a direct link between the prospective investors and the company. By providing liquidity and safety, the stock markets encourage the public to subscribe to the new issues. The market ability and the capital appreciation provided in the stock market are the major factors that attract the

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investing public towards the stock market. Thus, it provides an indirect link between the savers and the company.

- Even though they are complementary to each other, their functions and the organizational set up are different from each other. The health of the primary market depends on the secondary market and vice-versa.

11.7.2 Functions of Secondary Market

Role of secondary market are varied and highly important in the development of economy of a country. They measure and control the growth of a country. Secondary markets are the places, where exactly you do your business. They have very important role to play in the economy of the country. Some of them are listed below.

- **Pricing of Securities:** The stock market helps to value the securities on the basis of demand and supply factors. The securities of profitable and growth oriented companies are valued higher as there is more demand for such securities. The valuation of securities is useful for investors, government and creditors. The investors can know the value of their investment, the creditors can value the creditworthiness and government can impose taxes on value of securities.
- **Contribute to Economic Growth:** In stock exchange, securities of various companies are bought and sold. This process of disinvestment and reinvestment helps to invest in most productive investment proposal and this leads to capital formation and economic growth.
- **Provide Liquidity:** The main function of stock market is to provide ready market for sale and purchase of securities. The presence of stock exchange market gives assurance to investors that their investment can be converted into cash whenever they want. The investors can invest in long term investment projects without any hesitation, as because of stock exchange they can convert long term investment into short term and medium term.
- **Better Allocation of Capital:** The shares of profit making companies are quoted at higher prices and are actively traded so such companies can easily raise fresh capital from stock market. The general public hesitates to invest in securities of loss making companies. So stock exchange facilitates allocation of investor's fund to profitable channels.
- **Promotes the Habit of Saving and Investment:** The stock market offers attractive opportunities of investment in various securities. These attractive opportunities encourage people to save more and invest in securities of corporate sector rather than investing in unproductive assets such as gold, silver, etc.
- **Facilitate Healthy speculation:** Healthy speculation, keeps the exchange active. Normal speculation is not dangerous but provides more business to the exchange. However, excessive speculation is undesirable as it is dangerous to investors & the growth of corporate sector.
- **Economic Barometer**: A stock exchange is a reliable barometer to measure the economic condition of a country. Every major change in country and economy is reflected in the prices of shares. The rise or fall in the share prices

indicates the boom or recession cycle of the economy. Stock exchange is also known as a pulse of economy or economic mirror which reflects the economic conditions of a country.

- **Safety of Transactions**: In stock market only the listed securities are traded and stock exchange authorities include the companies names in the trade list only after verifying the soundness of company. The companies which are listed they also have to operate within the strict rules and regulations. This ensures safety of dealing through stock exchange

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11.7.3 Stock Exchanges

Stock Exchanges are an organized marketplace, either corporation or mutual organization, where members of the organization gather to trade company stocks or other securities. The members may act either as agents for their customers, or as principals for their own accounts. Stock exchanges also facilitates for the issue and redemption of securities and other financial instruments including the payment of income and dividends. The record keeping is central but trade is linked to such physical place because modern markets are computerized. The trade on an exchange is only by members and stock broker do have a seat on the exchange.

Share market in Indian started functioning in 1875. The name of the first share trading association in India was Native Share and Stock Broker's Association, which later came to be known as Bombay Stock Exchange (BSE). This association kicked off with 318 members. There are at present 19 recognised stock exchanges in India including the Over-the-Counter Exchange of India (OTCEI) and the National Stock Exchange (NSE). Some of them are voluntary non-profit-making organisations while others are companies limited by guarantee. Among the recognised stock exchanges in India Bombay Stock Exchange and National Stock Exchange are the prominent ones.

11.7.3.1 Bombay Stock Exchange (BSE)

The Bombay Stock Exchange (BSE) is known as the oldest exchange in Asia. It traces its history to the 1850s, when stockbrokers would gather under banyan trees in front of Mumbai's Town Hall. The location of these meetings changed many times, as the number of brokers constantly increased. The group eventually moved to Dalal Street in 1874 and in 1875 became an official organization known as 'The Native Share & Stock Brokers Association'. In 1956, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contracts Regulation Act.

The Bombay Stock Exchange developed the BSE Sensex in 1986, giving the BSE a means to measure overall performance of the exchange. In 2000 the BSE used this index to open its derivatives market, trading Sensex futures contracts. The development of Sensex options along with equity derivatives followed in 2001 and 2002, expanding the BSE's trading platform. Historically an open-cry floor trading exchange, the Bombay Stock Exchange switched to an electronic trading system in 1995.

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11.7.3.2 National Stock Exchange (NSE)

Capital market reforms in India and the launch of the Securities and Exchange Board of India (SEBI) accelerated the integration of the second Indian stock exchange called the National Stock Exchange (NSE) in 1992. National Stock Exchange (NSE) founded although late than BSE, is currently the leading stock exchange in India in terms of total volume traded. It is also based in Mumbai but has its presence in over 1500 towns and cities. In terms of market capitalization, NSE is the second largest bourse in South Asia. National Stock Exchange got its recognition as a stock exchange in July 1993 under Securities Contracts (Regulation) Act, 1956. Three segments of the NSE trading platform were established one after another. The Wholesale Debt Market (WDM) commenced operations in June 1994 and the Capital Market (CM) segment was opened at the end of 1994. Finally, the Futures and Options segment began operating in 2000. Today the NSE takes the 14th position in the top 40 futures exchanges in the world.

In 1996, the National Stock Exchange of India launched S&P CNX Nifty and CNX Junior Indices that make up 100 most liquid stocks in India. CNX Nifty is a diversified index of 50 stocks from 25 different economy sectors. The Indices are owned and managed by India Index Services and Products Ltd (IISL) that has a consulting and licensing agreement with Standard & Poor's.

In 1998, the National Stock Exchange of India launched its web-site and was the first exchange in India that started trading stock on the Internet in 2000. The NSE has also proved its leadership in the Indian financial market by gaining many awards such as 'Best IT Usage Award' by Computer Society in India (in 1996 and 1997) and CHIP Web Award by CHIP magazine (1999).

11.7.3.3 Over the Counter Exchange of India (OTCEI)

The traditional trading mechanism prevailed in the Indian stock markets gave way to many functional inefficiencies, such as, absence of liquidity, lack of transparency, unduly long settlement periods and benami transactions, which affected the small investors to a great extent. To provide improved services to investors, the country's first ring less, scrip less, electronic stock exchange - OTCEI - was created in 1992 by country's premier financial institutions - Unit Trust of India (UTI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Development Bank of India (IDBI), SBI Capital Markets, Industrial Finance Corporation of India (IFCI), General Insurance Corporation and its subsidiaries and CanBank Financial Services. Compared to the traditional Exchanges, OTC Exchange network has the following advantages:

- OTCEI has widely dispersed trading mechanism across the country which provides greater liquidity and lesser risk of intermediary charges.
- Greater transparency and accuracy of prices is obtained due to the screen-based scrip less trading.
- Since the exact price of the transaction is shown on the computer screen, the investor gets to know the exact price at which she/he is trading.
- Faster settlement and transfer process compared to other exchanges.

Table 11.2: Exchange-wise Brokers Registered with SEBI in Cash Segment

Stock Exchange	2013-14			Apr 13-Dec 13			Apr 14-Dec 14		
	Total Brokers	Corporate Brokers	Corporate Brokers as a percent of total brokers	Total Brokers	Corporate Brokers	Corporate Brokers as a percent of total brokers	Total Brokers	Corporate Brokers	Corporate Brokers as a percent of total brokers
1	11	12	13	14	15	16	17	18	19
Ahmedabad	336	178	53.0	339	179	52.8	334	176	52.7
Bangalore	258	127	49.2	258	127	49.2	Na	Na	Na
BSE	1,316	1,120	85.1	1,349	1,126	83.5	1,339	1,117	83.4
Bhubaneshwar	199	16	8.0	200	17	8.5	197	16	8.1
Calcutta	853	207	24.3	858	209	24.4	844	210	24.9
Cochin	395	77	19.5	396	78	19.7	Na	Na	Na
Delhi	473	264	55.8	476	265	55.7	468	258	55.2
Gauhati	36	2	5.6	44	2	4.5	Na	Na	Na
ICSE	835	304	36.4	844	305	36.1	Na	Na	Na
Jaipur	439	18	4.1	444	18	4.1	428	18	4.2
Ludhiana	303	86	28.4	303	86	28.4	Na	Na	Na
Madhya Pradesh	177	75	42.9	236	68	28.8	282	81	28.7
Madras	529	493	93.2	181	77	42.5	177	77	43.5
MCX-SX	282	80	28.4	534	493	92.3	536	496	92.5
NSE	1,316	1,167	88.7	1,326	1,175	88.6	1,310	1,157	88.3
OTCEI	616	471	76.5	621	473	76.2	538	412	76.6
Pune	169	47	27.8	169	47	27.8	167	46	27.5
UPSE	207	55	26.6	211	55	26.1	200	54	27.0
Vadodara	311	65	20.9	311	65	20.9	296	55	18.6
Total	9,050	4,853	53.6	9,150	4,877	53.3	7,116	4,174	58.7

Source: SEBI (http://www.sebi.gov.in/)

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Check your progress

7. Differentiate between primary market and secondary market.
8. Write the name of the major stock exchanges in India.

11.8 Key Terms

- **Blue Chip Stocks:** Stocks of leading and nationally known companies that offer a record of continuous dividend payments and other strong investment qualities.
- **Beta:** The degree of sensitivity of a stock in relation to swings in the market.
- **Bond:** A debt instrument issued by such entities as corporations, governments or their agencies with the purpose of raising capital by borrowing.
- **Bonus Shares:** Shares which existing shareholders receive from a company on a free, pro rata entitlement basis.
- **Buy-back:** The situation when managed funds are required to repurchase (buy-back) units from unitholders seeking to redeem part or all of their investment. In the financial markets, this term means the purchase of a long position to offset a short position; or a company's repurchase of issued shares.
- **Day Order:** An order that is placed for execution during only one trading session. If the order cannot be executed that day, it is automatically cancelled.
- **Initial Public Offering (IPO):** A company's first issue of shares to the general public.
- **Insider Trading:** There are two types of insider trading. The first type occurs when insiders trade in the stock of their company. Insiders must report these transactions to the appropriate securities commissions. The other type of insider trading is when anyone trades securities based on

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material information that is not public knowledge. This type of insider trading is illegal.

- **Listed Stock:** Shares of an issuer that are traded on a stock exchange. Issuers pay fees to the exchange to be listed and must abide by the rules and regulations set out by the exchange to maintain listing privileges.
- **Market Capitalization:** The number of issued and outstanding securities listed for trading for an individual issue multiplied by the board lot trading price. Should a trading price not be available, a bid price, a price on another market, or if applicable, the price for an issue of the same issuer which the first issue is convertible into, may be used. Total market capitalization for a market is obtained by adding together all individual issue market capitalizations (warrants and rights excluded). Escrowed shares are excluded from TSX Venture market capitalization.
- **Over-The-Counter (OTC) Market:** The market maintained by securities dealers for issues not listed on a stock exchange. Almost all bonds and debentures, as well as some stocks, are traded over-the-counter in Canada. An OTC market is also known as an unlisted market.
- **Settlement:** The process that follows a transaction when the seller delivers the security to the buyer and the buyer pays the seller for the security.
- **Transfer Agent:** A trust company appointed by a listed company to keep a record of the names, addresses and number of shares held by its shareholders. Frequently, the transfer agent also distributes dividend cheques to the company's shareholders.

11.9 Summary

- Capital Market is one of the significant aspects of every financial market. Broadly speaking the capital market is a market for financial assets which have a long or indefinite maturity. It is an institutional arrangement to borrow and lend money for a longer period of time.
- The capital market is classified in to two categories. They are the Primary market (New Issues Market) and the Secondary market (Old/Existing) Issues Market). This classification is done on the basis of the nature of the instrument brought in the market.
- Money market is a component of financial market where short-term borrowing can be issued. This market includes assets that deal with short-term borrowing, lending, buying and selling. The short-term ensures that the borrowing and lending period has a lease of less than one year. In Money Markets, Trading is usually done over the counter using instruments such as Treasury bills, commercial paper, bankers' acceptances, deposits, certificates of deposit, bills of exchange, repurchase agreements and asset-backed securities.

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- The primary market plays an important role in the securities market by forming a link between the savings and investments. The primary market is a market for fresh capital. The Primary Market is, hence, the market that provides a channel for the issuance of new securities by issuers (Government companies or corporate) to raise capital.
- When a company raises funds by selling (issuing) its shares (or debenture / bonds) to the public through issue of offer document (prospectus), it is called a public issue.
- A foreign company which is listed in stock exchange abroad can raise money from Indian investors by selling (issuing) shares. These shares are held in trust by a foreign custodian bank against which a domestic custodian bank issues an instrument called Indian depository receipts (IDR).
- The securities market has two interdependent and inseparable segments, namely, the new issues (primary) market and the stock (secondary) market. The primary market provides the channel for the creation and sale of new securities, while the secondary market deals in the securities that were issued previously. The secondary market enables participants who hold securities to adjust their holdings in response to changes in their assessment of risks and returns.
- Stock Exchanges are an organized market place, either corporation or mutual organization, where members of the organization gather to trade company stocks or other securities. The members may act either as agents for their customers, or as principals for their own accounts.
- The Bombay Stock Exchange (BSE) is known as the oldest exchange in Asia. It traces its history to the 1850s, when stockbrokers would gather under banyan trees in front of Mumbai's Town Hall. The location of these meetings changed many times, as the number of brokers constantly increased. The group eventually moved to Dalal Street in 1874 and in 1875 became an official organization known as 'The Native Share & Stock Brokers Association'. In 1956, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contracts Regulation Act.
- Capital market reforms in India and the launch of the Securities and Exchange Board of India (SEBI) accelerated the integration of the second Indian stock exchange called the National Stock Exchange (NSE) in 1992. National Stock Exchange (NSE) founded although late than BSE, is currently the leading stock exchange in India in terms of total volume traded.

11.10 Questions and Exercises

1. What do you mean by capital market? Explain the role of Indian capital market in economic development.

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2. Distinguish between capital market and money market.
3. Explain the various methods for floating new issue in India.
4. Explain in detail regulatory framework for Indian capital market.
5. Write a short note on the functions of stock exchanges
6. What is the difference between Stock brokers and underwriter?
7. What are the recent developments in Indian capital market?

11.11 Further Readings and References

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UNIT 12: STOCK MARKET TRADING

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Structure

12.0 Introduction
12.1 Unit Objectives
12.3 Overview of National Stock Exchange (NSE) Ltd.
12.3 Segments of National Stock Exchange (NSE)
12.4 Trading system of National Stock Exchange (NSE)
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12.0 Introduction

Most stocks are traded on exchanges, which are places where buyers and sellers meet and decide on a price. Some exchanges are physical locations where transactions are carried out on a trading floor. The other type of exchange is virtual, composed of a network of computers where trades are made electronically. The purpose of a stock market is to facilitate the exchange of securities between buyers and sellers and reducing the risks of investing. Indian capital market is divided into two parts one is primary market and other is secondary market. The primary market is where securities are created (by means of an IPO) while, in the secondary market, investors trade previously-issued securities without the involvement of the issuing-companies. The secondary market is what people are referring to when they talk about the stock market. It is important to understand that the trading of a company's stock does not directly involve that company. Most of the trading in the Indian stock market takes place on its two stock exchanges: the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). However, both exchanges follow the same trading mechanism, trading hours, settlement process, etc.

12.1 Unit Objectives

After studying this unit, students will be able to:

- Explain the overview of National Stock Exchange (NSE)
- Understand segments of National Stock Exchange (NSE)
- Familiarise with trading system of National Stock Exchange (NSE)
- Know the clearing and settlement system of National Stock Exchange (NSE)

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12.2 National Stock Exchange (NSE) Ltd.

The National Stock Exchange (NSE) is India's leading stock exchange covering various cities and towns across the country. NSE was set up by leading institutions to provide a modern, fully automated screen-based trading system with national reach. The Exchange has brought about unparalleled transparency, speed & efficiency, safety and market integrity. It has set up facilities that serve as a model for the securities industry in terms of systems, practices and procedures. NSE has played a catalytic role in reforming the Indian securities market in terms of microstructure, market practices and trading volumes. The market today uses state-of-art information technology to provide an efficient and transparent trading, clearing and settlement mechanism, and has witnessed several innovations in products & services viz. demutualisation of stock exchange governance, screen based trading, compression of settlement cycles, dematerialisation and electronic transfer of securities, securities lending and borrowing, professionalization of trading members, fine-tuned risk management systems, emergence of clearing corporations to assume counterparty risks, market of debt and derivative instruments and intensive use of information technology.

12.3 Segments of National Stock Exchange (NSE)

NSE has four segments for trading in securities. These are as follows-

12.3.1 Wholesale Debt Market Segment

The erstwhile Wholesale Debt Market (WDM) segment of the Exchange commenced its operations on June 30, 1994. This provided the first formal screen-based trading facility for the debt market in the country. It has now been merged under the New Debt Market as the Negotiated Trade Reporting Platform.

12.3.2 Capital Market Segment

The Capital Market (CM) segment (or the equity market segment) of NSE commenced its operations on November 4, 1995. The turnover in the Capital market segment witnessed a compound annual growth rate of 67.50% from Rs 1,805 crore (US $ 574.29 million) in the year 1994-95 to Rs. 4,138,023 crore (US $ 916,709 million) in 2009-10. The CM segment of NSE provides an efficient and transparent platform for trading for various types of securities such as equity shares, preference shares, debentures, warrants, exchange traded funds as well as retail government securities.

Table 12.1: Capital market growth

Capital Market Segment Growth			
Month/Year	No of companies listed*	Turnover (Rs cr)	Market Capitalisation (Rs cr)*
Oct-15	-	3,33,801	96,54,114
Sep-15	1,779	3,28,412	94,91,609
Aug-15	1,772	4,19,932	95,29,070
Jul-15	1,756	3,83,484	1,01,68,561
Jun-15	1,751	3,33,289	98,49,076
May-15	1,750	3,61,935	1,00,20,665
Apr-15	1,740	3,79,349	96,86,324
2014-2015	1,733	43,29,655	99,30,122
2013-2014	1,688	28,08,488	72,77,720
2012-2013	1,666	27,08,279	62,39,035
2011-2012	1,646	28,10,893	60,96,518
2010-2011	1,574	35,77,412	67,02,616
2009-2010	1,470	4,138,024	6,009,173
2008-2009	1,432	2,752,023	2,896,194
2007-2008	1,381	3,551,038	4,858,122
2006-2007	1,228	1,945,285	3,367,350
2005-2006	1,069	1,569,556	2,813,201
2004-2005	970	1,140,071	1,585,585
2003-2004	909	1,099,535	1,120,976
2002-2003	818	617,989	537,133
2001-2002	793	513,167	636,861
2000-2001	785	1,339,510	657,847
1999-2000	720	839,052	1,020,426
1998-1999	648	414,474	491,175
1997-1998	612	370,193	481,503
1996-1997	550	294,503	419,367
1995-1996	422	67,287	401,459

Source: NSE

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12.3.3 Equity Future and Options Segment

A futures contract is a forward contract, which is traded on an Exchange. NSE commenced trading in futures on individual securities on November 9, 2001. The futures contracts are available on 173 securities stipulated by the Securities & Exchange Board of India (SEBI). NSE defines the characteristics of the futures contract such as the underlying security, market lot, and the maturity date of the contract. The futures contracts are available for trading from introduction to the expiry date.

12.3.4 Currency Derivatives Segment

NSE was the first exchange to have received an in-principle approval from SEBI for setting up currency derivative segment. National Stock Exchange was the first exchange to launch Currency futures trading in India. The Currency Derivatives segment at NSE commenced operations on August 29, 2008 with the launch of currency futures trading in US Dollar-India Rupee (USD-INR). The Regulatory framework for currency futures trading in the country, as laid down by the regulators,

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provide that persons resident in India are permitted to participate in the currency futures market in India subject to directions contained in the Currency Futures (Reserve Bank) Directions, 2008, which have come into force with effect from August 6, 2008. The membership of the currency futures market of a recognised stock exchange has been mandated to be separate from the membership of the equity derivative segment or the cash segment.

Table 12.2: Trading Value of Different Market Segments

(Crores)

Segment/Year	2011-12	2012-13	2013-14	2014-15	2015-16
Capital Market	28,10,893	27,08,279	28,08,488	43,29,655	42,36,983
Equity Futures & Options	3,13,49,732	3,15,33,004	3,82,11,408	5,56,06,453	6,48,25,834
Wholesale Debt Market	6,33,179	7,92,214	8,51,434	7,72,369	5,69,495
Currency F&O *	46,74,990	52,74,465	40,12,513	30,23,908	45,01,886
Interest Rate Futures **	3,959	0.22	30,173	4,21,558	5,26,425
Total	**3,94,72,753**	**4,03,07,962**	**4,59,14,017**	**6,41,53,943**	**7,46,60,622**

*Trading in Currency Futures commenced on August 28, 2008

** Trading in Interest Rate Futures were Relaunch on January 21, 2010

Source: NSE

12.4 Trading System of the NSE

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NSE consciously opted in favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs.

12.4.1 Market Type

The NEAT system has three types of market. They are-

1. Normal Market

All orders which are of regular lot size or multiples thereof are traded in the Normal Market. For shares that are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as Regular lot orders, Special Term orders, Negotiated Trade Orders and Stop Loss orders depending on their order attributes.

2. Odd Lot Market

All orders whose order size is less than the regular lot size are traded in the odd-lot market. An order is called an odd lot order if the order size is less than regular lot size. These orders do not have any special terms attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place. Currently the odd lot market facility is used for the Limited Physical Market as per the SEBI directives.

3. Auction Market

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In the Auction Market, auctions are initiated by the Exchange on behalf of trading members for settlement related reasons. There are 3 participants in this market.

- Initiator - the party who initiates the auction process is called an initiator
- Competitor - the party who enters orders on the same side as of the initiator
- Solicitor - the party who enters orders on the opposite side as of the initiator

12.4.2 Order Books

The NSE trading system provides complete flexibility to members in the kinds of orders that can be placed by them. Orders are first numbered and time-stamped on receipt and then immediately processed for potential match. Every order has a distinctive order number and a unique time stamp on it. If a match is not found, then the orders are stored in different 'books'. Orders are stored in price-time priority in various books in the following sequence:

- Best Price
- Within Price, by time priority

Price priority means that if two orders are entered into the system, the order having the best price gets the higher priority. Time priority means if two orders having the same price are entered, the order that is entered first gets the higher priority.

The Equities segment has following types of books:

1. Regular Lot Book

The Regular Lot Book contains all regular lot orders that have none of the following attributes attached to them.

- All or None (AON)
- Minimum Fill (MF)
- Stop Loss (SL)

2. Special Terms Book

The Special Terms book contains all orders that have either of the following terms attached:

- All or None (AON)
- Minimum Fill (MF)

Note: Currently, special term orders i.e. AON and MF are not available on the system as per the SEBI directives.

3. Stop-Loss Book

Stop Loss orders are stored in this book till the trigger price specified in the order is reached or surpassed. When the trigger price is reached or surpassed, the order is released in the Regular lot book. The stop loss condition is met under the following circumstances-

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- *Sell order :* 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.
- *Buy 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.

4. Odd Lot Book

The Odd lot book contains all odd lot orders (orders with quantity less than marketable lot) in the system. The system attempts to match an active odd lot order against passive orders in the book. Currently, pursuant to a SEBI directive, the Odd Lot Market is being used for orders that have quantity less than or equal to 500 viz. the Limited Physical Market.

5. Auction Book

This book contains orders that are entered for all auctions. The matching process for auction orders in this book is initiated only at the end of the solicitor period.

12.4.3 Order Matching Rules

The best buy order is matched with the best sell order. An order may match partially with another order resulting in multiple trades. For order matching, the best buy order is the one with the highest price and the best sell order is the one with the lowest price. This is because the system views all buy orders available from the point of view of a seller and all sell orders from the point of view of the buyers in the market. So, of all buy orders available in the market at any point of time, a seller would obviously like to sell at the highest possible buy price that is offered. Hence, the best buy order is the order with the highest price and the best sell order is the order with the lowest price.

Members can proactively enter orders in the system, which will be displayed in the system till the full quantity is matched by one or more of counter-orders and result into trade(s) or is cancelled by the member. Alternatively, members may be reactive and put in orders that match with existing orders in the system. Orders lying unmatched in the 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. This ensures that the earlier orders get priority over the orders that come in later.

12.4.4 Other Conditions

A Trading Member can enter various types of orders depending upon his/her requirements. These conditions are broadly classified into three categories: time related conditions, price-related conditions and quantity related conditions.

1. Time Conditions

- ***DAY:*** A Day order, as the name suggests, is an order which is valid for the day on which it is entered. If the order is not matched during the day, the order gets cancelled automatically at the end of the trading day.
- ***Good Till Cancelled (GTC):*** A GTC order is an order that remains in the system until it is cancelled by the Trading Member. It will therefore be able to span trading days if it does not get matched. The maximum number of days a

GTC order can remain in the system is notified by the Exchange from time to time.

- ***Good Till Days/Date (GTD):*** A GTD order allows the Trading Member to specify the days/date up to which the order should stay in the system. At the end of this period the order will get flushed from the system. Each day/date counted is a calendar day and inclusive of holidays. The days/date counted are inclusive of the day/date on which the order is placed. The maximum number of days a GTD order can remain in the system is notified by the Exchange from time to time.
- ***Immediate or Cancel (IOC):*** An IOC order allows a Trading Member to buy or sell a security as soon as the order is released into the market, failing which the order will be removed from the market. Partial match is possible for the order, and the unmatched portion of the order is cancelled immediately.

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2. Price Conditions

- ***Limit Price/Order:*** An order that allows the price to be specified while entering the order into the system.
- ***Market Price/Order:*** An order to buy or sell securities at the best price obtainable at the time of entering the order.
- ***Stop Loss (SL) Price/Order*** : The one that allows the Trading Member to place an order which gets activated only when the market price of the relevant security reaches or crosses a threshold price. Until then the order does not enter the market.

  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.

  E.g. If for stop loss buy order, the trigger is 93.00, the limit price is 95.00 and the market (last traded) price is 90.00, then this order is released into the system once the market price reaches or exceeds 93.00. This order is added to the regular lot book with time of triggering as the time stamp, as a limit order of 95.00.

3. Quantity Conditions

- ***Disclosed Quantity (DQ):*** An order with a DQ condition allows the Trading Member to disclose only a part of the order quantity to the market. For example, an order of 1000 with a disclosed quantity condition of 200 will mean that 200 is displayed to the market at a time. After this is traded, another 200 is automatically released and so on till the full order is executed. The Exchange may set a minimum disclosed quantity criteria from time to time.
- ***Minimum Fill (MF):*** MF orders allow the Trading Member to specify the minimum quantity by which an order should be filled. For example, an order of 1000 units with minimum fill 200 will require that each trade be for at least 200 units. In other words there will be a maximum of 5 trades of 200 each or a single trade of 1000. The Exchange may lay down norms of MF from time to time.

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Check your progress

1. What is wholesale debt segment of NSE.
2. What do you mean by currency derivative segment of NSE.
3. Discuss stop loss orders.

- ***All or None (AON):*** AON orders allow a Trading Member to impose the condition that only the full order should be matched against. This may be by way of multiple trades. If the full order is not matched it will stay in the books till matched or cancelled.

Note: Currently, AON and MF orders are not available on the system as per SEBI directives.

12.5 Clearing and Settlement System of NSE

NSCCL carries out clearing and settlement functions as per the settlement cycles provided in the settlement schedule.

The clearing function of the clearing corporation is designed to work out a) what members are due to deliver and b) what members are due to receive on the settlement date. Settlement is a two way process which involves transfer of funds and securities on the settlement date.

NSCCL has also devised mechanism to handle various exceptional situations like security shortages, bad delivery, company objections, auction settlement etc.

Clearing is the process of determination of obligations, after which the obligations are discharged by settlement.

NSCCL has two categories of clearing members: trading clearing members and custodians. Trading members can trade on a proprietary basis or trade for their clients. All proprietary trades become the member's obligation for settlement. Where trading members, trade on behalf of their clients they could trade for normal clients or for clients who would be settling through their custodians. Trades which are for settlement by Custodians are indicated with a Custodian Participant (CP) code and the same is subject to confirmation by the respective Custodian. The custodian is required to confirm settlement of these trades on T + 1 day by the cut-off time 1.00 p.m. Non-confirmation by custodian devolves the trade obligation on the member who had input the trade for the respective client.

A multilateral netting procedure is adopted to determine the net settlement obligations (delivery/receipt positions) of the clearing members. Accordingly, a clearing member would have either pay-in or pay-out obligations for funds and securities separately. In the case of securities in the Trade for Trade – Surveillance segment and auction trades, obligations are determined on a gross basis i.e. every trade results into a deliverable and receivable obligation of funds and securities. Members pay-in and pay-out obligations for funds and securities are determined by 2.30 p.m. on T + 1 day and are downloaded to them so that they can settle their obligations on the settlement day (T+2).

- **Auto Delivery Out facility**

For pay-in through NSDL / CDSL a facility has been provided to members wherein delivery-out instructions will be generated automatically by the Clearing Corporation based on the net delivery obligations of its Clearing Members. These instructions will be released on the T+1 day to NSDL / CDSL and the securities in the Clearing Members' pool accounts will be marked for pay-in. Clearing members desirous of availing this facility shall send a letter in the format provided.

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- **Cleared and non-cleared deals**

NSCCL carries out the clearing and settlement of trades executed on the exchange except Trade for trade - physical segment of capital market. Primary responsibility of settling these deals rests directly with the members and the Exchange only monitors the settlement. The parties are required to report settlement of these deals to the Exchange.

12.5.1 Settlement Cycle

The important settlement types are as follows:

- Normal segment (N)
- Trade for trade Surveillance (W)
- Retail Debt Market (D)
- Limited Physical market (O)
- Non cleared TT deals (Z)
- Auction normal (A)

Trades in the settlement type N, W, D and A are settled in dematerialized mode. Trades under settlement type O are settled in physical form. Trades under settlement type Z are settled directly between the members and may be settled either in physical or dematerialized mode. Details of the modes of settlement are as under:

- **Dematerialised Settlement**

NSCCL follows a T+2 rolling settlement cycle. For all trades executed on the T day, NSCCL determines the cumulative obligations of each member on the T+1 day and electronically transfers the data to Clearing Members (CMs). All trades concluded during a particular trading date are settled on a designated settlement day i.e. T+2 day. In case of short deliveries on the T+2 day in the normal segment, NSCCL conducts a buy –in auction on the T+2 day itself and the settlement for the same is completed on the T+3 day, whereas in case of W segment there is a direct close out. For arriving at the settlement day all intervening holidays, which include bank holidays, NSE holidays, Saturdays and Sundays are excluded. The settlement schedule for all the settlement types in the manner explained above is communicated to the market participants vide circular issued during the previous month.

- **Rolling Settlement**

In a rolling settlement, for all trades executed on trading day i.e.T day the obligations are determined on the T+1 day and settlement on T+2 basis i.e. on the 2nd working day. For arriving at the settlement day all intervening holidays, which include bank holidays, NSE holidays, Saturdays and Sundays are excluded. A tabular representation of the settlement cycle for rolling settlement is given below:

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	Activity	Day
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T+1 working days
	Delivery Generation	T+1 working days
Settlement	Securities and Funds pay in	T+2 working days
	Securities and Funds pay out	T+2 working days
	Valuation Debit	T+2 working days
Post Settlement	Auction	T+2 working days
	Auction settlement	T+3 working days
	Bad Delivery Reporting	T+4 working days
	Rectified bad delivery pay-in and pay-out	T+6 working days
	Re-bad delivery reporting and pickup	T+8 working days
	Close out of re-bad delivery and funds pay-in & pay-out	T+9 working days

Source: NSE

- **Physical Settlement**

Limited Physical Market: To provide an exit route for small investors holding physical shares in securities the Exchange has provided a facility for such trading in physical shares not exceeding 500 shares in the 'Limited Physical Market' (small window).

Salient Features of Limited Physical Market

- Delivery of shares in street name and market delivery (clients holding physical shares purchased from the secondary market) is treated as bad delivery. The shares standing in the name of individuals/HUF only would constitute good delivery. The selling/delivering member must necessarily be the introducing member.
- Any delivery of shares which bears the last transfer date on or after the introduction of the security for trading in the LP market is construed as bad delivery.
- Any delivery in excess of 500 shares is marked as short and such deliveries are compulsorily closed-out.
- Shortages, if any, are compulsorily closed-out at 20% over the actual traded price. Non rectification/replacement for bad delivery is closed out at 10% over the actual trade price. Non rectification/replacement for objection cases is closed out at 20% above the official closing price in regular Market on the auction day.
- The buyer must compulsorily send the securities for transfer and dematerialisation, latest within 3 months from the date of pay-out.
- Company objections arising out of such trading and settlement in this market are reported in the same manner as is currently being done for normal market segment. However securities would be accepted as valid company objection, only if the securities are lodged for transfer within 3 months from the date of pay-out.

- Settlement for trades is done on a trade-for-trade basis and delivery obligations arise out of each trade. The settlement cycle for this segment is same as for the rolling settlement viz:

	Activity	Day
Trading	Rolling Settlement Trading	T
Clearing	Custodial Confirmation	T+1 working days
	Delivery Generation	T+1 working days
Settlement	Securities and Funds pay in	T+2 working days
	Securities and Funds pay out	T+2 working days
Post Settlement	Assigning of shortages for close out	T+2 working days
	Reporting and pick-up of bad delivery	T+4 working days
	Close out of shortages	T+4 working days
	Replacement of bad delivery	T+6 working days
	Reporting of re-bad and pick-up	T+8 working days
	Close out of re-bad delivery	T+9 working days

Source: NSE

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Check your progress

4. What is dematerialised settlement?
5. Explain the rolling settlement.

- **Bad Deliveries (in case of physical settlement)**

Bad deliveries (deliveries which are prima facie defective) are required to be reported to the clearing house within two days from the receipt of documents. The delivering member is required to rectify these within two days. Un-rectified bad deliveries are assigned to auction on the next day

- **Company Objections (in case of physical settlement)**

The CM on whom company objection is lodged has an opportunity to withdraw the objection if the objection is not valid or the documents are incomplete (i.e. not as required under guideline No.100 or 109 of SEBI Good/Bad delivery guidelines), within 7 days of lodgement against him. If the CM is unable to rectify/replace defective documents on or before 21 days, NSCCL conducts a buying-in auction for the non-rectified part of defective document on the next auction day through the trading system of NSE. All objections, which are not bought-in, are deemed closed out on the auction day at the closing price on the auction day plus 20%. This amount is credited to the receiving member's account on the auction pay-out day.

12.6 Key Terms

- **IPO:** An initial public offering (IPO) is the first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking the capital to expand, but can also be done by large privately owned companies looking to become publicly traded.

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- **Trading floor:** The floor where trading activities are conducted. Trading floors are found in the buildings of various exchanges, such as the New York Stock Exchange and the Chicago Board of Trade. These floors represent the area where traders complete the buying or selling of an asset.
- **Dematerialisation:** Dematerialisation is the process of converting physical financial instruments such as share certificates, mutual fund investments, and bonds into electronic form. An Investor who needs to dematerialise his shares needs to open a demat account with Depository Participant.
- **Preference shares:** Preference shares, more commonly referred to as preferred stock, are shares of a company's stock with dividends that are paid out to shareholders before common stock dividends are issued. If the company enters bankruptcy, the shareholders with preferred stock are entitled to be paid from company assets first. Most preference shares have a fixed dividend, while common stocks generally do not. Preferred stock shareholders also typically do not hold any voting rights, but common shareholders usually do.
- **Exchange traded funds:** An ETF, or exchange traded fund, is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stockexchange. ETFs experience price changes throughout the day as they are bought and sold.
- **Futures contract:** A futures contract is a contractual agreement, generally made on the trading floor of a futures exchange, to buy or sell a particular commodity or financial instrument at a pre-determined price in the future.
- **National Exchange for Automated Trading:** NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NSE consciously opted in favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs.
- **Lot size:** In other words, lot size basically refers to the total quantity of a product ordered for manufacturing. In financial markets, lot size is a measure or quantity increment suitable to or precised by the party which is offering to buy or sell it.

12.7 Summary

- The National Stock Exchange (NSE) is India's leading stock exchange covering various cities and towns across the country. NSE was set up by leading institutions to provide a modern, fully automated screen-based trading system with national reach. The Exchange has brought about unparalleled transparency, speed & efficiency, safety and market integrity. It has set up facilities that serve as a model for the securities industry in terms of systems, practices and procedures.

NOTES

- The erstwhile Wholesale Debt Market (WDM) segment of the Exchange commenced its operations on June 30, 1994. This provided the first formal screen-based trading facility for the debt market in the country. It has now been merged under the New Debt Market as the Negotiated Trade Reporting Platform.
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- A futures contract is a forward contract, which is traded on an Exchange. NSE commenced trading in futures on individual securities on November 9, 2001. The futures contracts are available on 173 securities stipulated by the Securities & Exchange Board of India (SEBI).
- NSE was the first exchange to have received an in-principle approval from SEBI for setting up currency derivative segment. National Stock Exchange was the first exchange to launch Currency futures trading in India. The Currency Derivatives segment at NSE commenced operations on August 29, 2008 with the launch of currency futures trading in US Dollar-India Rupee (USD-INR).
- NSE operates on the 'National Exchange for Automated Trading' (NEAT) system, a fully automated screen based trading system, which adopts the principle of an order driven market. NSE consciously opted in favour of an order driven system as opposed to a quote driven system. This has helped reduce jobbing spreads not only on NSE but in other exchanges as well, thus reducing transaction costs.
- NSCCL carries out clearing and settlement functions as per the settlement cycles provided in the settlement schedule.
- The clearing function of the clearing corporation is designed to work out a) what members are due to deliver and b) what members are due to receive on the settlement date. Settlement is a two way process which involves transfer of funds and securities on the settlement date.
- NSCCL has also devised mechanism to handle various exceptional situations like security shortages, bad delivery, company objections, auction settlement etc.

12.8 Questions and Exercises

1. State the segments of the National Stock Exchange and their growth in Indian Capital Market.

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2. How many types of market in the NEAT system? Discuss.
3. Differentiate between dematerialised settlement and rolling settlement.
4. Write short notes on:
   a. Types of orders based on time conditions
   b. Limit price order
   c. Market price order
   d. Rolling settlement

12.9 Further Readings and References

Books:

1. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.

Webresource:

1. https://www.nseindia.com

UNIT 13: SECURITIES EXCHANGE AND BOARD OF INDIA (SEBI)

Strucuture

13.0 Introduction
13.1 Unit Objectives
13.2 Origin of Securities Exchange and Board of India (SEBI)
13.3 Organisation of Securities Exchange and Board of India (SEBI)
13.4 Objectives of Securities Exchange and Board of India (SEBI)
13.5 Functions of Securities Exchange and Board of India (SEBI)
13.6 Capital Market Regulations
13.7 Legislations Governing Indian Capital Market
13.8 Key Terms
13.9 Summary
13.10 Questions and Exercises
13.11 Further Readings and References

13.0 Introduction

The capital market plays a very important role in promoting economic growth through the mobilization of long-term savings and the savings get invested in the economy for productive purpose. The capital market in India is a well-integrated structure and its components include stock exchanges, developed banks investment trusts, insurance corporations and provident fund organization. It caters to the varied needs for capital of agriculture, industrial and trading sectors of the economy. There are two important operations carried on in these markets. The raising the new capital and Trading in the securities already issued by the companies. With the pace of economic reforms followed in India, the importance of capital markets has grown in the last ten years. Corporate both in the private sector as well as in the public sector raise thousands of crores of rupees in these markets. The governments, through Reserve Bank of India, as well as financial institutes also raise a lot of money from these markets. The increasing number of investors' complaints and the steadily growing primary and secondary capital markets in India pointed out the necessity of some regulatory measures for the protection of investors and regulation of capital market.

13.1 Unit Objectives

After studying this unit, students will be able to:

- Understand organisation and objectives of Securities Exchange and Board of India (SEBI)
- Explain functions of Securities Exchange and Board of India (SEBI)
- Develop an understanding of legislations governing capital market

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13.2 Origin of Securities Exchange and Board of India

In India, stock exchanges were almost self-regulatory till 1988, supervised by Ministry of Finance under the Securities Contracts Regulation Act (SCRA). However, the stock exchanges were not discharging their self-regulatory role as well as a result of which malpractices crept into trading, adversely affecting investor's interests. On 12 April, 1988 the Securities and Exchange Board of India (SEBI) was established by the Government of India through an executive resolution to ensure that the stock exchanges discharge their self-regulatory role properly. It was subsequently upgraded as a fully autonomous body (a statutory Board) in the year 1992 with the passing of the Securities and Exchange Board of India Act (SEBI Act) on 30th January 1992. In place of Government Control, a statutory and autonomous regulatory board with defined responsibilities, to cover both development & regulation of the market, and independent powers has been set up.

13.3 Organization of Securities Exchange and Board of India

The affairs of SEBI shall be managed by a Board. The Board shall be a body corporate by the name aforesaid, having perpetual succession and a common seal, with power subject to the provisions of this Act, to acquire, hold and dispose of property, both movable and immovable, and to contract, and shall, by the said name, sue or be sued. The Board shall consist of the following members:

1. A Chairman.
2. Two officials of the Central Government from the Ministry of Finance and Ministry of Law, Justice and Company Affairs.
3. One official nominated by the Reserve Bank of India.
4. Two other members nominated by the Central Government.

The Chairman and the members should be persons of ability, integrity and standing who have shown capacity in dealing with problems of the securities market. They are required to have good knowledge or experience in the areas of finance, law, economics, accountancy, administration, etc.

The work of the SEBI has been organized into five operational departments each of which is headed by the executive director who reports to the chairman. Besides, there is a legal department and the investigation department. The departments have been divided into divisions. The various departments and the scope of their activities are as follows:

- **The Primary Market Policy, Intermediaries, Self-Regulatory Organizations (SROs) And Investor Grievance and Guidance Department:** It looks after all policy matter and regulatory issue in respect off primary market, registration, merchant bankers, portfolio management services, investment advisors, debentures trustees, underwriters, SROs and investor grievance, guidance, education and association.
- **The Issue Management and Intermediaries Department:** It is responsible for vetting of all prospectuses ad letters of offer for pubic and

right issues, for coordinating with the primary market policy, for registration, regulation and monitoring of issue-related intermediaries.

NOTES

- **The Secondary Market Policy, Operations and Exchange Administration, New Investment Products and Insider Trading Department:** It is responsible for all the policy and regulatory issues for secondary market and new investment products, registration and monitoring of members of stock exchanges, administration of some the stock exchanges, market surveillance and monitoring of price movements and insider trading, and EDP and SEBI's data base.
- **The Secondary Market Exchange Administration, Inspection and Non-member Intermediaries Department:** It looks after the smaller stock exchanges of Guwahati, Magadh, Indore, Mangalore, Hyderabad, Bhubaneshwar, Kanpur, Ludhiana and Cochin. It is also responsible for inspection of all stock exchanges and registration, regulation and monitoring of non-member intermediaries such as sub-brokers.
- **Institutional Investment (Mutual Funds and Foreign Institutional Investment), Mergers and Acquisitions, Research and Publications, and International Relations and IOSCO Department:** It looks after policy, registration, regulation and monitoring of Foreign Institutional Investors (FIIs). Domestic mutual funds, mergers and substantial acquisitions of shares, and IOSCO (International Organisational of Securities Commissions) membership, international relations, and research, publication and Annual Report of SEBI.
- **Legal Department:** This department looks after all legal matters under the supervision of the General Counsel.
- **Investigation Department:** This department carries out inspection and investigation under the supervision of the Chief of Investigation.

13.4 Objectives of Securities Exchange and Board of India

The SEBI operates within the legal framework of the SEBI Act, 1992. The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The statutory objectives of SEBI are:

- To regulate the activities of stock exchange.
- To protect the rights of investors and ensuring safety to their investment.
- To prevent fraudulent and malpractices by having balance between self-regulation of business and its statutory regulations.
- To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

NOTES

Check your progress

1. Discuss the organisation of SEBI.
2. Explain the main objectives of SEBI.

Table 13.1: SEBI Registered Market Intermediaries

Market Intermediaries	2010- 11	2011- 12	2012- 13	2013-14	Apr 13-Dec 13	Apr 14-Dec 14
1	2	3	4	5	6	7
Stock Exchanges (Cash Market)	19	19	19	16	17	14
Stock Exchanges (Derivatives Market)	2	2	3	3	3	3
Stock Exchanges (Currency Derivatives)	4	4	4	4	4	3
Brokers(Cash Segment)	9,235	9,307	10,128	9,411	9,150	7,306
Corporate Brokers(Cash Segment)	4,563	4,672	5,113	4,917	4,925	4,196
Sub-brokers(Cash Segment)	83,952	77,165	70,178	51,885	54,846	44,540
Brokers(Equity Derivatives)	2,301	2,337	2,957	3,051	3,072	3,008
Brokers(Currency Derivatives)	1,894	2,173	2,330	2,395	2,382	2,406
Foreign Institutional Investors	1,722	1,765	1,757	1,710	1,739	Na
Sub-accounts	5,686	6,322	6,335	6,344	6,394	Na
Foreign Portfolio Investors (FPIs)	Na	Na	Na	Na	Na	782
Deemed FPIs	Na	Na	Na	Na	Na	7,360
Custodians	19	19	19	19	19	19
Depositories	2	2	2	2	2	2
Depository Participants	805	854	865	857	866	858
Designated Depository Participants (DDP	Na	Na	Na	Na	Na	18
Qualified Depository Participants of NSDL & CDSL	Na	Na	59	62	62	62
Merchant Bankers	192	200	199	197	198	198
Bankers to an Issue	55	56	57	59	56	60
Underwriters	3	3	3	3	3	2
Debenture Trustees	29	32	32	31	32	32
Credit Rating Agencies	6	6	6	6	6	6
KYC Registration Agency (KRA)	Na	Na	5	5	5	5
Venture Capital Funds	184	207	211	207	210	201
Foreign Venture Capital Investors	153	175	182	192	193	201
Alternative Investment Funds	Na	Na	42	101	90	125
Registrars to an Issue & Share Transfer Agents	73	74	72	71	72	71
Portfolio Managers	267	250	241	212	221	193
Mutual Funds	51	49	52	50	50	49
Investment Advisors	Na	Na	Na	129	70	239
Collective Investment Management Company	1	1	1	1	1	1
Approved Intermediaries (Stock Lending Schemes)	2	2	2	2	2	2
STP (Centralised Hub)	1	1	1	1	1	1
STP Service Providers	2	2	2	2	2	2

Source: SEBI (http://www.sebi.gov.in/)

13.5 Functions of Securities Exchange and Board of India

The SEBI performs functions to meet its objectives. To meet its objectives SEBI has three important functions. These are:

- Protective functions
- Developmental functions
- Regulatory functions

13.5.1 Protective Functions

These functions are performed by SEBI to protect the interest of investor and provide safety of investment. As a protector of investor's interest, SEBI performs following functions

- **It Checks Price Rigging:** Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

- **It Prohibits Insider trading:** Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.
- **SEBI prohibits fraudulent and Unfair Trade Practices:** SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.
- SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

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13.5.2 Developmental Functions

These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange. Under developmental categories following functions are performed by SEBI:

- Investor education
- Training of intermediaries
- Promotion of fair practices and Code of conduct for all S.R.O.s
- Conducting Research and Publishing information useful to all market participants

13.5.3 Regulatory Functions

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

- SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.
- These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.
- SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.
- SEBI registers and regulates the working of mutual funds etc.
- SEBI regulates takeover of the companies.
- SEBI conducts inquiries and audit of stock exchanges.

13.6 Capital Market Regulations

Indian Capital Markets are regulated and monitored by the Ministry of Finance, The Securities and Exchange Board of India and The Reserve Bank of India.

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The Ministry of Finance regulates through the Department of Economic Affairs - Capital Markets Division. The division is responsible for formulating the policies related to the orderly growth and development of the securities markets (i.e. share, debt and derivatives) as well as protecting the interest of the investors. In particular, it is responsible for

- Institutional reforms in the securities markets,
- Building regulatory and market institutions,
- Strengthening investor protection mechanism, and
- Providing efficient legislative framework for securities markets.

At present, the five main Acts governing the securities markets are (a) the SEBI Act, 1992; (b) the Companies Act, 1956, which sets the code of conduct for the corporate sector in relation to issuance, allotment, and transfer of securities, and disclosures to be made in public issues; (c) the Securities Contracts (Regulation) Act, 1956, which provides for the 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 (dematerialized) shares; and (e) the Prevention of Money Laundering Act, 2002.

13.7 Legislations Governing Capital Market

1. The 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 corporate in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with the securities market. It can conduct enquiries, audits, and inspection of all concerned, and adjudicate offences under the Act. It has the powers to register and regulate all market intermediaries, as well as to penalize them in case of violations of the provisions of the Act, Rules, and Regulations made there under. SEBI has full autonomy and the authority to regulate and develop an orderly securities market.

2. Securities Contracts (Regulation) Act, 1956

This Act provides for the 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 the Central Government regulatory jurisdiction over (a) stock exchanges through a process of recognition and continued supervision, (b) contracts in securities, and (c) the listing of securities on the stock exchanges. As a condition of recognition, a stock exchange complies with the conditions prescribed by the Central Government. Organized trading activity in securities takes place on a specified recognized 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. 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) dematerializing the securities in the depository mode; and (c) providing for the maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages the 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.

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4. Companies Act, 1956

It deals with the issue, allotment, and transfer of securities, as well as various aspects relating to company management. It provides the 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 the management's perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights, and bonus issues, the payment of interest and dividends, the supply of annual reports, and other information.

5. Prevention of Money Laundering Act, 2002

The primary objective of this Act is to prevent money laundering, and to allow the confiscation of property derived from or involved in money laundering. According to the definition of "money laundering," anyone who acquires, owns, possess, or transfers any proceeds of crime, or knowingly enters into any transaction that is related to the 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 prescribing the punishment for this offence, the Act provides other measures for the prevention of money laundering. The Act also casts an obligation on the intermediaries, the 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.

6. Foreign Exchange Management Bill 1998 (FEMA)

As a part of the ongoing process of economic liberalization relating to foreign investments and foreign trade in India and as a measure for closer interaction with the world economy the Foreign Exchange Regulation Act, 1973 (FERA) was reviewed in the year 1993 and several amendments were made therein. Further review of the FERA was undertaken by the Central Government of India in the light of subsequent developments and on account of the experience in relation to foreign trade and investment in India, the Central Government felt that instead of further amending the FERA, the better course would be to repeal the existing Act and to enact a new legislation in its place. There has been a substantial increase in the Foreign Exchange Reserves of India. Since the year 1993, foreign trade has grown up. Development has taken place such as current account convertibility, liberalization in investments abroad, and increased access to external commercial borrowings by Indian Companies and participation by foreign institutional investors in securities markets in India. Keeping in view these changes the Central Government of India has introduced the FEMA to repeal FERA.

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A marked digression from the general rule that the Accused is presumed to be innocent until proved guilty beyond reasonable doubt, is found in the FEMA. A presumption regarding documents, contained in this Bill is contrary to the general rules of evidence. For example, when documents pertaining to a crime under FEMA are discovered the Court will presume that the contents of the documents are true and correct and will not go into the question whether the incriminating documents may have been forged. Thus, it becomes the responsibility of the Accused to prove, in case that the documents are fabricated. The main change between FERA and FEMA is in the approach. FERA seeks to regulate almost all the transactions involving foreign exchange and inbound/outbound investments. In FERA every provision is restrictive and starts with a negative proposition stating that whatever is mentioned in that section is prohibited unless the prior permission either general or special, as may be required in the specific case, of RBI is obtained. FERA provides that nothing can be done without RBI's permission. In comparison to this existing negative piece of legislation, the provisions of the proposed Bill have a positive approach. This can be found from the provisions of FEMA dealing with capital account transactions which are to be regulated. Unlike FERA which provides that these transactions cannot be entered into without prior permission of RBI, FEMA provides that any person may sell or draw foreign exchange for such transactions and then specifies the powers of the RBI to regulate the class or limits of such capital account transactions. Thus the basic proposition in the proposed FEMA Bill is positive. FEMA classifies foreign exchange transactions into capital account transactions and current account transactions and amongst the two regulates the former more closely. Under FEMA residential status will not depend upon the intent of the person to reside in India but would depend upon the exact period of his stay in India.

The provisions of the FEMA Bill aims at consolidating and amending the law relating to foreign exchange with the object of facilitating external trade and payments and for promoting the orderly payment and amendments in foreign exchange markets in India. The FEMA Bill empowers the RBI to authorize persons to deal in foreign securities specifying the conditions for the same. It also provides for a person resident in India in holding, owning, transferring or investing in foreign security and for a person resident outside India in holding, owning, transferring or investing in Indian Securities.

13.8 Key Terms

- **Primary Market:** A primary market is a market that issues new securities on an exchange. Companies, governments and other groups obtain financing through debt or equity based securities. Primary markets are facilitated by underwriting groups, which consist of investment banks that will set a beginning price range for a given security and then oversee its sale directly to investors.
- **Underwriters:** An underwriter is a company or other entity that administers the public issuance and distribution of securities from a corporation or other issuing body. An underwriter works closely with the issuing body to determine the offering price of the securities, buys them from the issuer, and sells them to investors via the underwriter's distribution network.

Underwriters generally receive underwriting fees from their issuing clients, but they also can earn profits when selling the underwritten shares to investors.

- **Stock Exchange:** A stock exchange or bourse is an exchange where stock brokers and traders can buy and /or sell stocks (also called shares), bonds, and other securities. Stock exchanges may also provide facilities for issue and redemption of securities and other financial instruments, and capital events including the payment of income and dividends.
- **Insider trading:** Insider trading is the buying or selling of a security by someone who has access to material, non-public information about the security.
- **Money Laundering:** Money laundering is the process of creating the appearance that large amounts of money obtained from serious crimes, such as drug trafficking or terrorist activity, originated from a legitimate source.
- **Security:** A security is a financial instrument that represents an ownership position in a publicly-traded corporation (stock), a creditor relationship with governmental body or a corporation (bond), or rights to ownership as represented by an option. A security is a fungible, negotiable financial instrument that represents some type of financial value. The company or entity that issues the security is known as the issuer.

NOTES

Check your progress

3. Describe the main functions of SEBI.
4. What are the main Acts governing the securities markets?

13.9 Summary

- In India, stock exchanges were almost self-regulatory till 1988, supervised by Ministry of Finance under the Securities Contracts Regulation Act (SCRA).
- On 12 April, 1988 the Securities and Exchange Board of India (SEBI) was established by the Government of India through an executive resolution to ensure that the stock exchanges discharge their self-regulatory role properly.
- The affairs of SEBI shall be managed by a Board. The Board shall be a body corporate by the name aforesaid, having perpetual succession and a common seal, with power subject to the provisions of this Act, to acquire, hold and dispose of property, both movable and immovable, and to contract, and shall, by the said name, sue or be sued.
- The work of the SEBI has been organized into five operational departments each of which is headed by the executive director who reports to the chairman. Besides, there is a legal department and the investigation department.
- The SEBI operates within the legal framework of the SEBI Act, 1992.The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market.

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- The SEBI performs functions to meet its objectives. To meet its objectives SEBI has three important functions. These are: Protective functions; Developmental functions and Regulatory function.
- Indian Capital Markets are regulated and monitored by the Ministry of Finance, The Securities and Exchange Board of India and The Reserve Bank of India.
- At present, the five main Acts governing the securities markets are (a) the SEBI Act, 1992; (b) the Companies Act, 1956, which sets the code of conduct for the corporate sector in relation to issuance, allotment, and transfer of securities, and disclosures to be made in public issues; (c) the Securities Contracts (Regulation) Act, 1956, which provides for the 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 (dematerialized) shares; and (e) the Prevention of Money Laundering Act, 2002.

13.10 Questions and Exercises

1. State the power and functions of the SEBI.
2. What are the roles of SEBI as a regulator of Indian security market?
3. Explain various legistations governing Indian Capital Market.

13.11 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.
2. Saha, S.S., ***"Indian Financial System and Markets",***TMH Education Private Limited.
3. Khan. M.Y., ***"Indian Financial system"***, TMH publishing company Limited.
4. Bhole L.M. & Mahakud J.(2009). **Financial Institutions and Markets- structure, growth and innovations.** Tata McGraw Hill Education Pvt. Ltd

Web resources:

1. "Organisation of SEBI" available at http://bbi.co.in/organization-of-sebi/
2. "Introducation to SEBI" available at http://finance.indiamart.com/india_business_information/sebi_introduction.html
3. "Legislations governing Capital Market" available at http://www.sebi.gov.in/acts/act15ac.pdf
4. "Objectives and functions of SEBI" available at http://www.yourarticlelibrary.com/education/sebi-the-purpose-objective-and-functions-of-sebi/8762/
5. "Legislations governing Capital Market" available at http://www.icsi.in/Study%20Material%20Executive/Executive%20Programme-2013/CAPITAL%20MARKET%20AND%20SECURITIES%20LAWS%20(MODULE%20II%20PAPER%206).pdf

UNIT 14: DEBT AND CREDIT MARKET

NOTES

Structure

14.0 Introduction
14.1 Unit Objectives
14.2 Concept of Debt Market
14.3 Overview of Indian Debt Market
14.4 Significance of Debt Market
14.5 Participants in Indian Debt Market
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14.0 Introduction

The Indian financial system is changing fast, marked by strong economic growth, more robust markets, and considerably greater efficiency. But to add to its world-class equity markets, and growing banking sector, the country needs to improve its Debt market. At the current time, when India is endeavouring to sustain its growth rate, it is imperative that financing constraints in any form be removed and alternative financing channels be developed in a systematic manner for supplementing traditional bank credit. In this context, the development of long-term debt markets is critical in the mobilization of the huge magnitude of funding required to finance potential business expansion and infrastructure development. The Debt Market in India with the liberalization has been transformed completely. The Debt market in India has diversified to a large extent and that is a huge contributor to the stable growth of the economy.

14.1 Unit Objectives

After studying this unit, students will be able to:

- Understand the Basics of Debt Market
- Know the structure of Indian Debt Market
- Discuss the significance of Debt Market in India
- Familiarise with the Instruments traded on Debt Market
- Develop an understanding of legislations governing Indian Debt Market

NOTES

14.2 Concept of Debt Market

A debt market is a part of the capital market. As the name suggests, Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of mortgages, promissory notes, bonds, and Certificates of Deposit. A debt market establishes a structured environment where these types of debt can be traded with ease between interested parties.These markets are important source of funds, especially in a developing economy like India. This market often goes by other names, based on the types of debt instruments that are traded. In the event that the market deals mainly with the trading of municipal and corporate bond issues, it may be known as a bond market. If mortgages and notes are the main focus of the trading, it 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. The debt market includes the primary market, where debts are first sold to the public; and the secondary market, where investors sell debts to each other afterward. On the secondary debt market, debts can be sold on exchanges or on the over-the-counter market, but most are traded over the counter. Market structure of debt market can be understood by following figure:

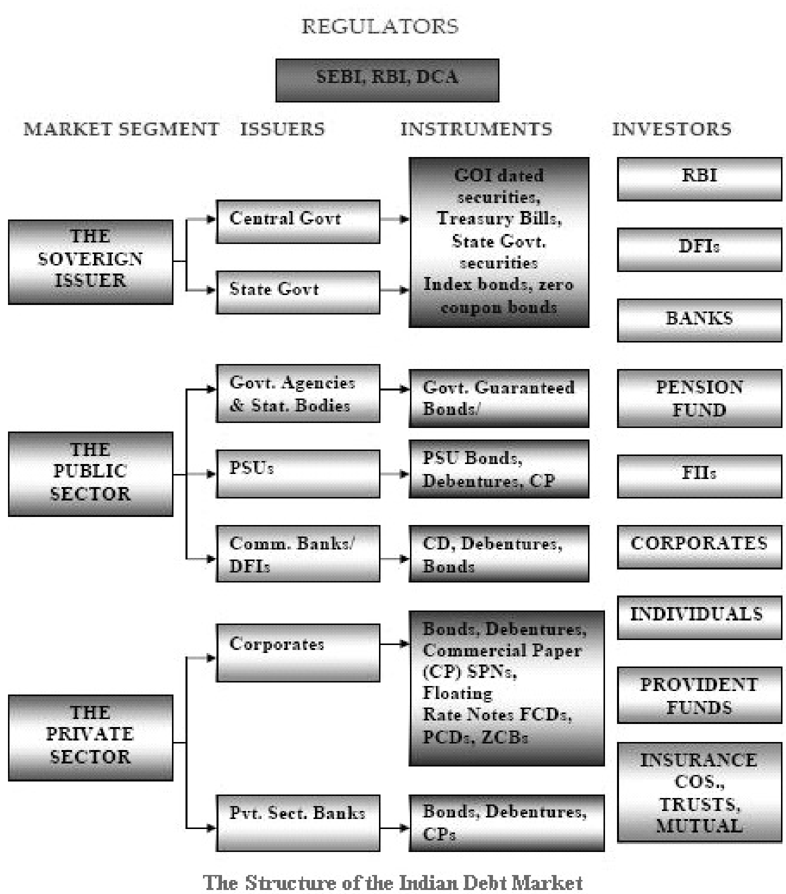

Figure 14.1: Structure of Indian Debt Market

Source: http://www.sebi.gov.in/workingpaper/corporate.pdf

14.3 Overview of Indian Debt Market

Indian debt markets, in the early nineties, were 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 transactions cost. The Indian debt market has traditionally been a wholesale market with participation restricted to few institutional players mainly banks. The turnover in the debt markettoo was quite low a few hundred crores till the early 1990s. Financial reforms have significantly changed the Indian debt markets for the better. Most debt instruments are now priced freely on the markets; trading mechanisms have been altered to provide for higher levels of transparency, higher liquidity, and lower transactions costs; new participants have entered the markets, broad basing the types of players in the markets; methods of security issuance, and innovation in the structure of instruments have taken place; and there has been a significant improvement in the dissemination of market information.

The debt market in India consists of mainly two categories—the government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market. In order to finance its fiscal deficit, the government floats fixed income instruments and borrows money by issuing G-Secs that are sovereign securities issued by the Reserve Bank of India (RBI) on behalf of the Government of India. The corporate bond market (also known as the non-Gsec market) consists of financial institutions (FI) bonds, public sector units (PSU) bonds, and corporate bonds/debentures.

The G-secs are the most dominant category of debt markets and form a major part of the market in terms of outstanding issues, market capitalization, and trading value. It sets a benchmark for the rest of the market. The market for debt derivatives have not yet developed appreciably, although a market for OTC derivatives in interest rate products exists.

Table 14.1: Market composition in Indian Debt Market

Type of Security	No. of Securities as on Apr 29, 2016	Issue Size* (Rs. in millions) As on 29 Apr 2016	As on 31 Mar 2016	As on 29 Feb 2016	As on 30 Apr, 2015	Increase / Decrease in Last one Year (%)
Govt. Bonds	113	26325753	27095753	27095753	28568192	(7.85)
State Govt. Bonds	1965	15461394	15317594	15131501	12875257	20.09
Treasury Bills	49	3665916	3487137	3751033	3801421	(3.56)
State Enterprise Bonds	1105	4916960	4890770	4849480	4548197	8.11
Financial Institutions / Bank Bonds	767	3984459	4026911	3993331	4045304	(1.50)
Corporate Debt	3140	4404113	4328750	4272155	3629495	21.34
Supra Institutional Bonds	10	4932	4932	4932	3300	49.45
Local Bodies	17	29750	29750	29750	29750	-
Mutual Fund	6	7502	7502	7502	7502	-
Preference share	1	1250	2750	2750	0	-
Total	**7173**	**58802029**	**59191849**	**59138187**	**57508418**	**2.25**

*rounded off to the nearest million.
**Debt oriented Mutual Funds not included in the above data.

Source: www.nseindia.com

NOTES

Check your progress

1. What do you understand by debt market?
2. Difference between bond market and credit market.
3. What is fixed income market?

NOTES

Table 14.2: Market Capitalisation as on April 29, 2016

Security Type	No. of Securities	Mkt Capitalisation (Rs Mn.)	% of Total
Govt. Securities	113	26825814.81	45.15
PSU Bonds	1105	4984682.30	8.39
State Loans	1965	15554381.14	26.18
Treasury Bills	49	3580939.34	6.03
Local Bodies	17	29750.00	0.05
Fin Inst.	208	997859.23	1.68
Bank Bonds	559	2990407.87	5.03
Corporate Bonds	3140	4441718.86	7.48
Supranational Bonds	10	4997.44	0.01
Mutual funds	6	7502	0.01
Preference share	1	1250.00	0.00
Total	**7173**	**59419302.99**	**100.00**

Source: www.nseindia.com

14.4 Significance of Debt Market in India

At the current time, when India is endeavoring to sustain its high growth rate, it is imperative that financing constraints in any form be removed and alternative financing channels be developed in a systematic manner for supplementing traditional bank credit. In this context, the development of long-term debt markets – corporate debt and municipal debt – is critical in the mobilization of the huge magnitude of funding required to finance potential business expansion and infrastructure development. Debt market in India plays following roles-

- **Ensuring financial system stability:** A liquid Debt market can play a critical role because it supplements the banking system to meet the requirements of the corporate sector for long-term capital investment and asset creation. Banking systems cannot be the sole source of long-term investment capital without making an economy vulnerable to external shocks. Debt financing reduces macroeconomic vulnerability to shocks and systemic risk through diversification of credit and investment risk.
- **Enabling meaningful coverage of real sector needs:** The financial sector in India is much too small to cater to the needs of the real economy. A comparison of the asset size of the top ten corporates and that of the top ten banks reveals that banks in India are unable to meet the scale or sophistication of the needs of corporate India. Needless to say, the financial system is not big enough to meet the needs of small and medium-sized enterprises either. While these are pointers to the fact that the banking sector in India needs to be larger than its current size, they are also clear indicators that debt markets need to grow manifold to ensure that the financial sector becomes adequate for an economy as large and as ambitious as India's.
- **Creating new classes of investors:** Commercial banks face asset-liability mismatch issues in providing longer-maturity credit. Development of a corporate debt market will enable participation from institutions that have the capacity

as well as aptitude for longer maturity exposures. Financial institutions like insurance companies and provident funds have long-term liabilities and do not have access to adequate high quality long-term assets to match them. Creation of a deep corporate bond market can enable them to invest in long-term corporate debt, thus serving the twin goals of diversifying corporate risk across the financial sector and enabling these institutions to access high quality long-term assets. Thus, access to long-term debt opens up the market to new classes of investors with an appetite for longer maturity assets and thereby helps prevent maturity mismatches.

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- **Reduced currency mismatches:** The development of local currency bond markets has been seen as a way to avoid crisis, not only by supplementing bank credit but also because these markets help reduce potential currency mismatches in the financial system. Currency mismatches can be avoided by issuing local currency bonds. Thus, well-developed and liquid bond markets can help firms reduce their overall cost of capital by allowing them to tailor their asset and liability profiles to reduce the risk of both maturity and currency mismatches.
- **Term structure and effective transmission of monetary policy:** The creation of long-term debt markets will also enable the generation of market interest rates at the long end of the yield curve – thus facilitating the development of a more complete term structure of interest rates. A deeper, more responsive interest rate market would in turn provide the central bank with a mechanism for effective transmission of monetary policy.

14.5 Participants in the Debt Market

- **Central Governments:** Central Governments, raises money through bond issuances, to fund budgetary deficits and other short and long term funding requirements.
- **Reserve Bank of India:** Reserve Bank of India, as investment banker to the government, raises funds for the government through bond and t-bill issues, and also participates in the market through open-market operations, in the course of conduct of monetary policy. The RBI regulates the bank rates and repo rates and uses these rates as tools of its monetary policy. Changes in these benchmark rates directly impact debt markets and all participants in the market.
- **Primary dealers:** Primary dealers, who are market intermediaries appointed by the Reserve Bank of India who underwrite and make market in government securities, and have access to the call markets and repo markets for funds.
- **State Governments, municipalities and local bodies:** State Governments, municipalities and local bodies also participate by issuing securities in the debt markets to fund their developmental projects, as well as to finance their budgetary deficits.

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Check your progress

4. Explain the major participants in the debt market.
5. What do you mean by mutual funds?

- **Public sector units:** Public sector units are large issuers of debt securities, for raising funds to meet the long term and working capital needs. These corporations are also investors in bonds issued in the debt markets.
- **Corporate treasuries:** Corporate treasuries issue short and long term paper to meet the financial requirements of the corporate sector. They are also investors in debt securities issued in the market.
- **Public sector financial institutions:** Public sector financial institutions regularly access debt markets with bonds for funding their financing requirements and working capital needs. They also invest in bonds issued by other entities in the debt markets.
- **Banks:** Banks are the largest investors in the debt markets, particularly the Treasury bond and bill markets. They have a statutory requirement to hold a certain percentage of their deposits (currently the mandatory requirement is 25% of deposits) in approved securities (all government bonds qualify) to satisfy the statutory liquidity requirements. Banks are very large participants in the call money and overnight markets. They are arrangers of commercial paper issues of corporate. They are also active in the inter-bank term markets and repo markets for their short term funding requirements. Banks also issue CDs and bonds in the debt markets.
- **Mutual funds:** Mutual funds have emerged as another important player in the debt markets, owing primarily to the growing number of bond funds that have mobilized significant amounts from the investors. Most mutual funds also have specialized bond funds such as gilt funds and liquid funds. Mutual funds are not permitted to borrow funds, except for very short-term liquidity requirements. Therefore, they participate in the debt markets pre-dominantly as investors, and trade on their portfolios quite regularly.
- **Foreign Institutional Investors:** Foreign Institutional Investors are permitted to invest in Dated Government Securities and Treasury Bills within certain specified limits.
- **Provident funds:** Provident funds are large investors in the bond markets, as the prudential regulations governing the deployment of the funds they mobilize, mandate investments pre-dominantly in treasury and PSU bonds. They are, however, not very active traders in their portfolio, as they are not permitted to sell their holdings, unless they have a funding requirement that cannot be met through regular accruals and contributions.
- **Charitable Institutions:** Charitable Institutions, Trusts and Societies are also large investors in the debt markets. They are, however, governed by their rules and byelaws with respect to the kind of bonds they can buy and the manner in which they can trade on their debt portfolios.

14.6 Debt Market Instruments

- **Commercial Paper (CP)**: They are primarily issued by corporate entities. It is compulsory for the issuance of CPs that the company be assigned a rating of at least P1 by a recognized credit rating agency. An important point to be noted is that funds raised through CPs do not represent fresh borrowings but are substitutes to a part of the banking limits available to them.

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- **Certificates of Deposit (CD)**: While banks are allowed to issue CDs with a maturity period of less than 1 year, financial institutions can issue CDs with a maturity of at least 1 year. The prime reason for an active market in CDs in India is that their issuance does not warrant reserve requirements for bank.
- **Treasury Bills (T-Bills)**: T-Bills are issued by the RBI at the behest of the Government of India and thus are actually a class of Government Securities. Presently T-Bills are issued in maturity periods of 91 days, 182 days and 364 days. Potential investors have to put in competitive bids. Non-competitive bids are also allowed in auctions (only from specified entities like State Governments and their undertakings, statutory bodies and individuals) wherein the bidder is allotted T-Bills at the weighted average cut off price.
- **Long-term debt instruments**: These instruments have a maturity period exceeding 1year. The main instruments are Government of India dated securities (GOISEC), State Government securities (state loans), Public Sector Undertaking bonds (PSU bonds) and corporate bonds/debenture. Majority of these instruments are coupon bearing i.e. interest payments are payable at pre specified dates.
- **Government of India dated securities (GOISECs)**: Issued by the RBI on behalf of the Central Government, they form a part of the borrowing program approved by Parliament in the Finance Bill each year (Union Budget). They have a maturity period ranging from 1 year to 30 years. GOISECs are issued through the auction route with the RBI pre specifying an approximate amount of dated securities that it intends to issue through the year. But unlike T-Bills, there is no preset schedule for the auction dates. The RBI also issues products other than plain vanilla bonds at times, such as floating rate bonds, inflation-linked bonds and zero coupon bonds.
- **State Government Securities (state loans)**: Although these are issued by the State Governments, the RBI organizes the process of selling these securities. The entire process, 17 rights from selling to auction allotment is akin to that for GOISECs. They also form a part of the SLR requirements and interest payment and other modalities are analogous to GOISECs. Although there is no Central Government guarantee on these loans, they are believed to be exceedingly secure. One important point is that the coupon rates on state own are slightly higher than those of GOISECs, probably denoting their sub-sovereign status.
- **Public Sector Undertaking Bonds (PSU Bonds)**: These are long-term debt instruments issued generally through private placement. The Ministry of Finance has granted certain PSUs, the right to issue tax-free bonds. This was done to lower the interest cost for those PSUs who could not afford to pay market determined interest rates.

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- **Bonds of Public Financial Institutions (PFIs)**: Financial Institutions are also allowed to issue bonds, through two ways - through public issues for retail investors and trusts and secondly through private placements to large institutional investors.
- **Corporate debentures**: These are long-term debt instruments issued by private companies and have maturities ranging from 1 to 10 years. Debentures are generally less liquid as compared to PSU bonds.

The instruments traded can be classified into the following segments based on the characteristics of the identity of the issuer of these securities

Issuer	Instrument	Maturity	Investors
Central Government	Dated Securities	2-30years	RBI, Banks, Insurance Companies, Provident Funds, Mutual Funds, PDs, Individuals
Central Government	T-Bills	91/182/364 days	RBI, Banks, Insurance Companies, Provident Funds, PDs, Mutual Funds, Individuals
State Government	Dated Securities	5-13 years	Banks, Insurance Companies, Provident Funds, RBI, Mutual Funds, Individuals, PDs.
PSUs	Bonds, Structured Obligations	5-10 years	Banks, Insurance Companies, Corporate, Provident Funds, Mutual Funds, Individuals
Corporates	Debentures	1-12 years	Banks, Mutual Funds, Corporates, Individuals
Corporates, PDs	Commercial paper	7 days to 1 year	Banks, Corporate, Financial institutions, Mutual Funds, Individuals, FIIs
Scheduled Commercial Banks	Certificates of Deposit (CDs)	7 days to 1 year	Banks, Corporations, Individuals, Companies, Trusts, Funds, Associations, FIs, NRIs
Financial Institutions		1 year to 3 years	
Scheduled Commercial Banks	Bank Bonds	1-10 years	Corporations, Individual Companies, Trusts, Funds, Associations, FIs, NRIs
Municipal Corporation	Municipal Bonds	0-7 years	Banks, Corporations, Individuals, Companies, Trusts, Funds, Associations, FIs, NRIs

14.7 Corporate Bond Market

Corporate debt market is a market wherein debt securities of corporates are issued and traded. The primary market for corporate debt is mainly dominated by private placements (more than 95 per cent of total issuance in 2014-15) as corporates prefer this route to public issues because of operational ease, i.e., minimum disclosures, low cost, tailor made structures and speed of raising funds. India lacks a long-term debt market for pure project finance. Corporate bonds issued in India usually carry a rating of AAA indicating lack of interest in bonds of lower rated borrowers in the debt market. Institutional participants, such as, banks, primary dealers, mutual funds, insurance companies, pension funds, corporates, etc. are the major players in this market. Retail investors are also gradually entering this market. Their participation is, however, minuscule. As regards regulation of corporate debt market, the regulatory involvement is clearly delineated between the Reserve Bank of India and the SEBI. Reserve Bank is responsible for the market for repo transactions and OTC credit derivatives besides framing prudential regulations for banks, etc. in respect of their exposure to corporate bonds. In all other cases, SEBI has the regulatory jurisdiction except in case of unlisted privately placed bonds.

Table 14.3: Sector-wise summary of primary issuances

Amount in Rs. Crore								
Sector	2012-13	%	2013-14	%	2014-15	%	2015-16	%
Financial Institutions and others	113,520	45%	109,425	31%	82,434	30%	127,892	30%
Housing Finance Companies	36,367	14%	57,850	16%	55,106	20%	73,938	17%
Private – Nonfinancial Sector	26,946	11%	60,473	17%	43,291	16%	79,864	18%
NBFCs	26,697	11%	45,777	13%	38,774	14%	64,957	15%
Public Sector Undertakings	27,176	11%	39,851	11%	31,784	12%	31,219	7%
Banks	14,974	6%	24,495	7%	14,388	5%	47,881	11%
State-Level Undertakings	4,184	2%	8,584	2%	3,686	1%	5,207	1%
State Financial Institutions	1,575	1%	5,394	2%	1,482	1%	1,733	0%
Grand Total	251,437		351,848		270,946		432,692	

Source: Prime database

Table: 14.4 Corporate Bond Trades at the Exchanges and OTC

Year/Month	BSE		NSE		MSEI		FIMMDA	
	No. of Trades	Traded Value (₹ crore)	No. of Trades	Traded Value (₹ crore)	No. of Trades	Traded Value (₹ crore)	No. of Trades	Traded Value (₹ crore)
1	2	3	4	5	6	7	8	9
2010-11	4,448	39,528	8,006	1,55,951	Na	Na	31,589	4,09,742
2011-12	6,424	49,842	11,973	1,93,435	Na	Na	33,136	3,50,506
2012-13	8,639	51,622	21,141	2,42,105	Na	Na	36,603	4,44,904
2013-14	10,187	1,03,027	20,809	2,75,701	Na	Na	39,891	5,92,071
2014-15	17,710	2,04,506	58,073	8,86,788	8	1	Na	Na
Apr 14-Dec 14	13,408	1,51,744	42,045	6,56,548	6	1	Na	Na
Apr 15-Dec 15	12,469	1,61,880	39,471	6,05,499	0	0	Na	Na

Notes:

1. As per RBI circular dated Feburary 24, 2014, reporting of secondary market transaction in Corporate Bond has been discontinued at FIMMDA with effect from April 1, 2014.
2. Vide SEBI circular dated March 21, 2014, all OTC trades in Corporate Bonds shall be reported only on any one of the reporting platform provided in the debt segment of stock exchanges within 15 minutes of the trade (with effect from April 1, 2014).

Source: SEBI

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Check your progress

6. Explain the Treasury bills.
7. What do you mean by commercial papers?
8. Define the corporate debentures.

14.8 Measures Taken to Develop the Corporate Bond Market

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Government, SEBI and other stakeholders have initiated several measures to develop the corporate debt market. Reserve Bank of India has also taken various initiatives in this regard. Some of these are recounted below-

- To promote transparency in corporate debt market, a reporting platform was developed by FIMMDA and it was mandated that all RBI-regulated entities should report the OTC trades in corporate bonds on this platform. Other regulators have also prescribed such reporting requirement in respect of their regulated entities. This has resulted in building a credible database of all the trades in corporate bond market providing useful information for regulators and market participants.
- Clearing houses of the exchanges have been permitted to have a pooling fund account with RBI to facilitate DvP-I based settlement of trades in corporate bonds.
- Repo in corporate bonds was permitted under a comprehensive regulatory framework.
- Banks were permitted to classify their investments in non-SLR bonds issued by companies engaged in infrastructure activities and having a minimum residual maturity of seven years under the Held to Maturity (HTM) category;
- The provisioning norms for banks for infrastructure loan accounts have been relaxed.
- The exposure norms for PDs have been relaxed to enable them to play a larger role in the corporate bond market.
- Credit Default Swaps (CDS) have been introduced on corporate bonds since December 01, 2011 to facilitate hedging of credit risk associated with holding corporate bonds and encourage investor's participation in long term corporate bonds.
- FII limit for investment in corporate bonds has been raised by additional US$ five billion on November 18, 2011 taking the total limit to US$ 20 billion to attract foreign investors into this market. In addition to the limit of US$ 20 billion, a separate limit of US$ 25 billion has been provided for investment by FIIs in corporate bonds issued by infrastructure companies. Further, additional US$ one billion has been provided to the Qualified Financial Institutions (QFI).
- The terms and conditions for the scheme for FII investment in infrastructure debt and the scheme for non-resident investment in Infrastructure Development Funds (IDFs) have been further rationalized in terms of lock-in period and residual maturity; and
- Further, as a measure of relaxation, QFIs have been now allowed to invest in those MF schemes that hold at least 25 per cent of their assets (either in debt or equity or both) in the infrastructure sector under the current US$ three billion sub-limit for investment in mutual funds related to infrastructure.

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- Revised guidelines have been issued for securitization of standard assets so as to promote this market. The guidelines focus on twin objectives of development of bond market as well as provide investors a safe financial product. The interest of the originator has been aligned with the investor and suitable safeguards have been designed.
- Banks have been given flexibility to invest in unrated bonds of companies engaged in infrastructure activities within the overall ceiling of 10 per cent;
- Bank has issued detailed guidelines on setting up of IDFs by banks and NBFCs. It is expected that IDFs will accelerate and enhance the flow of long-term debt for funding the ambitious programme of infrastructure development in our country.
- SEBI notified regulations for Issuance of debt securities by municipalities. i.e SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015.

14.9 Key Terms

- **Coupon:** The 'Coupon' denotes the rate of interest payable on the security. E.g. a security with a coupon of 7.40% would draw an interest of 7.40% on the face value.
- **Interest Payment Dates (IP dates):** The dates on which the coupon (interest) payments are made are called as the IP dates.
- **Yield to Maturity (YTM):** YTM implies the effective rate of interest received if one holds the security till its maturity. This is a better parameter to see the effective rate of return as YTM also takes into consideration the time factor.
- **Holding Period Yield (HPY):** HPY comes into the picture when an investor does not hold the security till maturity. HPY denotes the effective Fixed Income Instruments in India 19/90 yield for the period from the date of purchase to the date of sale.
- **Clean Price:** Clean Price denotes the actual price of the security as determined by the market.
- **Shut Period:** The government security pays interest twice a year. This interest is paid on the IP dates. One working day prior to the IP date, the security is not traded in the market. This period is referred to as the 'Shut Period'.
- **Face Value:** The Face Value of the securities in a transaction is the number of Government Security multiplied by Rs.100 (face Value of each Government Security). Say, a transaction of 5000 Government Security will imply a face value of Rs. 5,00,000 (i.e. 5000 * 100)
- **"Cum-Interest" and "Ex-Interest":** Cum-interest means the price of security is inclusive of the interest accrued for the interim period between last interest payment date and purchase date. Security with ex-interest means the accrued interest has to be paid separately

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- **Trade Value:** The Trade Value is the number of Government Security multiplied by the price of each security.
- **Market Lot:** Market lot refers to the standard value of the trades that happen in the market. The standard market lot size in the Government securities market is Rs. 5 crore in face value terms.
- **Maturity Date:** The date when the principal (face value) is paid back. The final coupon and the face value of a debt security is repaid to the investor on the maturity date. The time to maturity can vary from short term (1 year) to long term (30 years).
- **Residual Maturity:** The remaining period until maturity date of a security is its residual maturity. For example, a security issued for an original term to maturity of 10 years, after 2 years, will have a residual maturity of 8 years.
- **Treasury Bills:** Debt obligations of the government that have maturities of one year or less are normally called Treasury Bills or T-Bills. Treasury Bills are short-term obligations of the Treasury/Government. They are instruments issued at a discount to the face value and form an integral part of the money market.
- **Primary Dealers:** In order to accomplish the objective of meeting the government borrowing needs as cheaply and efficiently as possible, a group of highly qualified financial firms/ banks are appointed to play the role of specialist intermediaries in the government security market between the issuer on the one hand and the market on the other. Such entities are generally called Primary dealers or market makers. In return of a set of obligations, such as making continuous bids and offer price in the marketable government securities or submitting reasonable bids in the auctions, these firms receive a set of privileges in the primary/ secondary market.

14.10 Summary

- Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of mortgages, promissory notes, bonds, and Certificates of Deposit.
- The debt market includes the primary market, where debts are first sold to the public; and the secondary market, where investors sell debts to each other afterward. On the secondary debt market, debts can be sold on exchanges or on the over-the-counter market, but most are traded over the counter.
- The debt market in India consists of mainly two categories—the government securities or the G-Sec markets comprising central government and state government securities, and the corporate bond market.
- The G-secs are the most dominant category of debt markets and form a major part of the market in terms of outstanding issues, market capitalization, and trading value. It sets a benchmark for the rest of the market. The market for debt derivatives have not yet developed appreciably, although a market for OTC derivatives in interest rate products exists.
- Reserve Bank of India, as investment banker to the government, raises funds for the government through bond and T-bill issues, and also participates

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in the market through open-market operations, in the course of conduct of monetary policy. The RBI regulates the bank rates and repo rates and uses these rates as tools of its monetary policy.

- Public sector financial institutions regularly access debt markets with bonds for funding their financing requirements and working capital needs. They also invest in bonds issued by other entities in the debt markets.
- Commercial papers are primarily issued by corporate entities. It is compulsory for the issuance of CPs that the company be assigned a rating of at least P1 by a recognized credit rating agency.
- T-Bills are issued by the RBI at the behest of the Government of India and thus are actually a class of Government Securities. Presently T-Bills are issued in maturity periods of 91 days, 182 days and 364 days.
- Corporate bonds issued in India usually carry a rating of AAA indicating lack of interest in bonds of lower rated borrowers in the debt market. Institutional participants, such as, banks, primary dealers, mutual funds, insurance companies, pension funds, corporates, etc. are the major players in this market.

14.11 Questions and Exercises

1. Why is the debt market an important segment of financial markets?
2. What are the various financial instruments used by Government to raise the fund in India?
3. What do you mean by Bond? Explain the different types of Bond.
4. Who are the various participants in Indian Debt Market?
5. Explain the structure of Indian Debt Market?

14.12 Further Readings and References

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1. "Concept of bond market" available at http://business.mapsofindia.com/sectors/financial/bond-market.html
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UNIT 15: FINANCIAL INSTITUTIONS RISKS

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Structure

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15.0 Introduction

In the course of their operations, banks are invariably faced with different types of risks that may have a potentially negative effect on their business. Risk management in bank operations includes risk identification, measurement and assessment, and its objective is to minimize negative effects risks can have on the financial result and capital of a bank. Banks are therefore required to form a special organizational unit in charge of risk management. Also, they are required to prescribe procedures for risk identification, measurement and assessment, as well as procedures for risk management.

The risks to which a bank is particularly exposed in its operations are: liquidity risk, credit risk, market risks (interest rate risk, foreign exchange risk and risk from change in market price of securities, financial derivatives and commodities), exposure risks, investment risks, risks relating to the country of origin of the entity to which a bank is exposed, operational risk, legal risk, reputational risk and strategic risk.

15.1 Unit Objectives

After studying this unit, students will be able to:

- Understand various risks faced by Financial Institutions
- Familiarise with different type of banking risks

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15.2 Overview of Risk faced by Financial Institutions

Risk in a way can be defined as the chance or the probability of loss or damage. All companies which have a profit maximising objective hold a certain degree of risk whether through microeconomic or macroeconomic factors. Banks also face a number of risks atypical of non-financial companies due to the payment and intermediary function which they perform. Recent changes in the banking environment has led to an increased pressure to maximise shareholder value, this means that banks take on a higher risk in order to gain a higher return. It is due to this increased pressure and market volatility that banking risk needs such effective management to ensure the banks continued solvency. Risk can be defined as an "exposure to uncertainty of outcome" measured by the volatility (standard deviation) of net cash flow within the firm. Banks aim to add equity to the bank by maximising the risk adjusted return to shareholders highlighting the importance of fully considering the risk and return business equation. Exposure to risk does not always lead to a loss, pure risk only has a downside from the expected outcome but speculative risk can produce either a better or worse result that expected.

Banks face a number of risks owing to the type of business they transact. The function of intermediation is a source of many of these risks. Maturity intermediation for example gives rise to interest rate and liquidity risks. These risks can be classified as asset-liability generated risks, portfolio risks, operational risks and solvency risks. Asset-liability risks include interest rate risk, foreign exchange and liquidity risks. Portfolio risks include credit and market risks. These risks are so named because they arise from the dissimilar characteristics of assets and liabilities. These dissimilar characteristics could be interest rate related, foreign exchange related or maturity related.

15.3 Types of Risks

There are different types of risks that a firm might face and needs to overcome. Widely, risks can be classified as follows:

15.3.1 Credit Risk

Credit risk is the risk that the counterparty will fail to repay the loan in part or full. This includes delayed payments or any default on the loan agreement. It is widely known that credit risk is one of the most damaging risks to banks, for this reason there is usually a separate credit department run around a credit culture of the management's views. The objective of the credit department will be to maximise shareholder value added through credit risk management. To manage credit risk banks do sometimes take a security over the loan such as property or shares which the bank can take possession of in the event of default on the loan agreement. If the market prices of the security become volatile the bank may ask for more security to offset the probability of marginal default increasing. Credit constraints are implemented to make sure there is a restriction on certain loan agreements to a specific category of borrower; well defined credit limits will reduce the risk of adverse selection. Pricing the loan is a technique which uses a risk adjusted premium to determine the rate of interest on a loan, with the riskier the loan the higher the premium, although a higher interest rate may increase probability of default so must be monitored regularly.

A similar but more specific concept to credit risk is sovereign risk involving risk that a government will default on a loan agreement from a private sector bank. This case is unusual because if a government sates that the default is due to movement of resources to resolve domestic issues it can declare the loan agreement void due to immunity in the legal process, this will barrier debt recovery through the taking the possession of assets and often leave the bank with partial or full loss of the loan.

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Table 15.1: Impact of weakness in debt servicing capacity of NGNF companies on bank credit

(Share of bank credit in total bank credit of scheduled commercial banks)

			(per cent)
	Mar-12	**Mar-13**	**Mar-14**
All NGNF companies	31.9	31.5	32.4
Weak companies	7.4	9.0	10.4
Leveraged weak companies	5.5	7.1	7.3
Source: Basic statistical returns of scheduled commercial banks in India (BSR) and MCA database (Select NGNF companies).			

Source: RBI

15.3.2 Liquidity Risk

Liquidity risk is the risk of economic losses resulting from the fact that the sum of all inflows and the cash reserves of a financial intermediary on a day are not sufficient to meet its outflows on that day. The assumption of liquidity risk is a natural outcome of the maturity intermediation performed by financial intermediaries. Banks, in particular, are vulnerable to this risk owing to the presence of demand liabilities on their balance sheet. These demand liabilities are matched by largely illiquid assets in the form of loans and advances, generating large possibilities of liquidity risk. All financial intermediaries are vulnerable to liquidity risks to the extent that the maturity characteristics of their liabilities differ from those of their assts.

First, the proportion of central government securities with longer maturities in the Indian bond market, significantly increasing during the 1970s and 1980s, affected the banking system because longer maturity securities have greater volatility for a given change in interest rate structure. This problem gets accentuated in the context of change in the main liability structure of the banks, namely the maturity period for term deposits. For instance in 1986, nearly 50% of term deposits had a maturity period of more than 5 years and only 20%, less than 2 years for all commercial banks. But in 1992, only 17% of term deposits were more than 5 years whereas 38% were less than 2 years (Vaidyanathan, 1999). In such a situation, we find banks facing significant problems in terms of mismatch between average life of bonds and maturity pattern of term deposits. In order to meet short-term liability payments, institutions have to maintain certain levels of cash at all points of time. Thus managing cash flows becomes crucial. Institutions could access low cost funding or could have assets that have sufficient short-term cash flows. Hence, banking institutions need to strike a reasonable trade-off between being excessively

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liquid and relatively illiquid. The recent failure of many non-banking financial companies can be ascribed to mismatch between asset-liability maturities, since many of them have invested in real estate type of assets with short-term borrowings. Particularly in a declining real estate market, it becomes difficult for non-banking financial companies to exit and meet obligations of lenders. In such a context, liquidity becomes a much more significant variable even at the cost of forgoing some profitability.

15.3.3 Interest Rate Risk

Interest rate risk is defined as the volatility in the earnings or the value of a financial institution owing to unexpected changes in interest rates. The major source of interest rate risk is the mismatched repricing of a financial intermediary's assets and liabilities. Consider for example the assets and liabilities of a housing finance company. The company gives housing loans at fixed rates to borrowers for a term of 15 years. These are its assets. These assets are financed by medium to short term borrowings from banks with a term of upto 5 years. These are its liabilities. The interest paid by the company on its borrowings constitutes its costs and the interest received on its loans constitutes its earnings. The difference between the interest earnings and interest costs of a financial intermediary is its spread. If interest rate changes over the next 5 years the interest rate on the borrowings of the housing finance company will reprice after 5 years. Its loan, on the other hand, will earn a fixed rate of return for the next 15 years irrespective of how interest rate changes in the economy. This mismatch in repricing of assets and liabilities exposes the spread of housing finance company to unexpected changes and generates interest rate risk.

The term to maturity of a bond provides clues to the fluctuations in the price of the bond since it is fairly well-known that longer maturity bonds have greater fluctuations for a given change in the interest rates compared to shorter maturity bonds. In other words commercial banks, which are holding large proportions of longer maturity bonds, will face more price reduction when the interest rates go up. Between 1970s and the early part of 1990s, there has been a substantial change in the maturity structure of bonds held by commercial banks. During 1961, 34% of the central government securities had a maturity of less than 5 years and 27% more than 10 years. But in 1991, only 9% of the securities had a maturity of less than 5 years, while 86% were more than 10 years (Vaidyanathan, 1999). During 1992, when the reform process started and efforts taken to move away from the administered interest rate mechanism to market determined rates, financial institutions were affected because longer maturity instruments have greater fluctuations for a given change in the interest rate structure. This becomes all the grimmer when interest rates move up because the prices of the holding come down significantly and in a marked-to-market situation, severely affect bottom-line of banks. Another associated issue is related to the coupon rate of the bonds. Throughout the 1970s and 1980s, the government was borrowing from banks using the statutory obligation route at artificially low interest rates ranging between 4.5% and 8% (The World Bank, 1995). The smaller the coupon rate of bonds, larger is the fluctuation associated with a change in interest rate structure. Because of artificially fixed low coupon rates, commercial banks faced adverse situations when the interest rate structure was liberalized to align with market rates. Therefore, the banking industry in India has substantially more issues associated with interest rate risk, which is due to circumstances outside its control. This poses extra challenges to the banking sector and to that extent; they have to adopt innovative and sophisticated techniques to meet some of these challenges.

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15.3.4 Market Risk

Market risk encompasses the risk of financial loss resulting from movements in market prices. Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchanges rates, commodity prices, or equity prices.
- The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.
- The nature and complexity of interest rate risk exposure arising from non - trading positions.
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

It is a speculative risk, measured by the probability in potential loss/gain in value of a portfolio. The risk occurs in two separate forms; Systematic market risk is caused by the price movement of all financial instruments due to changes in the macroeconomic climate. Unsystematic risk occurs when an instrument moves out of line with the rest of the market due to internal factors with the issuer. Systematic market risk can be prepared for in event of downturn in the economic climate by capital allocation to the specific risk calculated by the risk adjusted rate on capital. Value at risk is a measure of potential losses incurred to a portfolio due to adverse market price movements often used in risk management. Unsystematic risk can be offset by diversifications of investments into several different countries and/or industries affectively spreading the risk in attempt to avoid huge losses in specific sector investment. The diversification of investment into foreign countries may increase the potential probability of currency risk.

15.3.5 Foreign Exchange Risk

Foreign exchange risk is the risk that exchange rate changes can affect the value of financial institutions assets and liabilities denominated in foreign currencies. Ownership of foreign assets, international trade, overseas remittances, foreign currency loans, overseas payments and receipts, receipt of foreign stock dividends, pension funds, payment to an overseas supplier and holiday expenses overseas are transactions that are subject to foreign exchange risk.Foreign exchange rate fluctuations affect banks both directly and indirectly. The direct effect comes from banks' holdings of assets (or liabilities) with net payment streams denominated in a foreign currency. Foreign exchange rate fluctuations alter the domestic currency values of such assets. This explicit source of foreign exchange risk is the easiest to identify, and it is the most easily hedged.The indirect sources of risk are more subtle but just as important. A bank without foreign assets or liabilities can be exposed to currency risk because the exchange rate can affect the profitability of its domestic banking operations.

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Check your progress

1. What do you mean by risk in financial institutions?
2. Explain the interest rate risk.
3. How does the liquidity risk affect the financial institutions?

Foreign exchange risk also may be linked to other types of market risk, such as interest rate risk. Interest rates and exchange rates often move simultaneously. So, a bank's interest rate position indirectly affects its overall foreign exchange exposure. The foreign exchange rate sensitivity of a bank with an open interest rate position typically will differ from that of a bank with no interest rate exposure, even if the two banks have the same actual holdings of assets denominated in foreign currencies. Again, the vulnerability of the bank as a whole to foreign exchange fluctuations depends on more than just its holdings of foreign exchange.

15.3.6 Technology Risk

In recent years, various technology innovations in areas such as card payment, mobile technology and system virtualisation have helped to expand financial institutions' (FIs) business offerings and customer reaches. Information technology (IT) outsourcing has also become more attractive to FIs due to the abundance of outsourcing services. Against the backdrop of an increased reliance on complex IT systems and operations in the financial sector is the heightened risk of cyber-attacks and system disruptions. In this regard, FIs are expected to continue to deepen their technology risk management capabilities and be ready to handle IT security incidents and system failures.

15.3.7 Operational Risk

Operational risk is defined at the risk of loss from a breakdown in internal processes and/or management failure. Operational risk can widely occur in banks due to human errors or mistakes. Examples of operational risk may be incorrect information filled in during clearing a check or confidential information leaked due to system failure.

Operational risk can be categorized in the following way for a better understanding:

- Human risk: Potential losses due to a human error, done willingly or unconsciously
- IT/System risk: Potential losses due to system failures and programming errors
- Processes risk: Potential losses due to improper information processing, leaking or hacking of information and inaccuracy of data processing

Although there has been significant importance placed upon operational risk there is at present still no clear method of measuring its risk and effects on a general basis. The Basle II provided three suggested methods of calculating the operating risk of a firm.

- The basic approach allocates capital using gross income as an indicator for the bank's exposure to operational risk.
- The Standardised approach divides the bank into business units and lines and uses individual indicators to calculate a department specific level of exposure to operational risk.
- The final method of calculating operational risk is the internal measurement approach which allows each bank to use individual internal loss data to determine the capital allocation.

15.4 Key Terms

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- **Financial Institutions:** A financial institution (FI) is an establishment that focuses on dealing with financial transactions, such as investments, loans and deposits. Conventionally, financial institutions are composed of organizations such as banks, trust companies, insurance companies and investment dealers.
- **Risks:** The probability that an actual return on an investment will be lower than the expected return. Financial risk is divided into the following categories: Basic risk, Capital risk, Country risk, Default risk, Delivery risk, Economic risk, Exchange rate risk, Interest rate risk, Liquidity risk, Operations risk, Payment system risk, Political risk, Refinancing risk, Reinvestment risk, Settlement risk, Sovereign risk and underwriting risk.
- **Credit risk:** A credit risk is the risk of default on a debt that may arise from a borrower failing to make required payments. In the first resort, the risk is that of the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs.
- **Liquidity risk:** Liquidity risk is the risk that a company or bank may be unable to meet short term financial demands. This usually occurs due to the inability to convert a security or hard asset to cash without a loss of capital and/or income in the process.
- **Interest rate risk:** Interest rate risk is the risk that arises for bond owners from fluctuating interest rates. How much interest rate risk a bond has depends on how sensitive its price is to interest rate changes in the market. The sensitivity depends on two things, the bond's time to maturity, and the coupon rate of the bond.
- **Market risk:** Market risk is the risk that the value of an investment will decrease due to moves in market factors. Volatility frequently refers to the standard deviation of the change in value of a financial instrument with a specific time horizon.
- **Foreign exchange risk:** Foreign exchange risk (also known as FX risk, exchange rate risk or currency risk) is a financial risk that exists when a financial transaction is denominated in a currency other than that of the base currency of the company.
- **Operational risk:** Operational risk is the risk not inherent in financial, systematic or market-wide risk. It is the risk remaining after determining financing and systematic risk, and includes risks resulting from breakdowns in internal procedures, people and systems.

15.5 Summary

- Risk in a way can be defined as the chance or the probability of loss or damage. All companies which have a profit maximising objective hold a certain degree of risk whether through microeconomic or macroeconomic

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factors. Banks also face a number of risks atypical of non-financial companies due to the payment and intermediary function which they perform.

- Risk can be defined as an "exposure to uncertainty of outcome" measured by the volatility (standard deviation) of net cash flow within the firm. Banks aim to add equity to the bank by maximising the risk adjusted return to shareholders highlighting the importance of fully considering the risk and return business equation. Exposure to risk does not always lead to a loss, pure risk only has a downside from the expected outcome but speculative risk can produce either a better or worse result that expected.
- Credit risk is the risk that the counterparty will fail to repay the loan in part or full. This includes delayed payments or any default on the loan agreement. It is widely known that credit risk is one of the most damaging risks to banks, for this reason there is usually a separate credit department run around a credit culture of the management's views.
- Liquidity risk is the risk of economic losses resulting from the fact that the sum of all inflows and the cash reserves of a financial intermediary on a day are not sufficient to meet its outflows on that day. The assumption of liquidity risk is a natural outcome of the maturity intermediation performed by financial intermediaries. Banks, in particular, are vulnerable to this risk owing to the presence of demand liabilities on their balance sheet. These demand liabilities are matched by largely illiquid assets in the form of loans and advances, generating large possibilities of liquidity risk.
- Interest rate risk is defined as the volatility in the earnings or the value of a financial institution owing to unexpected changes in interest rates. The major source of interest rate risk is the mismatched repricing of a financial intermediary's assets and liabilities.
- Market risk encompasses the risk of financial loss resulting from movements in market prices. The risk occurs in two separate forms; Systematic market risk is caused by the price movement of all financial instruments due to changes in the macroeconomic climate. Unsystematic risk occurs when an instrument moves out of line with the rest of the market due to internal factors with the issuer.
- Foreign exchange risk is the risk that exchange rate changes can affect the value of financial institutions assets and liabilities denominated in foreign currencies. Ownership of foreign assets, international trade, overseas remittances, foreign currency loans, overseas payments and receipts, receipt of foreign stock dividends, pension funds, payment to an overseas supplier and holiday expenses overseas are transactions that are subject to foreign exchange risk.
- In recent years, various technology innovations in areas such as card payment, mobile technology and system virtualisation have helped to expand financial institutions' (FIs) business offerings and customer reaches. Information technology (IT) outsourcing has also become more attractive to FIs due to the abundance of outsourcing services. Against the backdrop

of an increased reliance on complex IT systems and operations in the financial sector is the heightened risk of cyber-attacks and system disruptions.

- Operational risk is defined at the risk of loss from a breakdown in internal processes and/or management failure. Operational risk can widely occur in banks due to human errors or mistakes.

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15.6 Questions and Exercises

1. Give a brief note on risk management in financial institutions.
2. Discuss the various types of risks faced by the financial institution and their effects on financial institutions.
3. Write short notes on:

   (i) Liquidity Risk

   (ii) Market Risk

   (iii) Interest Rate Risk

15.7 Further Readings and References

Books:

1. Pathak, B.V., ***"The Indian Financial System – markets, institutions and services",*** Pearson Education.

Web resource:

1. Vaidyanathan, R (1999). Asset-liability management: Issues and trends in Indian context. ASCI Journal of Management, 29(1), 39-48.
2. "Market risk" available at /www.federalreserve.gov
3. "Overview of Risk faced by Financial Institutions" available at www.ukessays.com

UNIT 16: RISK MANAGEMENT IN FINANCIAL INSTITUTIONS

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Structure

16.0 Introduction
16.1 Unit Objectives
16.2 Asset Liability Management: A concept
16.3 Asset Liability Management Strategies
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16.0 Introduction

Asset-liability management is the process through which an institution manages its balance sheet to allow for alternative interest rate and liquidity scenarios. Banks and other financial institutions are exposed to various kinds of risks like credit risk, interest risk, and liquidity risk. Asset liability management approach provides institutions with mechanisms that make such risk acceptable. Asset-liability management models allow institutions to measure and monitor risk, and provide suitable strategies for their management. Risk management is uniquely important for financial institutions because in contrast to firms in other industries, their liabilities are a source of wealth creation for their shareholders.

Asset Liability Management (ALM) plays a critical role in a sound functioning of a financial institution. For the sustenance of a financial institution, managing liquidity and the balance sheet are crucial. It is also required for unhindered profitable growth of the balance sheet of a financial institution.

16.1 Unit Objectives

After studying this unit, students will be able to:

- Understand risk Measurement tools
- Know mitigation Strategies

- Familarise with RBI Guidelines related to Risk Management
- Explain Basel Norms of Capital Adequacy and related guidelines of RBI

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16.2 Asset Liability Management : A Concept

The practical importance of ALM has been underestimated. It has been seen that even well-reputed firms and trusted institutions were not able to come out of the deep liquidity crisis. This has resulted in regulators taking precautionary measures to ensure a sound liquidity management in financial institutions. Therefore institutions like banks, finance companies, leasing companies, insurance companies and others focus on asset-liability management to tackle financial risks of different types. Even the understanding of ALM concepts is of great importance to an institution as it provides a complete picture of the risk-reward trade-off in the institution (Konishi & Fabozzi, 1991).

After independence banks in India had huge deposits of demand and savings deposits. Banks had to focus on the mechanisms by which they could make efficient use of these funds. So the emphasis was on asset management. But as the availability of low cost funds started to decline, liability management became the focus of banks' management. Liability management is the practice of buying money through deposits, government funds and commercial paper in order to fund profitable loan opportunities. With increase in volatility in interest rates and a severe recession damaging several economies, banks started to concentrate more on the management of both sides of the balance sheet (R. Vaidyanathan, 1999).

Over the years, banks have been focusing on 'asset-liability risk' to mitigate balance sheet weaknesses. The problem is not that the market value of assets might fall or that the value of liabilities might rise. It is that capital might be depleted by narrowing of the difference between assets and liabilities, since the values of assets and liabilities may not always move together in the same direction. Asset liability risk is therefore is a 'leveraged' risk. The capital of the bank is always small relative to the firm's assets or liabilities, so small percentage change in assets or liabilities can translate into large percentage changes in capital.

The asset liability risk could manifest itself in a number of forms, but what would concern bankers most would be two important risks-'*interest rate risk*' and '*liquidity risk*'. While interest rate risk would directly impact the net income of the bank, the liquidity risk would endanger the very solvency of the bank.

The above need for risk management led to the evolution of Asset liability management (ALM) in the 1980s. ALM was seen as a substitute to market value accounting. Traditionally banks and insurance companies have been using accrual accounting for essentially all their assets and liabilities. They would take on liabilities such as deposits, life insurance policies or annuities. They would invest the proceeds from these liabilities in assets such as loans, bonds or real estate. All assets and liabilities would be held at book values. Doing so did not recognize the possible risks arising from how the assets and liabilities were structured, or how the markets were moving. To overcome these shortcomings a combination of ALM and market value accounting was advocated. However many of the assets and liabilities of financial institutions cannot be marked to market. A firm can earn significant mark to market profits but go bankrupt due to inadequate cash flow. Market value accounting therefore was not the ideal solution. However where found suitable banks are increasingly using market value accounting for certain business lines. This is true of universal banks with trading operations, which find techniques of market risk management such as Value at Risk (VaR) more appropriate. On the other hand ALM is associated with those assets and liabilities-those business lines-that are accounted for on accrual basis. This includes bank lending and deposit taking.

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In short, ALM is concerned with strategic balance sheet management. Risks caused by changes in interest rates and exchange rates, credit risk and the bank's liquidity position have to be monitored and mitigated. With profitability of banking operations and the long term solvency of the banks becoming key factors, it has now becoming imperative for banks to move away from partial asset management (credit, non-performing assets) and partial liability management (deposits) to integrated balance sheet management. In such an approach all the components of bank's balance sheet, their maturity mix, their pricing and risks will be looked at not only from the angle of profitability but also from the angle of solvency and long term sustenance. Table 16.1 depicts the shift from traditional ALM objectives and practices to modern ALM techniques.

Table 16.1: Traditional ALM Objectives and Practices to Modern ALM

Traditional ALM	Modern ALM
Focus on short term earnings	Focus on earnings and value
Subjective scenarios based on parallel shifts	Objective scenarios based on statistical models complemented by all manner of subjective scenarios
Focus on home currency interest rate risk	Include all risk factors including foreign exchange, basis, credit, commodities and equity
Assumption of static portfolio-scenario Independent	Dynamic evaluation of the balance sheet encompassing growth forecasts, reinvestment and hedging strategies

Source: Black, Richard, Brown, Karl, and Moloney, James, 2003, 'Asset and Liability management: what does the future have in store?' *Balance Sheet*, Volume 11, No 2 (2003), page 33.

Techniques of ALM have been evolving over time. Banks typically have an Asset Liability Management Committee (ALCO) that comprises of a group of top or senior management personnel entrusted with the responsibility of managing the bank's assets and liabilities to balance the various risk exposures, to enable the bank achieve its operating objectives. At present in almost all banks ALCO has the responsibility to devise broad strategies for handling banks' competing long term

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Check your progress
1. What is asset liability management?
2. Differentiate between traditional ALM and modern ALM

needs and also monitor and manage interrelated risk exposures on a daily basis. Towards this objective ALCO receives and analyses a wide variety of reports that bring together information on the bank's asset/liability positions, its capital level, its internal plans and current and projected external conditions. Most ALCO primarily focus on managing bank's liquidity and interest rate risks, while a separate committee would be involved in managing credit risks. In practice evaluating interest rate and liquidity risks involve the consideration of different possible scenarios. For example:

- What if the bank experiences an unexpectedly large volume of deposit withdrawals?
- What if loan repayments occur earlier than anticipated? Or later than due date? Or not at all?
- What happens if interest rates suddenly rise by x basis points?
- What happens if counterparties do not keep up commitments? Or off balance sheet items turn into real cash outflows?

The ALCO's challenge is to assess the probability with which similar events would occur and position the bank to handle the most likely scenarios with the minimum impact on the bank's expected performance and solvency.

16.3 Asset Liability Management Strategies

The strategies that can be employed for correcting the mismatch in terms of D (A)> D (L) can be either liability or asset driven. Asset driven strategies for correcting the mismatch focuses on shortening the duration of the asset portfolio. The commonly employed asset based financing strategy is securitization. Typically the long-term asset portfolios like the lease and hire purchase portfolios are securitized; and the resulting proceeds are either redeployed in short term assets or utilized for repaying short-term liabilities. Liability driven strategies basically focus on lengthening the maturity profiles of liabilities. Such strategies can include for instance issue of external equity in the form of additional equity shares or compulsorily convertible preference shares (which can also help in augmenting the Tier I capital of finance companies), issue of redeemable preference shares, subordinated debt instruments, debentures and accessing long term debt like bank borrowings and term loans. Strategies to be employed for correcting a mismatch in the form of D (A) < D (L) (which will benecessary if interest rates are expected to decline) will be the reverse of the strategies discussed above. Asset driven strategies focus on lengthening the maturity profile of assets by the deployment of available lendable resources in long-term assets such as lease and hire purchase. Liability driven strategies focus on shortening the maturity profile of liabilities, which can include, liquidating bank borrowings which are primarily in the form of cash credit (and hence amenable for immediate liquidation), using the prepayment options (if any embedded in the term loans); and the call options, if any embedded in bonds issued by the company; and raising short-term borrowings (e.g.: fixed deposits with a tenor of one year) to repay long-term borrowings.

16.4 Interest Rate Risk Measurement Techniques

There are various techniques for measuring exposure of banks to interest rate risks:

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16.4.1 Gap Analysis Model

Measures the direction and extent of asset-liability mismatch through either funding or maturity gap. It is computed for assets and liabilities of differing maturities and is calculated for a set time horizon. This model looks at the repricing gap that exists between the interest revenue earned on the bank'sassets and the interest paid on its liabilities over a particular period of time (Saunders, 1997). It highlights the net interest income exposure of the bank, to changes in interest rates in different maturity buckets. Repricing gaps are calculated for assets and liabilities of differing maturities. A positive gap indicates that assets get repriced before liabilities, whereas, a negative gap indicates that liabilities get repriced before assets. The bank looks at the rate sensitivity (the time the bank manager will have to wait in order to change the posted rates on any asset or liability) of each asset and liability on the balance sheet. The general formula that is used is as follows:

$$\Delta NII_i = \Delta R_i \, (GAP_i)$$

While NII is the net interest income, R refers to the interest rates impacting assets and liabilities in the relevant maturity bucket and GAP refers to the differences between the book value of the rate sensitive assets and the rate sensitive liabilities. Thus when there is a change in the interest rate, one can easily identify the impact of the change on the net interest income of the bank. Interest rate changes have a market value effect. The basic weakness with this model is that this method takes into account only the book value of assets and liabilities and hence ignores their market value. This method therefore is only apartial measure of the true interest rate exposure of a bank.

16.4.2 Duration Model

Duration is an important measure of the interest rate sensitivity of assets and liabilities as it takes into account the time of arrival of cash flows and the maturity of assets and liabilities. It is the weighted average time to maturity of all the preset values of cash flows. Duration basically refers to the average life of the asset or the liability.

$$DP/p = D\ (dR\ /1+R)$$

The above equation describes the percentage fall in price of the bond for a given increase in the required interest rates or yields. The larger the value of the duration, the more sensitive is the price of that asset or liability to changes in interest rates. As per the above equation, the bank will be immunized from interest rate risk if the duration gap between assets and the liabilities is zero. The duration model has one important benefit. It uses the market value of assets and liabilities.

16.4.3 Value at Risk (VaR)

Refers to the maximum expected loss that a bank can suffer over a target horizon, given a certain confidence interval. It enables the calculation of market risk of a portfolio for which no historical data exists. It enables one to calculate the net worth of the organization at any particular point of time so that it is possible to focus on long-term risk implications of decisions that have already been taken or that are going to be taken. It is used extensively for measuring the market risk of a portfolio of assets and/or liabilities.

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16.4.4 Simulation

Simulation models help to introduce a dynamic element in the analysis of interest rate risk. Gap analysis and duration analysis as stand-alone tools for asset-liability management suffer from their inability to move beyond the static analysis of current interest rate risk exposures. Basically simulation models utilize computer power to provide what if scenarios, for example:

- What if the absolute level of interest rates shift?
- What if there are nonparallel yield curve changes. Marketing plans are under-or-over achieved?
- What if the margins achieved in the past are not sustained/ improved?
- What if the bad debt and prepayment levels change in different interest rate scenarios?
- What if there are changes in the funding mix e.g.: an increasing reliance on short term funds for balance sheet growth?

This dynamic capability adds value to the traditional methods and improves the information available to management in terms of:

- Accurate evaluation of current exposures of asset and liability portfolios to interest rate risk
- Changes in multiple target variables such as net interest income, capital adequacy, and liquidity
- Future gaps

There are certain requirements for a simulation model to succeed. These pertain to accuracy of data and reliability of the assumptions made. In otherwords, one should be in a position to look at alternatives pertaining to prices, growth rates, reinvestments, etc., under various interest rate scenarios. This could be difficult and sometimes contentious. It is also to be noted that managers may not want to document their assumptions and data is not easily available for differential impacts of interest rates on several variables. Hence, simulation models need to be used with caution particularly in the Indian situation. Last but not least, the use of simulation model calls for commitment of substantial amount of time and resources. If we cannot afford the cost or, more importantly the time involved in simulation modelling, it makes sense to stick to simpler types of analysis.

16.5 Interest Rate Risk Management

It is theoretically possible to manage interest rate risk by strategically varying static GAP or duration GAP (DGAP). We will study some of the strategies the banks could follow to achieve the desirable GAP position. To reduce asset sensitivity banks have the following alternatives. They could (a) extend the maturities in the investment portfolio, (b) increase floating rate deposits, (c) increase short term borrowings, (d) increase long term lending, (e) increase fixed rate lending and so on. Similarly to reduce liability sensitivity banks could do the opposite. Hence the basic balance sheet strategy to manage interest rate risk is to effect changes in portfolio composition. However any variation in portfolio has a potential impact on NII. According to Hingston (2002), there are four basic methods to mitigate interest rate risk in financial institutions- (a) selling assets, (b) extending liabilities, (c) off balance sheet hedging and (d) retaining status quo. While evaluating these alternatives, Hingston has concluded as follows:

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- Selling fixed rate, long term assets may reduce interest rate risk exposure, but could also lead to losses on such sale that may undermine the selling bank's capital;
- By obtaining matching fixed rate, long term liabilities to fund fixed rate and long term assets, a bank may theoretically be able to reduce interest rate risk. However this could create losses in a declining interest rate scenario;
- If the Board so decides, a bank may decide not to do anything about reducing interest rate risk.

16.5.1 Interest Rate Derivatives (IRDs)

Bank can explore yet another alternative to mitigate the interest rate risk on its investments. It can use interest rate derivatives (IRDs) to transform some of its fixed rate investments into floating rate assets. It can also use IRDs to transform floating rate liabilities into fixed rate liabilities. They are contracts that are used to hedge other positions that expose them to risk or speculate on anticipated price moves. In most cases banks use IRDs to replicate balance sheet transactions with off-balance sheet contracts, so that contingent positions are created.

Interest rate derivatives as the name suggests are financial instruments whose value depends on the value of other underlying instruments (such as the price of underlying fixed rate securities) or indices (such as interest rate indices). They have a variety of advantages over other interest rate mitigating approaches-

- They allow banks to completely customize their interest rate risk profile
- Since the derivatives can replicate the interest rate exposure of fixed income securities without the requirement of an upfront investment they may have lower credit risk and greater liquidity
- Sometimes, use of IRDs could lower transaction costs
- The accounting and regulatory treatment of IRDs are getting to be fairly streamlined

Given that bank management would prefer to manage rather than totally eliminate interest rate risk these tools can be used to complement existing strategies aimed at immunizing the volatility of earnings and MVE (Market Value of Equity) to changes in interest rates.

The most basic and widely used tools are swap contracts, financial futures, forward rate agreements (FRAs), options and swaptions.

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1. Swaps

A swap is an agreement in which two parties (counterparties) agree to exchange periodic payments. The monetary value of the payments exchanged is based on notional principal amount. Swaps are classified based on the characteristics of swap payments. There are four types of swaps-currency swaps, interest rate swaps, commodity swaps and equity swaps. Traditionally banks managed interest rate risks by adjusting the maturity or repricing schedules of their assets and liabilities. A bank wishing to lengthen the duration of its assets can add long term securities to its investment portfolio. However banks have now found that the same goal can be accomplished more efficiently and cost effectively by entering into plain 'vanilla' swaps-where they pay a floating rate, usually based on the London Interbank Offered Rate (LIBOR) or a market determined prime rate of the country and receive a fixed rate, which could typically be the treasury rate of equivalent maturity plus a premium. A liability sensitive bank on the other hand can enter into a swap where it pays a fixed rate and receives a floating rate. In a 'pure' interest rate swaps one party X agrees to pay the other party Y cash flows equivalent to a predetermined floating rate interest on a notional principal for a specified number of years. Simultaneously Y agrees to pay X cash flows equal to fixed rate interest rate on the notional principal for the same period of time. The currencies of the two sets of cash flows are also the same. Interest rate swaps were basically developed to satisfy borrowers' need for fixed rate funds. Banks typically hesitate to fund less creditworthy borrowers on a fixed rate basis but may be willing to lend at floating rates. Swaps can manage the banks' interest rate risk in the following ways:

a. **Adjusting the rate sensitivity of an asset or a liability:** Say, a bank has made a loan of Rs 100 crore with 5 year maturity to a prime customer at a rate of 10%. The corresponding liability is a 6 month deposit of Rs 100 crore, at a floating rate linked to the prevailing market determined 6 month prime rate. Obviously there exists an interest rate risk in this transaction. Every time the prime rate rises, the bank makes a loss on the transaction apart from the bank having to seek refinance for the loan every 6 months (at higher rates if interest rates are rising). Assume the bank wants to hedge this transaction through a swap and it agrees to pay say 6% and receive 6 month prime rate against Rs 100 crore for 5 years till the loan is fully paid. The net effect on the bank's balance sheet would be a follows: a) the bank would earn 10% from loans + 6 month prime from the swap and b) the bank would pay 6 month prime for the rupee deposit + 6% from swap as agreed upon. The net spread on this transaction would therefore be 4%. The bank has thus locked in a liability cost of 6%. Thus the use of swap has helped the bank not only reduce interest rate risk, but also to lock in a spread of 4% on this transaction.

b. **Creating synthetic transactions and securities:** Swaps are considered 'synthetic' as they are off the bank's balance sheet. Of course risks are associated with these positions. Bank can do away with the need for a swap and match the 5 year asset with a long term deposit. The decision to create a 'synthetic' security would be dependent on whether the yield advantage of the swap exceeded the costs and risks of such transactions.

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c. **Adjusting the GAP or DGAP to immunize earnings or MVE:** A liability sensitive bank with a positive DGAP will resort to a swap that would produce profits even when interest rates increase. This can be achieved by adjusting asset duration or increasing RSAs. A swap that pays fixed and receives floating is comparable to increasing RSAs over RSLs. Similarly a bank with a negative DGAP will want to hedge by taking a swap position that would produce profits when produce profits when interest rates fall.

2. Interest Rate Futures

A future contract is a legal contract between a buyer (or seller) and an established exchange in which the buyer (or seller) agrees to take (or make) delivery of something at a predetermined price at the end of a predetermined period of time. The price at which the parties agree to transact in the future is the 'futures' price. The predetermined date at which the parties must transact is the 'settlement' or 'delivery' date. Futures can be classified as financial or non-financial. Financial futures are contracts based on a financial instrument or financial index. The most commonly known financial futures are a) stock index futures b) interest rate futures and c) currency futures. When the underlying asset is an interest-bearing security the contract is termed 'interest rate futures'. Interest rate futures contracts are typically classified by the maturity of the underlying security. Short-term interest rate future contracts are those whose underlying securities mature in less than 12 months. A long-term futures contract is one whose maturity exceeds 1 year. The major function of the futures markets is to transfer the interest rate risk from the 'hedger' to the 'speculator'. In the futures market hedging acts as a temporary substitute for a transaction to be made in the cash market, locking in a value for the cash position at some point of time, locking in a value for the cash position at some point of time. When cash and futures price move together a 'perfect hedge' is possible where the profit in one market is equally offset by a loss in the other.

Banks can hedge at micro level or at macro level. In micro-hedging the bank can immunize itself against variations in asset or liability interest rates. For example the bank can protect itself from an upward of the interest rate on its liabilities by taking positions in futures contract on say CDs or long term deposits. In macro-hedging the entire DGAP of a bank is hedged using futures contracts.

In case of interest rate futures contract, a short hedge serves to protect against a decline in the futures spot price of an asset, which implies a rise in the interest rate. By entering into a short hedge the hedger has effectively frozen the future spot price and also transferred the ownership risk to the buyer of the futures contract. The strategy here is to sell futures contracts on securities similar to those carrying the interest rate risk. If spot rates increase, futures rate are also expected to increase. A loss in the spot position, therefore, is expected to be at least partially offset by a gain in the futures value. Similarly if spot rates decline, the gain in the spot market is expected to be offset by loss from futures. In contrast to the above, a long hedge is preferred when interest rates are declining. The appropriate strategy would be to buy futures contracts on securities similar to those facing interest rate risks. If interest rates decline, futures rates are also likely to decline and the value of the futures position is likely to increase. Any loss in spot market would be atleast partially offset by a gain in futures. However if spot prices rise the investor may profit more from not hedging. Therefore a hedger in this case foregoes gains arising from favorable price movements.

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a. **Applying Hedging to GAP:** According to Koch and MacDonald, the hedging strategy of a bank using GAP and Earnings sensitivity analysis to measure its interest rate risk is determined by a) whether a bank is asset or liability sensitive and b) the degree of impact of interest rate changes on the bank's NII. For example in an asset sensitive bank, declining interest rates could cause NII to fall. Hence the position will have to be offset by a long hedge. Similarly to overcome liability sensitivity a bank would have to institute a short hedge. In the case of a liability sensitive bank if rates subsequently increase leading to a fall in the NII, the sale of futures is expected to give rise to gains that atleast partially offset the dip in NII.

   For example, take the negative cumulative GAP of Rs 100 crore over a period of 1 year. If interest rates have to increase by 100 bps, NII falls. Let us now assume that the bank wants to hedge Rs 10 crore out of Rs 100 crore GAP over the next 6 months and it chooses 90 day T-bill futures as the hedge instrument. The bank would have to sell 20 futures contracts [10 x (180 days/90 days)], assuming that the expected movement between the effective interest rate on the RSLs relative to the futures rate equals unity. This short hedge transaction has effectively fixed a rate and has moved the GAP (and the earnings sensitivity) closer to zero.

3. Interest Rate Options

An option is a private contract between two parties in which the holder has (a) the right to buy an underlying asset at a predetermined price, k, by a specified date, t, or (b) the right to sell an underlying asset at a predetermined price, k, by a specified date, t. They give the buyer of the option the right but not the obligation to exercise the option. In other words the buyer uses the option only if it benefits him; otherwise the option can be discarded or allowed to lapse. The writer of the option is the seller of the option and he grants the right to buy/sell the underlying security to the buyer of the option. The holder of the option is the buyer of the option and he has the right to buy/sell the underlying security on or before specified date. The option with right to buy the underlying security is called call option and the option with right to sell the underlying security is called put option. The price has to be paid by the buyer of the option to the writer of the option for gaining the right under the option, called option premium.

They provide protection against adverse market moves, while enabling the holder to still benefit from favorable shifts in the market. Assume that Bank A has lent Rs 100 crore based on a floating rate. The rate is set at say LIBOR+3%. Bank A is happy when LIBOR is increasing but also wants to protect itself against drops in LIBOR. The level at which the bank would like to cover itself is say 9%. In other words it wants to protect itself against LIBOR falling below 6%. The solution is to buy an 'interest rate put option'. This contract will specify a notional amount (say Rs 100 crore- the loan amount), the strike rate (6% LIBOR) and a maturity date on which the option would expire. Let us assume that LIBOR drops to 4%. Bank A will exercise the option and receives a payment from the option issuer as follows:

Put option pay off = (strike rate-actual rate) x notional amount i.e. Rs 2 crore. The bank A will also receive from its borrower 7% (LIBOR+3%) times Rs 100 crore i.e. Rs 7 crore. In effect the bank has received the desired minimum return of 9%.

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Check your progress

3. What is Gap model in measuring the interest rate risk?
4. What do you mean by value at risk?
5. Explain interest rate swaps.

16.6 Liquidity Risk Management

Liquidity is a bank's ability to generate cash quickly and at reasonable cost. Liquidity risk is the risk that the bank may not be able to fund increases in assets or meet liability obligations as they fall due without incurring unacceptable losses. The problem may lie in the bank's inability to liquidate assets or obtain funding to meet its obligations. The problem could also arise due to uncontrollable factors such as market disruption or liquidity squeeze. Liquidity problems can have an adverse impact on the bank's earnings and capital, and, in extreme circumstances, may even lead to the collapse of the bank itself, though the bank may otherwise be solvent. A liquidity crisis in a large bank could give rise to systemic consequences impacting other banks and the country's banking system as a whole. Liquidity problems can also affect the proper functioning of payment systems and the other financial markets. Sound liquidity risk management is therefore essential to the viability of every bank and other for the maintenance of overall financial stability. Recent trends in the liability profiles of banks pose further challenges to the industry and have made it increasingly important for banks to actively manage their liquidity risk. Some of these developments are (a) the increasing proportion in bank liabilities of wholesale and capital market funding which is more sensitive to credit and market risks (b) the increase in off-balance sheet activities such as derivatives and securitization that have compounded the challenge of cash flow management and (c) the speed with which funds can be transmitted and withdrawn, thanks to advanced technology and systems.

To manage liquidity risk at the basic level, two sources of liquidity are equally important. One is the liquidity generated from liquidation of assets-this implies that in an adverse situation the bank needs excess liquidity from assets. The second is the funding liquidity-raised through liabilities.

However at present there is no technique for modelling liquidity risk that has wide acceptance. No single balance sheet category or ratio is sufficient to assess liquidity risk. It involves the entire balance sheet and off-balance sheet activity as well. Liquidity management is largely about being sure that adequate low cost sources of funding are available on short notice. This might include holding a portfolio of assets that can easily be sold, acquiring a large volume of stable liabilities or maintaining lines of credit with other financial institutions. However this effort must be balanced against the impact on profitability. In general, more liquid assets earn lower rates of return and certain types of stable funding may cost more than those that are more volatile.

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16.6.1 Modern Approaches to Liquidity Risk Management

The liquidity risk is closely linked to the nature of banking assets and liabilities. The assets and liability positions of a bank are affected by the bank's investment and financing decisions, irrespective of whether they have short- or long-term implications. The banks should be able to manage their liquidity positions both on an everyday basis as well as in the long term, to ensure that liquidity risk is effectively mitigated. Thus banks should preferably have two approaches to managing short-term and long-term liquidity. Choosing the appropriate approach would depend on the bank management's liquidity policy.

16.6.1.1 Approach to managing liquidity for long-term survival and growth

Since the bank's long-term survival and growth are the driving factors, this approach tries to mitigate long-term liquidity risk by strategically controlling the bank's asset and liability positions. This could be achieved by (a) aligning the maturity of assets and liabilities so that cash flow timing risks are eliminated, or (b) diversifying the funding sources so that liquidity availability is ensured. The alternative approaches used by banks are:

- Asset Management, and
- Liability Management

a) **Asset Management:** All bank assets are a potential source of liquidity. The asset portfolio of a bank can provide liquidity in the following circumstances- (i) on maturity of the asset, (ii) on sale of the asset and (iii) the use of the asset as collateral for borrowing or repo transactions. Typically banks hold liquid assets such as money market instruments and marketable securities to supplement the conventional funding sources such as deposits and other liabilities. When the cash inflows from asset realization, either on maturity or through sale, are less than anticipated due to default risk or price volatility, the bank incurs liquidity risk. Similarly secured funding such as repos may be affected if counterparties seek larger discounts on the collateral provided or demand better quality collateral. Many central banks insist on creating secondary liquidity reserve for banks through investing in approved securities. Securities can be liquidated quickly and at relatively little cost. However there is trade-off between asset liquidity and profitability for the bank since short term, liquid, risk free assets yield relatively low returns. The level of liquid assets is generally a function of the stability of the bank's funding structure and the potential for rapid expansion of its loan portfolio.

   Hence to balance liquidity and profitability, management must carefully evaluate the full return on liquid assets against the expected return associated with less liquid assets. Adverse balance sheet fluctuations may lead to a forced sale of securities in which case the potential higher income from securities may be lost.

b) **Liability Management:** This strategy focuses on sources of funds to mitigate liquidity risk. Contrary to the practice in 'asset management' where surplus funds of the bank are parked in cash or near cash assets like readily marketable securities, a bank resorting to 'liability management' would invest its surplus funds in long term assets. Where there is a need for liquidity the bank raises funds from external sources. Typically the 'liability managed' bank would manage its deposits and other borrowings judicially to meet its funding obligations. Banks typically employ different liability funding strategies to manage liquidity risk. Those with large branch networks find it easier to garner relatively low-cost retail deposits. Banks concentrating on wholesale business may find borrowing in the money market the most efficient way of obtaining short-term liquidity. Others may issue medium-term certificates of deposit or prefer term deposits with a spread of maturities to reduce liquidity risk. Generally banks that have large and ready source of core deposits find liability management an easier task than those that rely more on volatile and non-core deposits. The underlying implication of this approach is that a bank will not depend on its liquidity positions for credit commitments since it intends raising the required funds from external or market sources. While the approach would benefit large growth oriented aggressive banks by way of higher returns, it also involves greater risk for the bank. One risk would be the sustenance of high spreads-while the yields could be high, the cost of borrowing could also be high and in some cases, out of the bank's control, since borrowing depends on market conditions. The second would be the asset liability risk. Making long term investments or loans also require liabilities of matching maturity. It is likely that at the time the bank wants to source funds of a specific maturity, such sources may not be available, or available at very high cost, or with embedded options. The above factor would lead to a third risk-refinancing risk. If liabilities of shorter maturities are deployed in longer-term assets, the liability would fall due before the asset flows come in completely. The bank would then have to seek more liabilities to match the remaining maturity of assets. Fourth risk is critical. As the bank borrows more, it is vulnerable to credit risk. If the bank defaults on repayment of liabilities, it also runs a reputation risk.

16.6.1.2 Approach to managing liquidity in the short term

Banks usually use two kinds of tools used by banks to measure liquidity risk-forward looking and retrospective-since sound liquidity management requires a complement of measurement tools. Forward looking or prospective tools project funding needs in the foreseeable future-the planning horizon in such cases could range from daily to quarterly to half yearly and so on. When based on sound assumptions these tools provide a good basis for liquidity planning in the short term. Retrospective tools analyze historical behavior and try to draw inferences for the future. Some of the forward-looking tools prevalently used by banks are:

- Projected sources and uses of funds over the planning horizon
- Working funds approach
- Cash flow or funding gap report

Few retrospective tools are:

- Ratio analysis
- Historical fund flow analysis

a) **Working Funds Approach:** Working Funds typically constitute bank's capital and outside liabilities such as deposits and borrowings as well as float funds.

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In this approach, liquidity is based on the working funds available with the bank. There are two ways in the banks can estimate its liquidity requirements-one, as a proportion of total working funds. Second approach is to segment the working funds and maintain separate liquidity limits for each segment. In one commonly used segmentation approach the bank classifies its liabilities based on their maturity profiles. For example, volatile funds can be withdrawn at any time in the foreseeable future. They would generally include large amounts of funds parked by corporate houses and government bodies in the short term deposits and certificates of deposits. They call for almost 100% liquidity allowance. Based on the allowances for components of its working funds, the bank would assess its desired liquidity levels at any point of time during the planning period. The bank depending on its risk-return characteristics would determine the allowable variance over the desired liquidity levels. This variance is called 'acceptance range'. As long as the average cash or near cash balances fall within this acceptance range, the bank's profitability and liquidity would fall in line with its expectations. However the acceptance range changes along with the liability profile of the bank.

b) **Ratios Approach:** Table below describes some key ratios and limits that could be employed by banks to assess and manage liquidity risk. The applicability of these ratios to a specific bank depends on the nature of business and risk profile of the bank. For example a ratio considered relevant for a predominantly retail bank would be less meaningful to a predominantly wholesale bank.

c) **Cash Flow Approach:** This forward looking approach forecasts the cash flows of the banks over a specified planning horizon, and estimates liquidity needs by identifying the likely gaps between sources and the uses of funds. The bank then makes a decision on investing surplus funds and borrowing in case of deficit. This approach works well when two potentially conflicting parameters are reconciled-the planning horizon and the costs of forecasting. The shorter the desired planning horizon, the more will be the cost of forecasting.

16.7 Fund Management : Managing Credit and Investments

16.7.1 Credit Portfolio

Banks extend credit to different categories of borrowers for different purposes. For most of these borrowers bank credit is the primary and cheapest source of debt financing. For a bank, good loans are its most profitable assets and any loan is good till the borrower defaults in repayment. In its role as a financial intermediary, the direct assumption of financial risk is the bank's defining characteristics. The most prominent risk in lending is default risk, also called credit risk which can arise due to several factors. Borrowers may default due to industry downturns and business cycles or due to specific problems related to the borrowers' firms or activities. Banks therefore make it a practice to set aside substantial reserves (called provisions) to compensate for anticipated losses due to credit risk. Lending involves a number of risks. In addition to the risks related to creditworthiness of the counterparty, the

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banks are also exposed to interest rate, forex and country risks. Credit risk or default risk involves inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions. The Credit Risk is generally made up of transaction risk or default risk and portfolio risk. The portfolio risk in turn comprises intrinsic and concentration risk. The credit risk of a bank's portfolio depends on both external and internal factors. The external factors are the state of the economy, wide swings in commodity/ equity prices, foreign exchange rates and interest rates, trade restrictions, economic sanctions, Government policies, etc. The internal factors are deficiencies in loan policies/administration, absence of prudential credit concentration limits, inadequately defined lending limits for Loan Officers/Credit Committees, deficiencies in appraisal of borrowers' financial position, excessive dependence on collaterals and inadequate risk pricing, absence of loan review mechanism and post sanction surveillance, etc.

Table 16.2: Some Key Liquidity Ratios

Ratio	Numerator	Denominator	Remarks
Loan to deposit ratio	Performing loans outstanding	Deposit balances outstanding	A simple measure to understand and compute. Indicates the extent to which relatively illiquid assets (loans) are being funded by relatively stable sources (customer deposits). It can also show overexpansion of the loan book.
Incremental loan to deposit ratio	Incremental loans made during the period	Incremental deposit inflows during the same period	The ratio also shows how additional sources of funds are being deployed. The differences between the above mentioned overall ratio and the incremental ratio would throw up any significant shifts in the bank's funds utilization strategy.
Medium term funding ratio	Liabilities with maturity of over 1 year	Assets with maturity of over 1 year	The ratio focuses on the medium –term liquidity profile of a bank. It also highlights the extent to which medium term assets are being funded by roll over of short term liabilities. Hence a lower ratio would signify higher funding of medium term assets, which could lead to liquidity risk.
Cash flow coverage ratio	Projected cash inflow	Projected cash outflow	A higher ratio indicates lower liquidity risk.
Liquid assets ratio	Liquid Assets	Short term	

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Liquid assets coverage ratio	Net liquid assets	Total volatile liabilities	
Net non-core funding dependence	Non-core deposits (+borrowings) less short-term investments	Long term assets	An increasing trend over time could signify that the bank's sources of funds are becoming more volatile, and more and more long term assets are getting funded by volatile sources.
Net short term liabilities to assets	Net short term liabilities	Total assets	A variation of the medium term funding ratio given above. If the ratio shows an increasing trend over time the bank may be exposed to refinancing risk.
On hand liquidity to total liabilities	On hand liquidity-cash in hand + near cash assets	Total liabilities	A higher ratio signifies higher liquidity but carries the risk of eroding profitability.
Contingent liabilities	Contingent liabilities to loans	Total loans	A higher ratio indicates higher potential risk

The management of credit risk should receive the top management's attention and the process should encompass:

a) Measurement of risk through credit rating/scoring;

b) Quantifying the risk through estimating expected loan losses i.e. the amount of loan losses that bank would experience over a chosen time horizon (through tracking portfolio behavior over 5 or more years) and unexpected loan losses i.e. the amount by which actual losses exceed the expected loss (through standard deviation of losses or the difference between expected loan losses and some selected target credit loss quintile);

c) Risk pricing on a scientific basis; and

d) Controlling the risk through effective Loan Review Mechanism and portfolio management.

16.7.1.1 Instruments of Credit Risk Management

Credit Risk Management encompasses a host of management techniques, which help the banks in mitigating the adverse impacts of credit risk.

1. Credit Approving Authority

Each bank should have a carefully formulated scheme of delegation of powers. The banks should also evolve multi-tier credit approving system where the loan proposals are approved by an 'Approval Grid' or a 'Committee'. The credit facilities above a specified limit may be approved by the 'Grid' or 'Committee', comprising at least 3 or 4 officers and invariably one officer should represent the CRMD, who has no volume and profit targets. Banks can also consider credit approving committees at various operating levels i.e. large branches (where considered necessary), Regional Offices, Zonal Offices, Head Offices, etc. Banks could consider delegating powers for sanction of higher limits to the 'Approval Grid' or the 'Committee' for better rated / quality customers. The quality of credit decisions should be evaluated within a reasonable time, say 3 – 6 months, through a well-defined Loan Review Mechanism.

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2. Prudential Limits

In order to limit the magnitude of credit risk, prudential limits should be laid down on various aspects of credit:

a) Stipulate benchmark current/debt equity and profitability ratios, debt service coverage ratio or other ratios, with flexibility for deviations. The conditions subject to which deviations are permitted and the authority therefore should also be clearly spelt out in the Loan Policy;

b) single/group borrower limits, which may be lower than the limits prescribed by Reserve Bank to provide a filtering mechanism;

c) Substantial exposure limit i.e. sum total of exposures assumed in respect of those single borrowers enjoying credit facilities in excess of a threshold limit, say 10% or 15% of capital funds. The substantial exposure limit may be fixed at 600% or 800% of capital funds, depending upon the degree of concentration risk the bank is exposed;

d) Maximum exposure limits to industry, sector, etc. should be set up. There must also be systems in place to evaluate the exposures at reasonable intervals and the limits should be adjusted especially when a particular sector or industry faces slowdown or other sector/industry specific problems. The exposure limits to sensitive sectors, such as, advances against equity shares, real estate, etc., which are subject to a high degree of asset price volatility and to specific industries, which are subject to frequent business cycles, may necessarily be restricted. Similarly, high-risk industries, as perceived by the bank, should also be placed under lower portfolio limit. Any excess exposure should be fullybacked by adequate collaterals or strategic considerations;

e) Banks may consider maturity profile of the loan book, keeping in view the market risks inherent in the balance sheet, risk evaluation capability, liquidity, etc.

3. Risk Rating

Banks should have a comprehensive risk scoring / rating system that serves as a single poin tindicator of diverse risk factors of counter party and for taking credit decisions in a consistent manner. To facilitate this, a substantial degree of standardization is required in ratings across borrowers. The risk rating system should be designed to reveal the overall risk of lending, critical input for setting pricing and non-price terms of loans as also present meaningful information for review and management of loan portfolio. The risk rating, in short, should reflect the underlying credit risk of the loan book. The risk rating system should be drawn up in a structured manner, incorporating, *interalia*, financial analysis, projections and sensitivity, industrial and management risks. The banks may use any number of financial ratios and operational parameters and collaterals as also qualitative aspects of management and industry characteristics that have bearings on the credit worthiness of borrowers. Banks can also weigh the ratios on the basis of the years to which they represent for giving importance to near term developments. Within the rating framework,

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banks can also prescribe certain level of standards or critical parameters, beyond which no proposals should be entertained. Banks may also consider separate rating frameworkfor large corporate / small borrowers, traders, etc. that exhibit varying nature and degree of risk. Forex exposures assumed by corporates who have no natural hedges have significantly altered the risk profile of banks. Banks should, therefore, factor the unhedged market risk exposures of borrowers also in the rating framework. The overall score for risk is to be placed on a numerical scale ranging between 1-6, 1-8, etc. on the basis of credit quality. For each numerical category, aquantitative definition of the borrower, the loan's underlying quality, and an analytic representation of the underlying financials of the borrower should be presented. Further, as a prudent risk management policy, each bank should prescribe the minimum rating below which no exposures would be undertaken. Any flexibility in the minimum standards and conditions for relaxation and authority therefore should be clearly articulated in the Loan Policy. Variations in the ratings of borrowers over time indicate changes in credit quality and expected loan losses from the credit portfolio. Thus, if the rating system is to be meaningful, the credit quality reports should signal changes in expected loan losses. In order to ensure the consistency and accuracy of internal ratings, the responsibility for setting or confirming such ratings should vest with the Loan Review function and examined by an independent Loan Review Group. The banks should undertake comprehensive study on migration (upward – lowerto higher and downward – higher to lower) of borrowers in the ratings to add accuracy inexpected loan loss calculations.

4. Risk Pricing

Risk-return pricing is a fundamental tenet of risk management. In a risk-return setting, borrowers with weak financial position and hence placed in high credit risk category should bepriced high. Thus, banks should evolve scientific systems to price the credit risk, which should have a bearing on the expected probability of default. The pricing of loans normally should belinked to risk rating or credit quality. The probability of default could be derived from the past behaviour of the loan portfolio, which is the function of loan loss provision/charge offs for the last five years or so. Banks should build historical database on the portfolio quality and provisioning / charge off to equip themselves to price the risk. But value of collateral, market forces, perceived value of accounts, future business potential, portfolio/ industry exposure and strategic reasons may also play important role in pricing. Flexibility should also be made for revising the price (risk premia) due to changes in rating / value of collaterals over time. Large sized banks across the world have already put in place Risk Adjusted Return on Capital (RAROC) framework for pricing of loans, which calls for data on portfolio behaviour and allocation of capital commensurate with credit risk inherent in loan proposals. Under RAROC framework, lender begins by charging an interest mark-up to cover the expected loss – expected default rate of the rating category of the borrower. The lender then allocates enough capital to the prospective loan to cover some amount of unexpected loss- variability of default rates. Generally, international banks allocate enough capital so that the expected loan loss reserve or provision plus allocated capital cover 99% of the loan loss outcomes. There is, however, a need for comparing the prices quoted by competitors for borrowers perched on the same rating /quality. Thus, any attempt at price-cutting for market share would result in mispricing of risk and 'Adverse Selection'.

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5. Portfolio Management

The existing framework of tracking the Non-Performing Loans around the balance sheet date does not signal the quality of the entire Loan Book. Banks should evolve proper systems for identification of credit weaknesses well in advance. Most of international banks have adopted various portfolio management techniques for gauging asset quality. The CRMD, set up at Head Office should be assigned the responsibility of periodic monitoring of the portfolio. The portfolio quality could be evaluated by tracking the migration (upward or downward) of borrowers from one rating scale to another. This process would be meaningful only if the borrower-wise ratings are updated at quarterly / half-yearly intervals. Data on movements within grading categories provide a useful insight into the nature and composition of loan book. The banks could also consider the following measures to maintain the portfolio quality:

i) Stipulate quantitative ceiling on aggregate exposure in specified rating categories, i.e. certain percentage of total advances should be in the rating category of 1 to 2 or 1 to 3, 2 to 4 or 4 to5, etc.;

ii) Evaluate the rating-wise distribution of borrowers in various industries, business segments,etc;

iii) Exposure to one industry/sector should be evaluated on the basis of overall rating distribution of borrowers in the sector/group. In this context, banks should weigh the pros and cons of specialization and concentration by industry group. In cases where portfolio exposure to asingle industry is badly performing, the banks may increase the quality standards for that specific industry;

iv) Target rating-wise volume of loans, probable defaults and provisioning requirements as aprudent planning exercise. For any deviation/s from the expected parameters, an exercise for restructuring of the portfolio should immediately be undertaken and if necessary, the entry level criteria could be enhanced to insulate the portfolio from further deterioration;

v) Undertake rapid portfolio reviews, stress tests and scenario analysis when external environment undergoes rapid changes (e.g. volatility in the forex market, economic sanctions, changes in the fiscal/monetary policies, general slowdown of the economy, market risk events, extreme liquidity conditions, etc.). The stress tests would reveal undetected areas of potential credit risk exposure and linkages between different categories of risk. In adverse circumstances, there may be substantial correlation of various risks, especially credit and market risks. Stress testing can range from relatively simple alterations in assumptions aboutone or more financial, structural or economic variables to the use of highly sophisticated models. The output of such portfolio-wide stress tests should be reviewed by the Board and suitable changes may be made in prudential risk limits for protecting the quality. Stress tests could also include contingency plans, detailing management responses to stressful situations.

vi) Introduce discriminatory time schedules for renewal of borrower limits. Lower rated borrowers whose financials show signs of problems should be subjected

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to renewal control twice/thrice a year. Banks should evolve suitable framework for monitoring the market risks especially forex risk exposure of corporates who have no natural hedges on a regular basis. Banks should also appoint Portfolio Managers to watch the loan portfolio's degree of concentrations and exposure to counter parties. For comprehensive evaluation of customer exposure, banks may consider appointing Relationship Managers to ensure that overall exposure to a single borrower is monitored, captured and controlled. The Relationship Managers have to work in coordination with the Treasury and Forex Departments. The Relationship Managers may service mainly high value loans so that a substantial share of the loan portfolio, which can alter the risk profile,would be under constant surveillance. Further, transactions with affiliated companies/groupsneed to be aggregated and maintained close to real time. The banks should also put in place formalized systems for identification of accounts showing pronounced credit weaknesses well inadvance and also prepare internal guidelines for such an exercise and set time frame for deciding courses of action. Many of the international banks have adopted credit risk models for evaluation of credit portfolio. The credit risk models offer banks framework for examining credit risk exposures, across geographical locations and product lines in a timely manner, centralizing data and analyzing marginal and absolute contributions to risk. The models also provide estimates of credit risk (unexpected loss) which reflect individual portfolio composition. The Altman's Zscore forecasts the probability of a company entering bankruptcy within a 12-month period. The model combines five financial ratios using reported accounting information and equity values to produce an objective measure of borrower's financial health. J. P. Morgan has developed aportfolio model ***'Credit Metrics'*** for evaluating credit risk. The model basically focuses on estimating the volatility in the value of assets caused by variations in the quality of assets. The volatility is computed by tracking the probability that the borrower might migrate from onerating category to another (downgrade or upgrade). Thus, the value of loans can change overtime, reflecting migration of the borrowers to a different risk-rating grade. The model can be used for promoting transparency in credit risk, establishing benchmark for credit risk measurement and estimating economic capital for credit risk under RAROC framework.

16.7.2 Investment Portfolio

It is seen in the bank's financial statements that investments constitute a major asset on bank's books along with loans and advances. Typically banks invest in securities to meet the following objectives-

- Safety of capital
- Liquidity
- Yield
- Diversification of credit risk
- Managing interest rate risk exposure
- Meeting pledging requirement.

It is evident that bank's investment portfolio cannot satisfy all these objectives. There may be circumstances under which a bank looks for yield from security investments to bolster its dwindling spreads on loans made. There could be other times at which the bank's liquidity needs would be overarching. Regulators in most countries deal with this dilemma by stipulating that banks hold their investments in three classes to satisfy most of the objectives given above.

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1. Held to Maturity (HTM): These are securities purchased with the objective of holding till maturity. On the balance sheet they are carried at amortized cost. The capital gains or losses at the time of maturity will be taken to the income statement. However during the period they are held, unrealized gains or losses due to market fluctuations have no impact on the income statement.

2. Held for trading (HFT): These securities are purchased with the intention to sell in the near term. They are carried at market value on the balance sheet, and therefore unrealized gains or losses could impact the income statement.

3. Available for Sale (AFS): Securities not classified under the above two categories will be included here. They too are carried at market value on the balance sheet.

Market risk arises from the volatility in values of on and off balance sheet trading positions owing to unexpected changes in market prices. The focus of market risk is on changes in market prices of instruments that form a part of the trading book of a financial intermediary. These market prices could be interest rates, equity prices, commodity prices and foreign exchange rates.

Market Risk will be more significant when financial information has to be presented on marked-to-market basis since significant fluctuations in asset holdings could adversely affect the balance sheet of banks. In the Indian context, the problem is accentuated because many financial institutions acquire bonds and hold it till maturity. When there is a significant increase in the term structure of interest rates, or violent fluctuations in the rate structure, one finds substantial erosion of the value of the securities held. The primary objective of bank's investment portfolio is to maximize earnings while mitigating risks that are involved. These risks could cause volatility in returns from the investment portfolio. These risks are-

- *Interest rate risk* is the potential volatility in returns caused by changes in the interest rates. If the bank holds fixed income securities, the market value of these securities would change in the direction opposite to the change in interest rates of comparable securities.
- *Credit risk* arises in case when the bank's investment in debt securities does not yield the promised interest rate and principal payments. It is for this reason that this reason that many central banks require that banks invest in only 'investment grade' securities.
- *Liquidity risk* could arise from lack of market for the securities held by the bank.

Measuring Market Risk with VaR

The increasing volatility of financial markets has necessitated design and development of more sophisticated risk management tools. Value at risk (VaR) has become one of the standard measures to quantify market risk. The concept and use of VaR as a risk management tool gained prominence only about two decades ago. VaR is defined as the maximum potential loss in the value of a portfolio due to adverse market movements for a given probability. VaR summarizes the predicted maximum loss over a target horizon within a given confidence interval.

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Check your progress

6. What do you mean by liquidity management?
7. Difference between working fund approach and ratio approach.
8. What is risk rating?

- **Horizon:** If the bank's trading portfolio is invested in highly liquid securities even a 1day horizon may be acceptable. For an investment manager with a monthly rebalancing and reporting focus a 30 day period may be more appropriate.
- **Computing VaR:** Assume a bank holds Rs. 100 crore in medium term investments. How much could the bank lose in a month?

  In order to answer this question we first have to analyze the characteristics of medium term securities. This is done through following steps:

i. Obtain monthly returns on medium term bonds over the last 40 years. It is possible that these returns could range from a low of -6% to a high of +15%

ii. Construct regularly spaced buckets going from the lowest to the highest number and count how many observations fall into each bucket (frequency distribution). Thus we can construct a probability distribution for the monthly returns for the monthly returns, which counts how many occurrences have been observed in the past for a particular range.

iii. For each return compute a probability of observing a lower return. This is done as follows. Pick a confidence level, say, 95%. For this confidence level find on the graph a point such that there is a 5% chance of finding a lower return. This number is say -2%, which implies that all occurrences of returns less than -2% add up to 5% of the total number of months i.e. 24 out of 480 months.

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4. Now compute the VaR of Rs 100 crore portfolio. There is only a 5% chance that the portfolio will fall by more than Rs 100 crore times -2% or Rs 2 crore. The VaR is thus Rs 2 crore.
5. Thus we can say that under normal conditions the most the portfolio can lose over a month is Rs 2 crore.

iv. Now compute the VaR of Rs 100 crore portfolio. There is only a 5% chance that the portfolio will fall by more than Rs 100 crore times -2% or Rs 2 crore. The VaR is thus Rs 2 crore.

v. Thus we can say that under normal conditions the most the portfolio can lose over a month is Rs 2 crore.

- **Confidence Level:** The choice of the confidence level depends on how the bank wants to use VaR. Bank may intend to use the resulting VaR directly for the choice of a capital cushion. In this case the choice of confidence level becomes crucial. On the other hand if VaR is used just to provide a yardstick to compare risks across different markets then the choice of the confidence level is not too important.

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16.8 ALM Systems in Banks : RBI Guidelines

Over the last few years the Indian financial markets have witnessed wide ranging changes at fast pace. Intense competition for business involving both the assets and liabilities, together with increasing volatility in the domestic interest rates as well as foreign exchange rates, has brought pressure on the management of banks to maintain a good balance among spreads, profitability and long-term viability. These pressures call for structured and comprehensive measures and not just ad hoc action. The Management of banks has to base their business decisions on a dynamic and integrated risk management system and process, driven by corporate strategy. Banks are exposed to several major risks in the course of their business - credit risk, interest rate risk, foreign exchange risk, equity / commodity price risk, liquidity risk and operational risks.

RBI lays down broad guidelines in respect of interest rate and liquidity risks management systems in banks which form part of the Asset-Liability Management (ALM) function. The initial focus of the ALM function would be to enforce the risk management discipline viz. managing business after assessing the risks involved. The objective of good risk management programmes should be that these programmes will evolve into a strategic tool for bank management.

16.8.1 The ALM Process rests on Three Pillars

- ALM information systems

  => Management Information System

  => Information availability, accuracy, adequacy and expediency

- ALM organization

  => Structure and responsibilities

  => Level of top management involvement

- ALM process

  => Risk parameters

  => Risk identification

=> Risk measurement

=> Risk management

=> Risk policies and tolerance levels

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1. ALM information systems

Information is the key to the ALM process. Considering the large network of branches and the lack of an adequate system to collect information required for ALM which analyses information on the basis of residual maturity and behavioural pattern it will take time for banks in the present state to get the requisite information. The problem of ALM needs to be addressed by following an ABC approach i.e. analyzing the behaviour of asset and liability products in the top branches accounting for significant business and then making rational assumptions about the way in which assets and liabilities would behave in other branches. In respect of foreign exchange, investment portfolio and money market operations, in view of the centralized nature of the functions, it would be much easier to collect reliable information. The data and assumptions can then be refined overtime as the bank management gain experience of conducting business within an ALM framework.The spread of computerization will also help banks in accessing data.

2. ALM organization

I. a) The Board should have overall responsibility for management of risks and should decide the risk management policy of the bank and set limits for liquidity, interest rate, foreign exchange and equity price risks.

b) The Asset - Liability Committee (ALCO) consisting of the bank's senior management including CEO should be responsible for ensuring adherence to the limits set by the Board as well as for deciding the business strategy of the bank (on the assets and liabilities sides) in line with the bank's budget and decided risk management objectives.

c) The ALM desk consisting of operating staff should be responsible for analyzing, monitoring and reporting the risk profiles to the ALCO. The staff should also prepare forecasts (simulations) showing the effects of various possible changes in market conditions related to the balance sheet and recommend the action needed to adhere to bank's internal limits.

II. The ALCO is a decision making unit responsible for balance sheet planning from risk - return perspective including the strategic management of interest rate and liquidity risks. Each bank will have to decide on the role of its ALCO, its responsibility as also the decisions to be taken by it. The business and risk management strategy of the bank should ensure that the bank operates within the limits / parameters set by the Board. The business issues that an ALCO would consider, inter alia, will include product pricing for both deposits and advances, desired maturity profile of the incremental assets and liabilities, etc. In addition to monitoring the risk levels of the bank, the ALCO should review the results of and progress in implementation of the decisions made in the previous meetings. The ALCO would also articulate the current interest rate view of the bank and base its decisions for future business strategy on this view. In respect of the funding policy, for instance, its responsibility

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would be to decide on source and mix of liabilities or sale of assets. Towards this end, it will have to develop a view on future direction of interest rate movements and decide on a funding mix between fixed vs. floating rate funds, wholesale v/s retail deposits, money market vs. capital market funding, domestic vs. foreign currency funding, etc. Individual banks will have to decide the frequency for holding their ALCO meetings.

III. **Composition of ALCO:** The size (number of members) of ALCO would depend on the size of each institution, business mix and organizational complexity. To ensure commitment of the Top Management, the CEO/CMD or ED should head the Committee. The Chiefs of Investment, Credit, Funds Management/Treasury (forex and domestic), International Banking and Economic Research can be members of the Committee. In addition the Head of the Information Technology Division should also be an invitee for building up of MIS and related computerization. Some banks may even have sub-committees.

IV. **Committee of Directors:** Banks should also constitute a professional Managerial and Supervisory Committee consisting of three to four directors which will oversee the implementation of the system and review its functioning periodically.

3. ALM process

The scope of ALM function can be described as follows:

- Liquidity risk management
- Management of market risks(including Interest Rate Risk)
- Funding and capital planning
- Profit planning and growth projection
- Trading risk management

These guidelines mainly address Liquidity and Interest Rate risks.

16.9 Basel Norms -Original Accord and Indian Position

In the late 1980s a committee was set up under the auspices of the Bank for International Settlements (BIS) at Basel which consisted of representatives of the G10 countries and was later known as the Basel committee. The objective of the committee was to smoothen out competitive differences among international banks that were subject to different capital regulations by national regulators. The Basel committee first issued its consultative paper on capital adequacy of internationally active banks in 1987. The final accord was accepted in 1988 by the G10 countries. Apart from the G10 countries almost 100 countries across the world had implemented the accord by 1999 (Jackson 2001). The risks covered by this accord called Basel I, were credit and market risks. The accord is now being replaced by a new Basel accord called Basel II. The new accord was endorsed by the central bank governors and heads of banking supervision of G10 countries in 2005. The new accord has the same provisions as the old in relation to the minimum requirement of maintenance

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of 8% capital to risk weighted assets ratio; definition of capital; and the calculation of capital requirements for market risk. However the important difference is the greater risk sensitivity of the credit risk assessments of the new accord compared to the old. In addition the new accord includes capital requirements for operational risk apart from credit and market risk.

RBI introduced a capital adequacy system based on the first Basel accord in 1992. The movement towards implementation of Basel II was initiated in 2005 by RBI's directions that banks in India should implement Basel II with effect from 31/03/2007.

1. Capital Adequacy Guidelines issued by RBI – Basel I

- All banks operating in India to maintain minimum "Capital Funds" at 9% of "Total Risk Weighted Assets".
- Capital Funds is an addition of Tier-I Capital (consisting of Capital, Permanent Reserves and Profits retained for this purpose) and Tier-II Capital (consisting of Subordinated Debt, General Reserves, Hybrid Debt Capital Instruments)
- Total Risk Weighted Assets is computed on the basis of risk weights assigned for different asset types and obligors:
- Government - 0%
- Banks - 20%
- Others - 100% [except Housing (50-75%), Consumer (125%) loans, equity/capital market exposure (125%) and Venture capital funds (150%)]
- Market Risk Capital Charge is based on modified duration methodology.

2. Basel II – Changes

i. Credit Risk

- Previous norms prescribed single credit risk factor across a class of obligors thus ignoring the default probability or risk rating of different obligors. This result in assigning same amount of capital for exposures to AAA rated and BB rated corporate.
- Under Basel II, Risk Weights are more risk sensitive being based on risk rating of the obligor and tenor of the loan. E.g. AAA – 20%, AA – 30% etc.
- Three approaches for computing RWAs for Credit Risk:
    (a) Standardized Approach: Risk Weights linked to external ratings of obligors and tenor of the loan Range between 0% - 150%. Unrated exposures to be assigned 100% risk weight. We are currently using this approach.

    (b) Foundational Internal Rating Approach: Risk Weights assigned on the basis of obligors PD (Probability of Default).

    (c) Advanced Internal Rating Approach: Banks to use internal rating model for key statistical data: credit ratings (probability of default or PD), "Loss given Default" (LGD) and "Exposure at default" (EAD). Road map for migrating to these approaches is issued.

- To start with RBI has asked all banks to follow Standardized approach and use external ratings assigned by any of the RBI approved local and international rating agencies.

ii. Operational Risk & Market Risk

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- Operational Risk is defined as the risk of loss arising from inadequate or failed internal processes, people and systems or from external events.
- Basel II requires Banks to compute capital charge for Operational Risk.
- It defines three approaches for this calculation:
  (a) Basic Indicator Approach: Capital Charge computed at 15% of Gross Income of the Bank.
  (b) Standardized Approach: Capital Charge ranges between 12-18% of gross income of different business lines.
  (c) Advanced Measurement Approach: Banks to use internal model for computing potential operational loss.
- To start with RBI has asked all banks to apply the Basic Indicator Approach. Basic Indicator Approach is required to be implemented by all banks operating in India. Roadmap for Advanced approaches is prescribed by RBI
- Broadly no changes in the computation of Market risk capital charge under Basel II except a few minor differences.

iii. Original Accord & Indian Position – a broad comparison

Original Basel Accord	RBI Guidelines
Applies to all internationally active banks and on a consolidated basis to majority-owned or controlled banking entities, securities entities and financial entities, not including insurance.	Applies to all scheduled commercial banks both at solo and consolidated level and group entities, which include a licensed bank.
The total capital ratio must be no lower than 8%.	Banks are required to maintain a minimum capital to Risk-weighted assets ratio (CRAR) of **9%** on an ongoing basis.
Banks have been permitted to adopt the Standardized method, Internal Rating Based or Advanced Measurement Approach.	Banks mandated to use Standardized Approach for credit risk and Basic Indicator Approach for operational risk. Banks to make a road map for migration to advanced approaches only after obtaining specific approval of RBI.
Claims on sovereigns to be risk weighted from 0% to 150% depending upon the credit assessments – AAA to B-. Claims on banks – Risk weights can Either be one notch less favorable than the sovereign of the country or based on credit assessment of the banks – AAA to B- . Claims on	Exposures to domestic sovereigns (Central &States) rated at 0%. Banks in India (incl. Foreign bank branches) – 20% if CRAR is >= 9% else higher risk weights. Exposure to banks outside India - 20% to 150% depending upon the credit assessment of the banks. Claim on Primary Dealers treated as claims on corporates.

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securities firms at par with banks provided the securities company is subject to supervisory and regulatory arrangements.	
Orientation criterion for inclusion under regulatory retail portfolios is exposure to small business. Value of absolute threshold for inclusion as retail exposure kept at Euro 1MM	Orientation criterion is different, small business is defined to mean where the annual turnover of last three years is less than Rs. 50 crores ($12.5 MM). Each individual obligor not to contribute more than 0.2% of total retail portfolio.
Lending against fully secured mortgages on residential property will be risk weighted at 35%.	Lending against fully secured mortgages if the loan to value ratio (LTV) is not more than 75%, on residential property will be risk weighted at 75%, except where loan value is below Rs.30 lacs which is risk weighted at 50%. Lending for acquiring residential property, which meets the above criteria but have LTV ratio of more than 75 percent, will attract a risk weight of 100 %.
In the case of past due loans where specific provision are no less than 50% of the outstanding amount of the loan the risk weights of 100%.	In the case of past due loans where specific provision are less than 20% of the outstanding amount of the loan the risk weights of 150% will be applied. In the case of past due loans where specific provision are at least 20% of the outstanding amount of the loan the risk weights of 100% will be applicable. In the case of past due loans where specific provision are no less than 50% of the outstanding amount of the loan the risk weights of 50%.

3. BASEL III- Proposed Changes

Basel III proposes many new capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and new capital buffers will require banks to hold more capital and higher quality of capital than under current Basel II rules. The new leverage ratio introduces a non-risk based measure to supplement the risk-based minimum capital requirements. The new liquidity ratios ensure that adequate funding is maintained in case of crisis. The new regulations raise the quality, consistency and transparency of the capital base and strengthen the risk coverage of the capital framework. The major elements of the proposals are noted below. Basel III strengthens the three Basel II pillars; especially pillar 1 (see the figure below) with enhanced minimum capital and liquidity requirements.

Regulatory Element	Proposed Requirement
Higher Minimum Tier 1 Capital Requirement	» Tier 1 Capital Ratio: increases from 4% to 6% » The ratio will be set at 4.5% from 1 January 2013, 5.5% from 1 January 2014 and 6% from 1 January 2015 »Predominance of common equity will now reach 82.3% of Tier 1 capital, inclusive of capital conservation buffer
New Capital Conservation Buffer	»Used to absorb losses during periods of financial and economic stress »Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirement to 7% (4.5% common equity requirement and the 2.5% capital conservation buffer) »The capital conservation buffer must be met exclusively with common equity »Banks that do not maintain the capital conservation buffer will face restrictions on payouts of dividends, share buybacks and bonuses
Countercyclical Capital Buffer	» A countercyclical buffer within a range of 0% - 2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances » When in effect, this is an extension to the conservation buffer
Higher Minimum Tier 1 Common Equity Requirement	» Tier 1 Common Equity Requirement: increase from 2% to 4.5% » The ratio will be set at 3.5% from 1 January 2013, 4% from 1 January 2014 and 4.5% from 1 January 2015
Liquidity Standard	» Liquidity Coverage Ratio (LCR): to ensure that sufficient high quality liquid resources are available for one month survival in case of a stress scenario. Introduced 1 January 2015 » Net Stable Funding Ratio (NSFR): to promote resiliency over longer-term time horizons by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis » Additional liquidity monitoring metrics focused on maturity mismatch, concentration of funding and available unencumbered assets
Leverage Ratio	» A supplemental 3% non-risk based leverage ratio which serves as a backstop to the measures outlined above

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Check your progress

9. What is ALM information system?
10. Discuss the proposed changes in Basel III

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	» Parallel run between 2013-2017; migration to Pillar 1 from 2018
Minimum Total Capital Ratio	» Remains at 8% » The addition of the capital conservation buffer increases the total amount of capital a bank must hold to 10.5% of risk-weighted assets, of which 8.5% must be tier 1 capital » Tier 2 capital instruments will be harmonized; tier 3 capital will be phased out

Source: Bank for International Settlements, Basel Committee on Banking Supervision.

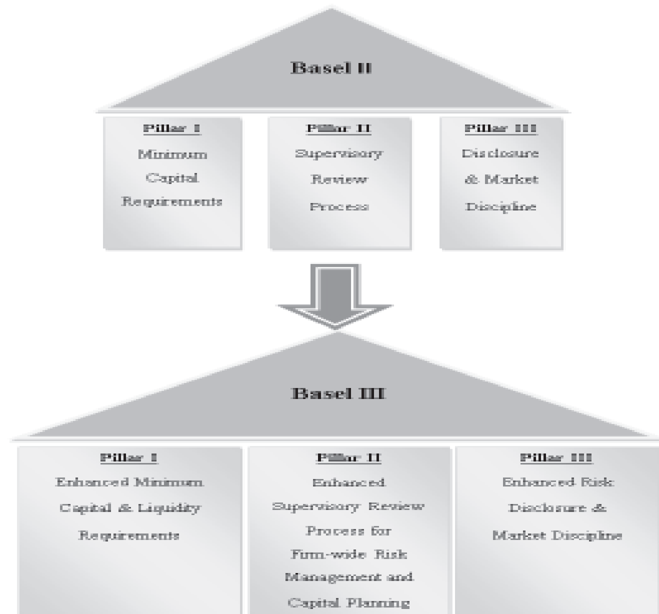

Figure 16.1: Basel III strengthens the three Basel II pillars with enhanced minimum capital and liquidity requirements.

16.10 Key Terms

- **Asset Liability Management:** Asset/liability management is a technique companies employ in coordinating the management of assets and liabilities so that an adequate return may be earned.
- **Value at Risk:** Value at risk (VaR) is a statistical technique used to measure and quantify the level of financial risk within a firm or investment portfolio over a specific time frame.
- **Cash flows:** Cash flow is the net amount of cash and cash-equivalents moving into and out of a business. Positive cash flow indicates that a company's liquid assets are increasing, enabling it to settle debts, reinvest in its business, return money to shareholders, pay expenses and provide a buffer against future financial challenges. Negative cash flow indicates that a company's liquid assets are decreasing. Net cash flow is

distinguished from net income, which includes accounts receivable and other items for which payment has not actually been received. Cash flow is used to assess the quality of a company's income, that is, how liquid it is, which can indicate whether the company is positioned to remain solvent.

- **Interest rate derivatives:** An interest rate derivative is a derivative where the underlying asset is the right to pay or receive a notional amount of money at a given interest rate.
- **Swaps:** A swap is a derivative contract through which two parties exchange financial instruments. These instruments can be almost anything, but most swaps involve cash flows based on a notional principal amount that both parties agree to. Usually, the principal does not change hands. Each cash flow comprises one leg of the swap. One cash flow is generally fixed, while the other is variable that is, based on a benchmark interest rate, floating currency exchange rate or index price.
- **Ratio analysis:** Ratio Analysis is a form of Financial Statement Analysis that is used to obtain a quick indication of a firm's financial performance in several key areas. The ratios are categorized as Short-term Solvency Ratios, Debt Management Ratios, Asset Management Ratios, Profitability Ratios, and Market Value Ratios
- **Fund flow:** Fund flow is the net of all cash inflows and outflows in and out of various financial assets. Fund flow is usually measured on a monthly or quarterly basis; the performance of an asset or fund is not taken into account, only share redemptions, or outflows, and share purchases, or inflows.
- **Risk Adjusted Return on Capital:** Risk-adjusted return on capital (RAROC) is a risk-based profitability measurement framework for analysing risk-adjusted financial performance and providing a consistent view of profitability across businesses. The concept was developed by Bankers Trust and principal designer Dan Borge in the late 1970s.
- **Yield:** The income return on an investment. This refers to the interest or dividends received from a security and are usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.
- **Liquidity:** Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.
- **Basel I:** Basel I is a set of international banking regulations put forth by the Basel Committee on Bank Supervision, which set out the minimum capital requirements of financial institutions with the goal of minimizing credit risk.
- **Basel III:** Basel III is a comprehensive set of reform measures designed to improve the regulation, supervision and risk management within the banking sector. The Basel Committee on Banking Supervision published the first version of Basel III in late 2009, giving banks approximately three years to satisfy all requirements. Largely in response to the credit crisis, banks are required to maintain proper leverage ratios and meet certain capital requirements.

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- **Capital Adequacy Ratio:** The capital adequacy ratio (CAR) is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures.

16.11 Summary

- After independence banks in India had huge deposits of demand and savings deposits. Banks had to focus on the mechanisms by which they could make efficient use of these funds. So the emphasis was on asset management. But as the availability of low cost funds started to decline, liability management became the focus of banks' management. Liability management is the practice of buying money through deposits, government funds and commercial paper in order to fund profitable loan opportunities.
- The asset liability risk could manifest itself in a number of forms, but what would concern bankers most would be two important risks-'interest rate risk' and 'liquidity risk'. While interest rate risk would directly impact the net income of the bank, the liquidity risk would endanger the very solvency of the bank.
- In short, ALM is concerned with strategic balance sheet management. Risks caused by changes in interest rates and exchange rates, credit risk and the bank's liquidity position have to be monitored and mitigated. With profitability of banking operations and the long term solvency of the banks becoming key factors, it has now becoming imperative for banks to move away from partial asset management (credit, non-performing assets) and partial liability management (deposits) to integrated balance sheet management.
- The strategies that can be employed for correcting the mismatch in terms of D (A) > D (L) can be either liability or asset driven. Asset driven strategies for correcting the mismatch focuses on shortening the duration of the asset portfolio. The commonly employed asset based financing strategy is securitization. Typically the long-term asset portfolios like the lease and hire purchase portfolios are securitized; and the resulting proceeds are either redeployed in short term assets or utilized for repaying short-term liabilities. Liability driven strategies basically focus on lengthening the maturity profiles of liabilities.
- Gap analysis model Measures the direction and extent of asset-liability mismatch through either funding or maturity gap. It is computed for assets and liabilities of differing maturities and is calculated for a set time horizon.
- Duration is an important measure of the interest rate sensitivity of assets and liabilities as it takes into account the time of arrival of cash flows and the maturity of assets and liabilities. It is the weighted average time to maturity of all the present values of cash flows. Duration basically refers to the average life of the asset or the liability.
- Value at Risk (VaR) refers to the maximum expected loss that a bank can suffer over a target horizon, given a certain confidence interval. It enables the calculation of market risk of a portfolio for which no historical data exists.

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- To reduce asset sensitivity banks have the following alternatives. They could (a) extend the maturities in the investment portfolio, (b) increase floating rate deposits, (c) increase short term borrowings, (d) increase long term lending, (e) increase fixed rate lending and so on. Similarly to reduce liability sensitivity banks could do the opposite.
- Recent trends in the liability profiles of banks pose further challenges to the industry and have made it increasingly important for banks to actively manage their liquidity risk. Some of these developments are (a) the increasing proportion in bank liabilities of wholesale and capital market funding which is more sensitive to credit and market risks (b) the increase in off-balance sheet activities such as derivatives and securitization that have compounded the challenge of cash flow management and (c) the speed with which funds can be transmitted and withdrawn, thanks to advanced technology and systems.
- RBI lays down broad guidelines in respect of interest rate and liquidity risks management systems in banks which form part of the Asset-Liability Management (ALM) function. The initial focus of the ALM function would be to enforce the risk management discipline viz. managing business after assessing the risks involved. The objective of good risk management programmes should be that these programmes will evolve into a strategic tool for bank management.
- In the late 1980s a committee was set up under the auspices of the Bank for International Settlements (BIS) at Basel which consisted of representatives of the G10 countries and was later known as the Basel committee. The objective of the committee was to smoothen out competitive differences among international banks that were subject to different capital regulations by national regulators. The Basel committee first issued its consultative paper on capital adequacy of internationally active banks in 1987.
- Basel III proposes many new capital, leverage and liquidity standards to strengthen the regulation, supervision and risk management of the banking sector. The capital standards and new capital buffers will require banks to hold more capital and higher quality of capital than under current Basel II rules.

16.12 Questions and Exercises

1. Discuss the concept of Asset Liability management in financial institutions.
2. Give a brief note on interest rate risk measurement techniques.
3. What is the importance of interest rate derivatives in interest rate risk management?
4. State the RBI guidelines for Asset liability management system in banks.
5. Highlight the modern approaches for liquidity risk management.

16.13 Further Readings and References

NOTES

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