Uttarakhand Open University, Haldwani

MS 407

School of Management Studies and Commerce

Management of Financial Services

Block I Financial System and Markets

Block II Nature and Scope of Financial Services

MS 407

Management of Financial Services

Block – I
Block Title- Financial System and Markets
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Course Contents

Course Name: Management of Financial Services

Course Code-MS407

Course Objective: This course aims at acquainting the students the understanding the nature of various financial services and managing them.

Block-I Financial System and Markets

Unit I Overview of Indian Financial System

Unit II Money Market

Unit III Capital Markets

Unit IV New Issues Market

Unit V Govt. Securities Market

Unit VI Foreign Exchange Market

Block II Nature and Scope of Financial Services

Unit VII Nature and Scope of Financial Services

Unit VIII Nature and Scope of Financial Services-Constituents & Classification

Unit IX Regulatory Framework for Financial Services

Unit X Management of Risk in Financial Services

Unit XI Pricing of Financial Services

Unit XII Marketing of Financial Services

Block III Financial Intermediaries

Unit XIII Mutual Funds

Unit XIV Merchant Banking

Unit XV Leasing and Hire Purchase

Unit XVI Debt Securitization

Unit XVII Housing Finance

Unit XVIII Credit Rating

Unit XIX Strategic Issues in the Management of Financial Intermediaries

Block IV Latest Concepts in the Management of Financial Services

Unit XX Venture Capital

Unit XXI Factoring and forfeiting

Unit XXII Asset Liability Management

Unit XXIII Insurance Services, Bancassurance and Reinsurance

Unit XXIV Securitization and Asset Reconstruction Companies

Unit XXV Non -Banking Financial Companies

Unit XXVI Indian and Global Perspective – Managing new challenges

Suggested Readings:

1. K.Sriram, 'Hand Book of Leasing, Hire Purchase & Factoring', ICFAI, Hyderabad, 1992.
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Index

<u>Block I</u>
Financial System and Markets

UNIT 1 OVERVIEW OF INDIAN FINANCIAL SYSTEM

1.1 INTRODUCTION

Financial sector also known as the financial system of any country. The various participants in the financial system are individuals, companies, banks, financial institutions and government. The financial system of a country helps to mobilize funds from the people who have excess funds or savings to the people who are in need of funds. A well-planned financial system of a country leads to the financial development of the country because it provides a mechanism through which savings can be transformed into investments. The financial system consists of money, credit and finance.

1.2 OBJECTIVES

After the completion of this unit, you will be able to:

- To understand about various financial markets (e.g., stock, bond, money market).
- To understand the risk involved in various markets and how to manage and mitigate the risk.
- To understand and gain insights into the economy's health, anticipate cycles, and make strategic decisions based on these functions.
- To understand how events in one part of the world can impact markets elsewhere, helping participants develop strategies for diversification and responds to global financial trends.
- To make better investment choices, manage risks, and adapt to changing economic condition.

1.3 MEANING OF INDIAN FINANCIAL SYSTEM

A financial system is a collection of interconnected services and activities that cooperate to accomplish a predefined objective. It consists of various markets, organizations, tools, services, and processes that affect the creation of savings, the formation and expansion of capital, and savings rates. Indian financial system helps the borrowers and lenders exchange funds. The financial system plays a vital role in the economic development of a nation because it helps in mobilizing the surplus funds available and invest those funds in some productive purposes. Possibly the most significant institutional and functional tool for economic reform is the financial sector. Finance serves as a link between the present and the future. The efficiency with which the financial system carries out its duties—whether it be mobilizing savings or allocating them fairly, efficiently, and effectively for investments—sets the pace for the accomplishment of larger societal goals. The development of an economy depends upon the capital formation and economic growth of a country. In economics capital does not mean money alone. Along with physical capital it includes human capital also. Physical capital like machinery, plant, raw material, infrastructure leads to increase in production, increase in profits, further leading to creation of capital assets in future. Human capital includes skilfulness, training and education of the humans so that it can lead to the development of individuals and enhances their productivity.

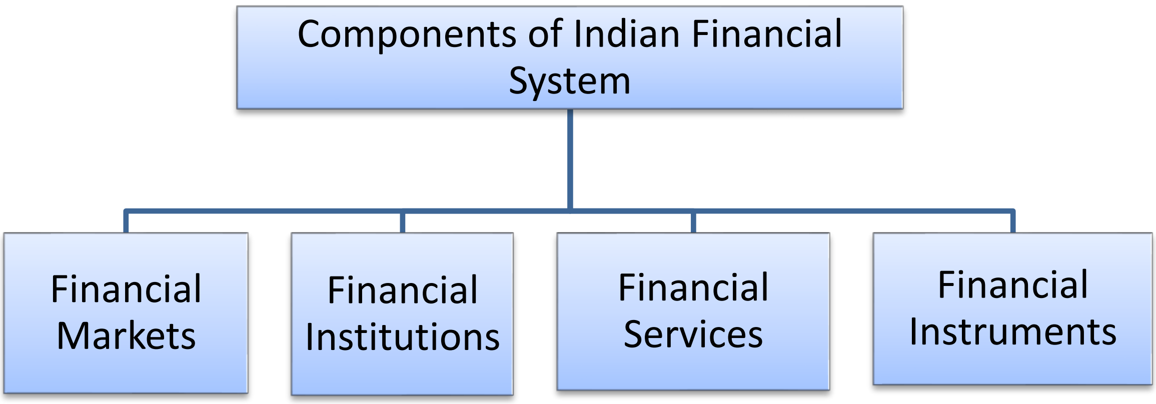
There are two main components of capital formation, one is savings and another is investment. Saving is the portion of income that is not spent. Savings develop into an investment when they are managed to generate returns in the future. For example- Mr. X works in an MNC having salary of 1,00,000 pm saves 50,000 from his salary per month for 5 years and then purchases a plot for Rs 30,00,000. Now after 2 years he constructs a building on that land and gives at on rent. So, this piece of land is an investment for him as it is helping to generate extra fund for him. Or Infact, even if he decides to sell that land at future date at a higher price as the value of land increases with time, the difference between the selling price and cost price of that land will be profit for Mr. X. So, this piece of land is an investment for Mr.X which he bought with the help of his savings.

Greater capital production and investment follow larger levels of savings, and this is what drives economic growth. Thus, the processes that result in capital formation are the generation, mobilization, and conversion of savings into capital assets.

1.4 COMPONENTS OF FINANCIAL SYSTEM

The four major components of Indian Financial system are as follows:

1. Financial Institutions
2. Financial Markets
3. Financial Services
4. Financial Instruments/ Assets/Securities



1.5 FINANCIAL MARKETS

The institutional hubs or arrangements known as financial markets provide the means to buy and sell various financial instruments and assets, including cash, checks, bank deposits, bills, bonds, financial claims, and services. Financial goods are traded by companies, financial institutions, people, and the government through various financial markets and institutions, either directly or through stock exchange brokers and dealers.

Participants in the financial markets include lenders, savers, borrowers, brokers, dealers, agents, and financial institutions, among others. There are two types of financial markets one is negotiated credit markets and other is open markets. The negotiated loan market is one in which lenders and borrowers get together in person to talk over the specifics of the loan arrangement.

CLASSIFICATION OF FINANCIAL MARKETS

Financial markets are classified into two parts.

1. Money Market
2. Capital Market

1.5.1 MONEY MARKET

The money market is the main segment of the organized sector of the financial system. It makes reference to the market where money is borrowed and lent on a temporary basis. The money market is where short-term money is exchanged. It serves as a centre for the purchase and sale of transient financial assets. The money market satisfies borrowers' immediate financial demands while providing lenders with access to cash or liquidity. Loans with periods less than a year are available on this market.

It is associated with the market where money is lent and borrowed on a temporary basis. The money market is the central location for dealing primarily in short-term financial assets; it provides lenders with access to cash and liquidity while meeting the short-term needs of borrowers. It is the market, where borrowers bid on short-term excess investable assets available to financial and other organizations and individuals, jeopardizing those entities as well as the government itself. Therefore, the money market is sometimes referred to as a short-term fund reservoir. Relatively liquid assets, or those that can be easily turned into cash, are referred to as short-term funds. A money market transaction may last for one day, fifteen days, a month, or longer, but never more than 365 days.

The following is a discussion of the money market's significance:

1. Economic Development:

By lending money to trade, commerce, and industry, the money market contributes significantly to a nation's economic development. It offers the nation's public and private entities short-term financing.

2. Profitable Investment:

Commercial banks can invest their excess reserves in near-money assets with the assistance of the money market. To earn a profit, the commercial banks put their extra reserves into profitable ventures.

3. Government Borrowing:

The money market also enables the government to get low-interest short-term loans.

4. Importance for Central Bank:

The money market aids in the central bank's effective monetary policy implementation. The central bank can only regulate the banking sector and hence support the growth of trade and commerce through the money market

5. Fund Mobilization:

The money market is crucial to the movement of funds between different sectors. Any economy's ability to grow depends on the availability of funding. Without the effective mobilization of financial resources, the nation's trade, commerce, and industry cannot grow.

1.5.2 CAPITAL MARKET

The foundational element for a nation's industrial and commercial development is an organized capital market. Two forms of credit are necessary for a nation's economic system to function: short-term and long-term credit. The money market provides the short-term credit. However, the capital market provides for the long-term capital requirements. A nation's capital market serves as a fundamental mechanism for directing and coordinating the free and equitable flow of financial resources into its economy. Put differently, a capital market serves as a means for lenders to find long-term markets for their surplus and for borrowers to ensure long-term needs are met.

The Objectives and Importance of Capital Markets

The part capital markets play in a country's economic development process can be summed up as follows.

1. Savings Mobilization:

To mobilize people's savings, the capital market is essential. The capital market distributes savings into lucrative ventures to promote company expansion trade, and industry. Therefore, capital market supports a nation's economic growth and capital production processes.

2. Prices for Securities Remain Consistent

In a sophisticated and well-run capital market, professionals in banking and non-banking financial intermediaries put in a lot of effort to maintain price stability for stocks, shares, and other assets.

3. Encourage Economic Growth:

The capital market has a direct role in the development and advancement of the nation's economy. The various capital market bodies provide qualitative and quantitative guidance on resource allocation that fosters the expansion of the country's commercial, industrial, and trade sectors.

4. Promotes Capital Formation:

The capital market promotes the capital formation of the country. Savings are the foundation of any country's economic expansion. Poverty is the main problem in emerging countries like India because it prevents people from saving, investing, and growing their economies.

5. Financial Resource Mobilization:

A sizable percentage of Indian households practice frugal spending. The capital market incentivizes individuals to allocate their savings towards debentures, shares, and other assets, hence boosting output and growth rates.

6. Working Capital Supply:

The capital market offers the working capital required for India's economy to grow industrially and commercially. Modern industrial progress requires sophisticated technology, which cannot get off the ground without sufficient funding

7. Increase in Income:

The capital market's structures and tools guarantee savers a simple and safe income. The chance to increase income motivates savers to increase their savings and allocate these funds to the capital market.

8. Securing Foreign cash:

Obtaining the foreign cash and expertise needed to close the gap in the resources needed for faster economic growth is another crucial role of the capital market.

• RELATIONSHIP BETWEEN CAPITAL MARKET AND MONEY MARKET

The following factors make money and capital markets closely related concepts.

1. Interrelated Interest Rates:

Because the short-term interest rate might occasionally influence the long-term interest rate and vice versa, the long-term and short-term markets are related. An increase in short-term interest rates, indicative of tight credit conditions, is expected to be followed by an increase in long-term interest rates.

2. Common Institutions:

A few organizations, including commercial banks, cater to both the capital and money markets. Long-term bonds and securities are also bought and sold by dealers in the short-term market.

3. Similar Users:

Fund users can obtain funds from any kind of market. If a company wants to raise money for more inventory, it can negotiate a bank loan through the money market or borrow short-term loans. It can also sell shares in the capital market or float a bond issuance to raise working capital.

4. Common Investors:

Depending on their investing philosophies and the available rate of return, fund suppliers/investors may decide to provide funds to one market or both markets. As such, there is a close relationship between capital markets and money.

- **DIFFERENCE BETWEEN CAPITAL MARKET AND MONEY MARKET**

The difference between both the capital and money market is as follows.

Basis	Money Market	Capital Market
Time Span	Money market renders money and capital for short term investment	Capital Market renders capital and money for long term investment.
Nature of Capital	The funds provided by the money market can be used for working capital requirements only.	The funds provided by capital market can be used for working as well as fixed capital requirements.
Components	Call money market, bill market	Stock exchange is the main component of capital market. Stock exchange deals in both shares and debentures.
Middleman	Money market act as a link between the depositor and the borrower.	Capital market act as a link between the investor and the entrepreneur.
Main activity	The main activity of money market is sale and purchase of bills.	The main activity of capital market is underwriting of share

Check Your Progress-A

Multiple Choice Questions.

1. What is the primary role of the money market in a country's economic development?

A. Providing long- term financing for industries.
B. Facilitating short -term borrowing and lending
C. Regulating the activities of financial institutions.
D. Mobilizing funds between different economic sectors**.**

2. Which of the following is NOT mentioned as a key function of the capital market?

A. Directing the flow of financial resources into the economy.
B. Enabling the central bank to implement monetary policy
C. Providing long-term financing for commercial and industrial development
D. Serving as a platform for lenders to find long-term markets for their surplus

3. What is the primary difference between the money market and the capital market?
   A. The money market deals with short-term financial instruments, while the capital market deals with long-term instruments.
   B. The money market is regulated by the central bank, while the capital market is not.
   C. The money market is used for borrowing by the government, while the capital market is used for borrowing by private entities.
   D. The money market is used for lending, while the capital market is used for investment.

4. Which of the following is described as a participant in the financial market

   A. Lenders
   B. Borrowers
   C. Savers
   D. All of the above

1.6 FINANCIAL INSTITUTIONS

The components of Indian Financial Institution are discussed below:

1. Financial Institutions

Financial Institutions play the role of intermediary between the borrower and the lender. It helps in the smooth functioning of the financial market by helping the lenders and buyers meet. Financial Institutions mobilize the savings of the surplus units in some productive activity and promise to pay a better return to the investor who is investing his surplus funds. The core of the Indian economy is its financial sector, which offers a wide range of services like credit provision, investment facilitation, and savings mobilization. These organizations can be roughly divided into two categories: non-banking financial institutions (NBFIs) and banking institutions.

Types of financial Institutions

Financial institutions can be classified into two categories

1. Banking Institutions
2. Non- Banking Institutions

A banking company is defined by the Banking Regulation Act 1949 as an organization that conducts banking business in India. Banking is defined as receiving deposits from the general public for the purpose of lending or investing, but with the option to withdraw funds by cheque, draft, order, or other means, and the guarantee of repayment upon the depositor's demand. Central Bank of India (RBI) controls and regulates the Indian banking system.

1.6.1.1 ORGANIZED SECTOR

1. Commercial Banks

Commercial banks are the most popular banks in India. These banks are engaged in the banking business to earn profit. In India, commercial banks carry out a number of crucial tasks that support economic growth and stability. Primary and secondary functions are the major categories into which these functions can be divided.

Primary functions:

These are the main duties performed by commercial banks, and they center on loan provision and deposit acceptance

A. Taking Deposits:

Taking deposits from the general public is one of a commercial bank's primary responsibilities. To accommodate the diverse needs of their clientele, banks provide a range of deposit account options.

Some of the options are as below:

1. **Savings deposit-** Savings deposit is a kind of deposit in which the depositor can withdraw his money any time, there is no such fixed period decided in advance. It offers interest to the depositor on his deposits.
2. **Current deposit-** Current deposit is a kind of deposit which does not offer interest and these are mainly for the businessmen. It offers unlimited transactions.
3. **Fixed deposit-** Under this the depositor earns a higher rate of interest but cannot withdraw money before the maturity date. The amount is fixed for a time period.
4. **Recurring deposit** – Under this the depositor can save a fix amount of money over a period of time and can earn interest on accumulated income.

B. Offering Loans and Advances:

Banks lend money to governments, corporations, and private citizens. Among the principal categories of loans are:

1. **Personal loans**: These are loans made to specific people, including mortgages, student loans, and auto loans.
2. **Business loans:** To help companies grow, buy assets, or handle operating capital.
3. **Cash Credit**: A loan that is backed by a business's current assets, including its inventory.
4. **Overdraft Facility:** This type of facility allows users to withdraw up to a certain amount of money beyond what is available in their account.
5. **Discounting Bills of Exchange:** By offering cash through the discounting of trade bills, banks help businesses maintain a steady cash flow.

2. Cooperative Bank

A financial organization that operates on a cooperative concept is known as a cooperative bank in India. This suggests that the bank is owned and operated by its members, who also act as shareholders. Established under the Cooperative Societies Act, these banks are jointly regulated by the State Governments and the Reserve Bank of India (RBI). Cooperative banks are locally organized and intended to serve the financial needs of small businesses, independent contractors, small industries, and rural communities. Their main objectives are to promote financial inclusion and offer banking services at fair prices.

1. Lend Money

In India, the main purpose of cooperative banks is to lend money and offer credit services to their members, who are small business owners, farmers, artisans, and traders. They support rural development by offering loans for both agricultural and non-agricultural purposes.

2. Mobilization of Deposits:

These banks welcome deposits from members and the general public alike, including savings accounts, fixed deposits, and recurring deposits, by providing a safe haven for clients to save their money.

3. Agricultural and Rural Development:

A significant amount of cooperative banking's attention is directed toward the agricultural sector. They provide medium- and short-term loans for purchases of agricultural equipment, seeds, and fertilizer.

3. REGIONAL RURAL BANKS

Established in India, Regional Rural Banks (RRBs) are financial institutions whose main goal is to serve the rural population, especially small farmers, agricultural laborers, craftsmen, and small business owners, by offering credit and other banking services. In order to ensure that banking services are available to the unbanked sectors of the population, RRBs were established to fill the gap that exists between commercial banks and cooperative banks in rural areas.

The Regional Rural Banks Act of 1976 served as the impetus for the establishment of RRBs, which are currently owned by the Indian government, state governments, and sponsor banks, which are often big commercial banks.

The shareholding is typically divided as:

- **50%** by the Government of India,

- **15%** by the respective State Government, and
- **35%** by the Sponsor Bank.

1. **Giving Credit to Rural Populations:** In order to enhance rural livelihoods, RRBs provide credit facilities to agricultural laborers, small-scale enterprises, craftsmen, and marginal farmers. They offer medium- and short-term loans for fisheries, farming, aquaculture, and related industries.
2. **Encouraging Financial Inclusion:** Rural banking cooperatives (RRBs) are essential in providing banking services to underserved rural communities in the absence of commercial banks. They guarantee that remittance services, insurance, savings accounts, and loans are available to rural people.
3. **Support for the Agricultural Sector:** RRBs give farmers money for a range of agricultural expenses, such as buying machinery, seeds, fertilizer, and irrigation supplies. They also provide funding for marketing agricultural products and post-harvest operations.

4. **FOREIGN BANKS**

Foreign banks in India are financial institutions that are headquartered in a foreign country but operate branches or subsidiaries within India. These banks are incorporated and regulated by their home countries' banking authorities, but their operations in India are regulated by the **Reserve Bank of India (RBI)** under the Banking Regulation Act, 1949.

Foreign banks in India bring international expertise, advanced technology, and innovative financial products to the Indian market. They typically cater to multinational corporations, large Indian companies, and high-net-worth individuals. However, they also offer retail banking services to a lesser extent.

1.6.1.2 UNORGANISED SECTOR

Financial institutions or businesses that function outside of the official, regulated banking system are referred to as unorganized banks in the Indian financial system. The Reserve Bank of India (RBI) and other regulatory organizations do not have strict controls or oversight over these entities. Even though they are not formally regulated, they frequently have a big part in the provision of financial services, especially in rural and semi-urban areas. An overview of the unorganized banking sector in India is provided below:

Traditional Role of Moneylenders:

In the past, moneylenders have dominated the rural loan markets. They give people and companies fast, informal credit, frequently without requiring collateral.
Benefits: They provide flexibility with regard to loan amounts and payback periods.
Problems: They frequently impose astronomical interest rates, which result in debt traps.
Borrowers have little options for redress in the event of a disagreement because of their uncontrolled operations.

Chit Funds Structure:

A group of people contribute a set amount each month to a chit fund, which is a sort of savings and credit plan. On a rotating basis, one member is permitted to withdraw the lump sum.

Regulation: The Chit Funds Act of 1982 allows for the registration of chit funds, while the majority of chit funds are unregistered and run informally.

Risks: Unregulated chit funds have a history of fraud, with organizers taking off with the money they have raised.

Bankers of Indian descent (Shroffs, Seths, Chettis)
Function: These are conventional, frequently family-owned companies that finance trade, take deposits, and offer lending services. Typically, they serve certain areas or populations.
Regulation: Without the protection of banking laws, the majority of native bankers conduct their business outside of the established financial system.
Problems: Despite offering practical services, they are unregulated and operate opaquely, which puts depositors and borrowers at danger

1.6.2 NON- BANKING FINANCIAL INSTITUTIONS

Financial organizations that offer services akin to those of typical banks but lack a complete banking license are known as non-banking financial institutions, or NBFIs. In contrast to banks, NBFIs are unable to take conventional demand deposits, such as checking accounts, but they do offer lending, asset management, insurance, and investment services. They are vital to the economy because they provide credit, risk management, and investment opportunities, frequently to markets that traditional banks do not cover.

Insurance Companies: Insurance companies that offer investment products and financial protection, such as annuities, health insurance, and life insurance.
Asset management firms and mutual funds: They combine investor capital to buy stocks, bonds, and other securities.

Leasing and Financing Companies: Provide lease financing for equipment and cars. Invest in a variety of financial assets and businesses, frequently in high-risk, high-return markets, through hedge funds and private equity firms.

Pension Funds: Oversee and invest people's retirement funds, usually over an extended period of time.

Microfinance Institutions (MFIs): Especially in developing nations, MFIs offer small loans and other financial services to marginalized groups.

Venture Capital: Startups and small enterprises can receive funding from venture capital and investment firms, which also take equity interests to support business expansion.

- **Reserve Bank of India**

As the nation's top bank, RBI oversees and controls the nation's financial and monetary systems. It was founded on the "Hilton-Young Commission's" advice. The Reserve Bank of India Act of 1934 established it as a banker to the central government. It started operating as a private shareholders bank in April 1935 with a paid-up capital of Rs. 5 crores. The RBI was nationalized in 1949.

Functions of RBI

RBI has various functions, some of the functions of RBI are as follows.

1. Note issuing authority:

In India RBI has the sole power and right to issue currency notes other than coins and one rupee note and coin. RBI ensures that in a country adequate amount of rupee notes and coins are available. All across the nation, the currency notes issued by the RBI are accepted as legal cash. The maximum denomination of currency notes the RBI can print is Rs. 10,000. Notes currently available in denominations of Rs. 2 and Rs. 5. There are notes for Rs 10, Rs 20, Rs 50, Rs 100, Rs 200, Rs 500. Coins in circulation also come in denominations of Rs. 1, Rs. 2, Rs. 5, and Rs. 10.

2. Banker to the banks

Every bank in the nation has an account with the RBI, which they use to settle client and interbank transactions. It also permits banks to operate as lenders of last resort and uphold statutory reserve requirements such as SLR. Additionally, it gives banks advances and short-term loans as needed.

3. Debt manager and governments' banker:

RBI acts as a banker for the federal government as well as the state governments that have collaborated with it. It maintains the government accounts and makes financial transactions from them in addition to transmitting government funds. In order to cover gaps in income, it raises money from the financial and public markets and supervises the management of the government's domestic debt.

4. The banking industry's regulator

In accordance with the provisions of the RBI Act and the Banking Regulation Act, the RBI regulates and supervises the nation's banking sector. In addition to licensing, capital adequacy requirements, paid-up capital, and lending to important economic sectors including women and farmers, the RBI oversees a broad range of industries. A number of regulatory criteria are set, banks and bank branches are inspected, interest rates are regulated, and new regulations are also introduced in response to changing circumstances.

5. Foreign Exchange Manager

As you have probably read, trade is essential to every economy. Maintaining enough foreign exchange reserves is an essential precondition for conducting business. The RBI oversees and plays a major role in the development of the foreign exchange market. By controlling import and export transactions, it ensures smooth operation in the local foreign exchange market. It is in charge of overseeing the country's gold holdings as well as its foreign exchange reserves. The banks and specific businesses that need to apply for an RBI license in order to transact in foreign exchange

6. The Development Role

The RBI works to guarantee that credit is available to the economically productive sectors of the economy while also fostering financial literacy and education among the general people. For the goal of development numerous organizations have been founded by RBI, including the Unit Trust of India (UTI), Deposit Insurance and Credit Guarantee Corporation, Industrial Development Bank of India (IDBI), and the National Bank for Reconstruction and Rural Development (NABARD).

7. Superintendent of Monetary Policy

The country's financial market is governed by the Reserve Bank of India's monetary policy, which is mostly utilized for credit regulation. One of the main roles of the bank is to create credit. Before continuing, let's clarify what credit creation is. When a bank receives a deposit from a customer, it must save a certain amount of the deposit for the depositor's needs and lend the remaining amount to the buyer. Thus, the process through which a bank makes money from money is known as credit creation. The process of creating credit is how money enters the system. Nonetheless, the economy suffers from both an excess and a lack of money circulation. Inflation is a problem that arises when the supply of money exceeds demand. On the other hand, deflation arises when the money supply falls short of the demand. Thus, the RBI manages credit through monetary policy.

The RBI uses two types of methods for credit control:

1) Quantitative and 2) Qualitative.

QUANTITATIVE TECHNIQUES

These techniques are used to regulate the overall amount or volume as well as the cost of the credit that banks create. They include both direct and indirect tools, such as the Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and Refinance Facilities are direct tools. Bank rates, repo and reverse repo rates, Liquidity Adjustment Facility (LAF), Open Market Operations, Market Stabilization Scheme (MSS), and Marginal Standing Facility (MSF) are indirect tools.

1. **Cash Reserve Ratio (CRR)**

   As a percentage of their Net Demand and Time Liabilities (NDTL), it is the bare minimum that banks maintain with the RBI. The RBI periodically updates the CRR %. CRR makes sure banks have enough cash on hand to meet depositor demands.

2. **Statutory Liquidity Ratio (SLR)**

The percentage of net domestic total liquidity (NDTL) that banks are required to hold in secure, liquid assets like cash, gold, or government securities is known as the Statutory Liquidity Ratio (SLR). SLR limits bank lending growth, boosts bank involvement in the securities markets, particularly for government securities, and protects bank solvency.

3. **Repo Rate**

It is the rate at which the RBI lends to banks overnight through the Liquidity Adjustment Facility (LAF) arrangement, using government and other authorized securities as collateral. To put it simply, it's the set interest rate that banks borrow short-term money from the RBI at. The Monetary Policy Committee (MPC) currently determines both the reverse repo rate and this policy rate.

4. **Liquidity Adjustment Facility:**

The Narasimham Committee on Banking Sector Reform of 1998 recommended the introduction of this facility, which the RBI did. It is a system for controlling the bank's need for liquidity. When there is excess or deficit of liquidity in the system, its goal is to absorb or inject it. The components of LAF are the repo, reverse repo, term repo (auction), overnight variable rate repo (auction), and overnight variable rate reverse repo (auction).

5. **Open Market Operations**

It alludes to the RBI's purchases and sales of government assets in the money market. The money supply may increase or decrease as a result of the buying and selling of these securities. For instance, the RBI sells these assets and banks purchase them during periods of inflation. Bank credit from the general public is diverted to the RBI when banks purchase these assets, which reduces the amount of money available in the market and the production of new credit.

6. **The Market Stabilization Program**

The RBI initiated this plan in 2004 with the goal of selling government bonds to remove excess liquidity from the market. The RBI's acquisition of foreign currency was the cause of the excess liquidity issue. Market Stabilization Bonds (MSBs) are bonds that are owned by the Government of India that are sold by the RBI.

7. Facility for Marginal Standing

It's a resource that banks can employ in an emergency. With the help of this facility, scheduled commercial banks can borrow from the RBI for a short period of time (overnight) of up to 1% of their NDTL at a rate 100 basis points (1%) higher than the repo rate. It offers banks a safety net against unforeseen liquidity shocks.

QUALITATIVE TECHNIQUE OF MONETARY POLICY

These techniques exclusively address specific industries. The RBI can reroute the flow of credit from one sector to another by employing these techniques. The Reserve Bank of India employs many qualitative strategies, such as credit rationing, consumer credit regulation, raising margin requirements, moral persuasion, direct action, and more. Only a few of them will be covered in this section.

1. Rationing of credit

Using this approach, the RBI manages and regulates the reasons banks give credit. The quantity of loans that can be given to banks can have a cap set by the central bank.

2. Consumer Credit Regulation

This strategy helps in curbing excess spending by the customers. RBI can require banks to impose a minimum percentage of down payment, installment amount, loan period, etc.

3. Margin Requirement

The difference between the maximum amount of loan that can be disbursed against a security and its market value when it comes to taking out a loan is known as the margin requirement. For instance, Mr.X let's say want to take out a loan and the margin requirement is 10%. Mr X went to bank with collateral security of worth Rs. 10,000. So, bank will lend him only 9,000 and will deduct 1,000 as the marginal requirement. At the time of deflation RBI reduces this rate as so that banks will lend more money to customers and customers can spend that money and the situation of deflation can be cured. At the time of inflation RBI increases the marginal requirement rate so the banks will lend less money to the customer and customer is left with less income to spend so that the situation of inflation can be cured.

4. Moral Suasion

Depending on the financial state of the economy, RBI asks or pressures commercial banks to act in a certain way. For instance, the RBI asks commercial banks to limit bank credit during periods of inflation. There is no RBI mandate; it's more of a suggestion. The RBI and commercial banks must coordinate for this policy to be effective.

5. Direct Action

It speaks about the guidelines and regulations that the RBI imposes on specific banks or on all banks in the event of default or disregard for its advice. The RBI has the authority to deny banks' requests for grants or rediscounting opportunities, or it may charge penal interest rates on loans that banks take out above the allowed maximum.

1.7 FINANCIAL SERVICES

The economic services provided through the finance sector are referred to as financial services. Any activities, advantages, and satisfactions associated with the sale of money that offer buyers and consumers financial related value can be summed up as financial services. Credit unions, banks, credit card companies, insurance companies, accounting firms, consumer financing companies, stock brokerages, and investment funds are among the businesses that offer financial services.

Financial services can be classified into two parts.

1. Fund based services
2. Fee based services

1.7.1 FEE BASED SERVICES

1. Project Counselling

Financial services related to project counselling are highly profitable and significant. The majority of merchant bankers offer it. This service handles all of these project-related, planning, implementation, and control-related issues. The following is a list of services that can be provided under this function.

(a) Project Identification:

This pertains to advice regarding the feasibility of a project. It could be for expanding or improving already-existing facilities, or for establishing new ones.

(b) Project Report Preparation:

Merchant bankers occasionally work on project reports or market research as well.

(c) Getting Government Approvals:

Merchant bankers assist in getting government approval for project formation.

(d) Capital Structure:

A good capital structure is also suggested by merchant banks.

(e) Sound Technoeconomic Practices

Project's techno-economic viability and marketing elements.

(f) Financial Structure:

It also aids in choosing the ideal combination of finance patterns, particularly for needs that are temporary.

2. Credit Syndication:

Another name for credit syndication is loan syndication. The service that financial organizations provide for organizing and handling loans in rupees and foreign currencies from banks, lending businesses, and other financial institutions both domestically and internationally is known as credit syndication.

A merchant bank provides a variety of credit syndication services to banks and institutions, including:

(a) Preparing financial aid applications to be presented to financial
(b) Negotiating the duration of support on the client's behalf.
(c) Serving as a specialized liaison agency and keeping an eye on the funding sanction.
(d) Determining and allocating the necessary operating capital.
(e) Estimating the projects' overall expenditures and costs.

3. Issue Management:

Managing public issuance of business securities, such as equity shares, preference shares, debentures, or bonds, is another crucial duty of the merchant bank. It entails marketing capital issues for already-existing businesses, such as rights issues and share dilution through letters of offer.

(i) One of the services offered by merchant bankers is prospectus preparation.
(ii) Creating a plan and budget to project how much money will be spent overall on the problem.
(iii) Putting up the application for the controller of capital issues and offering assistance in getting approval or the controller of capital problems.
(iv) Designating bankers, brokers, and registrars to the issue

4. Services for Capital Restructuring:

Redesigning the corporate units' option capital structure to maintain it at the lowest possible cost to the company is the major goal of a capital restructuring.

5. Corporate Counselling:

A corporate unit is not charged for this service. Corporate counselling involves advice on diversification, whether to maintain, grow, or stop a product line, and how to restructure capital.

6. One aspect of corporate counselling is:

(i) Merchant banks advise company units on areas of diversification after taking into account the current economic and licensing policies of the government.

(ii) Following a thorough market research, to assess each product line's profitability, growth, and demand both now and in the future, merchant banks provide advice on whether to maintain, grow, or abandon it.

(iii) Merchant banks also thoroughly examine ill units and old-line projects by evaluating their needs, researching their manufacturing methods, and examining their technology in terms of its obsolescence.

7. Portfolio Management:

When making investment decisions, merchant bankers counsel their clients on the kind and quantity of securities to purchase. Investing capital into marketable securities with the goal of making money later is known as portfolio management. It has to do with choosing the right financial instruments according to the investor's estimated risk and return. In addition, merchant bankers occasionally handle the buying and selling of securities on behalf of their clients in order to offer portfolio management services. These services are becoming more and more well-liked in India among both domestic and global investors.

1.7.2 FUND BASED SERVICES

1.**Bill Discounting:**

Another significant duty that financial organizations in various nations are acknowledged to perform is bill discounting. However, corporate units in India do not have access to this option through merchant banks

2. Venture Finance

A particular type of equity financing known as venture capital is used for initiatives that are highly technical and risky with the expectation of large returns in the future. The organized investment of relatively nascent businesses with the goal of generating significant capital profits is known as venture capital.

3. Bought Out Deals:

This strategy is used when a promoter approaches merchant bankers and places the company's initial shares with them, which are then offered to the public, in the event that he believes that a public issue intended to raise capital will not be completely subscribed.

4. Factoring:

This is a recent advancement in financing. With both financial and non-financial components, it is a hybrid service. On the one hand, it deals with the administration and acquisition of book debts that come up throughout the credit sale procedure. However, finance plays a part as well. The merchant bank is able to accept this assignment of book debt collection and offer an advance against factored debts with a specified margin.

5. Underwriting:

This is the term for a contract wherein a merchant banker guarantees the issuing firm that it will subscribe to the securities offered in the event that the public to whom it was offered chooses not to subscribe. Undersubscription results in the merchant banker's responsibility. Underwriting commission is charged by merchant bankers and varies depending on the securities being underwritten. Underwriting commission rates are negotiable.

6. Additional Specialized Services:

Merchant banks also offer corporate advising services on a range of topics, including executive hiring, tax planning, mergers and acquisitions, cost and management audits, and more.

1.8 FINANCIAL INSTRUMENTS

A legal contract that represents a right or claim over an asset, a loan, or a future financial payment is referred to as a financial instrument. The financial system uses these tools to make lending, investing, borrowing, and risk management easier. The financial system in India is well-developed and made up of different instruments that can be used for raising funds, transferring risk, or making investments and savings easier. The main financial tools in the Indian financial system are as follows:

1. Equity instruments
2. Debentures
3. Derivatives
4. Hybrid instruments
5. Money market instruments
6. Foreign market instruments

Instruments of the Capital Market

Equity Instruments:

Ownership in a business is represented by equity shares. In addition to receiving dividends or capital gains, investors buy shares to acquire equity ownership.

Preference Shares:

Give investors a fixed dividend and give them precedence over equity shares when it comes to dividend payments and liquidation.

Debentures and bonds

These are long-term debt instruments that governments and businesses issue to raise money. Compared to equity holders, holders of debentures have a greater claim on assets and get fixed interest payments.

Government Securities

Bonds issued by the Indian government to raise money are known as government securities, or G-Secs. These come in a range of tenures and are regarded as low-risk investments.

Derivative Instruments

Forward Instruments

Customized agreements between two parties to purchase or sell an asset at a given price at a later time are known as derivative instruments forwards. Typically, these are exchanged over-the-counter (OTC).

Futures:

Standardized agreements that are exchanged on exchanges to purchase or sell an item at a fixed price at a given future date.

Options:

These are agreements that grant the holder the right, but not the responsibility, to purchase (call) or sell (put) an asset within a given time frame and at a predetermined price.

Swaps:

These are derivative arrangements that allow two parties to hedge interest rate or currency risks by exchanging cash flows or other financial instruments.

Check Your Progress-B

State True or False

1. The Indian financial system is only for businesses and does not help individuals.
2. The Reserve Bank of India is responsible for issuing currency and monitoring banks.
3. Public sector banks in India are owned by private companies.
4. The financial market allows people to buy and sell stocks and bonds.
5. Non-banking financial companies (NBFCs) have a full banking license.

1.9 SUMMARY

Similar to a network, the Indian financial system aids in the management of finances for both individuals and companies. It consists of institutions, financial markets, banks, and tools that facilitate the movement of money. The efficient operation of the economy depends on this system. The banking industry is the key component of the Indian financial system. Banks are places where you can make deposits, apply for loans, and receive financial guidance. There are foreign banks, commercial banks, and public banks in India. Government-owned public sector banks are well-liked for savings accounts. Private businesses operate private sector banks, which provide a range of services

The Reserve Bank of India (RBI), which serves as a watchdog, is another. It issues currency, regulates the money supply, and monitors banks to make sure they are operating correctly. The nation's financial stability is preserved in part by the RBI.

The financial market, where people purchase and sell financial goods like stocks and bonds, is another significant factor. Shares of businesses are traded on the stock market. It enables people to invest and helps companies raise capital.

This system also includes non-banking financial companies (NBFCs). Despite not having a complete banking license, they offer services including loans and investments. They provide for a range of people's financial needs.

1.10 GLOSSARY

Capital Market: It is a market which renders capital and money for long term investment.

Cash Reserve Ratio (CRR): As a percentage of their Net Demand and Time Liabilities (NDTL), it is the bare minimum that banks maintain with the RBI.

Debentures and bonds: These are long-term debt instruments that governments and businesses issue to raise money.

Money Market: It is a market which renders capital and money for short term duration.

Portfolio Management: Investing capital into marketable securities with the goal of making money later is known as portfolio management

Venture Finance: A particular type of equity financing used for initiatives that are highly technical and risky with the expectation of large returns in the future.

1.11 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Q1. Match the following

1. B
2. B
3. A
4. D

Check Your Progress – B

1. False
2. True
3. False
4. True
5. False

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1.14 TERMINAL QUESTIONS

1. What is the difference between capital market and money market?
2. Write a short note on RBI.
3. What are the various financial instruments used in Indian Financial System?
4. What are the various components of Indian Financial System?
5. What are Debentures?

UNIT 2 MONEY MARKET

2.1 INTRODUCTION

Debt market comprises of money market and capital market. The money market is made up of products with short maturities, usually lasting a year or less. The capital market is made up of securities with maturities longer than a year. The purpose, nature, and extent of the money market will all be covered in this unit. The money market is where short-term money is traded. A period of 364 days or fewer is what we consider to be the short term. Stated differently, the duration of the loan and its repayment is no more than 364 days. The manufacturers require two different kinds of financing capital financing for things like buying machinery and installing pollution control systems, and daily financing for things like buying raw materials, paying labour, paying excise taxes, and using power. For a brief duration, the first type of financing is invested in the production process.

2.2 OBJECTIVES

After studying this unit, you will be able to understand;

- Understand the concept and significance of Money Market.
- Identify different instruments of Indian Money Market.
- Comprehend the functioning of Money Market
- Challenges faced by the Indian Money Market.

2.3 MEANING OF MONEY MARKET

The term money market refers to the market where this type of short-term financing is borrowed and lent. Liquidity management is a persistent issue for almost all financial system entities, including financial institutions, corporations, businesses, and government agencies. This is mostly due to the fact that receipts and expenditures rarely coincide.

To put it simply, the money market provides a means of short-term lending and borrowing. Although the money market facilitates the transfer of large amounts of capital between banks, it also gives banks, corporations, and other institutions that require short-term funding a way to use the excess funds of cash-rich corporations and other institutions—albeit at a cost.

The money market plays a crucial role in the financial system by giving lenders' excess funds and borrowers' needs for short-term loans—from overnight to a year—a way to balance each other out. Governments can implement monetary policy through open market operations, finance government deficits without creating inflation, and fix interest rates using the money market as a reference point

2.4 MONEY MARKET FUNCTIONS

The term "money market" refers to both the market for actual money and its close substitutes. Put another way, look for assets that can be quickly converted into money. It is also comparable to a market for short-term funds, or those with maturities of less than a year. There are three main roles that the money market is typically expected to fulfil.

1) A method for equilibrating the supply and demand of short-term money should be included.

2) It needs to offer a central bank focal point wherein the bank can intervene to affect the economy's overall level of interest rates and liquidity.

3) It must allow both short-term fund suppliers and users to have reasonable access.

One of the important segments of financial market is money market. Money market helps in circulation of funds from the people who have excess funds (lenders) to people who are in need of funds (borrowers) for a short period of time generally from overnight to one year. So, money market is a short-term market.

2.5 EVOLUTION OF MONEY MARKET

In 1985, the Reserve Bank of India established a committee headed by Shri Sukhamoy Chakravarty to review the functioning of the monetary system in light of the need for reforms in the country's financial system. Although this committee provided a thorough suggestion for the financial system's reforms, it also noted that money markets are a unique segment that require in-depth analysis and suggested the formation of a special research group to look into this issue. As a result, The Working Group on Money Market was established by the RBI, led by Shri. N. Vaghul, and submitted a report in 1987.

Based on the recommendations, the RBI made a number of efforts in the 1980s to develop and broaden the money market. The main initiatives were

1. The Discount and Finance House of India (DFHI) was founded in 1988 as a money market institution by the Reserve Bank of India, public sector banks, and financial institutions with the intention of supplying liquidity to money market instruments and encouraging the development of a secondary market in such instruments.

2. To increase the variety of money market products available, Commercial Paper, Certificates of Deposit, and Interbank Participation Certificates were introduced in 1988–1989. There is a wide range of instruments available these days.

3. The interest rate ceiling on call money was gradually removed starting in October 1988 to allow for price discovery. In May 1989, the interest rate ceiling was completely removed for all operators in the call/notice money market and on interbank term money, allowing for the risk-free rediscounting of commercial bills and Interbank Participation Certificates. This was the first step toward releasing DFHI's operations in the call/notice money market from the interest rate ceiling. At the moment, the market determines the majority of money market interest rates.

Institutions like to the DFHI were subsequently permitted to establish and be designated as several Primary Dealers (PDs). There are currently roughly 16 PDs in India, including in the public and private sectors. These PDs have a crucial function as market makers in the money market. They take an active part in the Treasury Bill and Government Bond auctions. As a result, they purchase retail government debt and stocks (primary securities).

2.6 FEATURES OF MONEY MARKET

1. **The state of liquidity** - Money market securities have a low value loss when easily converted to cash. They therefore possess a very high liquidity.

2. **Short term maturity** - The short- term maturity of money market instruments typically ranges from one night to one year.
3. **Minimal risk** - Money market instruments are less risky than long-term assets because of their short tenure and issuers' creditworthiness.
4. **Fixed return rate** - Money market instruments typically offer a fixed rate of return.
5. **Excessive Replication**- Because money market instruments are frequently issued in big denominations, institutional investors are better suited to use them.
6. **Commercial viability-** Money market instruments have increased liquidity since they are actively traded on secondary markets.

MONEY MARKET STRUCTURE

The organized and unorganized sectors make up the two main divisions of the Indian money market. The two divisions of money market are:

(i) Organised Sector

Governments, the RBI, other commercial banks, rural banks, and even foreign banks are all part of the organized sector. This industry is managed and organized by the RBI. Not directly, but indirectly, are other corporations such as the LIC, UTI, and others involved in this industry. Through banks, other sizable corporations and businesses take part in this market.

(ii) Unorganized Sector:

This includes local money lenders, hundis, and indigenous banks. They belong to the unorganized sector since the RBI or any other organization has no authority over their operations.

2.7 INSTRUMENTS OF MONEY MARKET

In case the institutions have surplus funds for temporary period, they want to invest it somewhere where there is low risk. So, there are various types of instruments in the market. These instruments are called money market instruments.

2.7.1 Call Money

One form of financial market that deals with short-term funding is the call money market, which is one of its instruments. Short-term funds are borrowed and lent in the call money market, typically for a single day. Here are a few key elements of the money market.

1. **Participants:**

Due to their need to meet reserve requirements and maintain liquidity, commercial banks are the key players in the call money market. Other than commercial banks, other financial institutions such as mutual funds and insurance firms also participate in the call money market.

2. **Goal:**

The call money market's primary goal is to give banks a way to manage their liquidity. Banks with excess funds can lend to other banks when they are short on funds or experiencing a deficit.

3. **Interest Rates:**

The term call rate describes the interest rate that is offered in the call money market. It varies according to the availability and demand of money. Policymakers and other participants in the financial markets keep a close eye on the call rate since it is a crucial indicator of the liquidity condition in the banking system.

4. **Regulation:**

To maintain stability and maintain control over monetary policy, central banks frequently regulate the call money market. They have the capacity to act by changing the money' availability to affect the call rate.

5. **Instruments:**

Call money market transactions are often unsecured, which means they are not supported by collateral. Because of this, it is a very liquid but relatively riskier part of the money market.

6. **Maturity:**

In the call money market, money is typically borrowed and lent for extremely brief times—often overnight. Nevertheless, the duration may occasionally be extended to 14 days. An essential part of the financial system that helps banks and other financial institutions effectively manage their liquidity demands is the call money market.

2.7.2 COMMERCIAL PAPER

Corporations issue commercial paper, which is an unsecured promissory note with a short maturity period, to raise money for operational expenses, inventories, and accounts payable. Here are some essential details regarding commercial paper:

1. **Issuer:** Commercial paper is typically issued by sizable, highly rated creditworthy enterprises. Large companies such as financial institutions may also issue commercial paper.
2. **Maturity:** Commercial paper can be as old as 270 days or just a few days. When it matures, it is often redeemed at face value, having been issued at a discount to its face value.
3. **Unsecured:** Since commercial paper is not secured by any assets, it is unsecured. Therefore, only businesses with excellent credit ratings are able to offer commercial paper on advantageous conditions.
4. **Interest Rates:** Compared to bank loans and other short-term borrowing options, commercial paper often has lower interest rates. The issuer's creditworthiness and the state of the market have an impact on the rate.
5. **Denominations**: Commercial paper is typically issued in large denominations, making it accessible primarily to institutional investors, such as money market funds, insurance companies, and large corporations.
6. **Usage**: Companies use commercial paper to meet short-term financial obligations, manage liquidity, and finance accounts receivable and inventories
7. **Secondary Market**: While commercial paper is mainly held until maturity, there is a secondary market where it can be traded. However, this market is not as active as those for other types of securities.

Advantages:

A. **Lower Cost**: Commercial paper usually offers a lower borrowing cost compared to other short-term financing options.

B. **Flexibility**: It provides flexibility in managing short-term funding needs.

Risks:

A. **Credit Risk**: Since it is unsecured, the primary risk is the issuer's credit risk. Investors must assess the issuer's creditworthiness carefully.

B. **Risk**: In times of financial stress, the market for commercial paper can become illiquid, making it difficult to issue or sell.

Overall, commercial paper is an essential tool for corporate financing, offering a cost-effective means for companies to manage their short-term financial needs while providing investors with a relatively low-risk investment option.

2.7.3 TREASURY BILLS

The government issues Treasury Bills (T-Bills), which are short-term debt securities, to meet its immediate financial needs. The following lists the main details regarding Treasury Bills.

1. **Issuer:** Treasury bills are released by the Indian government. The government issues the Treasury bills through the Reserve Bank of India.
2. **Maturity:** T-Bills have maturities of a few days to a year, which are considered short-term maturities. The duration of the Treasury bills is 91, 182, and 364 days.
3. **Denomination**: T-Bills are issued in denominations of 25,000 and multiples thereof. The minimum purchase amount is usually 25,000.
4. **Discounted issuance:** T-Bills are issued at a discount below their face value, or par value, and the investor receives the full-face value upon the bill's maturity. The interest earned is represented by the difference between the purchase price and the face value.
5. **Interest Rates**: Bills do not receive periodic interest payments, sometimes known as coupons. Instead, the difference between the face value at maturity and the discounted purchase price is used to compute interest. We call this the yield, or discount rate.
6. **Liquidity**: T-Bills are an extremely liquid investment because they are easily bought and traded in the secondary market prior to maturity. T-Bills are an extremely liquid investment. They rank among the most liquid and safest investing choices accessible.
7. **Risk**: T-Bills are issued by the government so are fully guaranteed by the faith, they are regarded as almost risk-free assets. The only risk connected with Treasury bills is inflation risk, which arises from the possibility that the return won't keep up with inflation.
8. **Uses**:
    - **Government Funding**: The government uses T- bills to address its immediate cash flow demands.
    - **Investment**: Investors use T-Bills as a safe, short-term investment vehicle.
    - **Monetary Policy**: T-Bills are one tool that central banks can use in their open market operations to control the money supply and set interest rates.

Overall, Treasury Bills are a fundamental tool for short-term government financing and a popular investment for individuals and institutions seeking a safe, liquid, and low-risk investment option.

2.7.4 REPURCHASE AGREEMENT (REPO)

A repurchase agreement (repo) is a short-term borrowing and lending instrument in which one party sells securities to another with an agreement to repurchase them at a later date at a predetermined price. The important characteristics of repo are:

1. **Participants**: The major participants of repo rate in the repo market are commercial banks, central banks, investment funds, and other financial institutions.
2. **Mechanism**:

- **Sale and Repurchase**: The seller (borrower)sells securities to the buyer (lender) and agrees to repurchase them at a future date for a higher price.
- **Collateral**: The securities sold serve as collateral for the loan. Common collateral includes government bonds, corporate bonds, and mortgage-backed securities.
- **Term**: Repos can have varying durations, from overnight (one-day) to term repos lasting several weeks or months.

3. **Interest Rate**: The difference between the sale price and the repurchase price represents the interest on the loan, known as the repo rate. This rate is negotiated between the parties.
4. **Types of Repos**:
   - **Overnight Repo**: The repurchase agreement is settled the next business day.
   - **Term Repo**: The repurchase agreement is settled on a specified future date beyond the overnight period.
   - **Open Repo**: The repurchase agreement has no fixed maturity date, and either party can terminate the agreement on any business day with proper notice.
5. **Reverse Repo:** When Repurchase agreements are reversed, they are referred to as reverse repos. In a reverse repo, the securities are purchased by the lender and agreed to be sold back to the borrower at a later time. Reverse repos are essentially from the lender's point of view during the initial repo transaction.
6. **Applications:**

1. **Financial institutions** utilize repos to invest extra cash, borrow money, and manage their short-term liquidity needs.
2. **Monetary Policy:** By regulating the money supply and affecting short-term interest rates, central banks employ reverse repos and repos to carry out monetary policy.
3. **Financing**: Repos provide a way for dealers and investors to finance their holdings of securities.

7. **Advantages**:
   - **Low Risk**: Repos are considered low-risk due to the collateral involved. The risk is mitigated by the underlying securities that can be sold in case of default.
   - **Liquidity**: They provide high liquidity, allowing participants to manage short-term cash needs effectively.
8. **Risks**:
   - **Counterparty Risk**: The primary risk is the potential default by the counterparty. This risk is mitigated by the collateral but cannot be entirely eliminated.
   - **Collateral Risk**: If the value of the collateral falls significantly, it may not cover the amount of the loan, leading to potential losses.

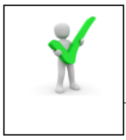
9. **Market Influence**: The repo market is a crucial part of the financial system, influencing short-term interest rates, liquidity, and overall market stability.

Repurchase agreements play a vital role in the financial markets, providing a secure and efficient means for institutions to manage liquidity, finance securities, and implement monetary policy.

2.7.5 Money Market Mutual Funds

To give investors another short-term option and make money market instruments more accessible to the general public, Money Market Mutual Funds (MMMFs) were first formed in India in April 1991. A Task Force was formed to investigate the ramifications of the Scheme as well as for the general framework presented in April 1991.The Reserve Bank unveiled a comprehensive plan for MMMFs in April 1992, based on the suggestions made by the Task Force that was established for that specific purpose. Instruments for the short-term money market make up the portfolio of MMMFs.

Investing in these funds gives investors the chance to get sufficient liquidity along with a yield that is comparable to short-term money market rates. However, the expansion of MMMFs has not been as rapid as anticipated



Check Your Progress-A

State true or False:

1. The money market includes products with long-term maturities.
2. Short-term money is traded in the money market.
3. The capital market deals with loans that last less than a year.
4. Manufacturers need two types of financing for their operations.
5. The money market is focused on loans that last more than 364 days.

2.8 FACTORS INFLUENCING MONEY MARKET

Money markets are impacted by a wide range of events. The RBI has the largest influence on the Indian money market. Due to the implications for monetary policy conduct, the money market is directly regulated by the RBI. The main goals of the Reserve Bank of India's money market operations are to maintain liquidity and short-term interest rates at levels that are consistent with the monetary policy goals of upholding price stability, guaranteeing a sufficient flow of credit to the economy's productive sectors, and establishing orderly conditions in the foreign exchange market.

2.9 PARTICIPANTS OF MONEY MARKET

There are various participants of money market, some of the participants are as follows.

1. Central Bank of India

The Central Bank of India (RBI) issues Treasury Bills (T-Bills) on the behalf of the government, which it borrows on the money market. The RBI is the entity that issues T-Bills. Zero risk instruments are the T-Bills. Their terms of issue are three months (91 days), six months (182 days), and one year (364 days). Banks, corporations, and other similar organizations purchase T-Bills and lend them to the government as part of its short-term borrowing program due to the risk-free nature of T-bills.

2. Public sector undertakings

Shares of a lot of government-owned businesses are traded on stock markets. They can issue commercial paper to raise operating capital because they are listed firms. In the money market, PSUs are the only borrowers. Because of their bureaucratic mentality, they hardly ever offer their excess. The PSUs' treasury procedures are incredibly inefficient, and they frequently leave large sums of cash on the table.

3. Insurance Providers

General and life insurance companies are regular lenders in the money market since they are cash surplus corporations; but, since the advent of CBLOs (collateralized borrowing and lending obligations), these companies have grown to be significant investors because their lending programs are for extremely long periods of time and the capital market deals with funds for long term, insurance firms participate more in capital market instruments than money market products. Thus, their influence in the money market is marginally reduced.

4. Mutual Funds

Mutual funds offer a variety of programs to accommodate the public's diverse investment objectives. These plans, which are categorized as Liquid Plans or Money Market Mutual Fund Plans, are designed to invest in money market instruments. By permitting withdrawals with a day's notice or the encashment of units through bank ATMs, they ensure maximum liquidity to investors. It goes without saying that these plans' money fund corpus is entirely invested in the money market; they do not borrow; they only lend to or invest in it.

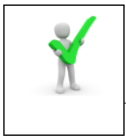
5. Banks

Scheduled commercial banks are significant lenders and borrowers in the money market. They lend and borrow in the call money, short-notice, repo, and reverse repo markets. They take out loans in the rediscounting market from the RBI and IDBI. They create loans in the commercial paper market by buying the commercial papers that companies and listed public sector entities issue. They also grant business companies Certificates of Deposit in order to borrow money.

6. Corporates

Favourable credit standing commercial papers, a type of promissory note with a short maturity date, are how corporations borrow money. Listed corporations issue the CPs after obtaining the necessary credit rating. They also lend their temporary excess in the CBLO market when the interest rate on the market is abnormally high. They act as lenders to the banks when they buy the certificates of deposit that the banks issue. Additionally, they purchase Treasury bills, functioning as lenders.

Numerous more minor participants exist, such as primary dealers, non-banking credit organizations, pension funds, and provident funds. They mostly make minor loans and investments in the CBLO industry.



Check Your Progress-B

Q1. Multiple Choice Questions.

1. Which of the following is NOT a reason for the capital shortage in the Indian money market?
   A. Lack of banking facilities in rural areas
   B. High interest rates during the busy season
   C. Insufficient savings among the population
   D. Dominance of the unorganized sector

2. What is the relationship between the organized and unorganized sectors of the Indian money market?
   A. They collaborate closely to achieve common goals.
   B. They have a friendly and cooperative relationship.
   C. They operate independently and do not coordinate with each other.
   D. They are in constant conflict and competition with each other.

3. Which of the following best describes the integration of the Indian money market with global markets?
   A. It is highly integrated and participates in international financial transactions.
   B. It is moderately integrated but still focused primarily on domestic players.
   C. It is completely isolated from global money markets.
   D. It has limited integration, which restricts its ability to attract foreign capital.

4. Which of the following issues is not mentioned in the passage as a problem with the Indian money market?

A. Volatility of interest rates
B. Lack of liquidity in certain money market instruments
C. Insufficient banking facilities in rural areas
D. Lack of government regulation and oversight

5. What is the main consequence of the seasonal tightness of lending in the Indian money market?

A. It leads to a decline in demand for borrowing during the slack season.
B. It results in higher interest rates during the busy season.
C. It causes volatility in the returns of money market instruments.
D. It reduces the overall efficiency of the money market.

2.10 CONSTRAINTS AND DEFECT IN INDIAN MONEY MARKET

A nation's money market needs to be well-developed and organized in order for its monetary policy to be formulated and implemented effectively. With the aid of the money market, the nation's central bank (RBI) controls monetary policy. Nonetheless, there are certain issues with the Indian money market and it is not very organized or methodical. Let's talk about a few of the Indian money market's shortcomings.

1. **Dichotomy between Organized and Unorganised Sectors**: The Indian Money Market's primary shortcoming is its division into two sectors. The Indian money market is divided into two segments: the organized and unorganised sectors. The two money market divisions do not collaborate or coordinate with one another.

2. The unorganized sector's dominance

Another significant disadvantage is the prominence of the unorganised sector in the Indian money market. Native American bankers play a significant role in the rural money lending sector. In this unstructured market, there is no obvious distinction between loans for different reasons or between durations that are long-term or short-term. These neighbourhood bankers, who do not belong to the organized sector, make up the bulk of the money market. As such, they have a significant impact on the Reserve Bank's capacity to control the money market.

3. Mindless Rivalry

Not only is there pointless rivalry among the individuals inside the structured and unorganized sectors, but also among them. The many money market divisions have only a shaky relationship with one another and are often separatist in nature, therefore their connections are not amicable.

For example, the commercial banks and the State Bank of India continue to view each other as rivals. International and Indian commercial banks compete with one other in a similar manner

4. **Absence of an All-India Money Market**:

There is no one, integrated market structure for the money market in India. It is divided into smaller parts that mostly cater to the local economy. For example, there is little connection between smaller towns and the financial markets of larger cities like Calcutta, Madras, and Bombay.

5. **Insufficient Banking Facilities:**

The nation's financial demands cannot be met by the Indian money market. Large rural areas remain devoid of banking services, despite the recent rapid expansion of bank branches, particularly following the nationalization of banks. Considering the size and population of the country, there are not enough banking institutions.

6. **Insufficient funding**

The Indian money market does not have enough capital to meet the demands of business and trade. The main reasons for this capital shortfall are (a) poor saving capacity due to low saving rates among the population; (b) inadequate banking facilities, particularly in rural regions; and (c) a lack of developed banking habits among the general public. The aforementioned factors are the main causes of the capital fund shortages that the Indian money market regularly faces.

7. **Inadequate funding based on the season.**

Two significant drawbacks of the Indian money market are the seasonal tightness of lending and higher interest rates for a portion of the year. During the busy months of November through June, when there is an excess of demand for credit to continue agricultural operations like harvesting and selling, this kind of gap always appears to occur. As a result, interest rates increase during this period. In contrast, there is a significant decline in the demand for borrowing as well as the interest rate during the slack season, which spans from July to October.

8. **Low Liquidity:**

While some securities, like T-Bills, have a high level of liquidity, other securities, like Commercial Papers and Certificates of Deposit, may not, particularly in hard times financially. This may make it more difficult to swiftly turn assets into cash without suffering a large loss in value.

9. **Volatility of Interest Rates**

High Sensitivity to Policy Changes: The Indian money market is extremely susceptible to changes in the Reserve Bank of India's monetary policy. Unexpected shifts in interest rates have the potential to cause volatility, which can impact money market instrument returns and raise investor risk.

10. Restricted Availability to Individual Investors

Institutional Dominance: Banks, mutual funds, and big enterprises are the main institutional investors that control the Indian money market. Retail investors' participation in this market category is restricted due to their limited access to money market products.

11. Inadequate Interaction with International Market

The Indian money market is less integrated with global money markets and is mainly targeted at domestic players. This restricts the market's capacity to draw in foreign capital and take part in international financial transactions.

12. Outdated Infrastructure

Some parts of the Indian money market continue to function on antiquated infrastructure in spite of technology breakthroughs, which causes delays in settlements and increased operating expenses. Another cause of operational inefficiencies is the manual process. In some contexts, the use of manual processes can raise the possibility of fraud and errors, which lowers market efficiency as a whole.

2. 11 ACTIONS TAKEN TO HELP THE MONEY MARKET

To strengthen the Indian money market, a combination of fiscal policies, infrastructural advancements, and regulatory adjustments are required. The efficacy and stability of the Indian money market could be enhanced by implementing the following measures.

1**. Regulation Reforms**

A. Reinforce the Regulatory Framework: Reducing fragmentation and standardizing rules for different financial market categories (banks, non-banking financial companies, and mutual funds) are necessary.

B. Boost Openness: There is a need of full disclosure requirements for participants to increase transaction transparency as it will boost investors' confidence and investor won't hesitate to invest.

2. Measures in Monetary Policy

A. Effective Liquidity Management: To guarantee sufficient liquidity in the economy without excesses that could cause inflation, the Reserve Bank of India (RBI) should keep refining its liquidity management activities.

B. Interest Rate Corridor: By keeping the gap between the repo rate and the reverse repo rate, short-term interest rates may remain stable and the money market's volatility may be minimized.

3. Development of Market Infrastructure

A. Improving Trading Sites: To enable quicker, more transparent, and efficient trading of money market products like Treasury Bills, Commercial Papers, and Certificates of Deposit, there is a need to enhance electronic trading platforms.

B. Boost Settlement and Clearing Systems: To lower settlement risk and boost transaction efficiency, modernize the clearing and settlement infrastructure.

4. Innovation in Product Design

A. Create New Instruments: To accommodate varying maturities and investor preferences, introduce new money market instruments such inflation-linked securities, floating rate bonds, and more diverse short-term securities.

B. Increase the Size of the Derivatives Market: To make the derivatives market better, add new products like interest rate swaps and futures, which can assist participants in more efficiently hedging risks.

5. Increase Participation

A. Increase Investor Base: Encourage participation from a wider range of institutional investors, including insurance firms, pension funds, and outside institutional investors, in order to deepen the market.

B. Educate Market Participants: Run training and awareness campaigns for prospective participants to increase the participation of small and medium-sized enterprises (SMEs) in the money market.

6. Financial involvement

B. Encourage Retail Participation: Provide instruments and materials that make it easier for retail investors to access the money market, since this can expand their range of possibilities for investments and improve market liquidity.

C. Microfinance Institutions: Increase the amount of clout they have in the money market to provide easier access to short-term loans for small borrowers.

7. Enhanced Risk Handling

A. **Enhancements to Credit Rating:** Make sure credit rating organizations uphold strict guidelines when assigning ratings to money market instruments. This will enhance investor confidence and risk assessment.

B. Stress Testing: Financial institutions should routinely carry out stress testing in order to identify any vulnerabilities in the money market and take preventative action.

8. Accessibility to Global Marketplaces

A. Liberalize Capital Flows: Gradually liberalize capital flows to get the Indian money market more in line with global markets and to draw in more foreign investment. **B. Adopt Global Best Practices:** To improve the stability and competitiveness of the Indian money market, adopt global best practices for risk management, market infrastructure, and regulation.

9. Policy Coordination

A. Collaboration Among Roles: Maintain strong coordination between the government, RBI, and Securities and Exchange Board of India (SEBI) to ensure that laws and regulations affecting the money market are in line.

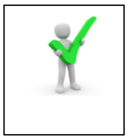
B. Long-term Policy Planning: Create and carry out long-term policies to deal with the money market's structural problems, guaranteeing stability and sustained growth. If these steps are successfully carried out, the Indian money market's depth, stability, and efficiency might all be greatly increased, strengthening its position as a vital component of the country's financial system.

2.12 SUMMARY

The unit's goal was to have a conversation about the short-term fund market with an emphasis on India. After making a distinction between capital and money markets, the lesson went on to outline the key characteristics and purposes of the money market. After that, the unit took an orientation that covered the state of the Indian money markets. The unit covered the development and expansion of India's money markets starting in the middle of the 1980s. It provided a thorough description of a few of the money markets in use in India. The unit then examined the variables influencing money market operations. It was stated that the primary factor influencing the money market is the Reserve Bank of India's policies. The lesson concluded with discussing monetary policy and how the money market is affected by it.

2.13 GLOSSARY

Call Money- Call money market, is one of the instruments of money market. Short-term funds are borrowed and lent in the call money market, typically for a single day.
Commercial Paper - It is an unsecured promissory note with a short maturity period, to raise money for operational expenses, inventories, and accounts payable.
Repurchase agreement (repo) - It is a short-term borrowing and lending instrument in which one party sells securities to another with an agreement to repurchase them at a later date at a predetermined price.
Treasury Bills - The government issues Treasury Bills (T-Bills), which are short-term debt securities, to meet its immediate financial needs.



2.14 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Q1.

(i) False

(ii) True

(iii) True

(iv) False

(v) True

Check Your Progress - B

1. **b**
2. **d**
3. **d**
4. **d**
5. **b**

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2.17 TERMINAL QUESTIONS

1. Define Money Market.
2. What are the various components of money market?
3. What are the challenges faced by money market?
4. Name various participants of money market.
5. Write a short note on T- Bills.
6. What is the significance of Indian Money Market?

UNIT 3 CAPITAL MARKET

3.1 INTRODUCTION

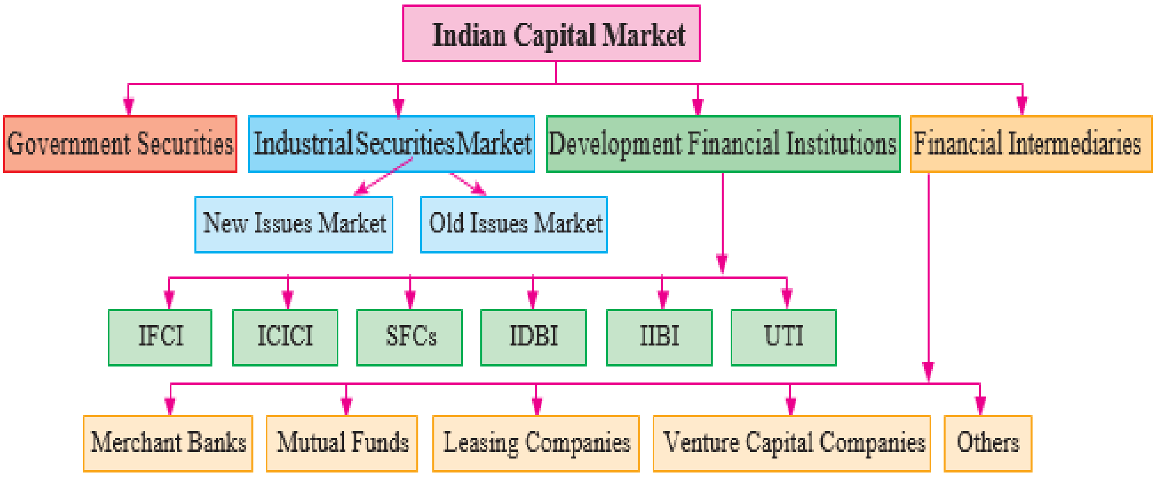
Definition: Capital market is one of the financial markets that provide savings and investments between capital suppliers (individuals or organizations with money) and capital consumers (people who need fluidity). They promote long -term funds such as bonds and promotion and increased commercial assets. For a country, capital market is an indicator of its growth and shows how aware the people of that country are about the capital market and how they invest in it.

Prasanna Chandra says: "Capital market refers to the market for long-term financial securities such as stocks and bonds. They play an important role in mobilizing savings for investment in productive assets by facilitating the transfer of financial resources from surplus to scarce units.

E. Gordon and K. Natarajan: "Capital markets are the markets in which financial securities such as stocks and bonds are issued and traded. Capital markets are essential for the efficient allocation of capital resources in an economy." These markets allow companies to raise long-term funds and provide investment opportunities to investors.

In other words, capital markets are financial systems where long-term bond and equity-backed assets are bought and sold. People can buy securities to grow their wealth, and companies, governments, and other organizations can use securities as a platform to raise funds for long-term investments. Capital markets include the equity market, used for trading company shares, and the bond market, used for issuing and trading debt.

These play a vital role in stimulating savings and investment between suppliers and companies in need of capital, and in promoting economic growth by providing liquidity, pricing and risk management functions. Indian capital market consists of Government securities, Industrial security market, development financial institutions, and financial intermediaries. Which acts as a mediator between the needy and the investor, so that capital appreciation happens in an economy.



3.2 OBJECTIVES

After reading this unit you will able to:

- Understand what Capital market is.
- Institutions responsible for proper functioning of capital market.
- Sources through which Organizations can generate funds.

3.3 IMPORTANCE OF CAPITAL MARKET

The country's financial stability and economic growth are greatly influenced by its capital markets. The significance of financial markets is as follows:

1. Capital Formation: Financial markets enable governments and businesses to raise long-term funds by issuing stocks and bonds. Encouraging innovation, growing businesses, and financing ambitious initiatives depend on capital markets. Companies can raise the funds required for their expansion and development by issuing new securities in the primary market.

2. Investment Opportunities: The investment instruments available in the financial market include bonds, mutual funds, stocks, derivatives, etc. Within this range of assets, investors can choose the assets that match their investment objectives and risk tolerance. Individuals and institutions alike can grow their wealth through these investment options, which contributes to the overall success of the economy.

3. Enhancing Liquidity: The secondary market provides liquidity, enabling investors to buy and sell existing securities. This liquidity is vital for investor confidence and the functioning of the capital market. A deep and liquid market allows for large volumes of trading to take place without major price fluctuations, maintaining market stability.

4. Price Discovery: The process by which supply and demand interact to determine the fair price of securities is facilitated by financial markets. Pricing is guaranteed to represent all available information when trading is frequent and the number of participants is large. Capital market prices often reflect the mood of the economy as a whole and provide important information to investors and decision makers.

5. Economic Efficiency: Efficient allocation of capital ensures that resources are used in a way that promotes economic progress. Companies with access to the capital market can invest in R&D, which drives innovation and technological progress.

6. Risk Management: Investors can reduce portfolio risk through diversification by spreading their funds across different securities. Diversification spreads risk by reducing the impact of adverse events on individual investments. Market volatility, interest rate fluctuations and currency fluctuations are just some of the risks that investors can protect themselves against using capital market instruments such as futures, swaps and options.

7. Mobilizing Savings: Capital markets facilitate the conversion of savings by individuals and institutions into profitable investments, thereby promoting capital accumulation and economic expansion. They provide savers with a range of profitable investment opportunities with their extra money. Capital markets promote financial inclusion by providing investment opportunities to a diverse group of investors and facilitating their participation in the economy.

8. Global Integration: Capital flows freely between nations thanks to capital markets, which promote cross-border investment. Accessing international opportunities and diversifying investment portfolios are made easier by the relationship between them. Global financial markets allow nations to work together and become more dependent on one another economically, which promotes economic progress and stability.

3.4 HISTORICAL BACKGROUND OF CAPITAL MARKET IN INDIA

Early Beginnings

Ancient India: In India, the idea of financial markets has been around for centuries. Texts like the Arthashastra by Kautilya (300 B.C.), which addresses economic policies, trade, and market regulation, contain references to trade and market practices.

Medieval India: The subcontinent had a sophisticated system of money lending and trading practices throughout the Mughal Empire. The foundation for more organized financial markets was built by the massive trading activity of merchants and dealers in cities like Kolkata and Surat.

Evolution of Capital Markets in India

Pre-Liberalization and Modernization:

19th Century Establishment of Formal Exchanges: The Bombay Stock Exchange (BSE), the country's first formal stock market, was founded in Mumbai in 1875. The founding of the Madras Stock Exchange in 1937 and the Calcutta Stock Exchange in 1908 came next. British colonial control, which imposed contemporary financial norms and rules, had a major impact on the development of India's capital markets during this time.

1940s to 1960s Economic Planning: India developed a mixed economy model with strong governmental control over important industries after attaining independence in 1947. Investing in the public sector and bank-based finance dominated the capital markets, which were still comparatively undeveloped.

Securities Contracts (Regulation) Act, 1956: "This act was enacted to regulate the trading of securities and the functioning of stock exchanges in India, laying the foundation for the modern regulatory framework."[1]

[1] https//: archivers.nseindia.com

1970s to 1980s Nationalization and Reforms: During this period, the government nationalized banks and other key financial institutions, further consolidating state control over the economy. However, efforts were made to strengthen the capital markets.

Introduction of Mutual Funds: The Unit Trust of India (UTI) was established in 1963, marking the beginning of the mutual fund industry in India, which played a crucial role in mobilizing savings for investment in capital markets.

Liberalization and Modernization:

1990s Reforms Economic Liberalization: In 1991, India embarked on a path of economic liberalization, which included significant reforms in the financial sector. This period marked the beginning of a new era for the Indian capital markets.

Establishment of SEBI: "The Securities and Exchange Board of India (SEBI) was established in 1988" and in 1992 was given the legal powers to regulate and develop the capital markets and ensure transparency, investor protection and efficient functioning.

National Stock Exchange (NSE): The NSE was established in 1992 and was a pioneering electronic trading system that revolutionized business practices in India, making trade and investment more efficient and transparent.

2000s to Present:

Technological Advancements: The adoption of technology, including online trading platforms, algorithmic trading, etc., has transformed India's capital markets, making them more accessible and efficient.

Improved Regulation: SEBI, the apex body, has introduced various rules and reforms to enhance market integrity, protect investors and encourage innovation. Key initiatives include the introduction of a T+2 regulatory cycle and streamlining and improving governance standards.

Growth of Mutual Funds and SIP's: With Systematic Investment Plans (SIPs) becoming more popular among retail and public investors in the capital market, the mutual fund industry has grown significantly.

Integration with Global Markets: Indian capital markets are increasingly integrated with global markets by attracting foreign institutional investors (FIs) and foreign direct investment (FDI), thereby increasing liquidity and introducing international best practices into the Indian financial system.

"Key Milestones in Indian Capital Market Development" [2]

Bombay Stock Exchange (BSE): Established in 1875, BSE is Asia'soldest exchange and one of the largest in the world.

Securities Contracts (Regulation) Act, 1956: This legislation laidthe foundation for the regulation of securities trading and the functioning of stock exchanges in India.

Securities and Exchange Board of India (SEBI): Established in1988 and given statutory powers in 1992, SEBI has been instrumental in regulating and developing the Indian capital markets.

National Stock Exchange (NSE): Established in 1992, NSE introduced electronic trading and brought significant changes tothe trading practices in India.

Dematerialization: The introduction of the Depository Act in 1996 facilitated the dematerialization of shares, reducing the risk of fraud and making trading more efficient.

Initial Public Offerings (IPOs): The liberalization period saw a surge in IPOs, providing companies with a mechanism to raise capital from the public and enabling investors to participate in the growth of these companies.

[2] https://archives.nseindia.com

3.5 KEY COMPONENTS OF CAPITAL MARKETS

"Capital markets are made up of various elements that work together to facilitate fund raising, investment, trading, and risk management. The main components of capital markets are:

1. Primary Market: The primary market is, where a new title is created and sold for the first time. Companies, governments, and other organizations issue new shares and duty to attract capital. When a company offers its shares to the public for the first time, it is called an IPO. This process helps the company raise funds from a wide range of investors. In private equity, ownership is sold directly by an institution or a small group of investors without public issue.

2. Secondary Market: The secondary market is where already issued securities are bought and sold between investors. It provides liquidity to investors by allowing them to sell their securities. These are organized market platforms where the title is replaced. India's main scholarships include bomber scholarships (BSE) and National Stock Exchange (NSE).

3. Stock Market Indices: Stock market indices, such as the Sensex of BSE and Nifty of NSE in India, represent the performance of a specific group of stocks, providing insights into market trends and investor sentiment.

4. Bond Market: The bond market involves the authorization and trading of debt securities, such as government bonds, corporate bonds, and municipal bonds. Investors lend money to issuers in exchange for periodic interest payments and the return of principal at maturity.

5. Derivatives Market: Financial contracts are contracts whose value is based on underlying assets such as indexes, equities, bonds, or commodities. They are employed for both speculative and risk-hedging purposes."[3]

[3] https://siesce.edu.in

6. Commodity Market: "Involves the buying and selling of physical goods like gold, silver, oil, agricultural products, and other raw materials. Provide platforms where commodity futures and options are traded. In India, prominent commodity exchanges include the Multi Commodity Exchange (MCX) and the National Commodity and Derivatives Exchange (NCDEX)"4.

[4] https://www.investopedia.com

7. Foreign Exchange (Forex) Market: Businesses and investors can exchange one currency for another using the forex market, making currency trading easy. Globally, it is the largest and most liquid financial market.

8. Market Intermediaries: Market Intermediaries includes: -

a) **Brokerage Firms**: Brokerage firm like Zerodha, Angel one, 5paisa etc. acts as intermediaries between buyers and sellers in the trading of securities. They facilitate transactions and provide investment advice.

b) **Investment Banks**: Assist companies in raising capital through IPOs, bond issuances, and private placements. They also provide advisory services for mergers, acquisitions, and other corporate finance activities.

c) **Credit Rating Agencies**: Assess the creditworthiness of issuers and assign ratings to their securities, helping investors make informed decisions.

9. Clearing and Settlement Systems: clearing and settlement system includes: -

a) **Clearing Houses**: Ensure the efficient and secure settlement of trades by acting as intermediaries between buyers and sellers, reducing counterparty risk.

b) **Depositories**: "Depositories participant help in facilitating the holding into electronic forms and facilitate transfer of securities, reducing the risks associated with physical certificates. In India, the two main depositories i.e., National Securities Depository Limited (NSDL) and the Central Depository Services Limited (CDSL) provides this facility." [5]

[5] https://archives.nseindia.com

10. Investor Services

a) **Custodians**: Provide safekeeping and administration of securities on behalf of investors, ensuring their assets are secure and properly managed.

b) **Registrar and Transfer Agents (RTAs)**: Maintain records of investors and manage the transfer and redemption of securities.

3.6 INSTRUMENT OF CAPITAL MARKET

Capital markets provide a wide range of tools for raising capital, investing, and managing financial risk. Below is a summary of the main capital market instruments:

1. Equity Instruments:

a. Normal Shares: Also known as common stocks, these stocks give investors ownership in the company and the shareholders are entitled to receive the remainder of the company's profits, usually in the form of dividends. These shareholders receive voting rights based on their shares in that particular company and can benefit from capital gains, but can also incur losses until the shares are liquidated.

b. Preferred Shares: A class of ownership with a higher claim on assets and earnings than common shares. Preferred shareholders receive dividends before common shareholders and have a higher claim in the event of liquidation. They get fixed dividends and have no voting rights. They get priority over common shares in dividend payments and at the time of liquidation.

2. "Debt Instruments:

a) Bonds: A bond is a debt security issued by a company, government, or other entity to raise capital from the public. Bondholders are lenders to the issuer and receive periodic interest (coupons) and the principal at maturity.

The following types of obligations are distinguished:

i. Government Bonds: Issued by the government to finance public projects and manage fiscal deficits (e.g., Treasury bonds, Treasury bills).

ii. Corporate Bonds: Issued by high-net-worth companies to finance their operations and expansion.

iii. Municipal Bonds: Issued by state or local governments to finance public projects.

iv. Convertible Bonds: Can be converted into a predetermined number of the issuer's equity shares."[6]

b) Debentures: Debentures are debt instruments backed only by the issuer's creditworthiness and its reputation. Typically, debentures pay a fixed rate of interest and are used by corporations to raise long-term funds and get principal amount at the time of maturity. They are not backed with collaterals, and have higher risk in comparison to secured bonds, and usually get higher interest rates to compensate for the risk.

[6] www.sebi.gov.in

[7] https://www.investopedia.com

[8] https://siesce.edu.in

4. Hybrid Instruments:

a) Convertible Securities: "A financial instrument (usually a share of the issuing company's stock) that can be converted into another form. These include convertible bonds and convertible preferred stock. These combine debt and equity features, providing a fixed income initially and the potential for capital appreciation after conversion.

b) Warrants: Long-term options issued by a company that gives holders the right, but not the obligation, to buy the company's shares at a specified price before the expiry date. Potential for capital appreciation, often issued along with bonds or preferred shares to make them more attractive."[7,8]

5. Derivative Instruments:

a) Futures: Standardized contracts to buy or sell an asset at a pre-determined price on a specified date in the future. Tradable on a stock exchange. Used for hedging or speculation, standardized terms, and margin requirements.

b) Options: Contracts that give the holder the right, but not the obligation, to buy (call option) or sell (put option) an asset at a specified price before the expiration date. Used for hedging or speculation purposes, high return potential, limited risk for buyers (premium paid).

c) Swaps: financial agreements to exchange cash flows or other financial instruments between two parties. The most common types are interest rate swaps and currency swaps; customized contracts used to manage interest rate and exchange rate risk.

6. Mutual Funds and Exchange-Traded Funds (ETFs):

a) **Mutual Funds**: An investment vehicle that pools the funds of multiple investors and invests them in a diversified portfolio of securities. Managed by professional fund managers, investors invest in funds according to their risk appetite. Mostly common types of mutual fund are:

i. **Equity Funds**: Invest primarily in stocks.

ii. **Debt Funds**: Invest primarily in bonds and other debt instruments.

iii. **Hybrid Funds**: Invest in a mix of equity and debt instruments.

iv. **Index Funds**: Track a specific market index.

b) "Exchange-Traded Funds (ETFs): They are similar to mutual funds but trade on exchanges like Nifty Large Cap, Small Cap etc. ETFs can track an index, commodity, bond or basket of assets. Lower expense ratios, day trading, and diversification."[9]

[9] https://fastercapital.com

[10] https://www.investopedia.com

7. Real Estate Investment Trusts (REITs): "Companies that own, operate, or finance income-producing real estate. Investors can buy shares of REITs on stock exchanges. Types of REITs:

a) Equity REITs: Own and operate income-producing real estate.

b) Mortgage REITs: Provide financing for income-producing real estate by purchasing or originating mortgages and mortgage-backed securities.” [10]

8. Infrastructure Investment Trusts (InvITs): Like REITs, but with an emphasis on infrastructure assets. Investing in infrastructure projects, including electricity transmission, renewable energy assets, and highways, is made possible by InvITs. Offers a diversified infrastructure portfolio, consistent revenue, and liquidity via stock exchange listing.

9. Certificates of Deposit (CDs) and Commercial Papers (CPs):

a) Certificates of Deposit (CDs): Bank-issued time deposits having set interest rates and dates of maturity. Higher interest rates than savings accounts on a safe, low-risk investment.

b) Commercial Papers (CPs): commercial paper are short-term unsecured promissory notes issued by high net worth corporations to meet short-term liabilities. Typically issued at a discount, maturity up to one year at par value, higher returns in comparison to Treasury bills.

9. Gilt-Edged Securities: High-grade bonds issued by the government or blue-chip companies, are considered to be low-risk investments. Provide stable returns, with high credit quality, it is suitable for investors who is risk-averse.

3.7 REGULATORY ENVIRONMENT

The regulatory environment of capital markets in India is designed to provide transparency, protect investors, and maintain the stability and integrity of the financial system so that investor’s interest is safeguarded. Several key institutions and regulatory bodies are created for the proper functioning of capital markets. The overview of regulatory institutions are as follows:

1. Securities and Exchange Board of India (SEBI): “Security and Exchange Board of India is an apex body of capital market. SEBI was established in 1988 and given statutory powers in 1992 through the SEBI Act, 1992”11. As India's principal capital markets regulator, SEBI is in charge of overseeing stock exchanges, defending investor rights, and guaranteeing honest and open market operations. In addition to having the power to regulate the operations of market intermediaries including brokers, mutual funds, and depositories, SEBI can also create regulations, carry out investigations, and apply penalties.

[11] https://archives.nseindia.com

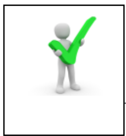
[12] https://www.rbi.org.in

2. “Reserve Bank of India (RBI): RBI is the central bank of India. The RBI primarily regulates the banking sector and the money market, but also plays a role in regulating government securities and the foreign exchange market. The RBI is the authority that administers the country's monetary policy, manages the payments system, and regulates the issuance and trading of government securities. It is the only institution that has the power to generate money in India."[12]

3. Ministry of Finance: The Ministry of Finance, through a number of ministries and agencies, formulates and implements capital market policy. It oversees the capital markets sector and sets rules for the market and the issuance of securities. Monitors the operations of intermediaries and financial institutions.

4. Insurance Regulatory and Development Authority of India (IRDAI): The highest authority responsible for regulating the insurance sector, including the issuance and trading related to insurance. The main role is to ensure the economic efficiency of the insurance company and protect the interests of the policyholders.

5. Pension Fund Regulatory and Development Authority (PFRDA): Is the Institute that regulates pension funds in India, it ensures the security and effective management of pension assets. The main function of PFRDA is to oversee the National Pension System (NPS) and other pension schemes.



Check Your Progress-A

Q1. Discuss the role of capital markets in economic development and how they contribute to economic growth.

Q2. What are the Key Components of Capital Markets?

Q3. Explain how capital markets facilitate the mobilization of savings and their channelization into productive investments.

3.8 KEY REGULATIONS AND ACTS

In India different regulations and Acts has been passed by Institutions and Government to protect the interest of investors so that their trust is maintained in capital market, some of the key regulation and Acts are as follows:

1. Securities and Exchange Board of India Act, 1992: The main purpose is to establish SEBI as a regulatory authority in the securities market and explain its power and functions. The law regulates scholarships to SEBI, protects investors' interests, and manages the management of intermediaries.

2. Securities Contracts (Regulation) Act, 1956: This Act regulates the trading of securities and the operation of stock exchanges. Provisions of the Act require stock exchanges to be recognized by the government and establish rules for fair trading practices.

3. Depositories Act, 1996: The objective is to promote dematerialization of securities by enabling electronic holding and transfer of securities. The provisions of the Act aim at setting up of depositories such as NSDL and CDSL which provide for electronic storage and transfer of securities, thereby reducing the risks associated with physical certificates.

4. Companies Act, 2013: The law on new companies regulates the inclusion, regulation and dissolution of companies in India. The law includes the rules related to the issuance of securities, corporate governance and the requirements for disclosing information to protect investors and ensure transparency.

5. Foreign Exchange Management Act (FEMA), 1999: A law that regulates exchange transactions and foreign trade. FEMA is trying to promote trade and external payments and promote the order of the Indian exchange market.

6. Prevention of Money Laundering Act (PMLA), 2002: The Act prevents money laundering and ensures that financial institutions keep proper records to identify and report suspicious activities. Provisions in the Act require financial institutions and intermediaries to follow Know

Your Customer (KYC) standards and report suspicious transactions to the Financial Intelligence Unit (FIU).

7. 1882 Indian Trust Law: The purpose is to control the functions of Indian trustee. This includes regulations governing the management of trust funds such as investment trusts and pension funds.

Key Regulatory Initiatives and Reforms

1. "Dematerialization and Depositories: Introduction of the Depositories Act, of 1996, which facilitated the conversion of physical securities into electronic form. The main impact of this is to reduced risks of fraud, theft, and loss associated with physical certificates and made trading more efficient."[13]

[13] https://www.nirmalbang.com/knowledge-center

[14] www.sifma.org

[15] www.latestlaws.com

[16] https://groww.in/p/real-estate-investment-trust-reit

2. Introduction of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015: To Streamlined and consolidated the listing and disclosure requirements for listed entities. It Enhanced transparency, corporate governance, and investor protection.

3. Implementation of the T+2 Settlement Cycle: "By Reduced the settlement cycle for securities transactions to two days after the trade date, which increases market efficiency and reduced settlement risk."[14]

4. Regulation of Alternative Investment Funds (AIFs): "The Introduction of the SEBI (Alternative Investment Funds) Regulations, 2012, provide a regulatory framework for private equity, venture capital, and other alternative investment funds. AIFs ensures their transparency and accountability so that investor's interests are protected."[15]

5. "Introduction of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs): SEBI has created rules for REITs and InvITs to boost investments in the real estate and infrastructure sector. These rules have helped investors to raise funds for infrastructure and real estate development by providing access to new asset classes."[16]

3.9 SUMMARY

Financial markets, also known as capital markets, are used to buy and sell securities backed by long-term debt or equity. They connect investors with organizations that need capital, such as governments and corporations, thereby attracting capital and providing a safe investment environment for investors. An economy can develop capital in several ways: new securities are issued in the primary market and existing securities are traded in the secondary market. The important financial instruments that help in raising capital for businesses are stocks, bonds, mutual funds and derivatives. The market is monitored by regulatory bodies such as SEBI and RBI to maintain stability, protect investors and ensure transparency. Individual investors and institutional

players, such as banks and investment funds, are examples of market participants. Market infrastructure includes scholarships, depositors and compensation houses. Capital markets play a vital role in economic growth by mobilizing savings for investment and ensuring efficient allocation of resources.

3.10 GLOSSARY

Capital Market: Market where long-term debt or equity backed securities are bought and sold.

Equity: It represents the ownership in a company to the percentage of share held by an investor.

Debt Instrument: It is form of loans provided by an investor to the borrowers with fixed rate of interest and have a maturity date.

Derivatives: A financial contract whose value is derived from the underlying assets or a stock.

Regulatory bodies: Organisation responsible for overseeing and regulating financial market to ensure transparency, protection and maintain stability in the market.

Institutional investors: They are large organisation that invest substantial amount of money in securities.

Initial Public Offer (IPO): The process through which a private company offers its shares to the public for first time in the market.

Depositories: Institutions that hold and provide the facility of securities in decartelized form.

Credit Rating Agencies: forms that assess the creditworthiness of issuer of debt securities and their ability to meet financial obligations.

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3.13 TERMINAL QUESTIONS

1. What is Capital Market?
2. What are the financial instrument that are primarily traded in Capital market?
3. How capital market contribute to the development of a country?
4. What are the risk associated with capital market investing?
5. How institutions like SEBI and RBI contribute to the function of capital market?

UNIT 4 NEW ISSUES MARKET

4.1 INTRODUCTION

The Primary Market, also referred to as the New Issue Market (NIM), is where companies and governments first issue and sell new securities directly to investors. This market is crucial in the financial system as it allows businesses and governments to raise long-term capital. It serves as a platform for organizations to issue securities, such as stocks and bonds, to fund projects, expand operations, or start new ventures. Through this market, issuers obtain funds from both institutional and retail investors. One of the most common ways for companies to enter this market is through an Initial Public Offering (IPO), where they offer shares to the public for the first time. Besides IPOs, securities are also sold through rights issues, private placements, and preferential allotments. The primary market plays a vital role in channelling funds from investors to companies and governments in need of capital, promoting economic growth. It ensures transparency and investor protection through regulation, helping maintain confidence and stability in the financial system.

4.2 OBJECTIVES OF THE UNIT

After reading the unit, learners shall be able to understand;

- Characteristics of the Primary Market
- Types of securities in primary market
- Methods of Issuing Securities in the Primary Market
- Role of Intermediaries in the Primary Market

4.3 IMPORTANCE OF THE PRIMARY MARKET

The primary market plays a vital role in generating capital, which drives economic expansion and progress. By allowing businesses and governments to secure funding, it facilitates infrastructure growth, business expansion, and technological innovation. This influx of new capital promotes job creation, boosts productivity, and encourages innovation. Moreover, it offers investors the chance to invest in growing companies, with the potential to earn returns through dividends or capital appreciation.

4.4 CHARACTERISTICS OF THE PRIMARY MARKET

1. Direct Sale of Securities: In the primary market, companies or governments issue securities directly to investors, often with the assistance of intermediaries like investment banks or underwriters.

2. Fundraising Objective: The main purpose of the primary market is to enable organizations to raise capital for activities such as expanding businesses, funding new projects, or managing debt.

3. One-Time Issuance: Securities are issued only once in the primary market. After the initial sale to investors, they move to the secondary market for subsequent trading.

4. Regulatory Oversight: The primary market is closely monitored by regulatory bodies such as the Securities and Exchange Commission (SEC) or similar authorities in different regions. These agencies mandate that companies provide transparent disclosures, such as prospectuses, to safeguard investor interests.

4.5 TYPES OF SECURITIES ISSUED IN THE PRIMARY MARKET

In the primary market, various types of securities are issued, including:

Equity Shares: These shares signify ownership in a company. Investors buying these shares in the primary market gain partial ownership of the company, which may include voting rights and dividend payments.

Debt Instruments: To secure funding, companies and governments can issue bonds or debentures. These debt instruments involve borrowing money from investors, with a commitment to repay the principal amount along with interest.

Hybrid Instruments: Certain securities, such as convertible debentures or preference shares, blend characteristics of both equity and debt instruments, providing greater investment flexibility.

4.6 METHODS OF ISSUING SECURITIES IN THE PRIMARY MARKET

The primary market provides several methods for issuing securities:

1. Public Offering: This involves a company offering its shares or securities to the general public. The most well-known type is the Initial Public Offering (IPO), where a company first sells shares to the public. There is also the Follow-on Public Offering (FPO), which involves issuing additional shares after the IPO.

2. Private Placement: Here, securities are sold directly to a limited group of investors, typically institutional investors such as mutual funds, banks, or insurance companies. This method is quicker and less expensive than public offerings but is limited in the number of investors.

3. Rights Issue: Companies offer new shares to existing shareholders, allowing them to purchase additional shares at a discounted rate based on their current holdings.

4. Preferential Allotment: In this approach, securities are offered to a specific group of investors, often insiders or major investors, at a preferential price before being made available to the public.

4.7 ROLE OF INTERMEDIARIES IN THE PRIMARY MARKET

The primary market engages various intermediaries, including investment banks, underwriters, brokers, and registrars, who support the securities issuance process. These intermediaries help with tasks such as performing due diligence, setting security prices, and ensuring regulatory compliance. Underwriters are especially important as they commit to purchasing any remaining shares if the public does not fully buy into the offering, thereby ensuring that the capital target is met.

4.8 REGULATORY FRAMEWORK GOVERNING THE PRIMARY MARKET

The regulatory framework that oversees the primary market is vital for its effective, transparent, and orderly operation within the capital markets. This framework is established to safeguard investors, uphold market integrity, and support economic stability through the enforcement of rules and regulations related to the issuance of new securities. Various regulatory agencies and laws oversee this process, ensuring that companies adhere to legal requirements and that investors receive accurate and timely information.

1. Key Regulatory Bodies in the Primary Market

Every country has its own regulatory agencies tasked with supervising the operations of the primary market. These authorities ensure that companies adhere to legal standards, meet disclosure requirements, and uphold transparency in the issuance of securities. In India **Securities and Exchange Board of India (SEBI)** regulates the Indian securities market, focusing on protecting investors, ensuring market efficiency, and maintaining fair security pricing.

2. Securities Laws and Regulations in the Primary Market

Governments create laws to set the rules for issuing securities in the primary market, providing a framework for regulatory bodies to ensure adherence to market practices. These laws aim to bolster investor confidence, safeguard public interests, and enforce transparency from companies. **The Companies Act, 2013 (India),** this legislation oversees securities issuance in the primary market, stipulating procedures for public offerings, disclosure requirements, and protection for minority shareholders.

3. Disclosure Requirements in the primary market

Disclosure is a crucial component of the regulatory framework in the primary market. When companies issue securities, they are required to provide thorough and precise information to potential investors. This information is typically presented in a prospectus, a legal document that details the company's financial status, the purpose of raising capital, the associated investment risks, and other pertinent details to help investors make informed choices.

A prospectus generally includes:

- Financial statements (such as income statements, balance sheets, and cash flow statements)
- Information on the business model and strategy
- Specifics about the securities being offered
- Risks related to the investment
- Details on management and governance

- How the funds from the securities will be used

Regulatory agencies ensure that the prospectus is clear, accurate, and in compliance with applicable laws. They may also require companies to get approval for the prospectus before the securities are offered to the public.

4. Regulation of Intermediaries in the Primary Market

In the primary market, intermediaries such as underwriters, investment banks, brokers, and registrars are essential for assisting companies with issuing securities and facilitating smooth transactions between issuers and investors. Regulatory authorities establish guidelines to oversee these intermediaries, aiming to prevent conflicts of interest, unethical behavior, and market manipulation.

- Underwriters are responsible for thoroughly evaluating companies issuing securities and ensuring that both the pricing and distribution of these securities are equitable.
- Investment banks involved in managing IPOs and other security offerings must adhere to regulations concerning capital adequacy and potential conflicts of interest.
- Brokers are required to follow standards that ensure transparency and fairness when marketing and selling securities to the public.

The purpose of regulating these intermediaries is to uphold fairness and prevent any form of misrepresentation or fraud during the issuance process.

5. Pricing Mechanisms and Regulations in the Primary Market

The price at which securities are issued in the primary market needs to be set in a fair and transparent manner. Regulatory authorities monitor the pricing strategies employed, such as book building and fixed pricing, to prevent overcharging of investors and to ensure companies do not manipulate or inflate prices. Book building involves setting the price according to investor demand during the IPO, whereas fixed pricing involves a predetermined price set by the issuing company. Regulators ensure that the pricing process is clearly disclosed and that investors understand how prices are determined.

6. Investor Protection Mechanisms

A key role of the regulatory framework is to safeguard investors from fraudulent practices and maintain market fairness. Regulatory agencies implement measures including:

a) **Anti-fraud Provisions**: Companies are prohibited from making false or misleading statements or failing to disclose important information.

b) **Equitable Share Allocation**: Ensuring that securities are distributed fairly to all investors, preventing favouritism.

c) **Complaint Resolution Systems:** Providing mechanisms for investors to report fraud, unfair practices, or inaccurate information.

d) **Required Risk Disclosure:** Mandating that companies disclose potential risks, such as market fluctuations or specific business risks, to investors.

7. Compliance and Enforcement in Primary market

Regulatory agencies rigorously oversee adherence to securities laws and regulations. Companies that do not meet these requirements may incur penalties such as fines, legal proceedings, or restrictions from participating in the capital markets. These enforcement measures are in place to uphold market integrity and prevent practices that could negatively impact investors.

Additionally, regulatory bodies may:

- Here is a paraphrased version of the provided text:
- Perform evaluations and audits on companies and intermediaries.
- Examine grievances and possible fraudulent activities.
- Implement corrective measures to safeguard investors and uphold the integrity of the primary market.

4.9 PROCESS OF ISSUING SECURITIES IN THE PRIMARY MARKET

The issuance of securities in the primary market follows a detailed, multi-phase approach aimed at ensuring transparency, safeguarding investors, and adhering to regulatory standards.

This procedure involves multiple parties, including the issuing company, regulatory authorities, investment banks, underwriters, and investors. Through this structured process, companies can secure new capital and present investment opportunities to the public. Once issued and allocated, these securities are listed on stock exchanges for secondary market trading, which offers liquidity to investors. The process includes several critical stages to ensure legal and regulatory compliance, along with transparency and fairness for investors. Here is a comprehensive overview of the process:

1. Pre-Issue Process

a. Appointment of Key Intermediaries

I. **Investment Bankers (Lead Managers):** The Company issuing securities selects investment banks to oversee the public offering. These banks handle underwriting, create required documentation, and set up the offering structure.

II. Underwriters: Underwriters are essential in evaluating the market and committing to buy any remaining shares if they are not sold during the public offering. They help guarantee that the offering is successful and fully subscribed.

III. Legal Advisors: Legal advisors ensure compliance with all regulatory standards and aid in drafting legal documents such as the prospectus.

b. Due Diligence

Before the issuance, underwriters and other intermediaries conduct thorough due diligence on the issuing company. This involves:

- Analysing the company's financials
- Evaluating its operations and management
- Checking compliance with legal and regulatory requirements

c. Drafting of Prospectus

The prospectus is a formal document that outlines comprehensive details about a company, including its financial health, the securities being offered, and associated risks. It must contain:

- Financial statements
- Information about the business model and potential for growth
- Specifics on how the funds raised will be utilized
- Risks related to the investment

This document is submitted to the appropriate regulatory body (such as the Securities and Exchange Commission (SEC) in the U.S. or the Securities and Exchange Board of India (SEBI) in India) for review and approval. The regulator assesses the prospectus to ensure it provides complete disclosure of all significant information to safeguard investors.

2. Pricing and Book Building

A. Determining the Offer Price: There are two primary approaches for setting the price of securities:

a) Fixed Price Method: This approach involves the company setting a specific price for the securities in advance, which is then stated in the prospectus before the offering begins.

b) Book Building Method: This method determines the price based on investor demand during the offering. The company establishes a price range, and investors submit bids within this range. The final price is set after evaluating the level of interest from investors.

B. Regulatory Approval and Roadshows: After determining the pricing method, the company seeks approval from regulatory authorities. The company and its lead managers then organize roadshows and marketing efforts to attract potential investors, both institutional and retail. These events are designed to generate interest and drive demand for the securities.

C. Issuance and Subscription Process

a. Opening of Subscription

a) The public subscription period for the issue is then initiated, allowing various types of investor's individuals, institutions, and retail investors to apply for shares within this timeframe.

b) During this period, investors place their bids according to the set offer price or within the price range established through the book-building process.

3. Underwriting and Subscription Handling

a) If a public offering does not attract enough investors, underwriters will buy the unsold securities to help the company achieve its capital-raising goals.

b) When an offering is oversubscribed, meaning there are more applications than available shares, the company might allocate shares proportionally among investors or potentially expand the offering to accommodate the high demand.

c) Oversubscription or Under subscription: In the case of oversubscription, where there are more applications than available shares, the company may opt to either increase the number of shares offered or distribute the shares proportionally among the applicants. If the issue is undersubscribed, underwriters will purchase the remaining shares to ensure the company achieves its desired capital raise.

4. Allotment of Securities and Listing

a. Allotment of Shares

When the subscription period ends, the company and its intermediaries complete the process of distributing shares to investors. Shares are allocated according to the investors' subscriptions and the final price set (if using the book-building method). Investors are then issued allotment letters or notifications indicating the number of shares they have been assigned.

b. Refund Process

For investors who requested more shares than they received or in cases of oversubscription, any excess application funds are refunded. This refund is typically processed via electronic transfers or other methods outlined in the offering details.

c. Listing on the Stock Exchange

Once the allotment process is finalized, the shares are listed on a stock exchange (such as the BSE, or NSE), allowing them to be traded in the secondary market. This listing facilitates liquidity for investors interested in buying or selling shares after the initial offering.

The day when shares are first available for trading is referred to as listing day. On this day, the market sets the stock price according to the forces of supply and demand.

5. Post-Issue Compliance and Reporting

a. Continuous Disclosure Obligations

• After a company’s shares are listed, it is required to meet continuous disclosure obligations set by regulatory agencies and the stock exchange. This includes:

• Submitting quarterly financial statements

• Reporting significant business developments

• Revealing any key information that might impact the stock price or investor decisions

b. Oversight of Performance

• Regulatory bodies keep track of the company's performance to ensure compliance with market rules and to maintain transparency for investors. This involves regular financial updates, adherence to corporate governance standards, and ongoing investor relations management.

4.10 THE ROLE OF UNDERWRITING IN THE PRIMARY MARKET

Underwriting is crucial in the primary market as it enables companies to raise capital with certainty by managing risks and ensuring the success of the issuance. It is vital for determining the pricing of securities, generating investor interest, ensuring adherence to regulatory standards, and lending credibility to the offering. Underwriters, typically financial institutions like investment banks, play a key role in assessing the risks involved, setting appropriate pricing, and guaranteeing the sale of securities by purchasing any unsold shares. This process helps companies achieve their capital-raising goals while safeguarding investor interests and upholding the offering’s integrity. Here are the main reasons underwriting is vital in the primary market:

1. Risk Mitigation for Issuers: Underwriting primarily ensures that the issuer will secure the desired amount of capital. Underwriters commit to buying any remaining shares if there is insufficient demand, thus guaranteeing that the issuer receives the full amount of funds it aims for. Additionally, underwriting mitigates the risk for the issuer by absorbing the potential shortfall if investor interest falls short, particularly in unstable or uncertain market conditions. This arrangement protects the issuer from the adverse effects of a poorly received or undersubscribed offering.

2. Fair Pricing of Securities

a) Setting the Price: Underwriters are essential in assisting the issuer in establishing the correct price for the offered securities. They evaluate the company's financial status, current market trends, and investor interest to determine a price that is appealing to investors and enables the issuer to achieve its capital-raising goals.

b) Preventing Price Misalignment: Through thorough market analysis and feedback from investors, underwriters work to avoid the issues of under-pricing, where the issuer might raise less capital than possible, and overpricing, where the securities may be too costly for investors, potentially leading to insufficient demand.

3. Enhancing Market Confidence

a) Credibility and Trust: Underwriting adds legitimacy to the offering. When respected financial institutions or investment banks take on the underwriting role, it enhances investor confidence by indicating that the issuing company is reliable and financially sound.

b) **Investor Protection:** Underwriters perform thorough due diligence on the issuer to ensure full disclosure of financial details, regulatory compliance, and the accuracy of the offering. This process helps safeguard investors from potential risks and fraudulent activities.

4. Efficient Marketing and Distribution

a) **Generating Interest:** Underwriters play a key role in promoting securities to potential investors. They organize roadshows, conduct presentations, and engage in other marketing activities to spark interest in the securities.

b) **Expansive Reach:** By leveraging their connections with institutional and retail investors, underwriters ensure that the securities are widely distributed. This broad outreach is crucial for raising the necessary capital by attracting a wide range of investors.

5. Structuring the Offering

Underwriters play a key role in organizing the securities offering by defining the size of the issue, deciding the type of security (such as equity or debt), and setting the terms of the offering, including factors like maturity dates, interest rates for bonds, or dividend policies for equity. Additionally, during Initial Public Offerings (IPOs), underwriters oversee the book-building process, gathering bids from investors to assess demand. This process aids in determining the optimal price and facilitates a more efficient allocation of securities.

6. Handling Oversubscription and Allotment

a. Handling Oversubscription: When the demand for securities surpasses their availability, underwriters handle the allocation process to ensure that shares are distributed equitably and effectively among investors.

b. Price Stabilization: Post-offering, underwriters frequently assist in stabilizing the stock price during initial trading. They may purchase shares if the price drops below the initial offering price to sustain market confidence in the new securities.

7. Regulatory Compliance

a. Compliance Assurance: Underwriters are tasked with making sure that the entire securities issuance process adheres to legal and regulatory standards. This includes preparing and filing necessary documents, such as the prospectus, and ensuring conformity with securities regulations set by bodies like the Securities and Exchange Commission (SEC) or the Securities and Exchange Board of India (SEBI).

b. Transparency and Disclosure: Underwriters collaborate with legal and financial advisors to guarantee that all information in the prospectus and other related documents is accurate, clear, and comprehensive, thereby safeguarding investor interests.

8. Support for Smaller Companies

a. Capital Market Access: Underwriting plays a crucial role for smaller or lesser-known companies that may struggle to attract investors independently. By leveraging their credibility and expertise, underwriters offer these companies a vital platform to raise capital effectively.

b. Advisory Services: For smaller businesses, underwriters also provide advisory support, helping them navigate market conditions, determine the optimal timing for their issue, and make strategic decisions that influence the success of the offering.

9. Underwriting Syndicates

a. Risk Sharing: In major public offerings, multiple underwriters often form an underwriting syndicate to collectively assume the risk associated with the issuance. This approach is especially beneficial for substantial offerings, where a single institution may not have the capacity to handle the entire underwriting process on its own.

b. Broad Market Access: Syndicates also expand their reach to a broader investor base by combining the marketing and distribution resources of several firms.

4.11 PRICING MECHANISMS IN THE PRIMARY MARKET

In the primary market, choosing the right pricing mechanism is essential for setting the price at which new securities are sold to investors. Each method comes with its benefits and drawbacks, influenced by factors like market conditions, the issuer's objectives, investor preferences, and the offering's scale. Fixed price methods provide straightforwardness and predictability, whereas book building and Dutch auctions offer a more flexible approach based on investor demand. Selecting the most suitable pricing strategy helps issuers align their offerings with market trends and investor expectations, thereby improving the chances of a successful capital raise. These methods ensure that securities are priced both fairly and attractively, balancing the interests of issuers and investors. Here is the main pricing mechanisms used in the primary market:

1. Fixed Price Method

In the fixed price method, the issuer establishes a set price for the securities prior to the commencement of the offering. This price is outlined in the prospectus, and investors purchase the securities at this fixed amount.

Process:

1) Setting the Price: The issuer, typically in collaboration with underwriters, establishes a fixed price for the securities, taking into account market trends, the company's financial status, and investor demand.

2) Announcement: The predetermined price is clearly outlined in the prospectus and promotional materials.

3) Investment: Investors submit applications to purchase the securities at the established fixed price during the subscription period.

4) Distribution: Shares are distributed to investors according to their applications at the set price. If the offering is oversubscribed, shares may be allocated proportionally among investors.

Advantages:

a) Simplicity: The process is uncomplicated because the price is set and communicated beforehand.

b) Certainty: Both investors and issuers benefit from clarity; investors are aware of the exact price, and issuers can predict the amount of capital to be raised.

Disadvantages:

a) Mispricing Risk: There is a potential risk of the issuer setting the price too high or too low if market conditions shift during the offering.

b) No Market Feedback: The fixed price approach does not allow for adjustments based on investor interest during the subscription period.

2. Book Building Method

The book-building method is a flexible pricing approach where the final price of securities is set according to investor demand. This process involves gathering bids from investors within a predetermined price range and then establishing the final price based on the level of demand received.

Process:

1) Setting the Price Range: The issuer and underwriters establish a price range for the securities, which is outlined in the prospectus.

2) Investor Bidding: During the book-building phase, investors place bids specifying the number of shares they want to purchase and the price they are willing to pay within the set range.

3) Aggregating Bids: Underwriters collect and analyse these bids to assess demand at various price levels.

4) Determining the Final Price: The final issue price is set based on the overall demand and investor responses, ensuring that the entire issue can be sold.

5) Share Allocation: Shares are distributed to investors at the determined final price, often giving preference to institutional investors with higher bids.

Advantages:

a) Price Discovery: The book-building method enables a more precise setting of the market price by reflecting actual investor demand.

b) Flexibility: It offers the ability to adjust the price within a specified range based on changing market conditions and investor interest.

c) Market Efficiency: It contributes to fair pricing and improved distribution of shares.

Disadvantages:

a) Complexity: This approach is more intricate than the fixed price method, necessitating careful management of investor bids and pricing.

b) Price Volatility: Significant fluctuations in investor demand can lead to variability in the final price.

3. Dutch Auction Method

The Dutch auction method is a variation of the book-building approach where the issuer gathers bids at different prices to establish a clearing price for the shares.

Process:

1) Auction Setup: Investors place bids specifying the number of shares they want to purchase and the price they are prepared to pay.

2) Price Adjustment: The auction process involves gradually lowering the price until the total number of shares requested equals the number available.

3) Clearing Price: The final price, known as the clearing price, is the lowest at which all available shares can be sold. All successful bidders receive their shares at this clearing price, irrespective of their initial bid amounts.

4) Allotment: Shares are distributed to investors according to their bids and the established clearing price.

Advantages

a) Clear Pricing: The clearing price is set based on actual demand, ensuring transparent pricing.

b) Equitable Distribution: Shares are allocated fairly to all successful bidders at the clearing price.

Disadvantages:

a) Price Uncertainty: Investors might not know the final price until the auction concludes.

b) Possibility of Lower Price: The final price might end up lower than expected due to high competition among bidders.

4. Fixed Price with Book Building Option

This hybrid approach integrates aspects of both the fixed price and book-building methods. Initially, the issuer establishes a set price and presents it in the prospectus, but adjustments can be made based on feedback gathered during the book-building process.

Process:

1) Initial Fixed Price: The issuer determines and announces a preliminary fixed price in the prospectus.

2) Feedback Collection: Throughout the subscription period, the issuer and underwriters collect feedback and modify the final price according to investor demand.

3) Final Pricing: The ultimate price may be revised within a set range, reflecting the feedback and demand from investors.

4) Share Allocation: Investors receive shares at the final adjusted price.

Advantages:

a) Balance: Provides a mix of the certainty offered by fixed pricing with the flexibility of book building.

b) Adaptability: Facilitates adjustments in response to current market conditions and investor interest.

Disadvantages:

a) Complexity: Results in a more intricate process compared to straightforward fixed pricing, as it integrates aspects of both methods.

b) Share Allocation: Investors receive shares at the final adjusted price.

4.12 RISKS AND CHALLENGES IN THE PRIMARY MARKET

The primary market, where new securities are introduced to investors, comes with a variety of risks and challenges for issuers, investors, and intermediaries. Recognizing these risks and challenges is essential for successful market participation and for addressing potential issues that might arise during the issuance process. Effective management of these risks involves detailed planning, rigorous due diligence, strategic pricing, and adherence to regulatory standards. By understanding and addressing these risks, participants in the primary market can more effectively manage the complexities of securities issuance and achieve their capital-raising goals. Below are some of the primary risks and challenges in this market:

1. Market Risk

Market risk is the possibility of financial loss arising from unfavourable changes in market conditions. It influences both the demand for securities and the pricing of new issuances.

Challenges

a) Volatility: Significant market volatility can cause shifts in investor sentiment, affecting demand for new securities and potentially leading to pricing challenges or under-subscription.

b) Economic Conditions: Poor economic conditions, such as during recessions, can lower investor confidence and reduce interest in new securities.

2. Pricing Risk

Pricing risk entails the difficulty of establishing a price for new securities that appeals to investors while fulfilling the issuer's objectives for raising capital.

Challenges:

a. Mispricing: Setting the price of securities too high or too low can negatively affect market performance. Overpricing may result in low demand, while under-pricing could lead to raising insufficient capital.

b. Price Adjustments: In methods like book building, finalizing the price based on investor interest can be complicated, and adjustments may not always be well-received by all stakeholders.

3. Regulatory and Compliance Risk

Regulatory and compliance risks involve the difficulties associated with adhering to legal and regulatory standards during the issuance process.

Challenges:

a. Regulatory Updates: Shifts in regulations or compliance guidelines during the issuance can lead to uncertainties and potential hold-ups.

b. Errors in Documentation: Mistakes or missing information in key documents, such as the prospectus, may result in legal consequences, fines, or the cancellation of the offering.

c. Delays in Approval: A slowdown in securing regulatory approvals can affect the timeline and overall success of the issuance.

4. Underwriting Risk

Underwriting risk refers to the difficulties underwriters may encounter during the issuance process.

Key Challenges:

a. Underwriter Obligation: If the issue is heavily undersubscribed, underwriters might struggle to meet their obligations, which could result in financial losses.

b. Conflict of Interest: Underwriters might face conflicts of interest, especially when they are involved in other financial dealings with the issuer, which can compromise their impartiality.

5. Operational Risk

Operational risk involves the potential threats originating from internal procedures, systems, and human elements during the issuance process.

Challenges:

a) Process Errors: Mistakes in the issuance procedures, like mishandling subscriptions or allocation problems, can affect the offering's overall success.

b) Technical Problems: Malfunctions in the electronic platforms used for subscriptions or trading can disrupt the process and limit investor engagement.

6. Legal Risk

Legal risk refers to the possibility of facing legal issues or disputes during or after the issuance of securities**.**

Challenges:

a) Lawsuits: Investors or other stakeholders may initiate legal actions if they suspect violations of disclosure requirements or fraudulent behavior.

b) Contractual Conflicts: Disagreements may occur between the issuer, underwriters, or other parties involved regarding the terms and conditions of their agreements.

9. Reputational Risk

Reputational risk refers to the possible effects on the reputation of the issuer or underwriter due to complications with a securities offering.

Challenges:

a) Adverse Publicity: If the issued securities perform poorly or the offering faces controversies, the reputations of both the issuer and underwriters may suffer.

b) Investor Trust: A failed or flawed offering can diminish investor trust in the issuer, making future fundraising more difficult.

10. Demand Risk

Demand risk refers to the difficulty in generating enough investor interest to guarantee the success of an offering.

Challenges:

a) Investor Sentiment: Changes in investor attitudes may result in lower demand, potentially undermining the issuance's success.

b) Market Competition: Competing investment options or securities offerings can reduce the appeal of the new issuance.

11. Liquidity Risk

Liquidity risk relates to the difficulty of buying or selling newly issued securities in the secondary market after they have been issued.

Challenges:

a) Low Trading Volume: If the securities experience low trading activity, their liquidity and attractiveness can be diminished.

b) Price Impact: Limited liquidity can cause greater price fluctuations and broader bid-ask spreads, which may affect investors' ability to transact in the securities.

10. Economic and Political Risk

Economic and political risks involve external factors that influence the primary market.

Challenges:

a) Economic Downturns: Recessions or economic slowdowns can diminish investor interest and disrupt market conditions.

b) Political Instability: Political events or unrest can create uncertainty, affecting investor confidence and market performance.

4.13 SIGNIFICANCE OF THE PRIMARY MARKET IN ECONOMIC DEVELOPMENT

The primary market, where newly issued securities are sold to investors for the first time, is crucial in driving economic development. It allows businesses and governments to raise essential capital, thereby supporting growth, job creation, infrastructure development, and overall financial advancement. Here’s how the primary market contributes to economic development:

1. Capital Formation and Resource Mobilization

The primary market enables businesses and governments to secure long-term funding through the issuance of equity (stocks) or debt (bonds). This funding is crucial for initiating new projects, expanding operations, and building infrastructure.

a) Business Expansion: Companies can obtain capital to support growth initiatives, adopt new technologies, or enter new markets, which fosters business development, boosts productivity, and increases profitability.

b) Public Infrastructure: Governments can issue bonds to gather funds for public infrastructure projects like roads, bridges, hospitals, and schools, contributing to national development.

c) Efficient Resource Allocation: By directing savings from individuals and institutions into productive investments, the primary market helps allocate resources effectively to sectors with high growth potential.

2. Job Creation and Employment Opportunities

When companies secure capital via the primary market, they can invest in new ventures, broaden their operations, and boost production capacity, which leads to increased job creation.

a) Direct Job Creation: Companies that obtain funding through the primary market typically invest this capital into expanding their operations, resulting in the direct creation of new jobs.

b) Indirect Job Creation: The expansion of companies leads to a higher demand for suppliers, services, and infrastructure, thereby generating additional employment opportunities in related sectors.

c) Government Projects: Funds raised by governments through bond issuance finance public projects that need labour, thereby contributing to job creation in areas such as construction, education, and healthcare.

3. Promoting Entrepreneurship and Innovation

The primary market supports entrepreneurship and innovation by offering capital to start-ups and smaller enterprises that might otherwise struggle to obtain funding through traditional banking channels.

a) Start-up Financing: Through the issuance of new shares, emerging and innovative businesses can secure the capital needed to advance new technologies and business models.

b) Venture Capital and Private Equity: Investors can contribute to the growth of nascent companies by buying shares in initial public offerings (IPOs) or through venture capital investments, which encourages both innovation and risk-taking.

c) Technological Progress: Access to funding from the primary market allows companies to invest in research and development (R&D), driving technological progress that enhances productivity and fosters economic development.

4. Enhancement of Corporate Governance

When companies issue securities in the primary market, they must comply with more rigorous regulations and governance standards. This results in improved transparency and accountability in their operations.

a) Increased Disclosure: Companies going public are required to provide detailed financial and operational information, which enhances transparency and builds investor confidence.

b) Improved Management Practices: Publicly traded companies face greater scrutiny from regulators, shareholders, and the general public, which promotes better management practices and a focus on long-term success.

c) -Investor Protection: Regulatory oversight in the primary market safeguards investors' rights, minimizes fraudulent activities, and contributes to a more secure financial environment.

5. Advancement of Financial Markets

The effectiveness and expansion of the primary market are crucial for the advancement of the overall financial markets. A robust primary market supports the development of secondary markets and enhances the entire financial system.

a) Enrichment of Financial Markets: The creation of new securities expands the pool of financial assets, enriching the financial markets and offering additional investment prospects for investors.

b) Enhanced Market Liquidity: Newly issued securities transition from the primary market to the secondary market, which boosts liquidity and facilitates more efficient trading.

4.14 SUMMARY

The primary market plays a vital role in generating capital, which drives economic expansion and progress. By allowing businesses and governments to secure funding, it facilitates infrastructure growth, business expansion, and technological innovation. This influx of new capital promotes job creation, boosts productivity, and encourages innovation. In the primary market, various types of securities are issued, including:

Equity Shares: These shares signify ownership in a company. Investors buying these shares in the primary market gain partial ownership of the company, which may include voting rights and dividend payments.

Debt Instruments: To secure funding, companies and governments can issue bonds or debentures. These debt instruments involve borrowing money from investors, with a commitment to repay the principal amount along with interest.

Hybrid Instruments: Certain securities, such as convertible debentures or preference shares, blend characteristics of both equity and debt instruments, providing greater investment flexibility

The primary market engages various intermediaries, including investment banks, underwriters, brokers, and registrars, who support the securities issuance process. These intermediaries help with tasks such as performing due diligence, setting security prices, and ensuring regulatory compliance. Underwriters are especially important as they commit to purchasing any remaining shares if the public does not fully buy into the offering, thereby ensuring that the capital target is met.

4.15 GLOSSARY

Public Offering: This involves a company offering its shares or securities to the general public. The most well-known type is the Initial Public Offering (IPO), where a company first sells shares to the public. There is also the Follow-on Public Offering (FPO), which involves issuing additional shares after the IPO.

Private Placement: Here, securities are sold directly to a limited group of investors, typically institutional investors such as mutual funds, banks, or insurance companies. This method is quicker and less expensive than public offerings but is limited in the number of investors.

Rights Issue: Companies offer new shares to existing shareholders, allowing them to purchase additional shares at a discounted rate based on their current holdings.

Preferential Allotment: In this approach, securities are offered to a specific group of investors, often insiders or major investors, at a preferential price before being made available to the public.

Legal risk refers to the possibility of facing legal issues or disputes during or after the issuance of securities.

Reputational risk refers to the possible effects on the reputation of the issuer or underwriter due to complications with a securities offering.

Demand risk refers to the difficulty in generating enough investor interest to guarantee the success of an offering.

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4.18 TERMINAL QUESTIONS

1. What distinguishes the primary market from the secondary market?

2. Can you explain what an Initial Public Offering (IPO) is?

3. What function do underwriters serve in the primary market?

4. What does regulatory risk entail in the context of the primary market?

5. Which regulatory bodies oversee the primary market?

UNIT 5 GOVERNMENT SECURITIES MARKET

5.1 INTRODUCTION

The **Government Securities Market** in India refers to the market where debt instruments issued by the Government of India (GoI) and state governments are traded. These securities are used by the government to raise funds to meet its expenditure and fiscal needs. They are considered one of the safest forms of investment due to the backing of the government, offering low-risk opportunities for investors.

5.2 OBJECTIVES

After studying this unit, you will be able to understand;

- Features of Government Securities Market
- Players in Government Securities (G-Secs) Market
- Purpose of Issuing Government Securities Market
- Importance of Government Securities Market
- Types of Government Securities

5.3 KEY FUNCTIONS

The government requires enormous amounts of money to perform several key functions essential for the functioning and development of the country. These functions include:

1. Public Administration and Governance

- **Salaries and Benefits:** The government needs funds to pay for the salaries, pensions, and other benefits of its employees, including bureaucrats, defense personnel, law enforcement, and public service staff.
- **Public Infrastructure:** Funds are needed for maintaining and upgrading public buildings, government offices, courts, and other administrative infrastructure.
- **Policy Implementation:** Governments require money to execute policies, programs, and initiatives designed to achieve national development goals.

2. National Defense and Security

- **Defense Expenditure:** A significant portion of government spending is allocated to defense forces, including the army, navy, air force, and intelligence agencies. This includes costs for:
    - Procurement of weapons, equipment, and technology.
    - Salaries and welfare of military personnel.
    - National security operations, including counter-terrorism and border security.

3. Public Welfare and Social Programs

- **Health Care:** Governments allocate funds to maintain public health systems, including hospitals, clinics, vaccination programs, and public health campaigns.
- **Education:** Large amounts of money are needed to fund public education at all levels, including schools, colleges, and universities. This also includes government subsidies for education and scholarships for students.

- **Pensions and Social Security:** Funds are required for pension schemes for retired government employees, social security benefits for citizens, and other welfare programs targeting marginalized and vulnerable groups.
- **Subsidies and Grants:** The government often provides subsidies on essential goods (e.g., food, fuel, fertilizers) and grants to sectors such as agriculture, industry, and small businesses.

4. Economic Infrastructure and Development

- **Transportation and Connectivity:** Funding is required to build and maintain infrastructure like roads, highways, bridges, railways, airports, and ports. This also includes mass transit systems in urban areas.
- **Energy Infrastructure:** Investment in power generation, distribution networks, and renewable energy projects (such as solar and wind) is a significant area of government expenditure.
- **Urban and Rural Development:** The government invests in urban planning, rural development, housing, sanitation, and water supply systems.

5. Debt Servicing (Repayment of Loans)

- **Interest Payments:** A substantial part of government expenditure is used to service the debt—paying interest on loans taken both domestically and internationally. This includes payments to bondholders, commercial banks, and international organizations.
- **Repayment of Principal:** Governments also need funds to repay the principal amount of their outstanding loans or bonds when they come due.

6. Disaster Management and Emergency Response

- **Natural Disasters:** Governments need money to manage natural disasters such as floods, earthquakes, droughts, and cyclones. This includes relief efforts, rebuilding infrastructure, and compensating affected populations.
- **Pandemic Response:** During health crises like pandemics (e.g., COVID-19), governments need funding to provide healthcare services, conduct mass vaccinations, and provide economic relief to businesses and individuals.

7. Public Debt and Fiscal Deficit Management

- Governments often run **fiscal deficits**, where their expenditure exceeds their revenue. To bridge this gap, they borrow money from various sources, including issuing bonds and taking loans from domestic and foreign lenders. These borrowings come with the responsibility of repaying both principal and interest, requiring careful fiscal management.

8. Economic Stabilization and Monetary Policy

- **Stabilizing the Economy:** During periods of inflation or recession, the government may need funds to stimulate the economy through public spending, subsidies, or stimulus packages.
- **Central Bank Operations:** Funding is required for the operations of the central bank (RBI in India) to manage inflation, control money supply, and maintain currency stability.

9. Research, Innovation, and Technological Development

- Governments need funding for scientific research, innovation, and technological advancements, especially in sectors like defense, space exploration, healthcare, and agriculture. Investments are made in research institutions and the promotion of technological startups.

10. Environmental Protection and Sustainability

- Governments allocate funds to address climate change, pollution, and conservation. This includes efforts to promote renewable energy, protect forests, and manage waste.
- Investment in sustainable agriculture, water conservation, and green infrastructure is also a growing area of government expenditure.

11. Foreign Relations and Diplomacy

- Governments need to allocate funds for maintaining diplomatic relations, foreign aid programs, defense alliances, and contributions to international organizations (e.g., the United Nations, WTO, etc.).

To meet these diverse functions and obligations, the government needs vast amounts of capital. This is typically sourced from:

a. **Tax Revenues:** Collected through income tax, corporate tax, goods and services tax (GST), excise duties, etc.

b. **Borrowing:** Through the issuance of government bonds and loans.

c. **Non-Tax Revenues:** From the sale of public assets, dividends from public sector enterprises, and other revenue-generating activities.

One of the important sources of borrowing funds is the government securities market (GSM). The government raises short term and long-term funds by issuing securities. While treasury Bills are issued to meet short term cash requirements of the government, dated securities are issued to mobilize longer term resources to finance the fiscal deficit. These securities do not carry risk and are as good as gold as the government guarantees the payment of interest and the repayment of principal. They are, therefore, referred to as gilt-edged securities. The government securities market is the largest market in any economic system and therefore is the benchmark for others.

5.4 FEATURES OF GOVERNMENT SECURITES MARKET

The main features of the government securities market in India are as follows:

1. The government securities are the marketable debt instruments issued by the central and state governments.
2. Government securities occupy an important place in the financial market. Reserve Bank of India purchases and sells these securities in the open market to exercise monetary control in the country.
3. Government securities carry a fixed rate of interest which is payable half yearly. The rate of interest on government securities is generally lower as compared to other securities.
4. The face value of these securities is either Rs 100 or Rs 1,000
5. Government securities are safest as regards the payment of interest and the repayment of the principal amount.
6. Government securities can be issued either in the form of Stock Certificate (SC), Promissory note (PN) or Bearer Bond. But out of these, promissory notes are most important.
7. Government securities are issued through the Public Debt Office (PDO) of the RBI. There is no need to issue prospectus. However, no objection certificate is obtained from primary issues which is generally granted in routine.
8. The government securities market is an over-the-counter market where there is one to one correspondence between the buyer and the seller without using the services of brokers.
9. Institutional investors are the main participants in the government securities market. But Since December,2001, the RBI allowed individuals also to buy government securities in a noncompetitive environment.
10. Brokers and dealers play a very limited role in marketing of government securities because banks can approach RBI directly for these securities.

5.5 PLAYERS IN GOVERNMENT SECURITES (G-SECS) MARKET

The Government Securities (G-Secs) market in India is an essential component of the country's financial system. It is made up of various players who participate in the issuance, trading, and regulation of these securities. Below are the key players involved in the G-Secs market:

1. Reserve Bank of India (RBI)

Role:

i. **Issuer of Government Securities:** The RBI acts as the **agent** of the Government of India (GoI) for issuing and managing government securities.

ii. **Monetary Policy Operations:** The RBI conducts **Open Market Operations (OMOs)** to manage liquidity and control inflation, which involves buying and selling government securities in the secondary market.

iii. **Regulator:** The RBI regulates the primary market for government securities, conducting periodic **auctions** for T-Bills and government bonds on behalf of the government.

iv. **Market Maker:** As the central authority, the RBI also provides liquidity to the G-Secs market, ensuring smooth operations and price discovery.

v. **Retail Direct Scheme:** The RBI has also launched platforms like the **RBI Retail Direct Scheme** to facilitate retail investors' participation in the G-Secs market.

2. Government of India (GoI)

Role:

i. **Issuer of Securities:** The Government of India is the issuer of government bonds, treasury bills, and other securities. It raises funds to meet fiscal requirements, such as financing budgetary deficits and funding public projects like infrastructure, welfare programs, and defense spending.

ii. **Fiscal Policy Influence:** The GoI determines the borrowing needs for each fiscal year and sets the terms for the issue of government securities.

3. State Governments

Role:

i. **State Development Loans (SDLs):** Like the central government, state governments issue **State Development Loans (SDLs)** to meet their financial needs. These bonds are issued to fund state-level development projects and fiscal expenditures.

ii. **Borrowing from Markets:** While state governments issue SDLs, the **Reserve Bank of India (RBI)** conducts the auctions on behalf of the states, and the state governments are responsible for repaying the debt.

4. Primary Dealers

Role:

i. **Market Makers:** Primary dealers are specialized financial institutions authorized by the RBI to deal in government securities. They play a key role in **market making**, i.e., providing liquidity by buying and selling government securities in the secondary market.

ii. **Underwriting Auctions:** They are responsible for underwriting the issuance of government securities in primary auctions. This means that they commit to purchasing any unsold portion of government securities during the auctions.

iii. **Trading and Liquidity:** Primary dealers contribute to the **liquidity and depth** of the G-Secs market by actively buying and selling government securities in the secondary market.

Examples of Primary Dealers:

- Commercial banks (e.g., State Bank of India, ICICI Bank)
- Specialized financial institutions (e.g., Securities Trading Corporation of India, IDFC Bank)

5. Commercial Banks and Financial Institutions

Role:

i. **Major Investors:** Commercial banks are one of the largest categories of institutional investors in G-Secs. They buy government bonds to meet their **Statutory Liquidity Ratio (SLR)** requirements, a mandate by the RBI that requires banks to hold a certain percentage of their net demand and time liabilities in the form of liquid assets like government securities.

ii. **Custodians and Traders:** Banks act as custodians and intermediaries in the G-Secs market, helping retail and institutional investors buy and sell securities.

iii. **Liquidity Providers:** Banks also play an important role in providing liquidity in the secondary market for government securities.

6. Mutual Funds

Role:

i. **Investors:** Mutual funds, especially debt-oriented schemes, invest heavily in G-Secs due to their low-risk nature and stable returns. G-Secs form a significant portion of the portfolios of **bond funds**, **government securities funds**, and **short-term debt funds**.

ii. **Investment Strategy:** Mutual funds invest in G-Secs to provide investors with relatively safer options while maintaining a balance between risk and return.

iii. **Market Makers:** Some large mutual funds also act as market participants, buying and selling government securities, contributing to the overall liquidity in the market.

7. Insurance Companies

Role:

i. **Large Investors:** Insurance companies are another important institutional investor in the G-Secs market. They prefer G-Secs as part of their portfolio because they offer long-term, stable returns, which align with the long-term nature of their liabilities.

ii. **Asset-Liability Matching:** Since insurance companies have long-term liabilities (e.g., life insurance payouts), they often invest in long-duration G-Secs to match the maturity profiles of their liabilities.

8. Pension Funds

Role:

i. **Safe Investment Vehicles:** Pension funds are long-term investors in G-Secs due to their stable and predictable income flows, which are crucial for pension liabilities.

ii. **Large-Scale Investors:** They allocate a significant portion of their portfolios to government securities, especially in the **long-term bonds** market.

9. Foreign Institutional Investors (FIIs) / Foreign Portfolio Investors (FPIs)

Role:

i. **Global Investors:** FIIs and FPIs can invest in Indian government securities as part of their global portfolio allocation. They contribute to the demand for G-Secs in the secondary market.

ii. **Capital Flows:** Foreign investments in Indian G-Secs help in inflows of foreign capital, impacting the rupee exchange rate, and can be a signal of foreign confidence in India's fiscal policies.

iii. **Regulation:** The RBI and SEBI regulate the participation of foreign investors in government securities, with specific limits on the amount of G-Secs foreign investors can hold.

10. Retail Investors

Role:

i. **Direct Participation:** Retail investors can participate directly in the G-Secs market through platforms like the **RBI Retail Direct Scheme**, which allows individuals to purchase government bonds and securities online.

ii. **Low-Risk Investment:** Retail investors are increasingly attracted to G-Secs due to their low-risk profile, fixed returns, and safety compared to other market instruments like equities and corporate bonds.

iii. **Government Schemes:** Retail investors can also invest in specialized schemes like **Sovereign Gold Bonds (SGBs)**, which offer returns linked to the price of gold along with a fixed interest.

11. Rating Agencies

Role:

i. **Credit Rating:** Credit rating agencies (e.g., CRISIL, ICRA, CARE Ratings) provide independent assessments of the creditworthiness of government securities. While G-Secs are generally considered to have low credit risk, the agencies may also provide ratings for specific government bonds, including state bonds (e.g., State Development Loans or SDLs).

ii. **Market Confidence:** Ratings help investors gauge the relative risk of investment in different securities and ensure greater transparency in the market.

12. Regulatory Authorities:

Securities and Exchange Board of India (SEBI):

i. SEBI oversees the **secondary market trading** of government securities and ensures **transparency**, **fair practices**, and **investor protection**.

ii. While the RBI governs the issuance and primary market of G-Secs, SEBI's role is crucial in ensuring that the secondary market is well-regulated and operates efficiently.

The Government Securities (G-Secs) market in India is a well-developed ecosystem involving a range of participants from the government to institutional and retail investors. The major key players in the government securities market include the following:

i. Central and state governments
ii. Commercial banks, RBI, SBI and Cooperative banks
iii. Specialized financial institutions such as IDBI, IFCI, SFC etc.
iv. Joint stock companies
v. Non-banking financial companies (NBFCs)
vi. Investing institutions such as LIC, GIC and UTI
vii. Provident funds, both statutory and non-statutory
viii. Individuals

The market is highly regulated, with authorities like the RBI and SEBI playing crucial roles in its oversight and operations. This ecosystem facilitates the government's fiscal management and provides investors with a stable and low-risk investment avenue.

5.6 PURPOSE OF ISSUING GOVERNMENT SECURITIES

Government securities (G-Secs) are debt instruments issued by the government to raise funds for various purposes. These securities allow the government to borrow money from the public, financial institutions, and foreign investors to finance its spending and fulfill various financial needs. The issuance of government securities serves several key purposes, which can be broadly categorized as follows:

1. Financing Fiscal Deficit

- **Covering Budget Deficits:** One of the primary purposes of issuing government securities is to finance the **fiscal deficit**. When the government's expenditure exceeds its revenues (through taxes and other income), it borrows funds to cover the gap. These funds are raised by issuing bonds, treasury bills, and other securities.
- **Public Debt:** The government borrows money in the form of G-Secs, which creates a liability to be repaid in the future. This is a common method used by most governments worldwide to bridge the gap between income and expenditure.

2. Funding Infrastructure and Development Projects

- **Capital Expenditure:** Governments use the funds raised through the issuance of G-Secs to finance **long-term capital projects** such as infrastructure development. These include the construction of roads, bridges, airports, power plants, hospitals, schools, and other public facilities.
- **Public Sector Investments:** G-Secs provide a way for the government to invest in public sector enterprises, developmental programs, and large-scale projects that are critical for national growth and welfare.

3. Supporting Economic Stimulus and Growth

- **Economic Stimulus in Times of Recession:** During periods of economic downturn or recession, the government may issue more securities to raise funds for economic stimulus packages. These funds can be used to support industries, provide unemployment benefits, subsidize certain sectors, or invest in social welfare schemes to stimulate economic activity.
- **Crisis Management:** In times of national emergencies, such as natural disasters or pandemics (e.g., COVID-19), the government may issue securities to raise funds for immediate relief and recovery efforts.

4. Monetary Policy Implementation (Open Market Operations)

- **Managing Liquidity in the Economy:** The **Reserve Bank of India (RBI)** uses the issuance and buying/selling of G-Secs as a tool for **monetary policy** implementation. Through **Open Market Operations (OMOs)**, the RBI buys or sells government securities in the market to manage liquidity levels in the economy and influence interest rates.

- **Controlling Inflation and Money Supply:** By issuing G-Secs, the RBI can absorb excess liquidity from the market (through bond sales) or inject liquidity into the economy (by purchasing bonds). This helps control inflation and stabilize the economy.

5. Debt Management and Refinancing Existing Debt

- **Managing Existing Debt:** Governments use G-Secs to manage their existing debt burden. If the government has maturing debt (i.e., previous bonds or loans coming due), it may issue new bonds to refinance or roll over this debt, effectively extending the repayment period and reducing the immediate fiscal pressure.
- **Debt Restructuring:** G-Secs can also be used in **debt restructuring** processes, where the government may offer new securities to replace old ones with more favorable terms (e.g., lower interest rates or longer maturities).

6. Funding Social Welfare Programs and Public Services

- **Welfare Programs:** Funds raised through G-Secs can be allocated for various social welfare schemes, such as **pension schemes**, **healthcare**, **education**, **subsidies**, and **employment generation** programs. These are often critical in ensuring social stability and reducing inequality.
- **Public Goods and Services:** The government uses the funds to provide essential public goods and services, such as clean drinking water, sanitation, public health initiatives, and emergency services. These are typically non-revenue generating sectors that require sustained funding.

7. Encouraging Domestic Savings and Investment

- **Attracting Investment:** Issuing G-Secs allows the government to tap into **domestic savings** and invest it in long-term, stable instruments. Since government securities are considered a safe investment, they attract a large number of institutional and retail investors.
- **Safe Investment Avenue:** G-Secs offer a low-risk, fixed-income investment opportunity, which is attractive to conservative investors such as banks, pension funds, mutual funds, and individual investors looking for secure returns.

8. Increasing Financial Market Depth and Liquidity

- **Developing Financial Markets:** The issuance of G-Secs enhances the depth and liquidity of the country's **capital markets**. A robust market for government securities is essential for the efficient functioning of the overall financial system, as these securities serve as the benchmark for pricing other financial instruments (such as corporate bonds).
- **Benchmark for Other Instruments:** Government securities, especially long-term bonds, provide a benchmark for pricing other fixed-income securities. They are

used by financial institutions and investors to determine the yield curve, which reflects the interest rates for different maturities.

9. Encouraging Foreign Investment and Capital Inflows

- **Foreign Portfolio Investment (FPI):** Foreign investors, particularly Foreign Portfolio Investors (FPIs), are allowed to invest in Indian government securities. This brings in much-needed **foreign capital** and helps the country maintain a favorable balance of payments.
- **Strengthening the Currency:** The inflow of foreign funds into G-Secs can help stabilize the national currency (e.g., the Indian Rupee) by increasing the demand for the currency and reducing volatility.

10. Promoting Financial Inclusion and Retail Participation

- **Retail Direct Scheme:** In recent years, the government has launched initiatives like the **RBI Retail Direct Scheme**, which allows individual investors to buy government securities directly from the market. This promotes **financial inclusion** and allows retail investors to participate in a safe and regulated investment avenue.
- **Sovereign Gold Bonds (SGBs):** The issuance of **Sovereign Gold Bonds** is another example of using government securities to diversify investment options, especially for retail investors interested in gold as an asset class.

11. Funding Specific Government Programs

- **Special Purpose Bonds:** Sometimes, governments issue securities to fund specific programs or projects. For instance, the government might issue bonds to fund large infrastructure projects, national defense needs, or specific social welfare schemes such as rural development or education reforms.
- **Public-Private Partnerships (PPPs):** In some cases, G-Secs are used to support **PPP models** by providing long-term funding for collaborative development initiatives between the government and private sector.

The issuance of government securities is a crucial financial tool for the **Government of India** to manage its fiscal requirements and achieve its development and economic goals. By raising funds through G-Secs, the government can finance infrastructure projects, social welfare programs, manage debt, support economic growth, and maintain overall financial stability. Additionally, G-Secs provide a safe and stable investment option for institutional and retail investors, while also contributing to the development of the country's capital markets.

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5.7 IMPORTANCE OF GOVERNMENT SECURITIES MARKET

GSM constitutes the principal segments of the debt market. It not only provides resources to the government for meeting its short term and long tern needs by also acting as a benchmark for pricing corporate players of varying maturities. Development of the government securities market is a prerequisite for the development of the corporate bond market. It acts as a channel for integration of various segments of the domestic financial market and helps in establishing inter linkage between the domestic and external financial market.

The government securities issues are helpful in implementing the fiscal policy of the government. It is critical in bringing about an effective and reliable transmission channel for the use of indirect instruments of money control. The working of two of the major techniques of monetary control; Open Market Operations (OMOs) and Statutory Liquidity Ratio (SLR) are closely connected with the dynamics of this market.

The GSM is the avenue for raising the budgetary financing requirements of various levels of government. From a monetary transmission perspective, however, its importance lies in providing the risk-free term structure for pricing instruments issued by all other sectors of the economy.

Government securities provide the highest type of collateral for borrowing against their pledge. They have the highest degree of security of the capital and the return on each security depends on the coupon rate and period of maturity. They are traded for both the long term and short-term periods depending on the investment and liquidity preference of the investors. Switches between the short dated and long dated securities place on the basis of difference in redemption yields.

5.8 TYPES OF GOVERNMENT SECURITES

In India, government securities (G-secs) are debt instruments issued by the Reserve Bank of India (RBI) on behalf of the Government of India. They are considered one of the safest investment options since they are backed by the government. These securities can be broadly classified into two categories: **Central Government Securities** and **State Government Securities**.

Here are the main types of government securities in India:

1. Treasury Bills (T-Bills)

- **Short-term instruments** with a maturity of 91 days, 182 days, and 364 days.
- Issued at a discount to face value and redeemed at par (face value).

- They do not pay any interest but the return comes from the difference between the issue price and the face value at maturity.
- Primarily issued to meet short-term funding requirements of the government.

2. Government Bonds (G-Secs)

These are long-term debt securities issued by the central government.

- **Fixed-rate bonds**: These securities pay a fixed interest (coupon) at regular intervals (usually half-yearly or annually). The principal is repaid at the time of maturity.
    - Example: Government of India Savings Bond.
- **Floating-rate bonds**: These pay interest based on a benchmark rate (like the RBI's repo rate) plus a spread, so the interest rate varies with changes in the benchmark rate.
    - Example: Government of India Floating Rate Savings Bond.
- **Long-term maturity**: These bonds typically have a maturity of 5 years, 10 years, 15 years, or even longer.

3. Savings Bonds

- Issued by the Government of India to provide small investors with a safe and fixed return.
- These are often for retail investors and come in two variants:
    - Government of India Savings Bond (5-year or 7-year tenure).
    - Interest is paid periodically, usually every six months, and the principal is repaid at maturity.

4. State Development Loans (SDLs)

- These are debt instruments issued by state governments in India.
- Like government bonds but issued by individual states to raise funds for various developmental projects.
- They are typically offered in the form of fixed-rate bonds with a maturity period ranging from 1 to 15 years.

5. Dated Securities

- These are long-term bonds issued by the Government of India with a fixed tenure (anywhere from 5 to 40 years).
- These bonds carry a fixed rate of interest (coupon) which is paid periodically.
- The principal amount is paid back at the end of the term.

6. Sovereign Gold Bonds (SGBs)

- These bonds are a way for investors to invest in gold without needing to physically purchase gold.
- Issued by the Government of India in association with the Reserve Bank of India.
- These bonds provide returns based on the market price of gold and pay a fixed interest (usually 2.5% annually).
- Maturity is typically 8 years, with an option to exit after 5 years.

7. Inflation-Indexed Bonds (IIBs)

- These are bonds whose principal and/or interest payments are adjusted for inflation based on the Consumer Price Index (CPI).
- They are designed to protect investors from inflationary pressures.

8. Zero Coupon Bonds (ZCBs)

- These bonds are issued at a discount to their face value and do not offer periodic interest payments.
- The investor receives the full face value at maturity.
- These bonds are typically long-term in nature and are issued for periods ranging from 5 to 20 years.

9. Bonds Issued by Public Sector Undertakings (PSUs)

- While not directly issued by the government, these are bonds issued by state-owned enterprises (such as Indian Oil Corporation or NTPC) which are guaranteed by the Government of India.
- These bonds offer relatively higher returns compared to government securities but still carry low credit risk.

10. Cash Management Bills (CMBs)

- These are short-term debt instruments issued by the Government of India to meet short-term liquidity mismatches.
- They are similar to T-Bills but with a shorter maturity period, usually ranging from a few days to a few weeks.

5.9 STRIPS (SEPARATE TRADING OF REGISTERED INTEREST AND PRINCIPAL SEUCRITIES) IN GOVERNMENT SECURITES

STRIPS in government securities offer a flexible investment option for those seeking either regular income from coupon payments or long-term capital appreciation from the principal repayment. They are particularly suitable for investors with specific cash flow needs or those looking to diversify their portfolios with zero-coupon instruments.

STRIPS are a form of **zero-coupon bonds** derived from the Government Securities (G-Secs) market. In India, the Reserve Bank of India (RBI) allows the stripping of Government of India (GoI) securities into their principal (face value) and interest components, which can then be traded separately as individual securities

Key Features of STRIPS in Indian Government Securities:

1. **Stripping Process**:
   i. When a **government bond** (such as a fixed coupon bond) is "stripped," its **principal repayment** and **coupon payments** are separated and traded independently.
   ii. This results in two types of instruments:
      - **Coupon STRIPS**: The interest (coupon) payments are separated into individual securities with a specific maturity (usually equal to the coupon payment date).
      - **Principal STRIPS**: The principal repayment at maturity is also separated and can be traded independently.
2. **Zero-Coupon Bonds**:
   i. STRIPS are **zero-coupon bonds** because they do not pay periodic interest. Instead, the return comes from the difference between the **purchase price** and the **face value** (which is paid at maturity).
   ii. The coupon STRIPS and principal STRIPS are sold at a discount to their face value, and the buyer receives the full face value at the time of maturity.
3. **Marketability**:
   i. STRIPS are **marketable securities**, meaning they can be bought and sold on the secondary market. Investors can buy specific coupon payments or the principal repayment (or both) depending on their investment preference.
   ii. This feature gives flexibility to investors, as they can choose to buy the interest component (if they prefer periodic income) or the principal component (if they are focused on capital appreciation at maturity).

4. **Maturity**:
    i. The maturity of **coupon STRIPS** corresponds to the date on which the coupon payments are scheduled to be made.
    ii. The maturity of **principal STRIPS** is the same as the maturity of the original bond, which is the date when the face value of the bond is paid back to the investor.
5. **Interest Rate Sensitivity**:
    i. Since STRIPS are **zero-coupon securities**, their prices are more sensitive to changes in interest rates compared to coupon-bearing securities.
    ii. A rise in interest rates causes a larger drop in the price of STRIPS (since they have no interim interest payments to cushion the effect), making them more volatile.
6. **Taxation**:
    i. The income from STRIPS is taxed as **interest income**. Even though STRIPS do not make periodic interest payments, the appreciation in value (the difference between the purchase price and the face value) is considered taxable income.
7. **Investor Profile**:
    i. STRIPS are attractive to investors who prefer **capital gains** or **tax deferral** (as they do not receive periodic interest payments).
    ii. They can also be a good choice for long-term investors looking for a guaranteed return at maturity.

Example:

If you purchase a Government of India bond with a **10-year maturity**, which pays a fixed coupon of 6% annually:

- After **stripping**, you can buy two types of securities:
    1. **Coupon STRIPS**: These would represent the annual coupon payments (e.g., 6% of the face value), which you could sell separately at the time of each coupon payment date.
    2. **Principal STRIPS**: This would represent the face value of the bond, which you will receive at the maturity date (in this case, 10 years from issuance).

Advantages of STRIPS:

- **Customization**: Investors can choose to buy either principal or coupon components based on their investment goals (e.g., regular income or capital appreciation).
- **Higher Yield**: STRIPS often provide a higher yield compared to regular coupon-bearing bonds, as they are sold at a discount.

- **Liquidity**: Because they can be traded independently, STRIPS provide increased liquidity and marketability.

Risks:

- **Interest Rate Risk**: As mentioned, STRIPS are more sensitive to interest rate changes than coupon-bearing bonds.
- **Taxation**: Even though no interest is received, the increase in the value of STRIPS is taxed as interest income, which can be less tax-efficient than coupon-paying bonds for some investors.

5.10 TRADING MECHNAISM OF GOVERNMENT SECURITES MARKET

1. Primary Market: Issuance of Government Securities

In the primary market, government securities are issued by the Government of India or State Governments to raise funds. These securities can be issued through:

- **Public Auctions**: Most G-secs are issued through a competitive bidding process via public auctions conducted by the **Reserve Bank of India (RBI)**. The RBI acts as the agent of the government for issuing and managing public debt.
  - **Competitive Bidding**: In competitive bidding, institutional investors (like banks, mutual funds, insurance companies) submit bids at various prices (yields). The securities are allotted to the highest bidders.
  - **Non-Competitive Bidding**: Retail investors, smaller institutions, or others who don't want to participate in the auction process can submit non-competitive bids. These bidders are allotted securities at the weighted average price/yield determined by the competitive bidding process.
- **Reserve Bank of India (RBI) and Public Debt Office**: The RBI's **Public Debt Office** is responsible for the management and settlement of government securities. It also oversees the auctions and issuance processes.
- **Sovereign Gold Bonds (SGBs)**: These are issued on behalf of the government through a series of periodic tranches. SGBs are typically sold through scheduled commercial banks, post offices, and stock exchanges.

2. Secondary Market: Trading of Existing Government Securities

In the secondary market, investors buy and sell previously issued government securities. The secondary market is where liquidity and price discovery happen. There are two main platforms for trading G-secs:

A. Over the Counter (OTC) Market:

- The **OTC market** is a decentralized market where transactions are executed directly between buyers and sellers, usually through brokers or dealers.
- The **OTC market** for G-secs is mainly dominated by **institutional investors**, such as banks, mutual funds, insurance companies, and pension funds.
- In this market, G-secs are bought and sold via **phone or electronic communication networks**.

B. Electronic Trading Platforms (ETPs):

- In recent years, electronic platforms have been introduced to enhance transparency, efficiency, and liquidity in the secondary market for G-secs. These platforms are regulated by the **Securities and Exchange Board of India (SEBI)** and the **Reserve Bank of India (RBI)**.
- **NDS-OM (Negotiated Dealing System-Order Matching)**: This is an electronic trading platform developed by the RBI. It is the main platform for trading G-secs in India and supports both **auction-based and order-matching** systems. It is primarily used by banks and financial institutions.
- **NDS (Negotiated Dealing System)**: Another electronic platform used by dealers to execute G-sec trades. It provides a transparent and automated mechanism for price discovery and trade settlement.

C. Stock Exchanges:

- G-secs can also be traded on the **National Stock Exchange (NSE)** and **Bombay Stock Exchange (BSE)**. These exchanges offer both **cash market** (spot) trading and **derivatives market** (futures) trading for G-secs.
- **Bonds and Debt Segment**: On the exchanges, government securities are listed in the bonds/debt segment. Retail investors can buy and sell G-secs using their demat accounts.
- **Electronic Clearing System (ECS)**: The settlement of G-sec transactions on the exchanges is done via **ECS**, which helps in reducing settlement risks and ensuring quicker and more efficient settlement.

3. Settlement of Trades

The settlement of trades in G-secs can be done through two systems:

A. Delivery versus Payment (DVP):

- In this system, the **delivery of securities** and **payment** occurs simultaneously on the settlement date. This helps eliminate settlement risks.

- The settlement is done through the **RBI's Real Time Gross Settlement (RTGS)** or **National Electronic Funds Transfer (NEFT)** systems.

B. T+1 (T+2) Settlement:

- Most trades in government securities are settled on a **T+1** (or sometimes **T+2**) basis. This means that the securities are delivered to the buyer and payment is made on the next business day (T+1) after the trade date.
- **Central Bank** or **clearing houses** like the **Clearing Corporation of India Ltd. (CCIL)** are responsible for clearing and settling government securities transactions.

4. Participants in the G-Secs Market

The market for G-secs is primarily dominated by the following participants:

- **Government**: The issuer of the securities.
- **Banks**: Major players, acting as primary dealers, market-makers, and investors.
- **Financial Institutions**: Insurance companies, pension funds, mutual funds, and other large investors.
- **Retail Investors**: Retail investors can buy and sell G-secs through stock exchanges, brokers, or through direct investment schemes like the **RBI Retail Direct Scheme**.
- **Primary Dealers (PDs)**: Specially authorized institutions (usually banks or financial institutions) that are responsible for the distribution of government securities and the functioning of the secondary market.

5. Types of Trading in G-Secs

The trading of G-secs can take the following forms:

A. Spot Trading:

- **Spot trades** are the purchase or sale of securities where the settlement happens immediately (or within two business days).

B. Repo and Reverse Repo Transactions:

- A **repo (repurchase agreement)** is a short-term borrowing arrangement in which a dealer sells government securities to another party with an agreement to repurchase them at a later date (usually the next day) at a higher price.
- A **reverse repo** is the mirror image of a repo transaction, where an investor lends money in exchange for G-secs as collateral.
- These are commonly used for liquidity management by banks and financial institutions and are actively traded in the G-se cs market.
-

C. Futures Trading:

- Futures contracts based on government securities are available on exchanges like the NSE and BSE.
- G-sec futures allow investors to speculate on the future price movements of government bonds and hedge against interest rate risk.

6. Risk Management and Regulation

- The **Reserve Bank of India (RBI)** and **Securities and Exchange Board of India (SEBI)** regulate the G-sec market to ensure its integrity and transparency.
- **Clearing Corporation of India Ltd. (CCIL)** plays a critical role in clearing and settling G-sec transactions.
- The **RBI** uses the G-secs market to conduct **Open Market Operations (OMO)** for managing liquidity in the financial system.

The trading mechanism of the government securities market in India has evolved to be more transparent, efficient, and accessible. The primary market for G-secs is auction-based, while the secondary market is both OTC and electronic. Various platforms like NDS-OM and stock exchanges enable price discovery, liquidity, and the seamless execution of trades. Investors range from institutional players to retail investors, each participating according to their needs and preferences. The clearing and settlement processes ensure that trades are conducted in a secure manner, minimizing risks associated with payment and delivery.

5.11 PRIMARY DEALERS (PDS)

Primary Dealers (PDs) are the backbone of the Indian government securities market. They have direct access to government securities auctions and play a vital role in the primary and secondary markets. They help manage liquidity, ensure smooth market functioning, and facilitate the government's borrowing program.

Primary Dealers are entities that are authorized by the Reserve Bank of India (RBI) to deal directly with the government in the primary market for government securities. They are the most significant participants in both the primary and secondary markets for G-secs and are responsible for ensuring liquidity and supporting the development of the G-sec market.

Key Features of Primary Dealers (PDs):

- Role in the Primary Market:
  - Underwriting Government Securities: PDs play an essential role in underwriting government securities issued in the primary market. This means they commit to purchasing government securities at the auction if there are insufficient bids.

  - Auction Participation: PDs are required to actively participate in auctioning of government bonds, whether through competitive or non-competitive bidding. They are expected to support the government's borrowing program by absorbing a substantial portion of the securities issued.
- Role in the Secondary Market:
  - Market-Making: PDs help maintain liquidity in the secondary market for government securities. They quote both buy and sell prices for securities, ensuring that other market participants can transact efficiently.
  - Trading and Liquidity Support: PDs buy and sell government securities on a continuous basis to facilitate liquidity and ensure efficient price discovery.
- Regulatory Requirements:
  - PDs must maintain a minimum liquidity requirement and adhere to the capital adequacy norms set by the RBI and the Securities and Exchange Board of India (SEBI).
  - PDs are required to meet certain market-making obligations, including quoting buy/sell prices for securities during market hours and providing continuous quotes for a minimum portion of their portfolio.
- Types of Primary Dealers:
  - Scheduled Commercial Banks (SCBs): Many large private and public sector banks act as PDs.
  - Non-Banking Financial Companies (NBFCs): Some NBFCs, including investment firms and financial institutions, can also become PDs.
  - Foreign Banks: In certain cases, foreign banks operating in India may also participate as PDs, especially if they are large enough to handle the required scale of operations.
- Incentives for Primary Dealers:
  - PDs receive certain benefits such as priority access to government securities auctions and guaranteed allotments for the securities they underwrite.
  - They are also given financial incentives for maintaining liquidity and market-making activities, as well as access to liquidity management tools provided by the RBI.

Check Your Progress-A

1. Which of the following is a short-term government security issued in India?
    a) Government Bonds
    b) Treasury Bills (T-Bills)
    c) State Development Loans (SDLs)
    d) Sovereign Gold Bonds (SGBs)

2. Who is responsible for conducting auctions of government securities in India?
    a) Securities Exchange Board of India (SEBI)
    b) Reserve Bank of India (RBI)
    c) Government of India
    d) National Stock exchange (NSE)

3. What is the primary purpose of a Primary Dealer (PD) in the government securities market.
    a) Managing liquidity in the secondary market
    b) To issue government securities
    c) To participate in the stock market
    d) To create new financial products

4. . Which of the following bonds are linked to the price of gold?

a) Government Bonds
b) Treasury Bills (T-Bills)
c) State Development Loans (SDLs)
d) Sovereign Gold Bonds (SGBs)

5.12 SATELLITE DEALERS (SDS)

Satellite Dealers are entities that act as intermediaries or participants in the G-sec market but do not have the same core responsibilities or obligations as Primary Dealers. They are typically smaller, non-competitive market participants who have a limited role in government securities transactions.

Key Features of Satellite Dealers:

- Relationship with Primary Dealers:

- Satellite Dealers are affiliated with Primary Dealers and act as agents or sub-dealers. They typically do not have direct access to the government securities auctions in the primary market.
- They buy and sell government securities primarily in the secondary market and support the PDs by providing additional liquidity.
- Satellite Dealers may be smaller financial institutions, such as regional banks, non-banking financial companies (NBFCs), or mutual funds that do not meet the rigorous requirements to become full-fledged Primary Dealers.

- Market Role:
  - Satellite Dealers contribute to the secondary market by trading government securities, facilitating smoother transactions, and increasing market depth.
  - While they are not involved in underwriting or directly bidding at auctions, they are important players in the overall G-sec market ecosystem.
- Advantages:
  - Satellite Dealers may benefit from access to liquidity provided by the Primary Dealers and other market-making entities.
  - They may also have the ability to deal in a range of securities, including those that are less liquid or lower in market demand, which may not be as attractive for larger PDs.

Distinguishing Primary Dealers and Satellite Dealers:

Feature	**Primary Dealers (PDs)**	**Satellite Dealers (SDs)**
Role	Directly involved in both primary and secondary markets.	Only involved in secondary market activities.
Market Making	Required to maintain market-making obligations.	May provide liquidity but not as part of core obligations.
Auction Participation	Participate in government securities auctions (competitive & non-competitive bidding).	Do not participate directly in auctions.
Liquidity Support	Responsible for ensuring liquidity and continuous price discovery.	May contribute to liquidity in the secondary market.
Regulatory Requirements	Must meet RBI/SEBI capital adequacy and liquidity norms.	Less stringent requirements than PDs.

Feature	Primary Dealers (PDs)	Satellite Dealers (SDs)
Affiliation	Can operate independently.	Typically affiliated with a Primary Dealer.
Types of Entities	Banks, NBFCs, large financial institutions, and foreign banks.	Smaller financial institutions or firms.

5.13 SUMMARY

Government securities are essential financial instruments for funding government activities and providing investment opportunities. They are crucial for institutional and retail investors, offering low risk, liquid, and stable returns. The efficient trading and regulatory frameworks ensure the smooth functioning of the market, making G-Secs an important part of India's financial ecosystem. Government securities (G-Secs) are debt instruments issued by the government to raise funds for various purposes. These securities allow the government to borrow money from the public, financial institutions, and foreign investors to finance its spending and fulfill various financial needs.

Government Securities (G-Secs) are debt instruments issued by the government to raise funds for various purposes. They are considered low-risk investments because they are backed by the Government of India or state governments.

The major players in the government securities market include the following:

i. Central and state governments
ii. Commercial banks, RBI, SBI and cooperative banks
iii. Specialized financial institutions such as IDBI, IFCI, SFC, etc.
iv. Joint stock companies
v. Non-banking financial companies (NBFCs)
vi. Investing institutions such as LIC, GIC and UTI
vii. Provident funds, both statutory and non-statutory
viii. Individuals

The market is highly regulated, with authorities like the RBI and SEBI playing crucial roles in its oversight and operations. This ecosystem facilitates the government's fiscal management and provides investors with a stable and low-risk investment avenue.

- Primary Dealers (PDs) are the backbone of the Indian government securities market. They have direct access to government securities auctions and play a vital role in the primary and secondary markets. They help manage liquidity, ensure smooth market functioning, and facilitate the government's borrowing program.

Primary Dealers are entities that are authorized by the Reserve Bank of India (RBI) to deal directly with the government in the primary market for government securities. They are the most significant participants in both the primary and secondary markets for G-secs and are responsible for ensuring liquidity and supporting the development of the G-sec market.

Satellite Dealers are entities that act as intermediaries or participants in the G-sec market but do not have the same core responsibilities or obligations as Primary Dealers. They are typically smaller, non-competitive market participants who have a limited role in government securities transactions.

Trading of Government Securities:

1. Primary Market: G-Secs are issued by the government through auctions conducted by the Reserve Bank of India (RBI).
2. Secondary Market: Once issued, G-Secs can be traded among investors in the OTC (Over the Counter) market, stock exchanges, or via electronic trading platforms like the Negotiated Dealing System-Order Matching (NDS-OM).

5.14 GLOSSARY

Bonds: Debt securities issued by the government pay periodic interest and return the principal at maturity.

Capital Adequacy: The minimum amount of capital that a financial institution must hold as a percentage of its assets, ensuring it can absorb losses.

Clearing: The process of reconciling and confirming trades to ensure that both parties fulfill their contractual obligations.

Coupon: The interest payment made by a bond issuer to bondholders, typically expressed as a percentage of the face value.

Coupon Rate: The fixed annual interest rate paid by a bond, expressed as a percentage of the bond's face value.

Current Yield: The annual income (interest or dividends) from an investment, divided by the current market price of security.

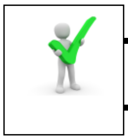
Dematerialization: The conversion of physical securities into electronic format, held in a demat account.

Delivery vs. Payment (DVP): A settlement mechanism where the delivery of securities occurs simultaneously with the payment for them, reducing counterparty risk.

Stripping: The process of separating the interest and principal components of a government bond into individual tradable securities.

Yield: The return on investment, typically expressed as a percentage of the face value of a bond or other fixed-income security.

Zero-Coupon Bonds: Bonds that do not make periodic interest payments, instead being issued at a discount and redeemed at face value at maturity.



5.15 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (b), 2 (b), 3 (a), 4 (d)

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5.18 TERMINAL QUESTIONS

1. Define government security. Why does the government issue securities.
2. Explain the procedures for trading in government securities.
3. Who can be primary dealer and explain his role.
4. Explain the concept of stripping in Government Securities market.

5.19 CASE LETS/CASES

The Indian government securities (G-secs) market has evolved significantly over the past few decades. Initially, the government borrowed from the Reserve Bank of India (RBI) to finance fiscal deficits, but this led to inflationary pressures and inefficient monetary policy transmission. In the early 1990s, with the onset of economic reforms and fiscal consolidation, India began to transition towards a more market-driven system of borrowing.

The Government Securities Act of 2006 provided the legal framework for the orderly development of the G-secs market. The introduction of Primary Dealers (PDs) helped enhance the liquidity and depth of the market. The RBI began conducting regular open market operations (OMOs) and began issuing government bonds in a more transparent and competitive manner through auctions. Over time, a wide range of government securities, including Treasury Bills, Government Bonds, and State Development Loans (SDLs), became available to institutional and retail investors.

The development of a dematerialized (e-archiving) system and the introduction of retail investment schemes, like Sovereign Gold Bonds (SGBs) and G-Secs in dematerialized form, have also broadened participation. The secondary market for government securities in India has become vibrant, with institutional investors such as insurance companies, pension funds, and mutual funds being key players.

Despite significant improvements, the market faces challenges such as low investor participation in retail bonds and the need for further development in trading infrastructure and transparency.

Questions:

1. How did the introduction of Primary Dealers (PDs) contribute to the development of the government securities market in India?
2. What role do retail investors play in the government securities market in India, and what are the challenges in enhancing their participation?

UNIT 6 FOREIGN EXCHANGE MARKET

6.1 INTRODUCTION

When two countries participate in trade, sovereignty implies independence from other countries, having their laws and currencies. The presence of various currencies creates barriers to global trade and financial transaction resolution. Although the exporter has the preference to receive payment in their own country's currency, whereas the importer can only pay in their own currency. This results in the conversion of the importers' currency into the exporter's country's currency. Foreign exchange is the process of conversion of one country's currency into another's currency. Banks that specialize in foreign exchange transactions carry out the conversion.

6.2 OBJECTIVES

- After going through the unit, the learners will be able to:
- Understand the concept of the foreign exchange market.
- Explain the components of the foreign exchange market.
- Able to learn about the interbank market.
- Understand the concept of foreign exchange rate and foreign exchange risk.

6.3 MEANING OF FOREIGN EXCHANGE

A foreign exchange market is a place where individuals or institutions engage in the purchase and sale of various currencies from across the world. The main objective of this is to deal with global business and encourage cross-border investments. The existence of multiple international currencies, including the US (dollar), UK currency (pound), Japanese (yen), and others, and the urgency of conducting transactions in these currencies demand the establishment of a foreign exchange market.

6.4 CHARACTERISTICS OF FOREIGN EXCHANGE

The foreign exchange market possesses key characteristics:

1. **Electronic Market**: The foreign exchange market is an over-the-counter (OTC) market which means the players deal the trading online rather than meeting physically. Instead, foreign currencies are traded through an interconnected network of banks, foreign exchange brokers, and dealers that are involved in arranging transactions between buyers and sellers.
2. **Geographical Spreading**: The foreign exchange market lacks a centralized location. Major financial centers worldwide, including London, New York, Amsterdam, Tokyo, Hong Kong, Toronto, and other locations, widely disperse it.
3. **Transfer of Purchasing Power:** By trading one currency for another, the foreign exchange market facilitates the transfer of purchasing power from one currency to another. For example, if an Indian exporter sells software to a business in the United States for dollars, and a company in the United States sells supercomputers to an Indian company for rupees, both companies would prefer payment in their respective currencies whenever possible. Given this, the Indian company desires payment in rupees, while the American company prefers payment in dollars. The foreign exchange market facilitates this type of settlement between countries in their respective currency units.
4. **Intermediary:** Foreign exchange markets allow participating countries to easily convert earned currency into desired currencies. To accomplish this purpose, the

market serves as an intermediary(middleman) between buyers and sellers of foreign exchange**.**

5. **Volume:** The foreign exchange market is unique in that around 95% of its trading activities include the purchase and sale of assets across international borders, also known as international capital flows. Exporting and importing actions account for only 5% of the total**.**

6. **The provision of credit:** A foreign exchange market is responsible for the provision of credit via the use of specialized instruments such as letters of credit and bankers' acceptance. Traders and businesspeople on the worldwide market platform stand to gain a tremendous deal from the provision of credit in this manner.

7. **Reducing the likelihood of adverse outcomes:** The foreign exchange market assists both importers and exporters in mitigating the risks often associated with international commerce. It is possible to do this through the implementation of a technique known as "hedging," which enables traders to conduct their business and operate in the international market platform while earning regular profits without being subject to variations in projected profits as a result of sudden changes in exchange rates.

8. **24-Hour Market:** The foreign exchange markets are strategically located across various time zones around the world, ensuring that as one market closes, another begins operations. This continuous cycle means that at any given moment, at least one market is always open. Therefore, the foreign exchange market operates continuously for 24 hours.

9. **Currencies Traded:** Generally, the US dollar serves as the vehicle currency in markets. It means it is commonly used to denominate foreign transactions.

6.5 MEANING OF HEDGING

Meaning of Hedging:

In the stock market, hedging is a risk management method employed by investors to decrease possible losses caused by adverse price movements. It comprises mitigating the risks associated with foreign trade by providing a wheel of mechanism for both the exporters and importers to protect against losses due to exchange rate fluctuations. It uses financial instruments to stabilize and make cash flows more predictable, allowing companies to estimate the amount of income, taxes, and revenues with greater accuracy. Mechanism of Hedging is not considered a means of increasing profits; instead, it is treated as a set of strategies aimed at minimizing risks. While hedging diminishes potential losses, it also limits the possibility of unexpected gains. For the investors class, hedging exercises like insurance for their assets or it can be their portfolios. It is extensively used by investors and well-known firms employed in international operations, enabling them to manage their exposure to currency exchange movements and mitigate the impact of negative changes. Few corporations may elect to hedge their entire portfolio, while others may opt not to hedge at all. Numerous companies tend to hedge a portion of their portfolio, balancing partial protection with some risk exposure, allowing for the possibility of additional earnings. The extent of hedging depends on each company's risk tolerance.

6.6 COMPONENTS OF FOREIGN EXCHANGE MARKET

Components of Foreign Exchange Market: The worldwide interbank network typically operates the foreign exchange market, utilizing telephones, telex machines, or the SWIFT system (Society for Worldwide Interbank Financial Telecommunication). Furthermore, these diverse individuals play a role in facilitating foreign currency trade.

Several constituents of the foreign exchange market include: The components of the interbank market Spot market, forward market and swap market. Normally the forward market refers to a financial market where participants can enter into contracts to buy or sell assets at a future date and at a predetermined price.

6.7 MEANING OF INTERBANK MARKET

Interbank Market: The interbank market refers to the financial market where banks and other financial institutions trade currencies and other financial instruments among themselves. As a substantial component of the foreign currency market. Most people recognize the wholesale market as the primary venue for currency transactions, especially interbank trading. It is a typical foreign exchange market, accounting for approximately 95% of all foreign currency transactions. Approximately 20 big banks generally dominate this sector.

6.8 CONSTITUENTS OF THE INTERBANK MARKET

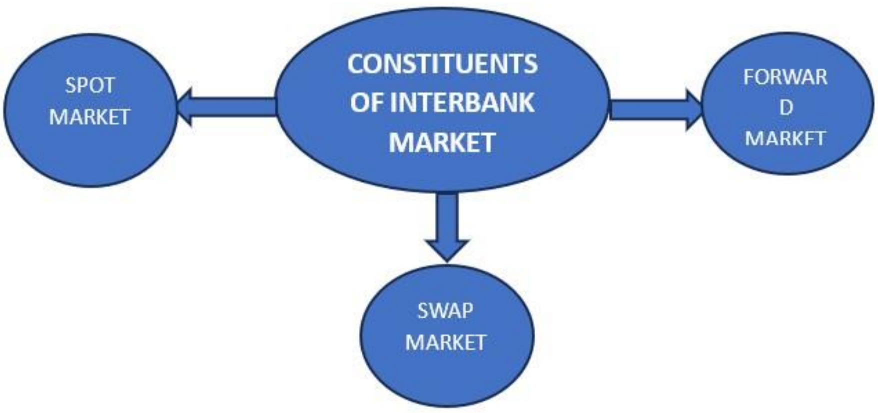


Figure 1.1 constituents of the interbank market pattern

The interbank market has three primary components. The following items are listed below:

1. Spot market- The spot market refers to a type of foreign exchange transaction that requires rapid currency exchange and delivery. In this, only the spot and current transactions are handled and the rate of exchange is determined instantly. Typically, settlement in the spot market is completed within a two-day timeframe in many marketplaces. The exchange rate for these transactions is the spot rate, and the specific market in which these transactions take place is known as the spot market. The swap market accounts for nearly 30% of all transactions in the foreign exchange market.

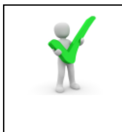
2. The Society for Worldwide Interbank Financial Telecommunication (SWIFT): SWIFT plays a leading role in spearheading trade activities in the foreign exchange market. It is recognized as a popular global banking communication network that electronically connects all brokers and traders in the foreign exchange market.

The terms bid rate, ask rate and spread refer to important elements in financial markets.

A. Bid Rate: The bid rate refers to the price at which a dealer is willing to buy the base currency. The value of the ask rate consistently exceeds the bid rate.

B. Ask Rate: The ask rate refers to the price at which a dealer is willing to sell the base currency. It consistently exceeds the bid rate value.

C. Bid-ask spread: The bid-ask spread is the monetary difference between the ask rate and the bid rate. It is a measure of the profit earned by the dealer.



Check Your Progress-A

Q1. Explain any two characteristics of foreign exchange market.

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Q2. Describe Hedging.

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Q3. MCQs

I. Spot market refers to the market where:

a). Spot and current transactions are handled

b). Future transactions are handled

c). Buying and selling of foreign currency take place

d). Currency is compared

Q4. In the light of the below statement choose the right option:

Statement I: The bid rate refers to the price at which a dealer is willing to buy the base currency.

Statement II: The bid-ask spread is the monetary difference between the ask rate and the bid rate.

a). Both statement I and II are correct.

b). Both statement I and II are incorrect.

c). Statement I is correct, but statement II is incorrect.

d). Statement I is incorrect, but statement II is correct.

6.9 MEANING OF ARBITRAGE

Meaning of Arbitrage: Arbitrage refers to the act of buying and selling foreign currency simultaneously to benefit from the varying exchange prices across different marketplaces.

6.10 MEANING OF SPECULATION

Meaning of Speculation:

Speculation is the practice of purchasing and selling currencies in the foreign exchange market to make substantial gains, relying on uncertain conditions. Speculators often engage in foreign currency transactions with the primary goal of capitalizing on unforeseen gains resulting from fluctuations in exchange rates. Speculators purchase currencies at a discount to their true value and frequently sell them at a premium.

6.11 MEANING OF FOREIGN EXCHANGE RATE

Foreign Exchange rate:

The foreign exchange rate is the value of one currency compared to another. Currency exchange rates indicate the relative worth of one currency in comparison to another and can vary over time due to changes in demand, supply, and market sentiment. The foreign exchange market has been categorized into major groups of participants:

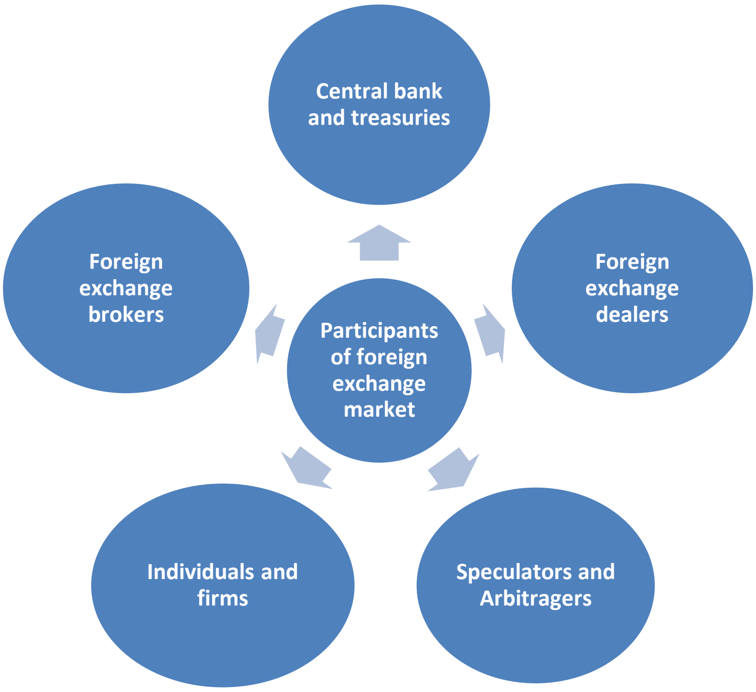

Figure 1.2 Foreign Exchange Participants

1. **Foreign Exchange dealers:** It encloses both banking and non-banking institutions. They are responsible for actively engaging in market-making operations. These dealers play a significant role in the foreign currency market by doing transactions on behalf of their own accounts. They engage in continual buying and selling of major foreign currencies, conducting trades with other banks both domestically and internationally to effectively manage their currency holdings within predetermined limitations. They generate profit by buying foreign exchange at a bid price and selling it at a slightly higher ask price. Global competition among dealers enhances the efficiency and dynamic character of the foreign currency market.

2. **Individuals and firms:** This category comprises exporters, importers, foreign investors, multinational companies (MNCs), and tourists who actively participate in the foreign exchange market to oversee business and investment transactions. International businesses should pay suppliers and employees in the local currencies of the countries where they operate, while still taking payments from clients in other currencies. They immediately exchange these revenues in foreign money into their domestic currency.

   The foreign exchange market approach is utilized by participants in currency trading to mitigate the risk of currency and to facilitate international trade and travel. Foreign direct investment (FDI) necessitates investors to acquire the currency of the destination country. Investors must participate in the foreign exchange market to acquire the required currency for significant international portfolio investments, such as buying bonds, shares, or other securities in foreign currencies. They also need to convert their earnings back into their original home currency and return the capital amount when the investment concludes.

3. **Speculators and arbitragers:** Speculators and arbitragers participate in currency trading with the main objective of capitalizing on anticipated fluctuations in exchange rates, without being involved in any other commercial activity that necessitate foreign currencies. Currency speculation is often associated with short-term financial products such as treasury bills. Key players in speculation include large banks and significant investment organizations. Speculators and arbitragers trade in foreign currency markets to generate profits through both regular and speculative activities. Dealers often profit from the spread between bid and offer prices, but speculators benefit from swings in currency exchange rates.
4. **Central Banks and Treasuries:** Central banks and treasuries generally use the foreign exchange market for buying and selling foreign reserves, influencing the value of their currency based on national economic policies. In addition to it, these transactions align with international trade agreements, such as the European Monetary System, ensuring stability and organization while dealing with foreign currency.
5. **Foreign Exchange Brokers:** Foreign exchange brokers serve as intermediaries between buyers and sellers of foreign currency. They get commissions from these transactions. Although they frequently specialize in specific currencies, they can handle all major currencies, including the US dollar, British Pound Sterling, and Deutsche Mark. Brokers offer major services including current and future exchange rates, market participant privacy, and guiding banks to reduce contractual responsibilities with other dealers.

   Categories of Foreign Exchange Transactions

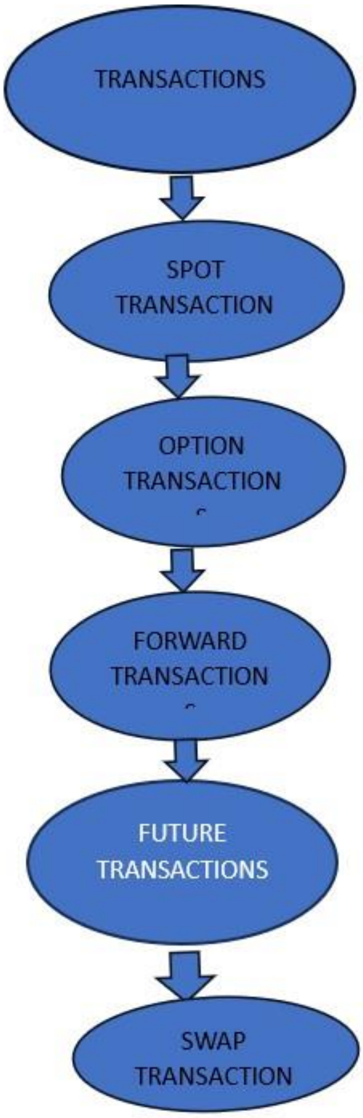

Figure 1.3 Category of Foreign Exchange Transactions

Foreign exchange markets include:

1. Spot Transactions:

A spot transaction is an interbank transaction in which the purchase of foreign exchanges, including its delivery and payment period, often takes place on the second business day following the transaction. The currency conversion rate utilized for these transactions is referred to as the 'sport rate' the settlement date is commonly known as the 'value date'.

CHIPS (The Clearing House Interbank Payments System): Also known as CHIPS, is a network that is based on electronic technology that facilitates the transfer and settlement of transactions that are conducted in United States currency. By utilizing electronic bookkeeping entries rather than official bank checks, CHIPS helps banks process and settle international payments efficiently.

6.12 INFLUENCING FACTORS DETERMINING SPOT EXCHANGE RATE

Influencing Factors Determining Spot Exchange Rates:

1. **Balance of Payments:** The Balance of Payments consists of the demand for and supply of foreign exchange, which forms the basis of a currency, and determines its value. In contrast to imports, which are responsible for creating demand, exports, regardless of whether they are visible or invisible, contribute to the supply of foreign exchange. When a nation exports goods or services, it creates demand for its currency on the foreign exchange market. This is because exporters convert their international income into the currency of the nation they are exporting products or services to. In contrast, imports increase the amount of currency that is available on the market for a country. When there is a persistent balance of payments deficit, currency demand is lower than supply, lowering market value.
2. **Inflation:** Inflation causes domestic prices to rise, which can reduce the export competitiveness in the worldwide market. subsequently, the demand for the domestic currency may decline, resulting in a decrease of value relative to other currencies. The key factor is the relative inflation rates between the two countries. For instance, if India and the USA have 10% inflation, the exchange rate between the respective currencies would continue to exist stable. However, if the inflation percentage in India is 15% and in the United States 10%, the rupee will depreciate against the dollar due to the higher inflation rate in India. Empirical studies indicate that inflation has a remarkable long-term effect on exchange rates, generally aligning with the inflation-adjusted rate. Significant deviations from this trend are very rare except in certain cases of major economic changes.
3. **Interest Rates:** They perform a key role in the short-term flow of capital. When interest rates increase in a financial center, short-term funds from other centers, raise the demand for that currency and boost its value. Countries might raise interest rates to manage tight monetary conditions or to attract foreign investment. Higher interest rates can lead to strengthening a currency by increasing the inflow of foreign investment and reducing the outflow of domestic capital.
4. **Money Supply:** A change in the value of the money supply can influence exchange rates both through inflation and more direct mechanisms. When the money supply increases faster than demand, it may lead to increased spending on foreign products and investments. This increases the currency's supply quantity in foreign exchange markets causing to decrease in value. The drop in the currency's value then raises import costs, which can further drive inflation. Although inflation and exchange rate variations are linked in the long term, short-term exchange rates are more responsive to any changes in the money supply. The total monetary supply represents value of all goods and services in the nation, influencing how its currency is valued internationally. For instance, if the money supply doubles, the currency’s value might halve. An excess

in money supply beyond domestic demand leads to capital flowing out of the country, putting downward pressure on the rate of exchange.

5. **National Income:** A rise in national income often enhances residents' income levels, which in turn drives up the demand for commodities. If the country's production capacity is underutilized, this may result in increased production and results in higher exports. However, adjusting production to meet rising incomes often takes time. If production fails to keep up with income growth, this can lead to an increase in imports, which would boost the supply level of country's currency in the foreign exchange market and induce its value to decline. Similar to inflation, changes in exchange rates can arise when national income rises, depending on whether the additional income is directed into investment or consumption. This means the comparative increase in national incomes between countries is more significant than the absolute increase.
6. **Resource Discoveries:** The discovery of major resources, such as oil, can cause an appreciation in a country's currency value. For instance, taking the case of oil supplies when oil supplies from major producers in the Middle East became unreliable, there was an increased demand for the currencies of oil self-sufficient countries Like the United States, Canada, the United Kingdom, and Norway. In contrast, the currency of oil-importing countries, such as Germany, and Japan experienced depreciation. Likewise, when certain countries discovered oil, their currency values appreciated.
7. **Capital Movements**: Capital movements between countries are driven by various factors. Short-term capital flows can be influenced by changes in a country's interest rate. When the rate of interest rises, possibly due to a rise in the bank rate, short-term funds will likely flow into the country, strengthening its currency. On the contrary, a drop in interest rates can lead to an outflow of capital, weakening the currency. Moreover, a favorable investment climate and political stability can attract portfolio investments, boosting currency demand and increasing exchange rates. On the other hand, a poor economic outlook may prompt investors to repatriate their funds, reducing currency demand and depreciating its value. External borrowing and financial assistance also play a role in capital movements. Large-scale external borrowing can raise the supply of foreign exchange in the market, positively affecting the exchange rate. However, once repayment of the principal and interest begins, it may negatively impact the currency's value.
8. **Political Factors:** Political stability enhances investor confidence, attracting capital inflows and strengthening the country's currency. Conversely, political instability compels investors to withdraw their funds and can lead to capital outflows weakening the currency. Additionally, news regarding changes in government, political leadership, or government policies can cause temporary disruptions in exchange rates.
   1. **Forward Transactions:** A forward transaction is a contractual arrangement between two parties to trade a certain amount of foreign currency for local currency at a predetermined future date. The forward exchange rate is a pre-established rate used in these transactions. This transaction takes place in the forward market, which

is frequently subject to regulation by governments in order to restrict speculation in the foreign exchange market. Only valid export transactions and imports in India allow commercial banks to offer forward cover. The forward exchange facilities are essential and very important for exporters and importers as they provide protection against currency rate volatility by utilizing proper forward contracts.

The forward rate condition can be either below three conditions:

- At Par: The forward exchange rate is considered at par when it matches the spot rate at the time the contract is made.
- At Premium: The forward contract is at a premium when the payment for future delivery of foreign currency is greater than the spot delivery rate.
- At Discount: A forward contract is discounted when the payment for future delivery is lower than the spot delivery rate.

Features of Forward Contracts: It is a private agreement between two parties.

As a bilateral agreement, it carries counterparty risk.

Unlike futures or options contracts, it is not traded in concern to public exchange.

Forward contracts are tailored to meet the specific requirements of the parties concerned.

The exchange rate is determined in advance through mutual agreement.

The contract eliminates the possibility of benefiting from favorable market movements.

A requirement of margin is not needed for a forward contract.

3) Swap Transactions: Swap transactions are the simultaneous exchange of two different currencies between two investors, in which one borrows one currency and lends it to the other investor. This process, which involves the simultaneous buying and selling of foreign exchange for various value dates, is known "swap transaction." The settlement of these transactions often takes place in United States dollars, and the same counterparty is involved in both the purchase and the selling of the item.

4) Future Transactions: A future transaction is an agreement to swap one currency for another at a certain time in the future. The exchange rate is set at the time the agreement is made. Currency futures contracts are uniform and sold on organized markets. They can be used for hedging or speculation, among other things. An initial balance should be put into a collateral account in order to enter a futures contract and keep the trade open. These contracts can only be bought and sold on organized platforms, where buying is done in a competitive environment.

Important parts of a futures contract are: On markets, people buy and sell futures contracts. Futures products can be bought and sold on exchanges. Because they are sold on the market, they are very standard. The exchange buys from all sellers and sells to buyers, so there is no chance of failure. When you start a futures deal, you have to pay a margin, which changes as the price does. The exchange market sets the rules for buying futures.

5) Option Deals: An option is a financial tool that gives the owner the right but not the duty to buy or sell a certain amount of any object at a certain price on a future date. A put option provides the right to sell an object, while a call option gives you the right to buy it. When you exercise your option, you buy or sell the underlying object at the exercise price, also known as the strike price. The person who buys an option is called the "long," and the person who sells it is called the "writer" or "short." The money that is paid for the choice is called the premium.

Payment made for the option is called premium.

Types of Options Based on Style:

a) American options: The American option can be exercised at any time throughout the term of the deal.

b) European options: If you have European options, you can exercise them only once at the time when the contract matures or expires.

Foreign Exchange Risk: Foreign exchange risk occurs when exchange rate fluctuations cause unanticipated changes in the value of assets, obligations, income, and expenses. The risk is especially important when dealing with uncovered foreign exchange claims or liabilities. A "long" position refers to an uncovered foreign currency claim. whereas an uncovered claim is termed a "short" position. With the globalization of business, engaging in international transactions—such as buying and selling goods, importing and exporting machinery and equipment, acquiring technology and know-how, and handling payments like royalties—has become essential. These transactions often involve complexities related to payment and pricing, where the amount payable or receivable is either in the seller's currency, or in the buyer's currency, or it can be widely accepted international currency like the currency of the U.S.

Foreign Exchange Exposure:

Foreign exchange exposure is the risk linked with frequent changes in exchange rates that adversely affect financial transactions denominated in a foreign currency instead of the company's domestic currency.

Types of Risks: There are three foreign exchange risks.

I. **Transaction Exposure:** Its other name is cash exposure; this type of risk arises in international trade involving multiple currencies. It occurs when a company faces the possibility that exchange rates may vary the time between the time a transaction is initiated and its final settlement. Transaction risk may occur in the following scenarios:

   a) **Cross-border transactions**: Transactions that involve different countries.

   b) **Invoicing in foreign currency**: When an invoice is issued in a currency other than the domestic currency.

c) **Difference in timing**: When the date of the transaction is not the same as the date of settlement.

II. **Translation Exposure.** It is also known by the name accounting exposure, which refers to the risk of financial loss resulting from fluctuations in the value of a company's foreign currency shares, sales, assets, or debts. This risk comes up when the book value of a parent company's investment in a business change, which could mean the parent company loses money. Businesses need to safeguard their translation risk as it can result in significant financial losses during the translation process.

III. **Economic Exposure:** Economic exposure, also known as operating exposure, is the chance that changes in exchange rates will cause the present value of a company's assets, liabilities, or even the company itself to change. Economic exposure looks ahead and considers how changes in the exchange rate will impact projected future responsibilities. This is different from translation exposure, which looks back at past events. It can affect a company even without foreign currency assets or debts.

IV. **Methods of Payment:** There are various ways to receive payment when conducting business in foreign trade. They're – In this case, the seller will be paid in his or her own cash.

a. **Payment in domestic currency:** Payment in the seller's currency benefits the seller. He would know more about how much money he expects to receive and how much it is worth right now. This will help him make correct predictions about his cash flow.

b. **Payment in any currency**: Individuals who sell goods may occasionally accept payment in multiple currencies.

Factors such as:

i) The rapid depreciation of the local currency could influence this decision.
ii) The government has faith in a different coin than the ones on sale.
iii) Sellers want to pay in a foreign currency that is simple to exchange.

Techniques for Managing Foreign Exchange Risk: The value of a currency changes all the time because of things like inflation, interest rates, current account deficits, trade terms, and how well a country is doing politically and economically. Changes like these can have a significant impact on businesses and individuals doing business internationally. Foreign exchange risk occurs when the value of one currency changes against another, there is a type of risk called foreign exchange risk. This risk is more likely to happen to companies or buyers who buy assets or start businesses in other countries. Managing foreign exchange risk well is important for keeping cash flows stable, reducing unsystematic risks, avoiding the need for outside financing, keeping the business from going bankrupt, increasing shareholder wealth, and improving investor trust.

1. **Sharing the Risk:** Both the buyer and the seller agree to share the currency risk in order to keep the business relationship going for a long time based on the quality of the product and the supplier's dependability.
2. **Diversification:** This is a business strategy in which companies use money from multiple capital markets and currencies.
3. **Natural hedging:** As a company conducts its routine operations, it inherently reduces its risk, a phenomenon known as a natural cushion. For example, if a business makes a lot of sales in a certain country and also spends money there, it makes sense for the company to protect its currency risk.
4. **Payment netting:** This is a way to reduce the credit, payment, and other risks that come with financial contracts by combining several obligations into a single net obligation. This method works particularly well for businesses dealing with more than one currency because it simplifies currency conversion by combining all funds into one transaction. This way, the company can stick to a uniform strategy and cut down on transaction costs.
5. **Leading and Lagging**: Adjusting the timing of payments in foreign currency is necessary. We refer to the payment of an obligation prior to its due date as "leading." We refer to the payment of an obligation after the due date as "lagging." The goal of these plans is to allow the business to benefit from the anticipated rise or fall in the value of certain currencies. Lead and lag payments come in handy when forward contracts are not feasible.
6. **Cross-hedging:** We use this when a change involves multiple currencies. For instance, an importer cannot directly convert Yuan, a form of Chinese currency, into INR. Instead, the importer must first convert the Yuan into USD before converting it into INR. This is an example of cross-hedging in action.
7. **Loans given in a foreign currency:** A trader can repay the loan in two different currencies. When you borrow money in your own currency, there is an exchange rate risk. When you borrow money in a foreign currency, there is no exchange rate risk. When your sales or debts are in a different currency, you use this method.
8. **Money market hedge:** This approach costs a lot of money and is not used very often. Companies purchase money in a different currency and give it back in the same currency. This makes them lose their spread. You can use forward trading as an alternative to this strategy.

Check Your Progress-A

Q1. Explain the concept of forward transactions.

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Q2. Describe foreign exchange risk.

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Q3. MCQs

1. Economic exposure is also known as:
a). Operating exposure
b). Accounting exposure
c). Payment exposure
d). Cost exposure

2. Statement I: The payment of an obligation prior to its due date as "leading."
Statement II: The payment of an obligation after the due date is "lagging."

In the light of the above statement choose the right option:

a). Both statement I and II are correct.

b). Both statement I and II are incorrect.

c). Statement I is correct, but statement II is incorrect.

d). Statement I is incorrect, but statement II is correct.

Tools for managing risk: It's always possible to lose money when you exchange one coin for another. Anyone who deals with currencies should be aware of the different risk management tools available. People use hedging to keep themselves from losing money due to various risks. The hedging process lessens the negative effects of impending exchange risks. Hedgers lower exchange risk by making sure that their assets and debts are in the same foreign currency. Tools and methods for hedging: "Hedging" is a process to keep from losing money because of multiple kinds of risks.

Hedge techniques consist of two components. These are internal strategies and outward strategies.

1. **External Techniques:**

a) Forward contracts: Forward contracts deal between two parties to buy or sell a certain amount of an underlying object at a set price at a later date. In these contracts, both parties commit to trading a specific quantity of an object for a predetermined price at a future date. Most of the time, these tools allow you to control foreign exchange risk. Businesses use forward contracts to buy or sell foreign currencies that they need to pay for or plan to get in the future. The exchange rate stays the same during the contract period, so there is no change in cash flow. Any changes that happen between the contract date and the real transaction date do not affect the result. It successfully lowers the risk of losing money in foreign exchange. If there isn't a set date, the future payment date can be any time between the two agreed-upon dates.

b) Currency Futures: Two people sign a standard agreement to buy or sell a certain amount of a currency at a set price on a future date. A regulated market sells this as a currency futures contract. Futures contracts are considered more liquid than other futures contracts due to their trading on these markets. You can protect yourself from currency drops by selling futures, and you can protect yourself from currency rises by buying upcoming. This allows futures to determine the predetermined inflows and outflows of various currencies through buying and selling, effectively eliminating foreign exchange risk.

c) Currency Options: A person who owns a currency options contract has the right to buy or sell a certain amount of a currency at a certain price during a certain time period. Currency options give the contract owner the choice to buy or sell, but not the duty to do so. No matter what the exchange rates are, the agreement owner can choose to accept or not. They can let the option lapse, sell or buy the currency, or do nothing. The option writer receives payment for providing this choice. The fee represents the amount that was paid. The owner can buy or sell the currency at a set price. We refer to this price as the purchase price or strike price. What are the differences between call and put options? Call options grant the holder the right to buy, and put options grant the holder the right to sell. You can use currency options to capitalize on potential gains.

Currency Swaps: A currency swap is a deal between two parties to trade a set of cash flows in one currency for a set of cash flows in another currency at set times over a certain length of time. Typically, this transaction facilitates the conversion of a debt from one currency to another.
One person or group exchanges their currency for the other person's or group's currency. During the loan term, each party pays interest on the traded currency at regular intervals parties return the capital amounts in their respective currencies when the loan ends or the agreement breaks.

A currency swap is a deal in which two parties trade a set of cash flows in one currency for a set of cash flows in another currency at regular intervals over a certain period of time. People often use this deal to transfer debts from one currency to another, enabling the raising of funds in multiple currencies.

e) Foreign Debt: You can use foreign debt to protect yourself from foreign price risk, as the international Fisher effect shows. For instance, if a business thinks it will get a certain amount of euros in the future, it might lose money if its own currency gets stronger against the euro. To lower this risk, the business can take out a loan in Euros for the same amount of time and then decide to change the foreign currency into US dollars at the spot exchange rate. Once the business receives the euros, it can pay back the loan. This method has been very helpful for the company in getting rid of its foreign exchange risk.

f) Cross-hedging: This strategy involves placing opposite bets on two currencies that are believed to have a positive correlation. When it's not possible to directly hedge the chosen foreign currency, businesses use this plan. Businesses can effectively manage their foreign exchange risk through cross-hedging, as the outcome remains consistent regardless of whether they hedge in one or another currency.

g) Currency Diversification: Currency diversification means investing in assets priced in different currencies. This plan lowers risk by spreading assets across different countries, even if they don't have anything to do with each other. It lets the company do business all over the world, lowers its foreign exchange risk, and makes most of its money from changes in exchange rates.

2. Internal Techniques:

a) Netting: When you net, you balance out an exposure in one currency with an exposure in either the same currency or a different currency. You do this because you think that a position may lose money due to changes in the exchange rate. Or, there may be a chance of making money, which can be adjusted by making cash or losing money in another case. There are two main types:

Two-way netting and three-way netting. When there is bilateral netting, each pair of companies evens out their situations against each other. Each company's decision to buy or sell less from its netting partner reduces the net flows. For multilateral netting, it is also possible for more than two parties to use a center or central exchange.

b) Matching: This refers to the process of aligning a company's plan. Cash comes in and goes out, both in terms of how much and when. When businesses receive and send foreign currency payments due at the same time, they can usually balance them. Hedging can be used for any part of a foreign currency cash amount that cannot be matched. This method is called "natural matching." Meanwhile, parallel matching means that if both currencies move in the same direction, expected gains in one will equal expected losses in the other.

c) Leading and Lagging: These typically pertain to adjustments in the timing of payments or debts. Leading means sending stronger currencies faster and receiving weaker currencies faster. When you lag behind, you defer payments in weaker currencies and even postpone earning in stronger currencies. In these situations, companies often delay payments or debts in foreign currency to capitalize on fluctuations in exchange rates.

d) Policy on Prices: How to set prices: The pricing strategy can be broken down into two main groups: price change and currency of billing policy. You can counteract the negative effects of exchange rate changes by raising the selling price. However, this could potentially lead to issues with the volume of sales. Therefore, before raising the price, conduct a thorough analysis of customer loyalty, market conditions, and the company's competitive standing. Second, foreign buyers may occasionally insist on receiving payment in their own currency and making all purchases in that same currency.

e) Guarantee of Exchange Risk by the Government: Government agencies in many countries provide insurance against export credit risk and have begun introducing special export financing schemes for exporters to promote exports. The exporters used to pay a small premium on their export sales, and for this premium, the government agency absorbs all exchange losses and gains beyond a certain limit.

6.13 SUMMARY

The foreign exchange market has numerous dealers with banks being the most dominant. It is a worldwide market where different countries 'currencies are exchanged. It is not restricted to any given country or geographical area. The foreign exchange market is the market for national currency operating anywhere in the world, as the world's financial center is under the umbrella of a single market.

6.14 GLOSSARY

Arbitrage: Refers to the process of buying a currency in one market at a lower rate and immediately selling it in another market at a higher rate.

CHIPS: It is a clearing house interbank payment system.

Inflation: An increase in the price of goods and services.

Hedging: This is the process of protecting a position in a currency pair from the risk of losses.

Matching: The practice of matching a company's foreign currency inflows and outflows in terms of both amount and time.

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6.17 TERMINAL QUESTIONS

1. Define the foreign exchange market. Explain its characteristics in detail.

2. Explain the constituents of the interbank market.

3. What is the foreign exchange rate? Describe the participants of the foreign exchange market.

4. Explain the factors determining the spot exchange rate.

5. Define hedging. Describe the internal and external techniques of hedging.

Block II

Nature and Scope of Financial Services

UNIT 7 NATURE AND SCOPE OF FINANCIAL SERVICES

7.1 INTRODUCTION

As financial markets are expanding, becoming complex and increasing interconnected as well as integrating with technology, it becomes essential to understand about the financial services and the impact at local and global scales.

As the financial market is expanding and evolving into every dimension, it has become very important to understand about the nature and scope of financial services. The nature of financial services will make clarity and better understanding about the characteristics of financial services. This is going to help in understanding the differentiation between core functions of financial services that will facilitate in creating new and innovative financial services. This will explore the ever-evolving landscape of financial technology, or "Fintech," this has revolutionized the way financial services are delivered and accessed. Innovations such as mobile banking, trading, cryptocurrency, and peer-to-peer lending have interrupted traditional practices and unlocked new avenues for financial inclusion and efficiency.

Due to the complexity and changes in the market, new financial services are needed. New financial have been developed over past few years and still there is need for new financial services in future to solve the existing and upcoming challenges. Furthermore, the unit will address the ethical considerations that arise within the financial services industry. Topics such as responsible lending, fair financial practices, and the management of potential conflicts of interest will be examined to underscore the importance of conducting business with integrity and accountability.

Overall, the study of the "Nature and Scope of Financial Services" is crucial for anyone aspiring to navigate the intricate world of finance, whether as a future financial professional, investor, or an informed consumer. It offers a comprehensive foundation that enables individuals to appreciate the significance of financial services in shaping economic landscapes and contributing to the well-being of societies worldwide. By acquiring this knowledge, students will be better equipped to make informed financial decisions, comprehend market dynamics, and critically assess the implications of financial services on global economic systems.

7.2 LEARNING OBJECTIVES

After studying this unit, students should be able to:

- Understand Financial Services.
- Explain the importance of Financial Services to the economy and society.
- Differentiate between various types of financial services.
- Understand the scope of financial services
- Describe the challenges being faced by financial service sector.

7.3 MEANING OF FINANCIAL SERVICES

After 1990, the Indian financial services sector has recorded a significant transformation in the market. In the late 70's and 80's the financial industry was mainly controlled by commercial banks and other financial institutions, primarily serving the needs of the Indian industrial sector, with the capital market assuming a subordinate role. However, the scenario underwent a comprehensive change with the introduction of economic liberalization.

Before the economic liberalization, the Indian financial service sector faced various challenges that impeded its growth and progress. Several key factors included:

(i) Excessive controls in the form of regulations on interest rates, money rates, etc.
(ii) Overbearing control over the prices of securities by the former Controller of Capital Issues.
(iii) Limited availability of financial instruments in terms of scale and variety.
(iv) Lack of independent credit rating and credit research agencies.
(v) Strict regulation of the foreign exchange market, with numerous restrictions on foreign investment and foreign equity holding in Indian companies.
(vi) Insufficient information about international developments in the financial sector.
(vii) Absence of a developed Government securities market and a stagnant capital market without any reforms.
(viii) Limited availability of debt instruments on a large scale.

However, after the implementation of economic liberalization, the entire financial sector has undergone a remarkable transformation, witnessing the emergence of new financial schemes and services. It has become necessary to understand the meaning and scope of financial services, due to reforms, innovation and creativity in the financial market.

In a general sense, 'financial services' encompass all activities related to financial matters and the mobilization and allocation of savings. It includes the transformation of savings into investments. Another term for 'financial services' is 'financial intermediation,' which denotes the process of gathering funds from numerous savers and making them available to those in need, particularly corporate customers. Thus, the financial services sector plays a crucial role and is vital for industrial development. A well-developed financial services industry is essential for mobilizing savings and allocating them to various investment channels, thereby promoting industrial development in a country.

Financial services refer to a broad range of economic activities and transactions that involve the management, creation, distribution, and utilization of money and financial assets. These services are provided by various institutions, both public and private, to individuals, businesses, and governments to facilitate the efficient functioning of the economy and meet their diverse financial needs. Financial services are an essential part of any modern economy, enabling the smooth flow of funds, allocation of resources, risk management, and wealth accumulation.

Key components of financial services include:

1. **Banking Services**: Banks play a crucial role in the financial services industry, providing services like deposit accounts, loans, credit cards, and various payment solutions. They facilitate the movement of funds and provide a safe environment for storing money.

2. **Investment Services**: Financial institutions offer investment products and services, such as mutual funds, stocks, bonds, and retirement accounts. These services help individuals and organizations invest their money to generate returns and achieve their financial goals.

3. **Insurance Services**: Insurance offers compensation and provide supports against financial losses that may arise from unexpected events, such as accidents, illnesses, natural disasters etc. Insurance sector offer various types of insurance schemes dealing to diverse needs, including life insurance, health insurance, property insurance, and etc.
4. **Financial Planning**: Financial planning services assist individuals and businesses in creating a comprehensive strategy to achieve their financial objectives. This involves budgeting, saving, investment planning, retirement planning, tax optimization, and estate planning.
5. **Credit and Lending**: Financial institutions extend credit and loans to individuals and businesses, enabling them to finance projects, purchases, or emergencies. They evaluate creditworthiness and manage the lending process to mitigate risks.
6. **Wealth Management**: Wealth management services cater to high-net-worth individuals, providing personalized financial advice and investment management to preserve and grow their wealth.
7. **Foreign Exchange Services**: Institutions facilitate currency exchange and provide hedging solutions for businesses and investors dealing with international transactions.
8. **Payment and Settlement Services**: Financial services include payment processing and settlement systems that enable the smooth transfer of funds between individuals, businesses, and institutions.
9. **Crowdfunding Platforms:** These platforms allow individuals and businesses to raise funds from a large number of people, often through small contributions from each participant.
10. **Financial Education and Training:** Some financial service providers offer educational resources and workshops to improve financial literacy and money management skills.
11. **Financial Consultancy and Advisory Services**: Professionals and firms offer financial consultancy and advisory services to clients, providing expertise on various financial matters, such as mergers and acquisitions, risk management, and strategic financial planning.
12. **Fintech Services**: With the advancement of technology, financial technology (Fintech) services have emerged, offering innovative digital solutions for banking, payments, investment, and lending.

The scope of financial services is continuously evolving due to technological advancements, changes in regulatory frameworks, and shifting market demands. It plays a crucial role in facilitating economic growth, stability, and prosperity by efficiently allocating capital and managing financial risks. However, it also demands a high level of responsibility, transparency, and ethical conduct from financial institutions and professionals to maintain credibility and reliability in the financial services.

7.4 EVOLUTION OF FINANCIAL SERVICES

The evolution of financial services has been a outstanding journey that spans centuries, shaped by technological advancements, economic shifts, and societal changes. From ancient bartering systems to the modern-day digital financial landscape, the world has witnessed a profound transformation in the way financial services are accessed, managed, and utilized. The key milestones in the evolution of financial services includes the major developments that have shaped the global financial landscape.

1. Early Beginnings: The origins of financial services can be traced back to ancient civilizations, where bartering was the primary means of trade. As societies advanced, the concept of currency emerged, leading to the introduction of coins and other forms of money. This laid the foundation for more sophisticated financial systems.
2. Emergence of Banking: In the 17th century, Europe saw the formation of the first modern banks, such as the Bank of England, which marked a significant shift in financial services. Banks began issuing banknotes and developing credit systems.
3. Industrial Revolution and Capital Markets: In the 18th and 19th centuries, the Industrial Revolution brought about extensive economic reforms. This has catalyzed the establishment of stock exchanges and capital markets, where businesses could raise capital by issuing stocks and bonds to investors, this leads to markets democratized investment opportunities.
4. Retail Banking and Consumer Services: In the 20th century, the rise of retail banking was witnessed, this enabled individuals to access basic financial services such as savings accounts, and loans. Thereafter Automated Teller Machines (ATMs) came into existence and banks offered customers to withdraw cash and perform basic transactions 24x7.
5. Globalization and Digitalization: With the arrival of the internet and advancements in telecom sector, the market witnessed rapid globalization and digitalization in the 20th century. This has created space for the emergence of online banking and electronic payment systems, making financial facilities more accessible and convenient.
6. FinTech Disruption: The financial industry experienced a disruptive wave with the rise of Financial Technology (FinTech) companies in the 21st century. The innovative FinTech startups leveraged technology to offer efficient and user-friendly services, resolving the challenges in traditional financial institutions and contributing to digital transformation in the market.
7. Blockchain and Cryptocurrencies: The formation of blockchain technology and cryptocurrencies, notably Bitcoin, transformed the concept of money and financial businesses. Blockchain offered decentralized and secure transactional arrangements, and cryptocurrencies provided alternative digital possessions and investment avenues.
8. Mobile Banking and Payment Solutions: The evolution of smartphones offered and facilitated individuals to access financial services. Mobile banking apps and digital

payment solutions transformed the system of managing finances, facilitating peer-to-peer transactions, mobile wallets, and cashless payments.

9. Rise of Robo-Advisors and AI in Finance: Artificial Intelligence (AI) found its way into the financial industry, enabling the development of robo-advisors for investment management and risk assessment. AI-driven algorithms also improved fraud detection and enhanced customer service through chatbots and virtual assistants.

A .Evolution of Financial Services in India.

Indian financial services sector has undergone significant transformations over the years, marked by progressive improvements, liberalization, and technological advancements. This could be divided into several key phases, each contributing to the country's economic growth and financial inclusion.

1. **Pre-Independence Era:** Before gaining independence in 1947, India's financial system was primarily under British colonial influence. It consisted of a few traditional financial institutions, mainly focused on meeting the needs of the colonial administration and a limited elite. These institutions included the Reserve Bank of India (RBI), established in 1935, which served as the central banking authority.
2. **Post-Independence Era:** After independence, India took measures to develop its financial infrastructure to support its growing economy. The RBI became the regulator and controller of the country's banking system. The government nationalized major banks in 1969, aiming to increase banking penetration and provide credit to priority sectors, such as agriculture and small-scale industries.
3. **Liberalization and Economic Reforms:** In 1991, India initiated a significant economic liberalization and reform process to open up its economy to the global market. This led to reforms in the financial sector, including the entry of private and foreign banks, the establishment of stock exchanges, and the introduction of market-driven interest rates. The reforms aimed to enhance competition, efficiency, and innovation in financial services.
4. **Technology and Digitalization:** The 21st century witnessed a surge in technological advancements that revolutionized financial services in India. The widespread adoption of the internet and mobile phones paved the way for digital banking and electronic payments. Services like online banking, mobile wallets, and Unified Payments Interface (UPI) became popular, simplifying transactions and increasing financial inclusion, especially in rural areas.
5. **Fintech Revolution:** The rise of fintech (financial technology) companies in India further accelerated the growth of financial services. This has offered innovative solutions in every financial service. Fintech company facilitated data analytics, artificial intelligence, and blockchain to offer customer-centric and efficient financial facilities.

6. **Financial Inclusion:** The government and regulators made concerted efforts to promote financial inclusion by bringing unbanked and underbanked populations into the formal financial system. Initiatives like Jan Dhan Yojana, Aadhaar (biometric identification), and the Pradhan Mantri Mudra Yojana played a crucial role in providing banking access and credit to millions of people.
7. **Regulatory Changes and Investor Protection:**The Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority of India (IRDAI) have been actively working to protect investors' interests, ensuring transparency and stability in the financial markets.
8. **Integration of Informal Economy:** The formalization of the informal economy has been a key focus to reduce cash usage and tax evasion. Measures like demonetization in 2016 aimed to bring more transactions into the formal financial system.

7.5 NATURE OF FINANCIAL SERVICES

Financial services play an important role in the functioning of modern economies, that facilitate the flow of funds and supporting economic growth. The following are nature of financial services that are characterized by some key aspects:

1. Intangible: Financial services are intangible in nature, it cannot be seen, touched, or physically experienced.

2. High Customization is required: In order to meet the expectations and need the customers financial services require a high degree of customization. Customers have diverse financial goals, risk taking capacity, and investment prospects, to get maximum customers satisfaction needed customized solutions.

3. Information Asymmetry: Information irregularity is general characteristic in financial transactions. Financial organizations have complete knowledge and expertise than customers. This asymmetric information can lead to possible conflicts of interest; this emphasizes the importance of transparency.

4. Regulation and Compliance: there is extensive regulation and compliance in the financial sectors because of high risks involved, and consequences related with financial services. Regulatory bodies implement rules and standards to protect consumer's interest, ensure market stability, and prevent fraudulent events.

5. Risk and Uncertainty: Financial services inherently involve risk and uncertainty. Both service providers and consumers face varying degrees of risk in financial transactions, such as credit risk, market risk, liquidity risk, and operational risk. Managing these risks is a critical aspect of financial service operations.

6. Intermediation: Financial services often act as intermediaries between borrowers and lenders, investors and companies, or individuals and insurers. These intermediaries facilitate the efficient allocation of capital and resources, connecting those with surplus funds to those in need of financing.

7. Wide range of Services: A wide array of services, like banking, insurance, investment management, securities trading, wealth management, financial advisory, and more. Each segment serves different purposes within the broader financial ecosystem.

8. Global Nature: In today's interconnected world, financial services transcend borders, enabling transactions and investments on an international scale. This global reach exposes the financial sector to global economic trends and regulatory variations across different countries.

9. Technology-driven Innovation: Advancements in technology have significantly impacted the nature of financial services. FinTech (Financial Technology) has emerged as a disruptor, offering innovative solutions in areas such as mobile banking, peer-to-peer lending, robo-advisors, and digital currencies.

10. Financial Inclusion: The concept of financial inclusion is gaining importance, emphasizing the need to provide access to essential financial services to all segments of society, especially the underserved and unbanked populations.

In conclusion, the nature of financial services is multifaceted, ranging from intangibility and information asymmetry to risk management and global reach. The sector's continuous evolution, driven by technological advancements and regulatory changes, underscores its critical role in supporting economic activities and improving overall financial well-being.

7.6 OBJECTIVES OF FINANCIAL SERVICES

The objectives of financial services revolve around meeting the diverse needs of individuals, businesses, and governments in managing their finances effectively. These services are provided by financial institutions and professionals and aim to achieve several key goals:

1. **Facilitating capital formation:** Financial services play a crucial role in mobilizing savings from various sources and channeling them into productive investments. By facilitating the flow of funds from savers to borrowers, financial services support economic growth and development.
2. **Providing liquidity and risk management:** Financial services help ensure that individuals and businesses have access to funds when needed. They provide various financial products, such as checking and savings accounts, insurance policies, and lines of credit, which enhance liquidity and offer protection against unexpected financial risks.

3. **Fostering investment and wealth creation:** Financial services offer a wide range of investment opportunities, from stocks and bonds to mutual funds and real estate investment trusts (REITs). By providing avenues for investment and wealth creation, financial services assist individuals and businesses in achieving their long-term financial goals.
4. **Enhancing financial security:** Insurance and risk management services are fundamental to enhancing financial security. These services protect against various risks, such as property damage, health emergencies, and income loss, providing peace of mind to individuals and businesses alike.
5. **Promoting efficient payment systems:** Financial services enable secure and efficient payment and settlement systems, such as electronic fund transfers, mobile payments, and credit card transactions. These systems facilitate smooth and timely transactions, supporting the overall functioning.
6. **To support international businesses and investment:** Banks and financial intermediaries, play a significant role in promoting international trade and investment. They provide foreign exchange services, trade financing, and cross-border investment prospects, fostering economic integration worldwide.
7. **Supporting retirement:** Retirement planning solutions, like pension funds and retirement accounts are facilitated by financial service organization. These help individuals to collect savings and create income streams for their post-retirement years.
8. **Promotion of financial inclusion:** To enhance financial inclusion by covering access to financial services to unreached and unbanked populations is the prime objective of financial services. Through this more people into the formal financial system could be included that will improves overall economic well-being of the huge unprivileged segment people.
9. **Financial guidance and education:** It covers financial advisory and educational services to help the targeted populations and businesses make informed decisions about managing their funds, investing rationally, and planning for the upcoming.
10. **Guaranteeing regulatory compliance for protecting consumer interest:** regulatory guidelines and standards must ensure to maintain the stability and credibility of the financial system. Regulatory frame work are ensured by the service organization to protect the interest of the stakeholders; to protect consumers' rights and interests, ensuring fair and transparent practices and healthy competition.

7.7 TYPES OF FINANCIAL SERVICES

Banking, Financial Services and Insurance (BFSI) is the industry's “umbrella” term used for companies that offering a range of such financial products or services. The Banks offers a wide range of financial services (Banking, Insurance, Stock broking and investment) that professionally managed in one or more of these financial sectors.

Types of financial services can be categorized into various classifications based on their nature, function, and the types of institutions involved in providing them.

1. **Banking Services:**
    - Retail Banking: Services provided to individual customers, such as savings accounts, checking accounts, personal loans, and credit cards.
    - Corporate Banking: Services provided to businesses and corporations, including commercial loans, trade financing, and cash management.
    - Investment Banking: Services related to capital raising, mergers and acquisitions, underwriting securities, and financial advisory.
2. **Investment Services:**
    - Asset Management: Managing and investing in various assets on behalf of clients, including mutual funds, hedge funds, and pension funds.
    - Wealth Management: Providing personalized investment advice and financial planning to high-net-worth individuals.
    - Brokerage Services: Facilitating buying and selling of financial assets like stocks, bonds, and other securities.
3. **Insurance Services:**
    - Life Insurance: Provides financial compensation to beneficiaries upon the death of the policyholder.
    - Health Insurance: this ensures medical expenses and provides financial support for healthcare services.
    - Property and Casualty Insurance: Protects against property damage and liability risks.
4. **Retirement Services:**
    - Pension Plans: Employer-sponsored retirement plans that provide financial security to employees after retirement.
    - Individual Retirement Accounts (IRAs): Personal retirement accounts with potential tax advantages.

5. **Lending Services:**
    - Consumer Lending: Loans provided to individuals for personal use, such as auto loans and personal loans.

- Commercial Lending: Loans extended to businesses and corporations to support their operations and expansion.

6. **Payment Services:**
   - Payment Processing: Facilitating transactions between consumers, businesses, and financial institutions.
   - Electronic Funds Transfer (EFT): Transferring funds electronically between accounts or institutions.
7. **Foreign Exchange Services:**
   - Currency Exchange: Converting one currency into another for individuals and businesses involved in international transactions.
   - Foreign Exchange Trading: Trading currencies in the foreign exchange market for profit.
8. **Financial Planning and Advisory Services:**
   - Financial Consultation: Offering advice on budgeting, investment strategies, and financial goals.
   - Tax Planning: Assisting individuals and businesses in optimizing their tax liabilities.
9. **Real Estate Services:**
   - Real Estate Financing: Providing loans and mortgages for purchasing or refinancing real estate.
   - Real Estate Investment Trusts (REITs): Investing in income-generating real estate properties.
10. **Trade Finance Services:**
    - Letters of Credit: Guaranteeing payments to suppliers in international trade transactions.
    - Export and Import Financing: Providing financing solutions to support cross-border trade.

7.8 NEW FINANCIAL PRODUCTS /SERVICES

Currently, worldwide, the significance of financial services is gaining momentum. In today's intricate financial landscape, people expect Financial Service Companies to play a versatile role, not merely as finance providers but also as comprehensive financial hubs. Economic liberation policies have been introduced, opening up our economy to multinational influences, and emphasizing the importance of the free market concept. Consequently, both corporate entities and individuals are exposed to the challenges of volatility and uncertainty, leading them to demand innovative financial products and services that cater to their diverse needs.

These demands for innovation have given rise to new instruments and products in the capital market, contributing to its expansion and depth. Simultaneously, the international capital market has undergone structural changes due to the emergence of novel products and innovative operational techniques. Many financial intermediaries, including banks, have already taken steps to increase their operations in the financial services by introducing various new service category. This tendency of innovation has significantly transformed the space of financial intermediation, contributing to the opportunities for new possibilities and advancements, few are discussed below:

(i) **Merchant Banking:** These banks act as an intermediary, facilitating the capital transfer between two parties. Merchant Banking offers wide-range of services, that may include the management of securities, assessment of projects, management of portfolios, underwriting of shares and debentures, loan syndication. Merchant bank plays a significant contribution by offering a variety of services for the industrial development in the country.

(ii) **Leasing:** leasing is an agreement between lesser and lessee, in which lessee company pays a rental fee to use a capital asset, like industrial equipment and machine. In the leasing, the lessee get control over the assets acquire through leasing without getting ownership. The lessee will take care of all maintenance, repairs, and operational cost till the maturity of the agreement. Developed countries like USA, UK and Japan are widely using for the industrial growth.
In past few years, several financial companies and commercial banks has entered the equipment leasing sector in India.

(iii) **Mutual Funds:** This is one of the financial services offered by mutual fund industry that manages the public fund with the help of professionally managed Fund manager. Mutual fund facilitates and offers best alternative of options with high/stable returns, with high liquidity, low risk and low cost. Fund manager creates diversified portfolio of the funds generated through pooling the investment from market. This is the best options for the investors who do not have any knowledge of market and wish invest in equity for potential capital appreciation in the long term.

(iv) **Loan Syndication:** It is also known as consortium financing, involves a merchant banker acting as the lead manager. It entails arranging a loan for a borrower, typically a large corporate customer or a government department. Other banks willing to lend can participate in the loan by contributing according to their lending policies. This collaborative approach allows multiple banks to share the credit risk associated with the loan.

A large token size as loan could not be offered by a single bank, few banks come together and form a syndicate, this enables the members of the syndicate to share the credit risk associated with a loan.

(v) **Factoring:** Factoring involves a financial service company managing a client's sales ledger. The factor assumes the credit risk in collecting book debts for the client, taking over the responsibility of debt collection, credit information, debt monitoring, and providing finance against debts. Factoring offers various services beyond financing.

(vi) **Venture Capital:** Venture capital is a form of equity participation financing that supports new innovative projects based on their potential. Unlike conventional security-based financing, venture capital emphasizes new ideas and technological innovations. It provides funding for both start-up and development stages of projects.

(vii) **Custodial Services:** Custodial services involve financial intermediaries offering services to clients, particularly foreign investors, for a fee. These services include safekeeping of shares and debentures, collecting interest and dividends, and providing reports on corporate developments and securities to foreign investors.

(viii) **Corporate Advisory Service:** Financial intermediaries, particularly banks, set up corporate advisory service branches exclusively for their corporate customers. This service provides convenience for corporate customers to conduct important banking transactions from their own offices. It also helps corporate customers access new finance avenues like Euro loans and GDRs

(ix) **Forfeiting:** Forfeiting is a technique where a financing agency (Forfeiter) discounts an export bill and pays cash to the exporter upfront. This allows the exporter to focus on exporting without worrying about collecting payments from importers. The exporter is protected from the risk of non-payment by the importer as the forfeiter assumes the risk.

(x) **Securitization:** Securitization is a technique where a financial company converts ill-liquid, non-negotiable, and high-value financial assets into tradable securities of smaller values. This helps the financial institution raise cash against such assets by issuing securities to the public, making the assets more liquid.

(xi) **Derivative Security:** A derivative security's value depends on the values of other underlying variables, often the prices of traded securities. Derivative securities serve as risk management tools, allowing investors to cover risks due to price fluctuations. Different risk components, such as credit risk and interest rate risk, can be precisely identified, priced, and even traded using derivatives.

(xii) **Lines of Credit (LOC):** LOC is a funding mechanism for importing goods and services on deferred payment terms. It involves an arrangement between financial institutions/banks of different countries to support exports and enable importers to import on deferred payment terms. LOC saves time and money on verification and acts as a source of foreign exchange.

(xiii) New Products in Forex Market: In developed countries, new products have emerged in the forex market, some of which are yet to enter the Indian market. These services include forward contracts, options, futures, and swaps, which offer various ways to handling foreign exchange and interest rate exposures.

7.9 SCOPE OF FINANCIAL SERVICES

Financial services play a vital role in managing money, investments, and financial risks. Some of the key areas that covers the scope of financial services:

1. **Banking Services:** Banking services are of mainly of three types Deposit account (Savings accounts, Certificates of deposits), Payment Services (Debit & credit cards and electronic fund transfers), Loan and credit facilities (Personal & Business loans, mortgages
2. **Investment Services:** This includes various investment alternatives for the investors. These are of mainly three types; Wealth management (portfolio management, investment advisory and financial planning), Brokerage services (Buying & selling of securities and mutual funds), Retirement planning (Individual Retirement Accounts and pension funds.
3. **Insurance Services:** Insurance services is the facility under that financial compensation be paid for the risk or losses due to some uncertainty. Insurance services include Life Insurance, health Insurance & property insurance and Business insurance.
4. **Financial Advisory and Consulting:** These services are the expert advice provided to the customers for financial planning, Tax planning and Investment advice.
5. **Risk Management Services:** Risk management services try to mitigate the financial risks include Hedging instruments (Derivatives, options, future and swap), and Risk assessment and analysis; Identifying and evaluation of potential business risks.
6. **Estate Planning:** These types of services involve managing and distribution of property and assets after death by creating wills and trust. This also ensures facilitates smooth transfer of wealth and minimize estate taxes.
7. **Corporate Finance:** Corporate financing includes supporting businesses in fund raising through equity or debt. This also involves offering consultancy on corporate restructuring, Mergers and acquisitions
8. **International Banking and Finance:** These services cover foreign exchanges facilities (Currency conversion and risk control), International Money Transfer services and encourages cross-border payments.
9. **FinTech and Digital Banking:** It includes online banking facilities like Internet banking, digital wallets and Mobile apps.

10. **Government and Public Finance:** This involves managing public funds, government budgets and providing financial schemes to the public entities.

    It is essential to note that the scope of financial services may vary depending on the regulatory environment of a country and the specific licenses and certifications held by financial institutions and professionals.

7.10 CHALLENGES IN THE GROWTH OF FINANCIAL SERVICES

The financial industry plays an essential role in the economy at worldwide, by offering various financial services. Despite these advantages there are several challenges that creates barriers in the growth of financial sectors. Some of the key challenges are as follows:

1. **Regulatory Compliance:** The financial sectors is highly regulated to ensure stability, consumer protection, and fair practices. Complying with complex and ever-changing regulations can be a significant burden for financial institutions. Navigating these regulatory requirements while maintaining efficiency and innovation poses a challenge.
2. **Cybersecurity Threats:** As financial services increasingly rely on digital technologies, they become more vulnerable to cyberattacks. Cybercriminals target financial institutions to steal sensitive customer information, commit fraud, or disrupt operations. Ensuring robust cybersecurity measures is a constant challenge for the industry.
3. **Data Privacy Concerns:** The industry handles vast amounts of personal and financial data, which raises concerns about data privacy and protection. Striking a balance between utilizing customer data for personalized services and safeguarding it from unauthorized access is a persistent challenge.
4. **Fintech Disruption:** The rise of financial technology (fintech) startups has disrupted traditional financial services. Fintech companies often provide innovative and convenient solutions that appeal to tech-savvy consumers. Established financial institutions must adapt and incorporate fintech innovations to remain competitive.
5. **Customer Expectations:** Customers now expect seamless, personalized, and instant financial services. Meeting these expectations requires substantial investments in technology, infrastructure, and customer service, posing challenges for traditional financial institutions.
6. **Low-Interest Rates:** Persistently low-interest rates can reduce profit margins for banks and other financial institutions that rely heavily on interest income. In a low-rate environment, it becomes challenging to generate sufficient returns on investments and loans.
7. **Global Economic Uncertainty:** Economic fluctuations, geopolitical tensions, and unexpected events (like pandemics) can impact the financial services industry

significantly. Uncertainty in the global economy can lead to reduced investment, increased risk aversion, and a decline in consumer spending.

8. **Financial Inclusion:** A considerable portion of the global population remains unbanked or underbanked. Expanding financial services to underserved communities and emerging markets requires innovative approaches and significant investments.
9. **Legacy Systems and Infrastructure:** Many established financial institutions still rely on outdated legacy systems, which can impede agility, efficiency, and scalability. Modernizing these systems while ensuring data integrity and security is a substantial challenge.
10. **Competition from Non-Traditional Players:** Besides fintech startups, large technology companies have shown interest in entering the financial services space. These non-traditional players can leverage their extensive customer bases and technological prowess to disrupt the industry.
11. **Compliance Costs:** Meeting regulatory requirements often comes with a high cost. Smaller financial institutions might struggle to keep up with the expenses related to compliance, potentially leading to consolidation or reduced service offerings.

Addressing these challenges requires strategic planning, technological innovation, collaboration, and a keen focus on customer needs. Financial institutions that can adapt to these changing dynamics will be better positioned for sustainable growth.

7.11RECENT DEVELOPMENTS

The following are the recent development;

1. **Cryptocurrencies and Blockchain Technology:** The introduction of cryptocurrencies, like Bitcoin and Ethereum, has captured the attention of the financial sector. Governments and regulators were starting to establish clearer guidelines for their use, and some traditional financial institutions began exploring ways to integrate blockchain technology into their operations.

2. **Fintech Innovation:** The financial technology (fintech) sector saw significant growth, with companies utilizing technology to create superior, innovative and attractive financial services. Fintech solution companies have done a revolutionary contribution in the economy with safe, secure, less risky, best interface with no time bond, this has offered 24x7 services to the society. Fintech is accessible as well as affordable to each and every segment of the society.

3. **Digital Banking:** Digital-only banks, also known as neobanks, gained popularity. These banks offered seamless digital experiences without brick-and-mortar branches, attracting tech-savvy customers with competitive fees, high-interest rates, and convenient mobile apps.

4. **Sustainable Finance:** Environmental, Social, and Governance (ESG) investing became increasingly important in the financial services industry. Investors showed growing interest in sustainable and responsible investment options, leading to the creation of more ESG-focused funds and products.
5. **Regulatory Changes:** Regulatory environments worldwide were adapting to the evolving financial landscape. Governments and central banks were reviewing and updating policies to accommodate emerging technologies, safeguard consumer interests, and ensure financial stability.
6. **Open Banking:** Open Banking initiatives were gaining traction, aiming to give customers more control over their financial data. This allowed for better integration between different financial service providers and fostered the development of more personalized financial products.
7. **Artificial Intelligence and Big Data:** Financial institutions continued to leverage AI and big data analytics to enhance risk management, fraud detection, customer service, and investment decision-making.
8. **Central Bank Digital Currencies (CBDCs):** Several countries explored the possibility of issuing their own digital currencies. CBDCs could potentially offer benefits such as increased efficiency, reduced costs, and financial inclusion.
9. **Remote and Contactless Services:** The COVID-19 pandemic accelerated the adoption of remote and contactless financial services. Online banking, digital payments, and remote customer support became essential during times of social distancing.
10. **Security and Cybersecurity:** As the financial industry relied more on digital infrastructure, cybersecurity became a top priority. Financial institutions invested heavily in cybersecurity measures to protect sensitive data and systems from cyber threats.

Remember that the financial services industry is constantly evolving, and new developments are likely to have occurred after my knowledge cutoff date.

Check Your Progress-A

Q1. Define a financial service industry and discuss the various services rendered by it.

Q2. "Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy". Discuss.

Q3. Discuss some of the contribution of Fintech companies in recent times in the financial Industry.

Q4. Critically analyze the present position of the financial service sector in India and state the challenges it has to face in the years to come.

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1. **Multiple Choice questions (select the correct option)**

A. What is the primary goal of financial services?

a) To maximize shareholder profits

b) To facilitate the efficient allocation of financial resources

c) To promote economic growth and development

d) To reduce the risk of investments

B. Which of the following is NOT a component of financial services?

a) Banking services

b) Insurance services

c) Retail services

d) Investment services

C. The term "scope of financial services" means

a) The geographical area of financial services provided.

b) The range of financial services available.

c) The regulations governing the financial services.

d) The profit margins related with different services

D. How do financial services contribute to economic growth?

a) By creating monopolies in the financial sector

b) By reducing the flow of capital between different sectors

c) By providing access to capital for businesses and individuals

d) By limiting the availability of credit for consumers

E. Which type of financial service involves pooling funds from multiple investors to invest in a diversified portfolio of assets?

a) Banking services

b) Insurance services

c) Retirement planning services

d) Mutual funds

F. What role do financial intermediaries play in the financial services industry?

a) They act as middlemen, connecting borrowers and lenders in the market

b) They facilitate direct transactions between buyers and sellers of financial assets

c) They enforce government regulations on financial transactions

d) They provide financial advice and consulting services to businesses and individuals

G. Which financial service provides protection against potential financial losses due to unforeseen events?

a) Mutual funds

b) Insurance services

c) Retirement planning services

d) Credit card services

H. How does globalization impact the nature of financial services?

a) It restricts the flow of capital across borders

b) It reduces the complexity and diversity of financial products

c) It increases competition and expands the market for financial services

d) It isolates domestic financial markets from international influences

6. State whether the statement is TRUE/FALSE

a) Financial services refer to the products and processes involved in managing money and assets.

b) The financial services are limited to banking and insurance industry only.

c) For the smooth functioning of modern economies financial services are not necessary.

d) Investment banking is involves facilitating the issuance of stocks and bonds for companies.

e) Credit cards and personal loans are not considered financial services.

f) Advancement in technology and digitalization does not influences financial services.

7.12 SUMMARY

The unit provides a comprehensive understanding of the diverse landscape of financial services and their significance in the modern economy. It delves into the evolution, nature, objectives, and types of financial services, along with exploring the challenges faced by the financial services industry.

The primary objectives of this unit are to familiarize learners with the fundamentals of financial services, their role in the economy, and the scope of services offered. Additionally, it aims to highlight the challenges and opportunities that arise in the rapidly evolving financial services sector.

Financial services refer to a wide range of economic activities and offerings provided by financial institutions, intermediaries, and professionals. These services play a pivotal role in facilitating the flow of funds, managing risk, and supporting economic growth. The unit traces the historical evolution of financial services from traditional barter systems to modern-day sophisticated financial instruments and digital services. It explores how financial services have adapted and transformed over time to meet the changing needs of businesses and individuals. The nature of financial services is characterized by intangibility, perishability, inseparability, and variability. These characteristics distinguish financial services from tangible goods and influence their delivery and consumption. Financial services aim to fulfill various objectives, including providing liquidity, channeling funds to productive sectors, offering risk management tools, promoting savings and investment, facilitating international trade, and fostering economic stability.

The unit explores a wide array of financial services, encompassing banking services (e.g., deposit accounts, loans, and credit cards), insurance products (e.g., life, health, and property insurance), investment services (e.g., mutual funds, stocks, and bonds), and other auxiliary services such as financial planning and advisory. As financial markets continue to innovate, the emerging financial services resulting from advancements in technology and changing consumer preferences like include fintech solutions, digital payment platforms etc.

The unit explores how financial services are crucial for mobilizing savings, supporting investment, and facilitating economic growth. There are certain complications for financial sectors like safety, security, cost, access, quality concerns. Some of the other challenges involve legal &regulatory compliances, cybersecurity risks, solving customer grievances, and dealing with the rapid technological obsolescence.

7.13 GLOSSARY

Blockchain: A decentralized and distributed ledger technology that records transactions across multiple computers securely and transparently, ensuring data integrity without the need for intermediaries.

Cryptocurrency: A digital or virtual currency that uses cryptography for secure financial transactions, operates on blockchain technology, and is typically decentralized. Examples include Bitcoin and Ethereum.

Algorithm: A step-by-step procedure or formula for solving a problem or performing a task, often used in AI and Big Data analytics.

7.14 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Question 5 MCQ

Correct answer: A- b) To facilitate the efficient allocation of financial resources

Correct answer: B- c) Retail services

Correct answer: C-b) The range of financial services available.

Correct answer: D- c) By providing access to capital for businesses and individuals

Correct answer: E- d) Mutual funds

Correct answer: F-c) They act as middlemen, connecting borrowers and lenders in the market

Correct answer: G-b) Insurance services

Correct answer: H-c) It increases competition and expands the market for financial services

Question 6 True/ False

1. Answer a): True
2. Answer b): False
3. Answer c): False
4. Answer d): False
5. Answer e): True
6. Answer f): False

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7.17 TERMINAL QUESTIONS

1. What do you understand by Financial Services? Write down key features of services.
2. Highlight the role and importance of financial services the economy.
3. Analyze the impact of technological advancements on the nature and delivery of financial services.
4. Describe the various types of financial intermediaries and their functions within the financial system.
5. Assess the challenges and opportunities faced by financial services providers in a globalized economy.
6. How have financial services evolved over the years, and what factors have contributed to their transformation?
7. Analyze the impact of the 2008 global financial crisis on the regulatory landscape of financial services. What reforms were implemented to prevent a similar occurrence?

8. How do financial services contribute to capital formation and allocation in an economy? Provide real-world examples.
9. "Cryptocurrencies have disrupted traditional financial services." Present arguments both in favor of and against this statement, considering their advantages and risks.
10. Describe the role of investment banks in facilitating capital raising for corporations and governments. Discuss their involvement in initial public offerings (IPOs) and bond issuances.

7.18 CASE LETS

Caselet: Narendra Financial Services (NFS)

Introduction:

Narendra Financial Services (NFS) is a well-established financial company that has been operating for more than 30 years. NFS offers a huge range of financial services, targeting the diverse needs of customers in the market. Over the year finance industry, MFS has been accepting, very flexible in adapting and developing its offerings with new schemes, embracing the dynamic nature and scope of financial services.

The Early Days:

In the early days of its establishment, NFS primarily focused on providing traditional banking services, such as savings and current accounts, fixed deposits, and loans. The scope of services was limited to basic transactions and basic advisory for customers. The market was relatively stable, and competition was moderate.

The Winds of Change:

In the 1990s, the financial landscape started undergoing significant changes. Deregulation and liberalization policies brought in more competition and new opportunities. Narendra Financial Services realized the need to innovate and diversify its offerings to stay ahead. The management decided to expand the nature of financial services they provided, integrating insurance products, mutual funds, and other investment options into their portfolio.

Venturing into Wealth Management:

By the early 2000s, NFS had firmly established itself as a full-fledged financial services provider. They ventured into wealth management, offering highly customized financial services to High-Net-Worth Individuals and corporate clients. Understanding the unique financial goals and risk tolerance of each client allowed the company to offer tailored investment strategies and wealth preservation techniques.

Embracing Digital Transformation:

As the world entered the digital age, NFS realized the significance of incorporating technology into their operations. They launched an advanced online banking platform that enabled customers to access their accounts, execute transactions, and obtain financial advice at their convenience. Embracing mobile applications further enhanced customer engagement and accessibility.

Navigating the 2008 Financial Crisis:

The global financial crisis of 2008 put financial institutions to the test. NFS navigated through the turbulent times by prudently managing risk and strengthening their risk assessment processes. The crisis highlighted the importance of robust risk management and stringent regulatory compliance, leading the company to enhance its risk and compliance departments.

The Rise of Fintech:

In the following years, fintech companies emerged, disrupting traditional financial services. Recognizing the potential benefits of collaborating with these startups, NFS formed strategic partnerships with select fintech firms. This enabled them to leverage cutting-edge technologies, expand their services further, and tap into new customer segments.

Towards Sustainable Finance:

With increasing awareness of environmental and social responsibility, NFS embraced the concept of sustainable finance. They started offering green bonds, socially responsible investment funds, and financing options for sustainable projects. By aligning their financial services with sustainable goals, the company attracted environmentally conscious investors and contributed to positive change.

Questions:

1. How did embracing digital transformation help Narendra Financial Services (NFS) enhance customer engagement and accessibility? Provide specific examples.
2. Analyze the impact of the 2008 financial crisis on Narendra Financial Services (NFS). How did the crisis influence their risk management and regulatory compliance practices?
3. Evaluate the strategic importance of forming partnerships with fintech companies for Narendra Financial Services (NFS). What benefits and challenges might have arisen from such collaborations?
4. Discuss the significance of Narendra Financial Services (NFS) incorporating sustainable finance options into their portfolio. How could these initiatives attract environmentally conscious investors and contribute to positive change?

UNIT 8 NATURE AND SCOPE OF FINANCIAL SERVICES- CONSTITUENTS & CLASSIFICATION

8.1 INTRODUCTION

Financial services in India form the backbone of the country's economy, playing a crucial role in its growth and development. This sector encompasses a wide range of services that cater to the financial needs of individuals, businesses, and the government. The Indian Financial Service industry has undergone a metamorphosis since 1990. During the late seventies and eighties, the Indian Financial Service industry was dominated by commercial banks and other financial institutions which cater to the requirements of Indian industry. In fact, the capital market played a secondary role only. The economic reforms of 1991, led by then-Finance Minister Dr. Manmohan Singh, marked a significant turning point.

The liberalization of the financial sector led to the entry of private and foreign banks, deregulation of interest rates, and the growth of the capital markets. Prior to the economic liberalization, the Indian financial service sector was characterized by so many factors which retarded the growth of this sector. Some of the significant factors were:

1. Excessive control in the form of regulation of interest rates, money rates etc.
2. Too many control over the process of securities under the erstwhile controller of capital issues
3. Non availability of financial instruments on a large scale as well as on different varieties
4. Absence of independent credit rating and credit research agencies
5. Strict regulation of the foreign exchange market with too many restrictions on foreign investments and foreign equity holding in Indian companies.
6. Lack of information about international developments in the financial sector
7. Absence of a developed government securities market and existence of stagnant capital market without any information
8. Non availability of debt instrument on a large scale

Economic liberalization in India, initiated in 1991, had a profound impact on the financial services sector. The reforms were part of a broader shift towards a market-oriented economy, with the aim of integrating India into the global economy, improving efficiency, and promoting growth. Economic liberalization significantly transformed the financial services sector in India. It introduced greater efficiency, innovation, and competition, contributing to the sector's rapid growth and integration with global markets. However, it also brought challenges, including the need for strong regulatory oversight to manage risks and ensure stability. Overall, the reforms played a crucial role in driving India's economic progress over the past few decades.

8.2 OBJECTIVES

After going through the unit, a learner shall be able to understand;

- Functions of Financial Services
- Importance of Financial Services
- Constituents of Financial Services
- Classification of Financial Services Industry

8.3 MEANING OF FINANCIAL SERVICES

Financial services refer to a broad range of activities and offerings provided by institutions within the financial sector to manage, invest, transfer, and protect money and assets. These services are essential for the functioning of an economy, as they facilitate various economic activities, including saving, investing, borrowing, and managing risk.

In general, all types of activities which are of financial nature could be brought under the term financial services. The term 'Financial services in a broad sense means 'mobilizing and allocating saving.' Thus, it includes all activities involved in the transformation of saving into investment. The 'Financial Service" can also be called 'financial intermediation'. Financial intermediation is a process by which funds are mobilized from large number of savers and make them available to all those who need it particularly to corporate customers.

Financial services encompass all the products and services offered by institutions like banks, insurance companies, investment firms, credit unions, and other financial intermediaries. These services are designed to help individuals, businesses, and governments manage their finances effectively.

The financial service sector is a key area, and it is very vital for industrial development. A well-developed financial service industry is absolutely necessary to mobilize the saving and to allocate them to various investable channels and thereby to promote industrial development in a country.

8.4 DEFINITION OF FINANCIAL SERVICES

Financial services can be defined as:

1. Comprehensive Definition:

"Financial services refer to the various offerings provided by financial institutions to help individuals, businesses, and governments manage their finances, including the facilitation of financial transactions, investment management, risk management, and advisory services."

2. Functional Definition:

"Financial services encompass a broad spectrum of services provided by the financial sector, including banking, insurance, investment, credit, payment processing, and wealth management, aimed at supporting economic activities, managing risks, and ensuring efficient allocation of resources."

8.5 NATURE /CHARACTERISTICS OF FINANCIAL SERVICES

The nature of financial services is characterized by several key features that define how these services are provided, utilized, and regulated. Here's an overview of the essential characteristics:

1. Customer-oriented: Like any other service industry the financial service industry is also a customer -oriented one. That customer is the king, and his requirements must be satisfied in full should be basic tenet of any financial service industry. Customers play an active role in the creation and delivery of financial services. For example, a client must provide personal financial information when applying for a loan or investing in a financial product. The effectiveness of financial services often depends on the active involvement and cooperation of the customer, such as in financial planning or insurance underwriting.
2. Intangibility: Financial services are intangible, meaning they cannot be seen, touched, or physically measured. They involve the management, transfer, and protection of money rather than tangible goods. Due to their intangible nature, financial services heavily rely on the trust and reputation of the service provider. Hence, there is a need to have a track record of integrity, reputation ,good corporate image and timely delivery of services.
3. Simultaneous Production and Consumption: Financial services are produced and consumed simultaneously. For example, when you deposit money in a bank, the service is delivered and consumed at the same moment. The delivery of financial services often requires direct interaction between the service provider and the client, such as during a consultation with a financial advisor or when processing a loan application.
4. Dominance of human element: Financial services are dominated by human element and thus, they are people intensive. It calls for competent and skilled personnel to make a quality financial product. But quality can not be homogenized since it varies with time, place and customer to customer.
5. Perishability: Financial Services are immediately consumed and hence inventories can not be created. There is a greater need to balance demand and supply properly. In other words, marketing and operations closely interlinked.
6. Service Differentiation: Financial services can vary significantly depending on the provider, the customer, and the situation. This variability comes from differences in the quality of service, expertise of the provider, and customization to meet specific client needs.
7. Customization: Financial services are often tailored to individual clients' needs, such as personalized investment portfolios or custom loan terms.

8. Regulation-Intensive: Financial services are subject to stringent regulations and oversight by government bodies and regulatory agencies. These regulations are necessary to maintain the stability, transparency, and integrity of the financial system. Financial institutions must comply with various laws, such as those related to anti-money laundering, consumer protection, and financial reporting standards.
9. Global and Dynamic Nature: Financial services operate in a global environment, with cross-border transactions, international investments, and global financial markets. The financial services sector is dynamic, constantly evolving with technological advancements, changing customer preferences, and new regulatory requirements. This leads to continuous innovation in products, services, and delivery channels.
10. Network and Relationship-Based: Financial services often rely on networks of relationships, both within the financial industry and with clients. This interconnectedness allows for the flow of capital, information, and risk management across the economy

8.6 FUNCTIONS OF FINANCIAL SERVICES

The function of financial services:

1. Mobilization of funds: Financial services aid in the mobilization of funds from investors, individuals, institutions and corporate entities. Funds are mobilized through various financial instruments like equities, bonds and mutual funds. Financial institutions, corporate entities and the government utilize the mobilized funds.
2. Provision of need based services: Depending on the needs of individuals and corporates, specific services are provided. Venture capital financing, lease financing and factoring services are provided to entrepreneurs in need of capital. Credit cards, housing finance and insurance services are provided to individuals. For a corporate approaching the capital market in order to raise funds, pre-issue and post-issue management services are offered by merchant bankers.
3. Liquidity Management**:** Financial services ensure that liquidity is available to meet the short-term needs of individuals, businesses, and governments. This includes services like overdraft facilities, short-term loans, and money market instruments. By facilitating the buying and selling of securities, financial services help maintain liquidity in financial markets, ensuring that assets can be quickly converted to cash.
4. Effective employment of funds: The mobilized funds should be employed effectively. Financial services help in this matter through services such as factoring, credit rating, Securitization of debts. Credit rating services provided by credit rating agencies enable the investors to make wise decisions in the

selection of bond/ debentures. Likewise, the services provided by merchant bankers in mergers and acquisitions help companies effectively utilize their funds.

5. Provision of regulated services: All the services that are provided in the financial market are well regulated by rules and regulations. The Reserve Bank Of India, Securities Exchange Board Of India. And Insurance Regulatory Development Authority of India (IRDA) regulate the providers of financial services. This provides safety to the users of financial services.
6. Facilitation of Economic Growth**:** Financial services contribute to capital formation by converting savings into investments, which fuels business expansion, infrastructure development, and economic growth. By providing access to capital and advisory services, financial institutions support the creation and growth of small businesses and start-ups, which are vital for economic dynamism.
7. Promoting Financial Inclusion: Financial services aim to extend access to financial products and services to underserved populations, including those in rural areas or with low incomes. This includes microfinance, mobile banking, and financial literacy programs. By improving access to financial resources, financial services help reduce poverty and promote economic equality.
8. Facilitation of Payments and Settlements: Financial services provide the infrastructure for facilitating payments and settlements in an economy. This includes services like electronic funds transfer, credit/debit card processing, mobile payments, and online banking. banks and financial institutions ensure the smooth clearing and settlement of transactions, which is essential for day-to-day commerce and trade.

8.7 IMPORTANCE OF FINANCIAL SERVICES

1. Economic growth: The financial service industry mobilizes the saving of the people and channels them into productive investment by providing various services to the people. In fact, economic development and growth depends upon these savings and investment.
2. Capital formation: The financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth. It is the principal mobiliser of surplus funds to finance productive activities and thus, it promotes capital accumulation.
3. Creation of employment opportunities: The financial service industry creates and provides employment opportunities to millions of people all over the world.
4. Promotion of saving: The financial service industry promotes saving in the country by providing transformation services. It provides liability, asset and size transformation services by providing large loans on the basis of numerous small

deposits. It also provides maturity transformation services by offering short term claims to savers on their liquid deposit and providing long term loans to borrowers.

5. Financial intermediation: The financial service industry facilitates the function of intermediation between savers and investors by providing a means and a medium of exchange and by undertaking innumerable services.
6. Provision of Liquidity: The financial service industry promotes liquidity in the system by allocating and reallocating savings and investment into various avenues of economic activities. It facilitates easy conversion of financial assets into liquid cash at the discretion of holder of such assets
7. Contribution to GNP: The contribution of financial services to GNP has been going on increasing year -after -year in almost all countries in recent times.

8.8 CONSTIUTENTS OF FINANCIAL SERVICE SECTOR

The financial service sector consists of:

- Market Participants: Market participants are of different categories. They range from individuals to corporate entities, banks, financial institutions, mutual funds and merchant bankers.
- Financial Service providers: Financial Service providers are financial institutions, insurance, leasing and factor companies and mutual funds, banks, non-banking financial institution, companies and agencies either carry out a particular service or several services. Leasing companies (The First Lease Division of India Limited, The Twentieth Century Finance Corporation Ltd.), Factoring agencies (Can Factoring Agency), Credit rating agencies (Credit Rating and Information Services

of India- CRISIL), Investment and Credit Rating Agency of India Limited (ICRAI), Venture capital funds (Credit Capital Venture India Ltd.) and merchant banking division of several banks are some of the institutions rendering specific financial services.

- Reserve Bank of India, Securities and Exchange Board of India, Department of Finance and several self-regulatory bodies regulate financial services. All parts of the financial system are interconnected with one another and the jurisdiction of the RBI and SEBI overlaps in many cases.

8.9 CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY

The financial service industry includes all kinds of organizations which intermediate and facilitate financial transactions. The financial intermediaries in India can be traditionally classified into:

I. Capital market intermediaries and
II. Money Market Intermediaries

Capital Market Intermediaries: It consists of term lending institutions and investing institutions which mainly provide long-term funds.

Money market intermediaries: It consists of commercial banks, cooperative banks and other agencies which supply only short-term funds.

8.10 SCOPE OF FINANCIAL SERVICES

Financial services cover a wide range of activities. They can be broadly classified into two namely:

I. Traditional activities
II. Modern activities

I. Traditional activities: Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads, viz.
    i. Fund Based activities and
    ii. Non-Fund based activities

Fund -Based activities: The traditional services which come under fund-based activities are the following:

a. Underwriting of or investment in shares, debentures, bonds etc., of new issues (primary market activities)
b. Dealing in secondary market activities
c. Dealing in foreign exchange market activities

d. Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills, etc.
e. Involving equipment leasing, hire purchase, venture capital, seed capital etc.

Non-Fund based activities: Financial Intermediaries provide services on the basis of non-fund-based activities also. This can also be called fee-based activity. Today, customers, whether individuals or corporate, are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services are being provided under this head. They include the following:

a. Managing the capital issue, i.e. management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issue.
b. Market arrangement for the placement of capital and debt instrument with investment institutions
c. Arrangement of funds from financial institutions for the client's project cost or his working capital requirements.
d. Assisting in the process of getting all government and other clearances.

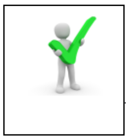
II. Modern activities: Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are non-fund-based activities. Some of modern services provided by them are given in brief here under:

    Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary government approval.

    a. Planning mergers and acquisitions and assisting for their smooth carry out.
    b. Guiding corporate customers in capital restructuring
    c. Acting as trustee to the debenture holders
    d. Recommending suitable changes in the management structure and management style with a view to achieving better results.
    e. Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.
    f. Hedging of risks due exchange rate risk, economic risk and political risk by using swaps and other derivative products.
    g. Structuring the financial collaboration/joint ventures by identifying suitable joint venture partners and preparing joint venture agreements
    h. Managing the portfolio of large Public Sector Corporations
    i. Undertaking risk management services like insurance services, buy back options.
    j. Advising the clients on the questions of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period,etc.
    k. Guidelines for the clients in the minimization of cost of debt and in the determination of the optimum debt equity mix.

l. Undertaking services relating to the capital market such as:
   i. Clearing services
   ii. Registration and transfers
   iii. Safe custody of securities
   iv. Collection of income on securities

m. Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.



Check Your Progress-A

1. Find the odd man out:
   a) Treasury Bills
   b) Commercial Papers
   c) Certificate of deposits
   d) Share Certificates
2. The following one is a kind of fee -based activity of a financial intermediary,
   a) Hire purchase financing
   b) Leasing
   c) Issue management
   d) Underwriting of shares
3. The important goal of the financial service industry is to mobilize and allocate-----
   a) Saving
   b) Investment
   c) Gold
   d) None of these
4. The process of managing the sales ledger if a client by a financial service is called
   a) Forfaiting
   b) Leasing
   c) Securitisation
   d) Factoring

8.11 KINDS OF FINANCIAL SERVICES

Financial services provided by various financial institutions, commercial banks and merchant bankers can be classified into two categories:

1. Asset Based / fund based
2. Fee based/advisory services

8.11.1 ASSET BASED/FUND BASED

- Leasing: A financial lease is a means of financing capital equipment. It gives impetus to investment activity and facilitates the flow of saving into real investment. A lease is an agreement under which a company or a firm acquires the right to make use of capital assets like machinery on payment of a prescribed fee called rental charges. The lessee can not acquire the ownership to the asset, but he can use it and have full control over it. He is expected to pay for all maintenance charges and repair and operating costs.
- Factoring: Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in collecting book debts for its clients. The entire responsibility of collecting the book debts passes on to the factor. His services can be compared to a del credere agent who undertakes to collect debt. But a factor provide credit information, collects debts, monitor the sales ledger and provide finance against debts. He provides several services apart of financing.
- Housing Finance: Till late 1970 the responsibility to provide finance for house building rested with the government of India. But it emerged as a fund based financial service in the country with the setting up of National Housing Bank NHB) by the RBI in 1988. NHB is an apex housing finance institution in the country and is a fully owned subsidiary of the RBI. Till now, several specialized financial institutions/companies in the public, private and joint sectors have entered in the field of housing finance such as HDFC, SBIH, CanFin Home, LIC Housing Finance, Ind Bank Housing, Citi Home, Gujrat Ambuja, ICICI Housing and so on. These companies have designed suitable schemes for individuals, corporates, builders and promoters. The HUDCO and commercial and cooperative banks have designed schemes specifically for lower-income and middle-income groups.
- Venture Capital: A venture capital is another method of financing in the form of participation. A venture capitalistic finances a project based on the potentialities of new innovative projects. It is in contrast to the conventional ‘security-based financing’. Much emphasis is given to new ideas oe technological innovations. Finance is being provided not only for start-up capital but also for development capital by the financial intermediary.
- Forfaiting: Forfaiting is a technique by which a forfeiter (financing agency) discounts an export front without bothering about collection of export bills. The forfeiter does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.
- Reverse mortgage: A reverse mortgage is a type of financial service aimed at helping homeowners, typically older individuals, access equity in their homes.

Unlike traditional mortgages, where homeowners make payments to the lender, a reverse mortgage allows homeowners to receive payments from the lender. In 2007-08, the National Housing bank and commercial banks introduced an innovative product viz., reverse mortgage to enable the senior citizen to fetch value out of their property without selling it. In a Reverse Mortgage (RM), the owner of a house property surrenders the title of his property to a lender and raises the money. The owner can ensure a regular cash flow in times of the need and enjoy the benefit of using the property. Usually after the death of the owner, the spouse can continue to use the property. In case both die during the period of RM scheme, the lender will sell the property, take his share and distribute the rest among heirs, It is reverse mortgage because the payment stream is reversed.

- Securitization: Securitization is a technique whereby a financial company converts its illiquid, non-negotiable and high value financial assets into security of small value which are made tradeable and transferable, A financial institution might a lot of its assets blocked up in assets like real estate, machinery etc., which are long term in nature, and which are non-negotiable. In such cases, Securitization would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public.
- Insurance Services: Insurance services in India provide financial protection against various risks, including life, health, property, and liability. Life insurance offers products like term plans, endowment policies, and ULIPs, ensuring financial security for individuals and their families. General insurance covers areas such as health, motor, home, and travel, safeguarding against unforeseen events. The sector is regulated by the Insurance Regulatory and Development Authority of India (IRDAI), with both public and private companies playing a significant role. Increasingly, digital channels are enhancing accessibility and convenience for policyholders.
- Hire purchase is a financial service in India that allows individuals or businesses to acquire assets, such as vehicles or machinery, by paying an initial down payment followed by fixed installments. Ownership of the asset is transferred to the buyer only after the final installment is paid. This method is widely used for financing consumer durables and commercial equipment, making expensive assets more accessible without needing full upfront payment. It’s a popular financing option, especially for small businesses and individuals looking to manage cash flow effectively.

8.11.2 FEE BASED /ADVISORY SERVICES

- Merchant Banking: Merchant banking in India involves specialized financial services offered to businesses, including underwriting, loan syndication, portfolio management, and advisory services for mergers and acquisitions. Merchant banks assist companies in raising capital through the issue of shares, debentures, and other securities. They also provide strategic advice on corporate restructuring and help with managing public issues and private placements. These services are crucial for companies seeking to expand, restructure, or optimize their financial strategies. Merchant banking plays a significant role in the development of the capital markets in India.

- Corporate advisory services: Financial intermediaries particularly have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers so that they can transact some of their important banking transactions by sitting in their own offices. As new avenues of finance like Euro loans, GDRs, etc., are available to corporate customers, this service is of immense help to customers.
- Loan syndication: Credit syndication in India involves arranging large loans by pooling funds from multiple lenders, usually for significant projects like infrastructure, real estate, or corporate expansions. This service is typically provided by banks or financial institutions, which act as lead arrangers, coordinating with other lenders to share the risk and financing. Credit syndication enables borrowers to access substantial capital that might be difficult to secure from a single lender, while also providing lenders with an opportunity to participate in large-scale financing with reduced exposure to risk. It's a crucial service for facilitating major projects and investments in India.
- Credit rating: credit rating is the opinion of rating agency on the relative ability and willingness of the issuer of a debt instrument to meet the debt service obligations as and when they arise. Credit rating services in India assess the creditworthiness of individuals, companies, or financial instruments, providing an independent evaluation of their ability to meet financial obligations. Agencies like CRISIL, ICRA, and CARE Ratings are prominent in this sector, offering ratings that influence investor decisions and interest rates on loans and bonds. A higher credit rating typically indicates lower risk and better terms for borrowing, while a lower rating suggests higher risk. These services are vital for maintaining transparency in the financial markets, helping investors make informed decisions and enabling borrowers to access capital more effectively.
- Stock -Broking: Stock broking services in India facilitate the buying and selling of stocks, bonds, and other securities on behalf of investors through stock exchanges like the NSE and BSE. Brokers act as intermediaries, providing access to the markets, executing trades, and offering investment advice. With the rise of online trading platforms, stockbroking has become more accessible, allowing retail investors to trade directly through digital platforms. Leading firms like Zerodha, HDFC Securities, and ICICI Direct dominate the market. Stock broking services are crucial for investors looking to build and manage their investment portfolios in India’s dynamic capital markets.

- Custodial Services: Custodial services in India involve the safekeeping and management of financial assets like securities, bonds, and shares on behalf of institutional and individual investors. These services are provided by banks and financial institutions, which ensure the secure storage, settlement, and transfer of assets, as well as handling corporate actions like dividends and interest payments. Custodians also offer portfolio reporting and compliance monitoring, playing a crucial role in reducing operational risks for investors. Key players in India include entities like SBI Custodial Services and HDFC Bank, supporting the efficient functioning of the financial markets.
- Mutual funds: Mutual funds are financial intermediaries that collect the saving of small investors and invest them in diversified portfolio of securities to minimize the risk and maximize the returns for participants.

8.12 CHALLENGES FACING THE FINANCIAL SERVICE SECTOR IN INDIA

The financial services sector in India faces several challenges, including:

1. Regulatory Compliance: Navigating complex and evolving regulations can be cumbersome and costly for financial institutions. Ensuring compliance with diverse rules from entities like the RBI, SEBI, and IRDAI can be challenging.
2. Lack of qualified personnel: The financial service sector is fully geared to the task of 'financial creativity'. However, This sector has to face many challenges. In fact the shortage of qualified and trained personnel is an important impediment to the growth of financial services. Hence it is vital that a proper and a comprehensive training must be given to various financial intermediaries.
3. Lack of investor awareness: The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and use of new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/ users to the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even audio-visual aids.
4. Fraud and Cybersecurity Threats: Increasing cyber threats and financial frauds pose significant risks, requiring constant updates to security measures and vigilance to protect sensitive data.
5. Financial Inclusion: Despite progress, achieving widespread financial inclusion remains a challenge, particularly in rural and underserved areas where access to financial services is limited.

6. Technological Disruptions: Rapid advancements in technology and the rise of fintech startups create both opportunities and challenges, as traditional institutions must adapt to new digital platforms and innovations.
7. Non-Performing Assets (NPAs): High levels of NPAs in the banking sector affect profitability and financial stability, necessitating effective asset management and recovery strategies.
8. Economic Volatility: Fluctuations in the economic environment, such as inflation, currency depreciation, and global economic uncertainties, impact financial market stability and investor confidence.
9. Customer Trust: Building and maintaining trust is crucial as issues related to transparency, service quality, and ethical practices continue to impact customers perceptions and satisfaction.

8.13 SUMMARY

The financial services sector encompasses a broad range of activities designed to facilitate the management, transfer, and growth of capital. Its nature and scope include banking, insurance, investment services, and financial planning. The sector's primary functions involve managing deposits, providing loans, underwriting insurance, facilitating investments, and offering financial advisory services. These functions support economic growth by enabling efficient capital allocation, risk management, and financial planning for individuals and businesses.

The importance of financial services lies in their role in promoting economic stability, fostering investment, and ensuring liquidity in the market. They enhance financial inclusion, providing access to capital and risk protection for diverse segments of the population.

However, the sector faces several challenges. Regulatory compliance can be complex and costly, with evolving rules requiring constant adaptation. Cybersecurity threats and financial fraud pose significant risks, demanding robust security measures. Achieving widespread financial inclusion remains a hurdle, particularly in rural areas. Technological advancements and fintech disruptions necessitate continuous innovation, while high levels of non-performing assets (NPAs) and economic volatility impact stability and profitability. Additionally, maintaining customer trust amid transparency and ethical concerns is crucial for sustained success.

8.14 GLOSSARY

Banking: Financial institutions providing services such as accepting deposits, granting loans, and managing investments.

Insurance: Risk management services offering protection against financial loss through various policies like life, health, and property insurance.

Investment Services: Financial activities involving the management and growth of capital through assets such as stocks, bonds, and mutual funds.

Stock Broking: The buying and selling of securities on behalf of investors, typically through stock exchanges.

Credit Rating: An assessment of the creditworthiness of borrowers, influencing their ability to secure loans and the terms of borrowing.

Custodial Services: Safeguarding and managing financial assets for investors, including handling transactions and corporate actions.

Mutual Funds: Investment vehicles pooling funds from multiple investors to invest in a diversified portfolio of assets.

Private Equity: Investment in private companies or startups, often involving restructuring and strategic guidance to enhance value.

Merchant Banking: Specialized financial services including underwriting, advisory, and capital raising for businesses.

Credit Syndication: The process of pooling loans from multiple lenders to finance large projects, sharing risk and capital.

8.15 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (d), 2 (c), 3 (a), 4 (d)

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8.18 TERMINAL QUESTIONS

1. Define the financial service industry and discuss the various services rendered by it.
2. Discuss the nature and scope of financial services.
3. Explain the significance and function of financial services.
4. Discuss challenges faced by financial service industry in India.

8.19 CASE

ABC Ltd has accounts receivable worth Rs 240 lacs. XYZ Ltd offer recourse factoring services to ABC Limited. The XYZ would pay 80 per cent of the value of the factored receivable at 15 per cent interest compounded annually. The remaining amount is retained as factor reverse; it also guarantees payment after three months from the date of purchase of the receivables. The factoring commission is 2% per cent of the value of factored receivables. It is predetermined that interest and commission will be collected in advance.

1. Find out the advance payable to ABC limited and the effective cost of funds.
2. Estimate the effective cost of funds based on the assumption that commission is collected in advance and interest is collected in arrears.

UNIT 9 REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

9.1 INTRODUCTION

Since 1990's there has been an upsurge in the financial services provided by various banks and financial institutions. Efficiency of emerging financial system largely depend on the quality and variety of financial services provided by the banking and non-banking financial companies.

The term 'Financial Services' can be defined as "activities, benefits and satisfaction, connected with the sale of money, that offers to users and customers, financial related value."

Suppliers of financial services include the following types of institutions:

1. Banks and Financial Institutions
2. House Building Services
3. Insurance Companies
4. Credit Card Issuer Companies
5. Investment Trusts and Mutual Funds
6. Stock Exchanges
7. Leasing Companies
8. Unit Trusts

9. Finance companies and so on

Financial Services organizations render services to industrial enterprises and ultimate consumer markets, these can be further subdivided to include government/ public sector/ private sector, the commercial sector, industry and international markets. Within the financial services industry the main sectors are banks, financial institutions and non-banking financial companies.

Regulations of Financial System: Before the investors lend money, they need to reassure that it is safe to exchange securities o for funds. The financial regulator who regulates the conduct of the markets and intermediaries to protect the investors interest provides the reassurance. The regulator conducts the issuers of securities and intermediaries to protect the interests of investors in securities and increase the confidence in markets in which in turn helps in the growth and development of financial system. Regulation is necessary not only to develop a system, but a system once developed needs to be regulated. Regulation is codification of sound principles, norms and practices. Regulations arise from four fundamental public policy concerns:

1. Protection of depositors, consumer and investor interests
2. Structure and competitive character of the market
3. Safety and soundness
4. Systematic stability

   The challenge is to evolve a regulatory mechanism which will achieve all the four objectives with minimum regulatory burden through efficiency and cost effectiveness. The RBI regulates the money market, and the SEBI regulates the capital market. The securities market is regulated and monitored by the Ministry of Finance. The Insurance Regulatory and Development Authority of India (IRDAI), constituted in April, 2000 under the IRDAI Act,1999 is vested with the power to regulate and develop the insurance and reinsurance business.FM Division is responsible for administration of SEBI Act, Securities Contracts Regulations (SCRA) Act 1956, Depository Act,1996 and Section 20 of Indian Trust Act 1882 and related regulations and notifications thereunder.

9.2 OBJECTIVES

After reading the unit, the learner shall be able to understand;

- Financial Sector in the Pre and Post Liberalization Periods
- Financial Regulatory Bodies in India

9.3 FINANCIAL SECTOR IN THE PRE AND POST LIBERALIZATION PERIODS

This can be discussed as follows:

PRE-LIBERALIZATION PERIOD:

The Indian Financial System was unorganized up to the 1970s and less transparent stock and commodity spot and future markets with limited volume of trade were prevalent. The capital account was closed. The commodity derivative market had several trader defaults during the period of three consecutive drought years and was closed in the latter parts of the 1960s With the nationalization of 14 major private sector banks on 19 July,1969, the Indian Banking system became predominantly owned by the government. Interest rates were controlled by the Reserve Bank Of India. Elaborate price and quantity controls were enforced on the financial sector. Large public sector monopolies dominated the financial service sector.

The State developed monolithic finance companies to provide financial services Development Financial Institutions (Industrial Development Corporation of India-1948, Industrial Development Bank of India-1964, State Financial Corporation, Insurance (Life Insurance corporation -1956, General Insurance Corporation 1973) and fund management (Unit Trust of India-1964 for mutual fund were established. However, they were monopolies in their respective area of functioning. These public sector organizations has rigid investment guidelines.

The controller of capital Issues (CCI) dictated whether, and what price firms could sell shares to the public in the primary market. The secondary market witnessed scams and irregularities, but the price discovery was also relatively free in the secondary market. The following key weaknesses were found in the pre-liberalization period in the financial sector in India.

i. Interest rates were administered and pegged at unrealistically low levels. Resources were widely drawn from the banking system, to finance the fiscal deficit.
ii. The banking industry was predominantly public sector in nature and the participation of the private sector was negligible, the quality of the banking system was largely determined by the public sector banks.
iii. Insurance Sector was under State monopoly. A limited range of life and non-life insurance products were available to the public. Financial products which combined the features of life insurance and quality related instruments were inadequately developed.
iv. The mutual funds industry was also a public sector monopoly in terms of both the number of funds and their market till 1992.
v. Foreign Firms were not permitted to operate in the insurance sector or mutual funds industry.
vi. Banks, pensions funds and insurance companies were forced to purchase government bonds as per their investments.

vii. There was no financial derivative market except the presence of a small currency forward market and local commodity derivative markets.
viii. Prudential regulations were not adequate in the financial sector.
ix. Debt and money markets were not fully developed.
x. Institutions and technological structures in capital markets were outdated. Bombay Stock Exchange (BSE) did not have appropriate structures for government and regulations
xi. Limited usage of bank cards prevailed among the customers.

POST-LIBERLIZATION PERIOD:

The Financial service sector and financial markets were targets for financial sector reforms in the period after 1991. Structural changes were introduced in the financial sector. Factors that necessitated reforms are given below:

i. The Balance of payment crisis of the 1990s threatened credibility of the country. Non debt capital inflows were required to fund the current account deficit.
ii. Foreign equity capital inflows through FDI and portfolio investment was needed for accelerating industrial growth.
iii. There was considerable growth in the size of the stock market and stock investment culture. This required regulations to protect investor's interests

SERVICE SECTOR REFORMS

Some of the significant reforms that took place in the financials service sector along with their impact have been listed:

i. Mutual fund services, one of the monopolies of UTI, was opened to national and international private players. A plethora of mutual funds with diverse portfolio mixes were issued and traded in the secondary market.
ii. Amendments to SEBI (Merchant Bankers) Regulations,1992 were made. Only body corporate was allowed to function as merchant bankers.
iii. The merchant bankers were required to seek separate registration if they wished to act as an underwriter or a portfolio manager.
iv. Also, merchant bankers were prohibited from carrying on fund-based activities other than those related exclusively to the capital market. In fact, the activities under taken by NBFCs such as accepting deposits, leasing, bill discounting etc., are not allowed to be undertaken by a merchant banker.
v. Insurance Regulatory Development Authority Act,1999, Insurance Regulatory and Development Authority (IRDA) was established on 19 April 2000 to protect the interests of holders of insurance policy and to regulate, promote and ensure orderly growth of the insurance industry.

vi. To regulate the credit rating agencies. The Securities and Exchange Board of India (Credit Rating Agencies) Regulations,1999 was given.
vii. The Act namely, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Ordiances,2002 (SARFASI) was enacted. Its purpose was to promote the setting up of assets reconstruction/securitization companies to take over the Non-Performing Assets (NPAs) accumulated with banks and public financial institutions.
viii. SEBI Investment Advice by intermediaries (Amendment) Regulations 2001 insisted on the appointment of a compliance officer by market intermediaries like bankers to an issue, credit rating agencies, debenture trustees, stock brokers and mutual funds to independently report to SEBI on non-compliance with rules/regulations issued by government and regulators.

CAPITAL MARKET REFORMS:

The major reforms in the capital market were the abolition of the Capital Issues Control Act and the introduction of free pricing of equity issues in 1992.

i. The Securities and Exchange Board of India (SEBI) was set up as an apex regulator of Indian capital markets in 1988. SEBI has framed regulations on several matters related to capital markets.
ii. The depository and share dematerialization system were introduced to enhance the efficiency of transaction cycle.
iii. Rolling settlement replaced the flexible, but often exploited, forward trading mechanism to bring transparency.
iv. Online trading was introduced in all stock exchanges.
v. Stock Exchanges were corporatized.
vi. Foreign Institutional Investors (FII) were permitted in the Indian stock market.
vii. Many new instruments were introduced in the market, including index futures, index options besides options and futures in select stocks.
viii. Entry norms for capital issues were tightened.
ix. Disclosure requirements were improved
x. Margining system was rigorously enforced
xi. Regulations were framed for insider trading.
xii. The regulatory framework for takeovers was revamped.

MONEY MARKET REFORMS

The Reserve Bank of India has introduced several reforms to foster balanced developed of different segments of the money market.

i. A phased exit of non-banks from the call/ notice money market was started in May 2001 to transformation of call /notice money market into a pure inter-bank market with participation of banks and primary dealers (PDs). Non -bank participants were completely phased out of the call money market from 6 August,2005.

ii. A full-fledged Liquidity Adjustment Facility (LAF) replaced the traditional refinance support on fixed terms.
iii. The development of the payment system infrastructure was strengthened with the introduction of the Negotiated Dealing System (NDS), formation of the Clearing Corporation of India (CCIL) and implementation of Real Time Gross Settlement (RTGS) system.
iv. Measures were also taken to make various other money market instruments (such as CDs, CPs, etc.) freely accessible to non-bank participants.

DEBT MARKET REFORMS

i. The government reduced its preemption of banks funds and moved to market determined interest rates on its borrowing.
ii. Substantial deregulations of interest rate took place
iii. A system of primary dealers for trading in government securities was set up.
iv. Banks were permitted to retail government securities.
v. RBI enhanced the efficacy of NDS by incorporating a screen based anonymous order matching system under its ambit with effect from August 2005.

9.4 FINANCIAL REGULATORY BODIES IN INDIA

India's financial sector is a dynamic and intricate system that significantly impacts the nation's economic landscape. With a rapidly growing economy and a diverse array of financial institutions, effective regulation and supervision are essential. To maintain stability, transparency, and fairness, various regulatory bodies oversee and govern this network.

In India, the responsibility for regulating the financial system is distributed among several authorities, each focusing on specific sectors of the financial market. These regulatory bodies work together to ensure stability, protect investors, and encourage innovation and growth within the Indian financial system. The Primary financial regulators bodies in India include :

1. Reserve Bank of India (RBI)
2. Securities and Exchange Board of India (SEBI)
3. Small Industries Development Bank of India (SIDBI)
4. Ministry of Corporate Affairs
5. Pension Fund Regulatory and Development Authority (PFRDA)
6. National Housing Bank (NHB)
7. Forward Market Commission
8. Association of Mutual Funds in India (AMFI)
9. Insolvency and Bankruptcy Board of India (IBBI)

9.4.1 RESERVE BANK OF INDIA (RBI)

Reserve Bank of India as the central bank of the country occupies a significant place in the Indian Banking and financial system. As an apex institution, it acts as a guide regulator, controller and promoter of the financial system. Reserve Bank of India was established in 1935, under the Reserve Bank of India Act 1934 with the objectives as stated in the Preamble of the RBI act. Till 1949 it was a private shareholders institution but became a state-owned institution after its nationalization. The bank, besides acting as regulator of the financial system, also performs a development role. It is said to be the bankers to the bank and controller of activities of banking, non-banking and financial institutions in the country. The RBI Act empowers the Central Government to issue such directions to it as they might consider necessary in the interests of public after consulting the governor of Bank.

Reserve Bank of India manages credit supply, regulates bank operations and help maintain a healthy financial system. RBI is an autonomous governing body that ensures price stability in the country. In addition, it stabilizes the value of the Indian currency and ensures that the Indian financial market stable and robust.

Central Board:

The Reserve Bank's affairs are governed by a Central Board of directors. The board is appointed by government with Reserve Bank of India Act. The general affairs and business of the bank is managed by the central Board of Directors having 20 members. The members include the following:

i. A governor and not more than four Deputy Governor to be appointed by the Central Government
ii. Four directors to be nominated by the central Government, one each from the four Local Board.
iii. Ten Directors to be nominated by the Central Government
iv. One government official to be nominated by the Central Government
v. Apart from the Central Board of Directors, four Local Boards are constituted representing each are specified in the first schedule to the act. Local Boards advise the Central Board on various matters referred to it. They also perform the functions delegated to them by the Central Board. However the final controls lies with the central Board.

OBJECTIVES:

i. Price Stability: To ensure that inflation remains within acceptable limits, contributing to the stability of prices in the economy.
ii. Economic Growth: To support and sustain economic growth by managing monetary policy effectively.

iii. Financial Stability: To maintain the stability of the financial system by regulating and supervising financial institutions.
iv. External Stability: To manage the foreign exchange market and facilitate external trade and payments, ensuring orderly development of the forex market.

FUNCTIONS:

i. Monetary Authority: Formulates and implements monetary policy to control inflation and stabilize the economy.
ii. Issuer of Currency: Issues and manages the supply of currency notes and ensures their authenticity and availability.
iii. Regulator of the Financial System: Regulates and supervises banks and other financial institutions to ensure their soundness and stability.
iv. Manager of Foreign Exchange: Manages foreign exchange reserves and regulates foreign exchange transactions under the Foreign Exchange Management Act (FEMA).
v. Developmental Role: Promotes financial inclusion and the development of financial markets and infrastructure.
vi. Bankers' Bank: Acts as a banker to the government and other banks, including managing government accounts and public debt, and providing banking services to other financial institutions.
vii. Consumer Protection: Sets regulations and guidelines to protect the interests of consumers in the financial sector.

9.4.2 THE SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

The securities market is regulated by various agencies such as Department of Economics Affairs (DEA), Department of Company Affairs, the Reserve Bank of India (RBI) and SEBI. The activities of these agencies are coordinated committee by high level committee on capital and financial markets.

The capital market i.e., the market for equity and debt securities is regulated by the Securities and Exchange Board of India (SEBI). The SEBI has full autonomy and authority to regulate and develop the capital market. The government has set rules under the Securities Contract (Regulations) SCRA, the SEBI Act and Depositories Act. The SEBI has framed regulation under the SEBI Act and Depositories Act for registration and regulation of all market intermediaries, for prevention of unfair practices and insider trading. The four main legislations governing the capital market are as follows:

i. The SEBI Act 1992 established the SEBI with four-fold objectives of protection of interests of investors in securities, development of the securities market, regulation of the securities market and matter connected therewith and incidental thereto.

ii. The Companies Act, 1956 which deals with issue, allotment and transfer of securities disclosures to be made in public issues, underwriting, rights and bonus issue and payment of interest and dividends.
iii. The Securities Contracts (Regulations) Act 1956 provides for regulation of securities trading and management of stock exchanges.
iv. The Depositories Act,1996 provides for establishment of depositories for electronic maintenance and transfer of ownership of demat securities.

THE SECURITIES EXCHANGE BOARD OF INDIA (SEBI)

- The Securities and Exchange Board of India (SEBI) is the regulatory authority for the securities and capital markets in India. Established under the SEBI Act of 1992, SEBI's primary mandate is to protect investors, regulate the securities markets, and promote fair and transparent trading practices. SEBI was initially established in 1988 as a non-statutory body to regulate the securities market in India. However, in 1992, it was granted statutory powers through the SEBI Act, which provided it with a formal legal framework and regulatory authority.

OBJECTIVES:

i. Investor Protection: To safeguard the interests of investors by ensuring transparency and fairness in the securities markets.

ii. Market Regulation: To regulate and supervise the functioning of stock exchanges, brokers, and other market intermediaries to prevent malpractices and ensure orderly market operations.

iii. Market Development: To promote the development of the securities markets and encourage innovation and investment.

iv. Promote Fair Practices: To prevent fraud and manipulation and ensure fair trading practices in the securities markets.

STRUCTURE:

- SEBI is headed by a chairman and supported by whole-time and part-time members. The board is appointed by the Government of India and is responsible for the strategic direction and operational decisions of SEBI.

JURISDICTION:

- SEBI regulates all aspects of the securities markets, including stock exchanges, brokers, merchant bankers, portfolio managers, and other intermediaries. It also oversees the functioning of mutual funds and other investment vehicles.

POWERS:

1. Regulatory Powers:

SEBI can frame regulations for the securities markets, including rules for the operation of stock exchanges, brokers, and other intermediaries.

It can impose penalties for violations of its regulations and take corrective measures to address malpractices.

2. Inspection and Investigation:

   SEBI has the authority to inspect and investigate the affairs of market participants, such as stock exchanges, brokers, and other entities involved in securities trading.

3. Enforcement Powers:

   It can take enforcement actions, including issuing orders to cease and desist, imposing fines, and suspending or canceling the registration of market intermediaries.

   SEBI can also refer cases for prosecution to the appropriate authorities.

4. Market Surveillance:

   SEBI monitors trading activities to detect and prevent fraudulent and manipulative practices, ensuring the integrity of the securities markets.

5. Regulation of Takeovers and Mergers:

   It regulates and oversees takeover and merger activities to ensure transparency and fairness in these processes.

<u>FUNCTIONS OF SEBI</u>

1. Regulation of Stock Exchanges and Intermediaries:
   - SEBI regulates stock exchanges, clearing houses, depositories, and other intermediaries. This includes setting rules for their functioning and ensuring compliance with regulations.
2. Registration and Regulation:
   - It registers and regulates market intermediaries, such as brokers, merchant bankers, portfolio managers, and investment advisors. SEBI ensures that these entities operate in accordance with its regulations.
3. Issuance and Trading of Securities:
   - SEBI oversees the process of issuing securities and the trading of these securities in the markets. It ensures that the issuance of securities is conducted transparently and that trading practices are fair.
4. Investor Protection and Education:
   - SEBI works to protect investor interests by ensuring transparency, providing investor education, and addressing grievances. It undertakes

initiatives to improve investor awareness and knowledge about the securities markets.

5. Regulation of Mutual Funds and Collective Investment Schemes:
   - SEBI regulates mutual funds, venture capital funds, and other collective investment schemes to ensure they operate in a fair and transparent manner.
6. Regulation of Market Practices:
   - It monitors and regulates various market practices to prevent insider trading, market manipulation, and other unfair practices.
7. Market Development:
   - SEBI promotes the development of the securities markets by encouraging innovation, improving market infrastructure, and fostering new investment avenues.
8. Policy Formulation:
   - SEBI contributes to policy formulation related to the securities markets by providing recommendations to the government and other regulatory bodies.
9. Grievance Redressal:
   - It provides mechanisms for investors to file complaints and grievances related to market practices and seeks to resolve these issues effectively.

SEBI's comprehensive powers and functions ensure that the securities markets in India operate smoothly, transparently, and fairly, thereby fostering investor confidence and contributing to the overall stability and growth of the financial markets.

9.4.3 SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)

The Small Industries Development Bank of India (SIDBI) was set up in 1990 under the SIDBI Act,1990. The main objectives of SIDBI has been to work as a principal financial institution for the promotion, financing and development of industries in the small scale sector. It is also expected to coordinate the functions of various financial institutions such as State Financial Corporations, State Small Industries Development Corporations, Scheduled Banks and State Co-operative Bank etc. engaged in the financiang, promotion and development of small-scale industries.

<u>FUNCTIONS OF SIDBI</u>

Initially, SIDBI performed the following functions:

1. Refinancing of the term loans granted by SFCs, SIDCs, banks and other financial institutions.
2. Rediscounting of short term trade bills arising out of sale of products of the small scale sector

3. Direct Discounting/rediscounting of bills arising out of sale of machinery/capital equipment of deferred credit manufactured by small Scale sector.

Presently SIDBI is performing following functions:

1. It renders equity types of assistance ot new promoters, women and ex-servicemen under National equity Fund
2. It aids the voluntary organization working for development/upliftment of under privileged women
3. It also provides technical support to small scale sector for promotion, development and growth
4. It also extends financial support to NSIC and SIDCs for purchase of material and marketing of SSI products and for financing hire purchase and leasing activities.
5. SIDBI introduced scheme of direct assistance in 1991-92 to encourage the existing units to undertake technology up gradation/ modernizations for improving quality of their products.

9.4.4 MINISTRY OF CORPORATE AFFAIRS

The Ministry of Corporate Affairs (MCA) is an important government department in India responsible for regulating and overseeing corporate affairs. Its main functions and responsibilities include:

Objectives

1. Corporate Regulation: To oversee the functioning and regulation of companies and corporate entities in India, ensuring compliance with the Companies Act and other relevant legislation.
2. Investor Protection: To protect the interests of investors and stakeholders by enforcing transparency and accountability in corporate governance.
3. Facilitation of Business: To promote a conducive environment for business growth and ease of doing business by simplifying regulatory processes and providing a clear legal framework.

Functions

1. Regulation and Compliance:
    - Administers the Companies Act, 2013, and other related laws. This includes the registration, regulation, and supervision of companies and limited liability partnerships (LLPs).
    - Ensures that companies adhere to legal requirements concerning corporate governance, financial disclosures, and accounting standards.
2. Corporate Governance:

- Promotes and enforces standards of corporate governance to ensure transparency, accountability, and ethical conduct in business practices.
- Issues guidelines and regulations on the functioning of boards of directors and audit committees.

3. Investor Protection:
   - Oversees mechanisms to protect investors' rights and address their grievances. This includes regulating market practices and ensuring fair play in corporate transactions.
   - Administers the Investor Education and Protection Fund (IEPF) to enhance investor awareness and resolve complaints.
4. Company Law Administration:
   - Facilitates the registration and regulation of companies and LLPs through the Registrar of Companies (RoC) under various regional offices.
   - Provides services related to company registration, annual filings, and compliance monitoring.
5. Corporate Data and Reporting:
   - Maintains a repository of corporate data and ensures that companies file annual returns and financial statements.
   - Provides public access to company information and financial reports through online platforms like the Ministry's website.
6. Policy Formulation:
   - Formulates and implements policies related to corporate laws and regulations. This includes proposing amendments to existing laws and introducing new legislation to address emerging issues.
7. Reforms and Modernization:
   - Undertakes reforms to simplify and streamline corporate procedures and regulatory processes. This includes digitization initiatives and the introduction of new technologies for efficient regulation.
8. Corporate Insolvency and Bankruptcy:
   - Oversees the implementation of the Insolvency and Bankruptcy Code (IBC), which provides a framework for the resolution of insolvency and bankruptcy issues for companies.

Structure

The Ministry of Corporate Affairs is headed by a Minister, who is supported by a Secretary. It has various departments and agencies responsible for implementing its functions, including:

- Registrar of Companies (RoC): Regional offices responsible for the registration and regulation of companies.
- National Company Law Tribunal (NCLT): Adjudicates disputes and matters related to company law, insolvency, and bankruptcy.
- National Financial Reporting Authority (NFRA): Regulates and monitors the quality of financial reporting and auditing practices.

The MCA plays a critical role in ensuring the effective functioning of corporate entities, maintaining investor confidence, and fostering a business-friendly environment in India.

9.4.5 INSURANCE REGULATORY AND DEVELOPMENT AUTHROITY OF INDIA (IRDAI)

he Insurance Regulatory and Development Authority of India (IRDAI) is the apex regulatory body responsible for overseeing and developing the insurance sector in India. Established under the Insurance Regulatory and Development Authority Act of 1999, IRDAI aims to ensure that the insurance industry operates in a stable, transparent, and efficient manner while promoting its growth and protecting the interests of policyholders.

Background

- Formation: IRDAI was formed to regulate the insurance industry in India, which had previously been under the control of the Controller of Insurance, a part of the Ministry of Finance. The creation of IRDAI marked a significant step in reforming and modernizing the insurance sector.
- Legal Framework: The authority operates under the Insurance Regulatory and Development Authority Act, 1999, which provides it with statutory powers to regulate and supervise the insurance industry.

Objectives

1. Regulation: To regulate and supervise the insurance industry to ensure its stability, fairness, and compliance with laws and regulations.
2. Development: To foster the growth of the insurance sector by promoting innovations, increasing insurance penetration, and enhancing the quality of services.
3. Consumer Protection: To safeguard the interests of policyholders by enforcing transparency, fairness, and accountability in insurance practices.

Functions

1. Regulatory Oversight: Formulates and enforces regulations for insurance companies, intermediaries, and other stakeholders. Monitors the financial health and operational practices of insurers to ensure they meet regulatory requirements.

2. Licensing and Registration: Issues licenses to insurance companies, agents, brokers, and other intermediaries. Ensures that entities operating in the insurance sector are qualified and adhere to regulatory standards.
3. Consumer Protection: Implements measures to protect policyholders' rights and address grievances. Ensures transparency in policy terms, pricing, and claim settlement processes.
4. Market Development: Encourages the development of new insurance products and services, and supports initiatives to increase insurance coverage in underserved areas.
5. Policy Formulation: Advises the government on insurance policy matters and suggests regulatory changes to support the sector's growth and stability.
6. Risk Management: Oversees risk management practices within the insurance industry to ensure that companies maintain adequate reserves and manage their risks effectively.
7. Education and Awareness: Promotes insurance literacy and public awareness to enhance understanding and confidence in insurance products.

Structure

IRDAI is led by a Chairman, with a team of Whole-Time Members and Part-Time Members appointed by the Government of India. The Chairman provides overall leadership, while the Whole-Time Members manage specific functional areas like regulations, market development, and consumer protection. Part-Time Members bring additional expertise from various sectors.

Significance

IRDAI plays a critical role in ensuring the stability and growth of the insurance sector in India. By providing a robust regulatory framework and promoting best practices, IRDAI helps build a trustworthy and efficient insurance market that benefits both consumers and industry participants.

9.4.6 PENSION FUND REGULATORY AND DEVELOPMENT AUTHROITY (PFRDA)

The Pension Fund Regulatory and Development Authority (PFRDA) is the regulatory body responsible for overseeing and developing the pension sector in India. Established under the Pension Fund Regulatory and Development Authority Act of 2013, PFRDA aims to ensure that the pension industry operates in a stable, transparent, and efficient manner, while promoting its growth and protecting the interests of subscribers.

Formation:

PFRDA was initially set up in 2003 as an autonomous body to regulate the pension sector. It was given statutory status and enhanced powers with the enactment of the Pension Fund Regulatory and Development Authority Act, 2013.

Legal Framework:

The authority operates under the Pension Fund Regulatory and Development Authority Act, 2013, which provides it with the legal framework to regulate, supervise, and develop the pension industry.

Objectives

1. Regulation: To regulate and supervise pension funds and related activities to ensure compliance with regulations and protect the interests of subscribers.
2. Development: To foster the growth and development of the pension sector by promoting new products, increasing coverage, and enhancing efficiency.
3. Consumer Protection: To safeguard the interests of pension subscribers by ensuring transparency, fairness, and accountability in pension schemes.

Functions

1. Regulation and Supervision: Formulates and enforces regulations for pension funds, pension fund managers, and other related entities. Monitors their operations to ensure compliance with legal and regulatory standards.
2. Licensing and Registration: Issues licenses to pension funds, fund managers, and other intermediaries. Ensures that these entities meet regulatory requirements and operate in a compliant manner.
3. Consumer Protection: Implements measures to protect the rights of pension subscribers, including ensuring transparent communication, fair practices, and effective grievance redressal mechanisms.
4. Market Development: Promotes the development of pension products and services, supports initiatives to enhance pension coverage, and encourages innovation within the sector.
5. Policy Formulation: Advises the government on pension policy matters and suggests regulatory changes to support the sector's growth and stability.
6. Risk Management: Oversees risk management practices within the pension industry to ensure that funds are managed prudently and securely.
7. Education and Awareness: Promotes financial literacy and awareness about pension products and services, helping subscribers make informed decisions about their retirement planning.

Structure

PFRDA is headed by a Chairman and supported by a team of members appointed by the Government of India. The authority's structure typically includes:

- Chairman: Provides overall leadership and strategic direction.

- Whole-Time Members: Manage specific functional areas, such as regulations, development, and consumer protection.
- Part-Time Members: Bring expertise from various sectors to provide additional perspectives and guidance.

Significance

PFRDA plays a crucial role in shaping India's pension landscape by ensuring that the pension sector is well-regulated, efficient, and inclusive. Its efforts help in providing a secure and stable retirement income for individuals, thereby contributing to the overall financial well-being of the population.

9.4.7 NATIONAL HOUSING BANK (NHB)

The National Housing Bank (NHB) is a specialized institution in India responsible for promoting and regulating housing finance institutions. Established under the National Housing Bank Act of 1988, NHB plays a crucial role in supporting the development of the housing sector and enhancing access to housing finance.

Formation:

NHB was set up by the Government of India as a subsidiary of the Reserve Bank of India (RBI) to provide a regulatory framework for housing finance and support the housing sector's development.

Legal Framework:

The authority operates under the National Housing Bank Act, 1988, which empowers it to regulate and oversee housing finance institutions and promote affordable housing.

Objectives

1. Regulation: To regulate and supervise housing finance companies (HFCs) to ensure stability and integrity in the housing finance sector.
2. Promotion: To promote the growth and development of the housing sector by facilitating the flow of credit and encouraging investment in housing.
3. Financial Inclusion: To enhance access to housing finance for various segments of the population, including lower-income and marginalized groups.

Functions

1. Regulation and Supervision:
    - Regulates HFCs to ensure compliance with norms and standards, including financial health and operational practices.
    - Monitors and supervises the functioning of these institutions to maintain stability and protect consumers.
2. Financial Support:

  - Provides refinancing facilities to HFCs and banks, helping them extend housing loans to individuals.
  - Offers financial assistance for housing projects, particularly those aimed at affordable housing and urban development.

3. Policy Formulation:
   - Advises the government on policy matters related to housing finance and the housing sector.
   - Suggests regulatory changes and improvements to support sector growth and efficiency.
4. Market Development:
   - Promotes the development of housing finance markets by encouraging innovations and improvements in housing finance products and services.
   - Supports initiatives to improve housing infrastructure and access.
5. Consumer Protection:
   - Ensures that housing finance practices are fair and transparent, protecting the interests of borrowers and consumers.
   - Addresses grievances related to housing finance and works to enhance consumer awareness.
6. Research and Data Collection:
   - Conducts research and collects data on housing finance and market trends to inform policy decisions and industry practices.
   - Provides insights and analysis to support the development of effective housing finance strategies.

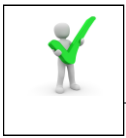
Structure

NHB is governed by a Board of Directors, which includes:

- Chairman: Provides leadership and strategic direction.
- Directors: Represent various sectors, including government, financial institutions, and housing experts.
- Executive Team: Manages day-to-day operations and implements policies and regulations.

Significance

NHB plays a pivotal role in facilitating access to housing finance, supporting the growth of the housing sector, and promoting affordable housing initiatives in India. By regulating housing finance institutions and providing financial support, NHB helps address housing needs and contributes to overall economic development.



Check Your Progress-A

1. Which authority is responsible for regulating securities and capital markets in India?
    a) Reserve Bank of India (RBI)
    b) Securities and Exchange Board of India (SEBI)
    c) Pension Fund Regulatory and Development Authority (PFRDA)
    d) Insurance Regulatory and Development Authority of India (IRDAI)
2. What is the primary role of RBI in the financial system?
    a) Manage monetary policy and supervise bank
    b) Regulate insurance companies
    c) Develop Pension funds
    d) Oversee commodity future markets.
3. Which regulatory body merged with SEBI in 2014 to oversee commodity future markets?
    a) National Housing Bank (NHB)
    b) Forward Markets Commissions (FMC)
    c) Small Industries Development Bank of India (SIDBI)
    d) Association of Mutual Funds in India (AMFI)
4. Which authority regulates the pension sector and oversees pension fund in India?
    a) Pension Fund Regulatory and Development Authority (PFRDA)
    b) National Housing Bank (NHB)
    c) Association of Mutual Funds in India (AMFI)
    d) Reserve Bank Of India

9.4.8 FORWARD MARKETING COMMISSION (FMC)

The Forward Markets Commission (FMC) was the regulatory authority overseeing the forward and futures markets in India before its merger with the Securities and Exchange Board of India (SEBI). Here's a brief overview of FMC:

Formation:

The FMC was established in 1953 under the Forward Contracts (Regulation) Act, 1952. It was responsible for regulating the commodity futures markets in India, ensuring their orderly functioning and transparency.

Legal Framework:

FMC operated under the Forward Contracts (Regulation) Act, 1952, which provided it with the authority to regulate futures trading in commodities and oversee the functioning of commodity exchanges.

Objectives

1. Regulation: To regulate and supervise the commodity futures markets, ensuring their integrity, transparency, and orderly functioning.
2. Market Development: To promote the development of commodity futures markets, supporting market efficiency and enhancing liquidity.
3. Consumer Protection: To protect the interests of market participants and investors by enforcing fair practices and resolving grievances.

Functions

1. Regulation and Supervision:
   - Regulated commodity exchanges and market participants to ensure compliance with regulations and fair-trading practices.
   - Monitored market activities to prevent manipulation and abuse and ensured the integrity of trading operations.
2. Licensing and Registration:
   - Issued licenses to commodity exchanges and registered market participants such as brokers and traders.
   - Ensured that these entities adhered to regulatory standards and operational norms.
3. Policy Formulation:
   - Formulated and enforced rules and regulations related to commodity futures trading.
   - Provided guidelines for market operations and trading practices to enhance market efficiency.
4. Market Development:
   - Supported the growth and development of the commodity futures markets by promoting innovations and improving market infrastructure.
   - Worked to increase participation and liquidity in commodity futures trading.
5. Consumer Protection:
   - Addressed grievances and complaints from market participants and investors.
   - Ensured transparency in trading practices and protected the interests of investors.
6. Market Surveillance:
   - Conducted surveillance of trading activities to detect and prevent any malpractices or irregularities.
   - Implemented measures to ensure fair and orderly trading in the commodity markets.

Merger with SEBI

In September 2014, the Forward Markets Commission (FMC) was merged with the Securities and Exchange Board of India (SEBI). This merger aimed to bring greater regulatory efficiency and integrate the regulation of commodity futures markets with the broader securities markets under SEBI's oversight.

Post-Merger Role

Following the merger, SEBI became the sole regulatory authority for both the securities and commodity futures markets in India. SEBI took over the functions of FMC, incorporating commodity market regulation into its broader mandate of overseeing financial markets.

The integration of FMC into SEBI was intended to streamline market regulation, improve oversight, and enhance the efficiency and transparency of both securities and commodity futures markets in India.

9.4.9 ASSOCIATIONS OF MUTUAL FUNDS IN INDIA (AMFI)

The Association of Mutual Funds in India (AMFI) is the industry body representing mutual funds in India. Established in 1995, AMFI plays a crucial role in promoting the mutual fund industry, ensuring industry standards, and protecting investor interests.

Objectives

1. Promotion: To promote mutual funds as an investment vehicle and enhance their popularity among investors.
2. Standardization: To establish and maintain industry standards and best practices for mutual fund operations and management.
3. Investor Protection: To safeguard investor interests by ensuring transparency, fairness, and integrity in the mutual fund industry.
4. Education and Awareness: To educate investors about mutual fund products and investment strategies, improving financial literacy.

Functions:

1. Industry Representation:
    - Acts as a representative body for mutual fund companies, engaging with regulators, policymakers, and other stakeholders.
    - Provides a unified voice for the mutual fund industry on regulatory and policy matters.
2. Regulatory Compliance:
    - Ensures that mutual fund companies adhere to regulatory requirements and industry standards.
    - Collaborates with regulatory bodies like SEBI to develop and implement guidelines for the mutual fund industry.
3. Standardization:

   - Develops and promotes standardized practices for mutual fund operations, including disclosure norms, reporting standards, and ethical practices.
   - Provides guidelines for the proper functioning and governance of mutual fund schemes.
4. Investor Education:
   - Conducts investor education programs and initiatives to raise awareness about mutual fund investments.
   - Provides resources and tools to help investors make informed decisions and understand mutual fund products.
5. Grievance Redressal:
   - Works to address and resolve investor grievances and complaints related to mutual fund investments.
   - Facilitates a mechanism for the resolution of disputes between investors and mutual funds.
6. Market Development:
   - Supports the development of the mutual fund market by encouraging innovation and new product offerings.
   - Works to increase mutual fund penetration and reach underserved segments of the population.

Structure:

AMFI is governed by a Board of Directors, consisting of representatives from various mutual fund companies. The key positions typically include:

- Chairman: Provides leadership and strategic direction for the association.
- Vice-Chairman: Assists the Chairman and represents the association in various capacities.
- Directors: Represent different mutual fund companies and contribute to decision-making and policy formulation.
  Significance

AMFI plays a pivotal role in the mutual fund industry by promoting best practices, ensuring regulatory compliance, and enhancing investor confidence. Its efforts contribute to the overall growth and development of the mutual fund sector in India, supporting a more robust and transparent investment environment.

9.4.10 INSOLVENCY AND BANKRUPTCY BOARD OF INDIA (IBBI)

The Insolvency and Bankruptcy Board of India (IBBI) is the regulatory authority responsible for overseeing and regulating the insolvency and bankruptcy processes in India. Established under the Insolvency and Bankruptcy Code (IBC) of 2016, IBBI plays a crucial role in ensuring the effective implementation of the insolvency framework and promoting the resolution of insolvencies in a timely and orderly manner.

Formation:

IBBI was established by the Insolvency and Bankruptcy Code, 2016, which aimed to streamline and standardize the insolvency and bankruptcy processes in India. The Code consolidated and simplified the existing insolvency laws and provided a comprehensive framework for the resolution of corporate and personal insolvencies.

Legal Framework:

IBBI operates under the Insolvency and Bankruptcy Code, 2016, which provides it with the authority to regulate insolvency professionals, insolvency professional agencies, and information utilities.

Objectives

1. Regulation: To regulate and oversee the functioning of insolvency professionals, insolvency professional agencies, and information utilities, ensuring compliance with the Code.
2. Resolution: To facilitate and promote the resolution of insolvencies and bankruptcies in an efficient and timely manner.
3. Development: To develop and promote the insolvency and bankruptcy ecosystem, including improving processes and practices.
4. Consumer Protection: To protect the interests of stakeholders, including creditors, debtors, and investors, by ensuring fairness and transparency in insolvency proceedings.

Functions

1. Regulation and Supervision:
    - Regulates insolvency professionals and insolvency professional agencies, including their registration, conduct, and compliance with the Code.
    - Oversees the functioning of information utilities that provide data and information related to insolvency proceedings.
2. Policy Formulation:
    - Develops and enforces regulations and guidelines under the Insolvency and Bankruptcy Code.
    - Advises the government on policy matters related to insolvency and bankruptcy and suggests amendments to the Code.
3. Resolution Process Oversight:
    - Ensures the effective implementation of insolvency resolution processes for corporate and personal insolvencies.
    - Monitors the performance of insolvency professionals and agencies to ensure the timely and efficient resolution of insolvencies.
4. Training and Capacity Building:
    - Provides training and capacity-building programs for insolvency professionals and other stakeholders to enhance their skills and understanding of insolvency processes.

5. Consumer Protection and Grievance Redressal:
    - Establishes mechanisms for addressing grievances and complaints related to insolvency proceedings.
    - Ensures that the rights and interests of stakeholders are protected during insolvency and bankruptcy processes.
6. Market Development:
    - Promotes the development of the insolvency and bankruptcy ecosystem by supporting reforms, innovations, and best practices.
    - Works to enhance the efficiency and effectiveness of insolvency resolution processes.

Structure

IBBI is governed by a Board consisting of:

- Chairman: Provides leadership and strategic direction for the Board.
- Whole-Time Members: Oversee various functional areas, such as regulation, policy formulation, and resolution processes.
- Part-Time Members: Represent different sectors and bring additional expertise to the Board's decision-making process.

Significance

IBBI plays a vital role in transforming India's insolvency and bankruptcy landscape by providing a robust regulatory framework and promoting best practices. Its efforts contribute to improving the efficiency of insolvency resolution processes, protecting stakeholder interests, and fostering a more resilient and dynamic business environment.

9.5 SUMMARY

In India, several regulatory authorities oversee different aspects of the financial services sector, each with a specific focus to ensure stability, transparency, and growth.

The Reserve Bank of India (RBI), established in 1935, serves as the central bank, regulating the monetary policy, managing currency, and overseeing the banking system to maintain financial stability and economic growth. It also supervises and regulates non-banking financial companies (NBFCs) and the money markets.

The Securities and Exchange Board of India (SEBI), founded in 1992, regulates the securities and capital markets. SEBI's mandate includes protecting investors' interests, promoting fair trading practices, and facilitating the development of a robust and transparent securities market. It oversees stock exchanges, mutual funds, and market intermediaries.

The Small Industries Development Bank of India (SIDBI), set up in 1990, focuses on the development and financing of small and medium enterprises (SMEs) in India. SIDBI provides financial assistance, facilitates access to credit, and supports initiatives to enhance the growth and sustainability of SMEs.

The Ministry of Corporate Affairs (MCA) oversees corporate governance and regulation in India. It administers the Companies Act, 2013, and other related legislation, ensuring compliance with corporate laws, promoting corporate governance practices, and facilitating corporate reforms.

The Insurance Regulatory and Development Authority of India (IRDAI), established in 1999, regulates and develops the insurance sector. IRDAI ensures fair practices, solvency, and the growth of insurance markets, overseeing insurance companies and protecting policyholders' interests.

The Pension Fund Regulatory and Development Authority (PFRDA), created in 2013, regulates the pension sector, overseeing pension funds, pension managers, and related entities. PFRDA's role includes promoting pension market growth, ensuring efficient pension fund management, and protecting subscribers' interests.

The National Housing Bank (NHB), established in 1988, regulates and supports housing finance institutions. NHB aims to promote affordable housing, oversee housing finance markets, and provide refinancing to banks and housing finance companies.

The Forward Markets Commission (FMC), operational before its merger with SEBI in 2014, regulated commodity futures markets. It was responsible for overseeing commodity exchanges and ensuring fair trading practices until its functions were absorbed by SEBI.

The Association of Mutual Funds in India (AMFI), founded in 1995, represents the mutual fund industry. AMFI works to promote mutual funds, establish industry standards, and protect investor interests by advocating for best practices and investor education.

The Insolvency and Bankruptcy Board of India (IBBI) is the regulatory authority responsible for overseeing and regulating the insolvency and bankruptcy processes in India. Established under the Insolvency and Bankruptcy Code (IBC) of 2016, IBBI plays a crucial role in ensuring the effective implementation of the insolvency framework and promoting the resolution of insolvencies in a timely and orderly manner.

These authorities collectively ensure the stability, growth, and regulation of various segments of India's financial services sector, contributing to a well-functioning and transparent financial system.

9.6 GLOSSARY

Compliance - Adhering to regulations and standards set by regulatory authorities.

Disclosure - The act of providing transparent information about financial products and services.

Governance - The framework of rules and practices that ensure effective regulation and oversight.

Intermediaries - Entities or individuals that facilitate transactions between parties in financial markets.

Licensing - The process of granting permission to operate under specific regulatory conditions.

Monitoring - The ongoing process of supervising and reviewing financial institutions and markets.

Regulation - The rules and standards established to govern financial activities and maintain stability.

Resolution - The process of addressing and solving financial issues or disputes, particularly in insolvency.

Transparency - The principle of making operations and financial information clear and accessible.

Supervision - The oversight and enforcement of compliance with financial regulations and standards.

9.7 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (b), 2 (a), 3 (b), 4 (a)

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9.10 TERMINAL QUESTIONS

1. What is the role of the Reserve Bank of India (RBI) in managing the country's financial system, and how does it affect everyday banking and monetary policy?
2. How does the Securities and Exchange Board of India (SEBI) ensure that the stock markets in India operate fairly and transparently?
3. What are the main functions of the Pension Fund Regulatory and Development Authority (PFRDA), and how does it impact the retirement planning of Indian citizens?
4. Discuss brief in regulatory machinery for financial services in India?
5. What steps has the Insurance Regulatory and Development Authority of India (IRDAI) taken to protect insurance policyholders, and why is this important for consumers?

9.11 CASE STUDY

Case Study: Regulatory Reform in the Indian Banking Sector

Background: In the early 2000s, the Indian banking sector faced challenges such as inadequate regulatory frameworks, poor risk management practices, and limited investor protection. The Reserve Bank of India (RBI), the central regulatory authority for the banking system, recognized the need for reforms to strengthen the sector and enhance financial stability.

Issue: Banks were struggling with non-performing assets (NPAs), which are loans that borrowers fail to repay. This issue affected the overall health of the banking system and raised concerns about the safety of depositors' money.

Regulatory Action: To address these challenges, the RBI implemented several key reforms:

1. **Introduction of Basel III Norms**: These international regulations aimed at improving the banking sector's ability to absorb shocks. Basel III norms required banks to maintain higher capital reserves and improve risk management practices.

2. **Asset Quality Review (AQR)**: The RBI conducted an AQR to assess the true quality of banks' assets, particularly focusing on NPAs. This review helped in identifying and addressing asset quality issues more accurately.
3. **Revised Loan Recovery Framework**: The RBI introduced measures such as the Insolvency and Bankruptcy Code (IBC) to expedite the recovery process of bad loans. The IBC provided a legal framework for faster resolution of insolvencies and encouraged better practices in loan management.

Outcome: These regulatory reforms led to several positive outcomes:

- **Improved Banking Stability**: Banks became more resilient to financial shocks due to higher capital reserves and improved risk management.
- **Enhanced Transparency**: The AQR and other measures led to greater transparency in the banking sector, helping investors and stakeholders gain a clearer picture of banks' financial health.
- **Better Loan Recovery**: The introduction of the IBC facilitated quicker resolution of insolvencies, improving the recovery of bad loans and reducing the burden on banks.

Conclusion: The regulatory reforms implemented by the RBI significantly strengthened the Indian banking sector, addressing key issues such as NPAs and enhancing overall financial stability. These changes not only improved the resilience of banks but also contributed to a more transparent and efficient financial system, benefiting both investors and the broader economy.

UNIT 10 MANAGEMENT OF RISK IN FINANCIAL SERVICES

10.1 INTRODUCTION

The term "financial services" encompasses a wide range of activities, including banking, insurance, housing finance, stock broking, and investment services. These services are broadly categorized into two types:

- **Fund-Based Services:** These involve raising equity, debt, and deposits to invest in securities or provide loans to individuals or entities in need of capital.
- **Fee-Based Services:** These services facilitate the process of capital raising for others or enable the exchange of financial assets and risk among market participants.

In developed Western economies, including the United States, the financial services sector has expanded significantly since World War II, now representing a substantial portion of overall economic activity. Similarly, in India, the sector has experienced rapid growth, particularly since the liberalization reforms were initiated in recent years.

The Critical Role of Financial Services

Financial institutions and markets are integral to the functioning of the economic system. The significance of this sector is evident from the disruption caused by events such as bank strikes and defaults by stock brokers, which have notable impacts on the economy and financial markets.

The financial sector is characterized by its dynamic nature, constantly introducing new products and services. Despite its growth and innovation, the sector faces high levels of risk. Instances of bank failures, insurance company collapses, securities frauds, and market crashes highlight the inherent volatility and risk within this industry.

The Importance of Risk Management

Given the high-risk environment in which financial services operate, the ability to manage risk effectively is crucial for the success of any financial institution. Effective risk management practices help mitigate potential losses and safeguard the stability and integrity of financial operations.

In summary, the financial services sector is a vital component of the global economy, continuously evolving and expanding. However, its dynamic nature and susceptibility to risk underscore the importance of robust risk management strategies to ensure long-term success and stability.

10.2 OBJECTIVES

After going through the unit, the learner shall be able to understand ;

- Meaning and Features of Risk
- Trade in Risk
- External and Internal Risk
- Types of Risk
- Risk Management in Financial Services

10.3 HISTORICAL OVERVIEW OF RISK MANAGEMENT IN FINANCIAL SERVICES

Early Beginnings

Risk management in financial services has evolved significantly over time. In the early days of banking and finance, risk management was relatively rudimentary, often limited to basic practices such as diversifying investments to reduce the impact of individual failures.

Institutions primarily focused on avoiding obvious losses rather than implementing systematic risk management strategies.

Development of Formal Risk Management

The modern era of risk management began to take shape in the late 20th century. The evolution was driven by several factors, including financial market innovations, increased complexity of financial products, and notable financial crises. Key milestones in this development include:

- **1980s - Introduction of Financial Derivatives:** The introduction of financial derivatives such as options, futures, and swaps marked a significant advancement in risk management tools. These instruments allowed institutions to hedge against various risks, including interest rate and currency fluctuations.
- **1990s - Emergence of Risk Management Frameworks:** The 1990s saw the formalization of risk management practices. The establishment of frameworks such as the Basel Accords (Basel I and Basel II) provided guidelines for capital adequacy, risk assessment, and regulatory compliance. These frameworks aimed to standardize risk management practices across financial institutions globally.

Post-2000s Developments

- **2008 Financial Crisis:** The global financial crisis of 2008 highlighted significant deficiencies in risk management practices. The crisis exposed weaknesses in credit risk assessment, risk concentration, and the oversight of complex financial instruments. In response, regulatory bodies and financial institutions undertook extensive reforms to strengthen risk management frameworks.
- **Basel III Framework:** The Basel III framework, introduced in the aftermath of the 2008 crisis, represented a comprehensive overhaul of previous regulations. It emphasized higher capital requirements, enhanced risk coverage, and greater emphasis on liquidity and leverage ratios. Basel III aimed to address the shortcomings revealed by the crisis and improve the resilience of the financial system.
- **Technological Advancements:** The 21st century has also witnessed significant technological advancements impacting risk management. The integration of big data analytics, artificial intelligence (AI), and machine learning has transformed how financial institutions assess and manage risk. These technologies offer sophisticated tools for risk modeling, prediction, and mitigation.

Current Trends and Future Directions

Today, risk management in financial services continues to evolve in response to emerging challenges such as cybersecurity threats, climate change, and geopolitical risks. The focus has shifted towards more dynamic and integrated risk management approaches, leveraging advanced technologies and data-driven insights. Organizations are increasingly adopting enterprise risk management (ERM) frameworks, which provide a holistic view of risk across the entire organization.

In summary, the history of risk management in financial services reflects a journey from basic practices to sophisticated and integrated approaches. The field has evolved in response to financial innovations, regulatory changes, and major crises, continuously adapting to the complex and ever-changing landscape of the financial sector.

10.4 MEANING OF RISK AND FEATURES OF RISK

Meaning of Risk: Risk in financial services refers to the potential for loss or uncertainty affecting financial outcomes.

Definition of Risk: Risk is the exposure to the chance of loss or damage arising from financial activities, investments, or market conditions.

The features of risk in financial services typically include:

1. Uncertainty: Risk involves the uncertainty of outcomes. It’s not possible to predict with certainty how an investment or financial decision will turn out.
2. Potential for Loss or Gain: Risk encompasses both the possibility of losing money and the chance of making money. It involves variability in returns.
3. Measurability: Risk can be quantified using various metrics, such as standard deviation, value at risk (VaR), or beta, to assess the level of uncertainty or potential loss.
4. Variability: Risk is characterized by the degree of variation in returns or outcomes. Higher variability indicates higher risk.
5. Time Horizon: The impact of risk often depends on the time frame. Short-term risks may differ significantly from long-term risks due to different factors influencing the outcomes over different periods.
6. Correlation: Risks can be correlated with other risks or factors. For instance, market risk might be correlated with interest rate risk, and understanding these correlations can help in managing overall risk exposure.
7. Control and Management: Risks can often be managed or mitigated through diversification, hedging, insurance, or other risk management strategies. The degree to which a risk can be controlled varies depending on its nature.
8. Dynamic Nature: Risk is not static; it can change over time based on market conditions, economic factors, and other variables. Regular monitoring and adjustment are required to manage evolving risks effectively.

9. Impact on Objectives: Risk affects the achievement of financial objectives. Higher risk might be associated with higher potential returns but also with greater chances of not meeting financial goals.

These features highlight the complexity and multifaceted nature of risk in financial services.

10.5 TRADE IN RISK

The financial services sector provides a variety of products and services, which can be understood in different ways. For example, when a bank accepts funds for a fixed deposit, you might view it as the bank offering a product called a fixed deposit. However, if you consider the broader activity of the bank, it is essentially exchanging money for a financial claim. This claim represents a promise to provide a fixed amount of money under certain predetermined conditions. Similarly, when the bank lends money to a firm, it acquires another financial claim.

In essence, the bank's primary function is to buy financial claims from borrowers and sell financial claims to deposit holders. All financial claims carry some level of risk, meaning that banks are fundamentally engaged in trading risk. Stockbrokers operate similarly, buying and selling shares and bonds, which are also financial claims issued by corporations. They too are involved in trading risk.

Insurance companies offer a way to transfer risk. For example, if you own a building and are concerned about risks like fire, you can transfer this risk to an insurance company. These companies assume the risk from you and may sometimes pass it on to other insurance companies. Additionally, insurance companies issue financial claims to those who invest in their equity and bonds.

Investment companies have analogous functions. Venture capital firms, for instance, take on business risk when they invest in emerging technologies. Mutual funds help in mitigating or reducing investment risks (specifically, unsystematic risk). Merchant bankers assist companies in issuing financial claims to the public.

Overall, risk is a central component of the financial services industry and is a fundamental product that this industry deals in.

10.6 EXTERNAL AND INTERNAL RISK

The financial services industry primarily handles financial claims, which involve the risk of default that can impact a company's performance. This inherent risk is high due to the potential for default by those issuing financial claims. Defaults can arise from various sources, broadly classified into two categories: external and internal.

External Risk: External risks stem from developments outside the financial services company and can vary based on the type of service provided. Here are a few examples:

a) **Institutions Providing Direct Finance**: Different financial institutions offer various types of financing, such as:

- **Commercial Banks**: Provide short-term loans to firms.
- **Term-Lending Institutions**: Offer long-term financing for industrial projects.
- **Housing Finance Companies**: Fund individuals or construction companies for acquiring property.
- **Venture Capital Firms**: Invest in new, innovative projects.
- **Credit Cards, Factoring, Forfeiting, and Bill Discounting**: Offer a mix of services and financing.

These institutions, including commercial banks, are primarily involved in lending and often borrow funds to provide these services. Since the core business of these institutions is lending, they face similar risks across their various services. For example, a bank might fail to meet its deposit obligations if its non-performing assets exceed its net worth. Although government ownership of major banks in India provides some protection, bank failures are more common in other countries with less government involvement in banking. In India, past failures like Bank of Karad and Bank of Thanjavore, which were merged with other banks, highlight the risk. With increasing privatization and the establishment of private sector banks in India, the risk of failures may rise if credit quality is poor.

Another external risk involves the quality of investments made by these institutions. Banks and financial institutions often invest in securities, either to meet regulatory requirements or for profit. Poor performance in these investments, whether due to market conditions or the issuer's issues, can affect the institution's ability to meet its obligations. Therefore, evaluating credit and investment quality is crucial in managing external risks.

b) **Insurance Services**: Insurance companies assume risks related to their clients' assets. Premiums collected are invested or lent out, exposing insurance companies to external risks in two ways:

1. **Investment Performance**: Poor performance of investments can impair an insurance company's ability to meet its obligations.
2. **Claims Experience**: If the insured assets underperform or face higher-than-expected claims, the company might struggle to honor its commitments.

Insurance companies also face challenges like moral hazard and adverse selection:

- **Moral Hazard**: Insured individuals might take greater risks because they are covered. For instance, a machine owner might ignore maintenance to expedite production, knowing insurance will cover potential damages.

- **Adverse Selection**: This occurs when lower-quality assets are more likely to be insured. For example, if insurance premiums are the same for all ships, owners of poorly maintained ships might be more inclined to insure them compared to owners of well-maintained ships.

Assessing the quality of assets is essential for insurance companies to manage these risks effectively.

Internal Risk: Internal risks arise from within the financial services company and include:

- **Risk-Taking Behavior**: Higher risk-taking in certain activities can affect the overall stability of the company.
- **Asset-Liability Mismatch**: Discrepancies between the maturities and characteristics of assets and liabilities can lead to financial instability.

Understanding and managing both external and internal risks is crucial for maintaining the stability and performance of financial services companies.

c) Stock Broking Services

Stock brokers facilitate the buying and selling of securities on behalf of their clients. They collect securities from sellers, obtain payment from buyers, and transfer the funds to sellers after deducting their brokerage fees. Despite appearing straightforward, stock broking involves significant external risks.

Firstly, in markets where trades are not guaranteed by stock exchanges or clearing corporations, the failure of a single broker can trigger a chain reaction affecting the entire market. There have been instances in the Indian stock market where exchanges were temporarily closed to address issues arising from broker defaults. Secondly, brokers face the risk of clients failing to honor their commitments, leaving brokers responsible for covering any resulting losses.

d) Leasing and Hire Purchase

Leasing and hire purchase services are similar to banking but involve raising funds from the market and providing assets instead of cash loans. The quality of the leased assets is crucial to the financial health of these companies. Although leasing companies can reclaim assets if lease payments are not made, the resale value of these assets is often low compared to the outstanding obligations. Additionally, these companies invest surplus funds in securities markets, making their performance susceptible to fluctuations in market prices. Regulatory changes can also impact on these companies. Recent Reserve Bank of India regulations have imposed stricter norms on public deposit collection, potentially driving many companies out of the market.

The success of leasing and hire purchase companies hinges on their ability to attract deposits, as high leverage is essential for their viability. For instance, a company with a debt-to-equity ratio of 4 or higher relies on a steady flow of deposits to balance its assets and liabilities. If deposits cease, even well-performing companies with high-quality lease portfolios may struggle.

Example: Consider a situation where you deposit ₹1 lakh with a leasing company for two years. The company might lease an asset worth ₹1 lakh for a term of 3 to 5 years. To repay your deposit at the end of two years, the company would need to secure new deposits or face a mismatch between the duration of its assets and liabilities. This dependency on continuous deposit inflow highlights the risk associated with asset-liability mismatches in leasing and hire purchase companies.

e) Institutions Offering Fee-Based Services

Institutions that offer fee-based services—such as merchant banking, mutual funds, credit rating, debt securitization, mergers and acquisitions, and corporate restructuring—typically face lower direct financial risk compared to those involved in funding. Their performance is largely dependent on the quality of services they provide. However, they are not immune to external risks.

Regulatory changes are a significant external risk affecting these services. For example, new regulations in merchant banking and mutual funds can alter industry dynamics and reduce the number of players. Credit rating agencies faced criticism during the East Asian financial crisis for failing to predict problems, and similar scrutiny arose in India with the failure of CRB Capital, which cast doubt on credit rating agencies. Debt securitization in India is still evolving, and issues such as the performance of securitized debt obligations and varying state laws on stamp duty present potential risks.

Overall, while fee-based service providers have reduced direct financial risk, they must navigate external factors such as regulatory changes and market conditions that can impact their operations.

10.7 TYPES OF RISK

1. **Credit Risk**
   Credit risk is a major concern for financial services firms engaged in fund-based activities, such as banking, credit cards, and leasing. This risk arises from the possibility of default by borrowers, which can impact the firm's financial stability. Evaluating credit risk involves assessing lending proposals and using credit ratings, either from external agencies or internal assessments. The percentage of non-performing assets (NPAs) reflects the impact of credit risk on a firm. Many financial institutions now use advanced models like KMV (Distance to Default) and CreditMetrics to quantify and manage credit risk.
2. **Asset-Liability Gap Risk**
   This risk pertains to financial firms involved in fund-based activities. Since these firms often rely on external funding, managing the duration of liabilities in relation

to assets is crucial. For instance, if a firm provides a five-year loan but funds it with a two-year deposit, it creates a mismatch between the duration of liabilities and assets. If this mismatch exceeds a certain threshold, it could lead to liquidity issues and potential cash flow problems.

3. **Due-Diligence Risk**
   Firms offering fee-based services, such as merchant banking and mergers and acquisitions, must exercise due diligence to ensure compliance with regulations and to protect their clients. For example, SEBI regulations require merchant bankers to submit a due-diligence certificate before public or rights issues open for subscription. Any lapses or inaccuracies in this process can result in legal repercussions, financial liability, or even suspension or cancellation of the firm's registration.
4. **Interest Rate Risk**
   Interest rate risk affects firms engaged in fund-based activities, especially in a volatile interest rate environment. Frequent changes in interest rates can impact:

   Treasury Operations: The market value of fixed-income securities is inversely related to interest rates; thus, rising rates can decrease the market value of these securities.

   Lending: When interest rates rise, the cost of existing loans can increase if there are no provisions for rate adjustments. While banks and leasing companies may adjust deposit rates, they may not always be able to revise loan rates correspondingly, affecting profitability.

   Resource Mobilization: Firms may face higher interest costs on funds committed before rates fell, impacting their profitability. For instance, a financial institution issuing high-interest debt when rates were high may suffer if market rates subsequently decline.
5. **Market Risk**
   Firms involved in investment activities or holding securities are exposed to market risk, which arises from economic changes affecting all securities. While diversification can mitigate unsystematic risk, systematic risk, or market risk, cannot be eliminated. Financial institutions often use Value at Risk (VaR) to gauge potential losses due to significant market changes at a specific probability level. For example, a firm might aim to limit its potential loss to 6% of its capital with a 99% probability. Although derivative products can help manage systematic risk, they come with costs. In India, where derivative products are less available, firms holding investments face higher exposure to market risk. This was notably evident after the 1992 securities scam, which severely impacted investor confidence in mutual funds.
6. **Currency Risk**
   Currency risk affects firms dealing in foreign exchange, including banks, financial institutions, and money changers. This risk arises from fluctuations in currency

values, influenced by economic conditions and supply-demand dynamics. Firms holding foreign currency liabilities are impacted when the domestic currency depreciates, while those with foreign currency assets are affected by appreciation. Additionally, firms borrowing in international markets or raising foreign currency loans are exposed to currency risk. As foreign currency derivatives become available, firms engaging in these markets will also encounter currency risk.

Understanding and managing these risks are essential for maintaining stability and profitability in the financial services industry.

Check Your Progress-A

1. What is the process of offsetting potential losses from adverse movements in financial markets called?
    a) Quantification
    b) Diversification
    c) Hedging
    d) Risk Assessment
2. Which risk is associated with a borrower's failure to meet their debt obligations?
    a) Currency Risk
    b) Interest Risk
    c) Credit Risk
    d) Market Risk
3. What term describes the risk due to fluctuations in exchange rates affecting firms with foreign currency exposures?
    a) Liquidity Risk
    b) Due-Diligence Risk
    c) Interest Risk
    d) Currency Risk
4. What is the risk of being unable to meet short-term financial obligations due to insufficient cash flow called?
    a) Liquidity Risk
    b) Market Risk
    c) Asset -Liability Gap
    d) Credit Risk

10.8 MANAGEMENT OF RISK

Risk is an inherent aspect of starting and running any business, and it is closely linked to potential rewards or profits. In the financial services industry, firms often deal with financial products that are intrinsically linked to risk. Many financial services firms create products specifically designed to transfer risk from others to themselves in exchange for a return.

For instance, consider a company with a payment obligation of $100,000 to an overseas supplier due in three months. This company faces currency risk due to potential fluctuations in exchange rates. A financial services company might offer a forward contract to the firm, allowing it to lock in a specific exchange rate and thereby transfer the currency risk to the financial services firm. The financial services firm earns a forward cover premium for assuming this risk. However, once the financial services firm takes on this risk, it must actively manage it to mitigate potential negative impacts. Success in the financial services industry relies on the ability to identify, transfer, and manage various risks effectively.

Strategies for Managing Risks

1) Managing Credit Risk

To manage credit risk, financial firms first need to quantify the risk involved. This is typically done through credit ratings, which can be obtained from external rating agencies or developed internally. Public sector banks, for example, use health codes to evaluate the creditworthiness of loan accounts. Although relying solely on high credit ratings can limit the number of loan proposals and reduce potential income, firms can use the following strategies to manage credit risk:

- **Desirable Loan Portfolio:** Develop a loan portfolio that balances different borrower categories. An aggressive lender might allocate more funds to lower-rated borrowers, while a conservative lender would focus on high-rated borrowers. Aggressiveness does not necessarily lead to loss if the firm carefully screens borrowers and secures valuable assets.
- **Continuous Monitoring:** Regular monitoring of loan accounts is crucial, regardless of the lending strategy. Firms must gather ongoing information from borrowers and the market to identify any signs of deteriorating credit quality. This could involve either simple assessments or advanced econometric models.
- **Action on Doubtful and Bad Debts:** Prompt action is needed when monitoring reveals potential problems with a loan. This includes reviewing the value of any collateral and possibly demanding additional security. Offering discounts for early repayment or working with recovery agencies can help manage problematic loans. For debts that have become bad, administrative actions like repossessing assets or filing claims with a liquidator may be necessary.

2) Managing Asset-Liability Gap Risk

Asset-liability gap risk arises from mismatches between the duration of assets and liabilities, particularly in a fluctuating interest rate environment. This concept is crucial for financial firms, such as banks and leasing companies, where the management of interest rate risk is essential.

In a stable interest rate environment, a financial firm's balance sheet will show equal assets and liabilities, as required by double-entry bookkeeping. The finance manager's role in this scenario is to focus on managing the spread between income from assets and the cost of liabilities, thereby maximizing net income.

To manage asset-liability gap risk effectively, firms need to:

- **Match Asset and Liability Durations:** Ensure that the duration of assets aligns with the duration of liabilities to minimize gaps. This helps in managing interest rate risk and maintaining liquidity.
- **Use Hedging Strategies:** Employ financial instruments like derivatives to hedge against interest rate fluctuations and manage the gap risk. This can include interest rate swaps or options.
- **Regularly Review and Adjust:** Continuously assess the balance between assets and liabilities, making adjustments as necessary to address any imbalances and mitigate potential risks.

3) Managing Due-Diligence Risk

Due-diligence risk arises from the need for firms to provide accurate certifications to regulatory agencies or clients. High standards of professional efficiency and ethics are essential to manage this risk effectively. In the Indian context, due-diligence risk is particularly relevant due to past instances where firms exploited market conditions to manipulate prices and issues, leading to a decline in public trust and regulatory scrutiny.

To manage due-diligence risk, firms can adopt the following strategies:

a) **Professional Standards and Ethics:** Employ qualified professionals and foster a culture of ethical behavior within the organization. Regulatory agencies often scrutinize these aspects before issuing certifications.

b) **Code of Conduct:** Develop and enforce a code of conduct for employees to follow in their professional duties. This helps ensure that all due-diligence processes are conducted with integrity.

c) **Internal Controls:** Implement a robust internal control system to ensure thorough investigations are conducted before issuing due-diligence certifications. This might involve having a separate officer review critical areas.

d) **Training and Development:** Provide ongoing professional training to staff to enhance their knowledge and expertise, and encourage sharing of experiences within the industry.

4) Managing Interest Rate Risk

Interest rate risk affects financial firms through fluctuations in market interest rates, which can impact various financial instruments and portfolios. This risk can be managed through the following steps:

- Quantification: Assess the interest rate risk associated with each asset and liability. For investments in securities, measure the risk using 'duration.' In asset-liability management, consider options such as call, put, or conversion options.
- Hedging Strategies: Select appropriate instruments to manage interest rate risk. This might include:
    a) Interest Rate Futures: Buying or selling futures contracts to hedge against rate changes.
    b) Interest Rate Swaps: Exchanging floating rate payments for fixed-rate payments, or vice versa.
- Forecasting: Research and forecast interest rate movements to determine the need for hedging. If forecasts suggest favorable conditions for certain assets or liabilities, adjust hedging strategies accordingly.

Example: If you enter into an interest rate swap transaction with a client to exchange floating rates for fixed rates and then enter into another swap with a different client to exchange fixed rates for floating rates, you effectively hedge 80% of the interest rate risk. The remaining 20% of the risk needs to be managed separately.

5) **Managing Market Risk**

Market risk, which affects investments due to changes in market conditions, can be managed through:

a) **Diversification:** Reduce unsystematic risk by diversifying investments across various asset classes and markets.

b) **Strategic Shifts:** Adjust investment allocations based on market conditions. For example, a mutual fund may shift investments from equities to bonds if a downturn is anticipated.

- **Derivatives:** Use financial derivatives to hedge against market risk. Techniques include:
    a) **Put Options:** Buying put options on indices or stocks for portfolio insurance.
    b) **Dynamic Hedging:** Adjusting hedge positions dynamically based on market movements. Increase hedging during downturns and reduce it when the market is rising.

6. Managing Currency Risk

Firms dealing with foreign exchange face currency risk due to fluctuations in exchange rates. This risk can be managed by:

1. **Identifying Exposures:** Determine the amount of uncovered foreign currency positions and forecast potential currency movements.
2. **Hedging Instruments:** Use various hedging tools to manage currency risk:
    a. **Forward Contracts:** Lock in exchange rates for future transactions.
    b. **Futures and Options:** Take positions in the futures or options markets based on risk perception and cost considerations.
3. **Adjusting Positions:** Cover open positions by either liquidating holdings or using hedging instruments, depending on the firm's risk assessment and market conditions.

10.9 SUMMARY

Risk is an inherent aspect of business, particularly in the financial services industry, where firms handle a variety of financial claims and products that are by nature risky. Effective risk management is crucial to maintaining stability and achieving profitability. The key types of risk in financial services include credit risk, asset-liability gap risk, due-diligence risk, interest rate risk, market risk, and currency risk. Here's how financial services firms can manage these risks:

1. Credit Risk

Credit risk arises from the possibility that borrowers may default on their obligations. To manage this risk, firms should first quantify it through credit ratings. They can rely on external rating agencies or develop in-house rating systems. Once quantified, firms should aim for a balanced loan portfolio, mixing high-risk and low-risk borrowers based on their risk tolerance. Continuous monitoring is crucial, with systems in place to track borrower performance and adjust credit assessments. Action on doubtful debts includes demanding additional security or offering discounts to encourage early repayment. For bad debts, recovery measures involve repossessing assets or legal action.

2. Asset-Liability Gap Risk

Asset-liability gap risk occurs when there's a mismatch between the durations of assets and liabilities, potentially leading to liquidity issues. In stable interest rate environments, the focus is on managing the spread between income from assets and the cost of liabilities. However, in volatile interest rate conditions, firms need to ensure that their asset and liability maturities align to avoid cash flow problems. Effective management involves careful planning of fund allocation and regular adjustment of asset-liability mismatches.

3. Due-Diligence Risk

Due-diligence risk pertains to the accuracy and integrity of certifications provided by financial services firms to clients or regulatory bodies. To manage this risk, firms must adhere to high standards of professionalism and ethics. Implementing a rigorous internal control system and developing a comprehensive code of conduct are essential. Regular training for staff and frequent audits help maintain high standards and prevent lapses that could lead to regulatory penalties or loss of reputation.

4. Interest Rate Risk

Interest rate risk arises from fluctuations in market interest rates affecting the value of assets and liabilities. Firms should first quantify this risk using measures such as duration for securities or sensitivity analysis for other financial products. Hedging strategies include using interest rate futures or swaps to manage exposure. Researching interest rate trends and forecasts helps in deciding whether to hedge or not, balancing the cost of hedging against potential benefits.

5. Market Risk

Market risk, or systematic risk, affects the value of investments due to market movements. Firms can manage this risk through diversification, spreading investments across various assets to reduce exposure to any single market. Using derivatives, such as options and futures, can also help hedge against adverse market movements. Dynamic hedging strategies, where adjustments are made based on market conditions, provide another layer of protection.

6. Currency Risk

Currency risk arises from fluctuations in exchange rates affecting firms with foreign currency exposures. To manage this, firms need to identify uncovered positions and forecast currency movements. Hedging can be achieved using forward contracts, futures, or options. Firms should evaluate the cost of hedging against the potential risk and adjust their strategies based on their exposure and market outlook.

In summary, managing risk in financial services involves quantifying each type of risk, implementing appropriate strategies to mitigate it, and continuously monitoring and adjusting these strategies based on changing conditions. Effective risk management ensures financial stability, protects against potential losses, and supports overall business performance.

10.10 GLOSSARY

Asset-Liability Gap Risk: Risk arising from mismatches between the durations of assets and liabilities.

Credit Risk: The risk of loss from a borrower's failure to repay a loan or meet obligations.

Currency Risk: Risk due to fluctuations in exchange rates affecting firms with foreign currency exposures.

Due-Diligence Risk: Risk associated with errors or lapses in verifying information or compliance.

Hedging: Strategies to offset potential losses from adverse movements in financial markets.

Interest Rate Risk: Risk arising from changes in interest rates affecting the value of assets and liabilities.

Liquidity Risk: The risk of being unable to meet short-term financial obligations due to insufficient cash flow.

Market Risk: Risk of losses due to changes in market prices, including stock prices, interest rates, and currencies.

Non-Performing Assets (NPA): Loans or assets that are in default or close to being in default.

Portfolio Diversification: Spreading investments across various assets to reduce exposure to any single risk.

Quantification: The process of measuring the amount of risk exposure or potential loss.

Rating Agencies: Organizations that evaluate the creditworthiness of borrowers and assign ratings.

Risk Management: The process of identifying, assessing, and controlling risks to minimize their impact.

Swap: A derivative contract in which two parties exchange cash flows or financial instruments.

Value at Risk (VaR): A statistical measure to estimate the potential loss in value of a portfolio over a given period.

10.11 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (c), 2 (c), 3 (d), 4 (a)

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10.13 SUGGESTED READINGS

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10.14 TERMINAL QUESTIONS

1. What do you mean by Risk in Financial Services.? Explain the features of risk in financial services.
2. Discuss the historical overview of risk management in financial services.
3. What do you mean by internal and external risk? Explain the various types of risk in financials services.
4. Discuss the process of risk management in financial services.

10.15 CASE STUDY

Management of Risk in Financial Services - The Collapse of IL&FS

Infrastructure Leasing & Financial Services (IL&FS) was a major Indian infrastructure financing and development company that faced a severe financial crisis in 2018. IL&FS's collapse is considered one of the most significant financial scandals in India, highlighting critical issues in risk management and corporate governance within the Indian financial services sector.

Risk Management Issues

1. High Leverage and Asset-Liability Mismatch: IL&FS had a high leverage ratio, relying heavily on short-term borrowings to finance long-term infrastructure projects. This created a significant asset-liability mismatch, making it vulnerable to liquidity shocks.
2. Overleveraged Investments: The company invested heavily in various infrastructure projects, many of which faced delays or cost overruns. These investments did not generate the expected returns, exacerbating the financial strain on the company.
3. Weak Risk Management Practices: IL&FS's risk management framework was inadequate. There was a lack of proper due diligence and risk assessment for the projects it financed. The company also had weak internal controls and oversight mechanisms.
4. Corporate Governance Issues: Governance issues were prevalent, with reports of poor oversight by the board of directors and questionable decision-making processes. There were allegations of financial mismanagement and fraudulent practices.
5. Regulatory Oversight: Regulatory oversight was insufficient. The regulators, including the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI), did not have adequate mechanisms in place to monitor the risks associated with such large and complex financial entities.

Management Strategies and Responses

1. Attempted Debt Restructuring: As the crisis unfolded, IL&FS attempted to restructure its debt by negotiating with creditors and stakeholders. However, these efforts were complicated by the scale of the financial distress and the company's deteriorating financial condition.
2. Government Intervention: In October 2018, the Indian government intervened by replacing the board of IL&FS with a new board appointed by the government. The new board was tasked with stabilizing the company and addressing the liquidity crisis.
3. Asset Sales and Debt Repayment: The new management focused on selling non-core assets and monetizing investments to repay outstanding debts. The company also sought to revive stalled projects and improve cash flows.

4. Legal and Forensic Investigations: The government and regulatory authorities initiated forensic audits and legal investigations to uncover the causes of the financial mismanagement and to hold responsible parties accountable.

Lessons Learnt

1. Importance of Effective Risk Management: The IL&FS case highlights the need for robust risk management frameworks, especially for companies dealing with high leverage and large-scale infrastructure projects. Proper risk assessment and management practices are crucial to avoid asset-liability mismatches.
2. Need for Strong Corporate Governance: Effective corporate governance is essential for ensuring accountability and transparency. The IL&FS case underscores the importance of having a well-functioning board of directors and internal controls to oversee financial operations and risk management.
3. Enhanced Regulatory Oversight: The crisis revealed gaps in regulatory oversight. Post-crisis, there have been calls for more stringent regulations and better monitoring mechanisms for financial institutions to prevent such occurrences in the future.
4. Importance of Liquidity Management: Companies should maintain adequate liquidity reserves and have contingency plans in place to manage short-term financial stress. Proper liquidity management is crucial for maintaining financial stability.
5. Systemic Risk Awareness: The interconnectedness of financial institutions means that the failure of one can have widespread implications. Regulators need to monitor systemic risks and implement measures to mitigate potential contagion effects.

Conclusion

The collapse of IL&FS is a significant case study for understanding risk management in the Indian financial services sector. It underscores the importance of effective risk management practices, strong corporate governance, and regulatory oversight. The lessons learned from this crisis are crucial for improving the resilience and stability of financial institutions in India and preventing similar financial failures in the future.

UNIT 11 PRICING OF FINANCIAL SERVICES

11.1 INTRODUCTION

The financial service industry has undergone considerable change since 1991 and this trend looks set to continue with the pure dominance of insurance, personal banking products, ICICI, Citi Bank, Standard Chartered Bank and HDFC Bank have successfully launched their financial products in Indian market with great popularity. Financial products or instruments are basically documents evidencing transfer of funds from the saving community, i.e., investors to the business community, where it can be gainfully employed on certain predetermined terms and conditions such as rate of return, repayment schedule, liquidity and benefits etc.

Financial services in India encompass a wide array of offerings, including banking, insurance, asset management, financial planning, and advisory services. The sector has seen significant growth and transformation, driven by economic reforms, technological advancements, and regulatory changes.

- Banking Services: Includes retail and corporate banking, savings and checking accounts, loans, and payment services.
- Insurance Services: Encompasses life insurance, general insurance, and health insurance products.
- Investment Services: Involves mutual funds, stock broking, portfolio management, and financial advisory.
- Financial Planning and Advisory: Services related to wealth management, retirement planning, and tax advisory.

11.2 OBJECTIVES

This unit aims to;

- Explore the factors influencing the pricing strategies of financial products and services in India.
- Understand the unique considerations for pricing banking, insurance, housing finance, and investment services.
- Analyze how economic, regulatory, and market dynamics impact pricing in different financial sectors.
- Provide a comparative understanding of pricing mechanisms across various financial industries.

11.3 PRICING THE SERVICE PRODUCTS

The price is a key element of the marketing mix. It must be acceptable to target customers, and it must reflect the other components of the mix accurately. The price of the service is the value attached to it by the service provider and it must respond with the customer's perception of value. Many factors influence the price, which ultimately changes over a period. This includes the type of organization, the structure of the market, the life cycle stage of the service and price charged by the competition and so on have an impact on pricing decisions.

1. Basic principle: The foundation underlying pricing strategy can be described as a tripod with three legs named costs, competition and value to the customer. The costs to be covered set a floor to the price that may be charged for a specific product, the value of the product to customer sets a ceiling, whereas the price charged by competitors for similar or substitute products may determine where, within the ceiling to floor range, the price level should set.
   Companies seeking to make a profit must recover the full costs associated with producing and marketing a service and then add a sufficient margin to yield a

satisfactory profit. Price may also play a role in communicating the quality of service. In the absence of tangible clues customers may associate higher prices with higher levels of performance on service attributes.

2. Price Elasticity: The concept of elasticity describes how sensitive demand is to change in price. When price elasticity is “unity”, sales of service rise (or fall) by the same percentage that price falls or (rises). When a small change in price has a big impact on sales demand for that product is said to be price elastic. But when a change in price has little effect on sales, demand is described as price inelastic.
3. Consumer surplus: Economists use the term “Consumer Surplus” to define the difference between the price of customer actually pays and the greater amount he or she would have been willing to pay to obtain the desired benefits offered by the product in question. A marketer can increase the net value of a product and ‘utility’ either by adding benefits or by cutting costs (or by combination of the two). When customers evaluate competing services, they are basically comparing net values. However, perception are often highly inaccurate, so those customers may be making these comparisons based on very imperfect information. Further perceptions of benefits and costs may vary widely from one customer to another and even from one situation to another.

SERVICE BASES FOR PRICING

When determining pricing for services, it's helpful to start with a solid service base. Here’s a general framework to consider:

1. Cost Analysis:
   - Direct Costs: These include costs directly related to providing the service, such as materials, labor, and overhead.
   - Indirect Costs: These include costs that support the service but aren't directly tied to a specific job, such as utilities, rent, and administrative expenses.
2. Market Research:
   - Competitor Pricing: Check what competitors are charging for similar services. This gives you a baseline and helps ensure your prices are competitive.
   - Customer Willingness to Pay: Understand what your target customers are willing to pay. Surveys and feedback can provide valuable insights.
3. Value Proposition:
   - Unique Selling Points: Determine what makes your service unique or superior and factor that into your pricing. Services that offer additional value can command higher prices.

4. Pricing Models:
    - Hourly Rate: Charge based on the time spent delivering the service.
    - Flat Fee: Set a fixed price for the entire service, which can simplify budgeting for customers.
    - Tiered Pricing: Offer different levels of service at different price points, catering to different customer needs and budgets.
    - Subscription Model: For ongoing services, consider a subscription model where customers pay a recurring fee.
5. Profit Margin:
    - Decide on the profit margin you aim to achieve. This is typically a percentage added to the total cost of providing the service.
6. Legal and Compliance Factors:
    - Ensure your pricing complies with any relevant regulations or industry standards.
7. Pricing Flexibility:
    - Be prepared to adjust your pricing based on feedback, changes in costs, or shifts in the market.

By balancing these elements, you can set a pricing strategy that reflects the value of your service, meets market expectations, and ensures profitability.

PRICING TECHNIQUES

There are many pricing concepts and techniques which organizations may use in developing their pricing policy, including traditional and modern bases.

i. Penetration pricing: In this case the price is set at low level to attract high volume sales, thus penetrating the market and gaining substantial market share, for new products and services the payback period is lengthy but with advantage of establishing a strong marketing position.

ii. Price Skimming: Here, the supplier ‘Skims the cream’ off the market by offering a product or service at a higher price on a low volume basis. This is particularly appropriate for new products in new market situations where a proportion of consumers are always prepared to pay more for new, innovative goods. The price skimming approach can help the company to speed up the payback period.

iii. Mixed pricing: This is based on the above two pricing strategies, begin with a price skimming policy then reduce the price as competitors enter market to defend the organization’s position and attract new customers.

iv. Cost-plus pricing: Here, pricing is based on the costs of producing the good or providing the service. The total costs are computed then the price is determined by adding on some required margins or mark up. This approach has a few weaknesses in that it considers neither the competitive situation nor the market potential. Price may be set too high against those of competitors to attract customers or may not be set high enough to exploit demand, especially if the product or service it innovative new or distinctive in some way from competitive offerings.

v. Competitor Pricing: Competition -oriented pricing occurs frequently in markets where the core benefits sought are similar. Organizations need information about competitor prices to make pricing decisions. This does not necessarily mean that organizations are going to set prices at the same level, or to undercut competitors' prices even though tactical pricing battles are often seen between rival organizations or brands. Organizations operating competition-oriented pricing strategies will tend to attempt to influence consumer preference through other elements of the marketing mix such as service quality.

vi. Promotional Pricing: Sales promotion techniques often use tactical pricing reductions as a means of increasing sales over a short period. Discounts, special offers, vouchers, rebates and even buy now pay later schemes and interest free credit are all examples of promotional pricing.

vii. Differential Pricing: Another form of promotional pricing of particular concern to service marketers is differential pricing. This involves charging different prices for different customers, based on their ability to pay, period, time slot (peak season, off season etc.) and place difference (balcony and front rows in a theatre, economy and executive classes in a plane)

viii. Break Even Pricing (BEP): Breakeven analysis is a basic tool which can be used to calculate the minimum quantity of a service which must be sold to cover the cost of producing and delivering the services. In other words, to break even. Cost curves are plotted in a chart then a revenue curve can be superimposed over them, thus creating a graph which depicts the profit /loss picture for several possible cost revenue situations at different levels of services sales volume to use costs as the basis for BEP pricing decision. It is necessary for the service organization to analyze all the costs accurately. Where an organization offers a range of services, the costs for each individual service must be assessed. There are three main components which make up the costs of providing services: variable cost, fixed costs and overheads. Break-even analysis is of limited value in determining pricing policy as it is based on very simplistic assumptions about the relationship between costs, price and demand.

ix. Variable Pricing: This is particularly relevant in industrial and business -to-business markets where individual contracts are priced according to specification. Service providers like architects and consultants quote a price according to a situation which generally reflects this approach.

x. Marginal Pricing: It is based on the concept of marginal cost and is particularly relevant for service industries. The marginal costs are the o cost of the last unit of output and may be very low. For example, a unit of output for an airline could be defined as fare paying passenger so the marginal cost of the last unit of output-one extra passenger on a plane will be very low in comparison with the overall costs of fuel, maintenance, staffing costs and so on probably equal to the cost of the meal and drinks on board. Therefore, when there is spare capacity on a passenger airline, empty seats, which can be filled by passengers paying vastly reduced ticket prices are preferable to empty seats. Hence this concept is following “cost of producing/ selling” the last unit like 101st in a 100 seat.

xi. Guaranteed pricing: This is a method where the free of commission is to be paid after the results are achieved. Employment agencies charge their fees when a person gets a job. Similarly, a realtor or a real estate agent charges his commission only after the deal is made.

11.4 TYPES OF FINANCIAL SERVICES IN INDIA

Financial services in India are diverse and play a crucial role in the economic development of the country. Here’s a detailed overview of various types of financial services available in India:

1. Banking Services
    - Retail Banking: Includes services offered to individuals such as savings accounts, checking accounts, personal loans, home loans, and fixed deposits. Major retail banks include State Bank of India (SBI), HDFC Bank, and ICICI Bank.
    - Corporate Banking: Services for businesses and corporations, including business loans, trade finance, cash management, and merchant banking. Banks like Bank of Baroda and Axis Bank cater to corporate clients.
    - Investment Banking: Focuses on capital raising, underwriting, advisory services for mergers and acquisitions (M&A), and financial restructuring. Leading firms include JM Financial and Kotak Mahindra Capital Company.
2. Insurance Services

- Life Insurance: Provides financial protection against death and offers investment options. Major players include Life Insurance Corporation of India (LIC), HDFC Life, and ICICI Prudential Life Insurance.
- General Insurance: Covers risks other than life, such as health, motor, travel, and property insurance. Notable companies include Bajaj Allianz, New India Assurance, and Reliance General Insurance.
- Health Insurance: Specifically for covering medical expenses, with products like individual health plans, family floater plans, and critical

- illness plans. Key providers include Star Health & Allied Insurance and Max Bupa Health Insurance.

3. Investment Services
    - Mutual Funds: Investment vehicles pooling money from various investors to invest in a diversified portfolio of securities. Prominent mutual fund houses include SBI Mutual Fund, HDFC Mutual Fund, and UTI Mutual Fund.
    - Equity and Debt Markets: Trading and investment in stocks (equities) and bonds (debt instruments). Services include brokerage accounts and market analysis. Leading brokers are Zerodha, Angel One, and ICICI Direct.
    - Wealth Management: Personalized financial planning and investment management for high-net-worth individuals (HNWIs). Firms like IIFL Wealth Management and Edelweiss Wealth Management offer these services.
4. Asset Management
    - Portfolio Management Services (PMS): Customized investment strategies for individuals and institutions. Providers include Motilal Oswal, Kotak PMS, and Birla Sun Life.
    - Alternative Investments: Investments in assets like real estate, private equity, and hedge funds. Companies such as Blackstone and Indiareit are involved in this sector.
5. Financial Planning and Advisory
    - Financial Planning: Comprehensive planning for managing personal finances, including budgeting, retirement planning, and tax planning. Independent financial advisors and firms like Prudent Corporate Advisory and Scripbox offer these services.
    - Investment Advisory: Providing recommendations on investment opportunities, asset allocation, and market strategies. Firms like Value Research and Morningstar India provide advisory services.
6. Payment and Transaction Services
    - Digital Payments: Services for online transactions, including mobile wallets, UPI (Unified Payments Interface), and payment gateways. Major players are Paytm, Google Pay, and PhonePe.
    - Payment Processing: Solutions for merchants to accept payments through various channels like credit/debit cards, POS terminals, and online payment systems. Companies like Razorpay and CCAvenue are prominent in this space.
7. Capital Markets Services
    - Stock Exchanges: Platforms for buying and selling securities, such as the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE).
    - Clearing and Settlement: Ensuring the accurate and timely completion of transactions. Entities like the National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) facilitate these processes.

8. Microfinance

- Microloans: Small loans provided to low-income individuals or communities to support entrepreneurship and income generation. Notable organizations include SKS Microfinance (now Bharat Financial Inclusion) and Ujjivan Small Finance Bank.

9. Housing Finance

- Home Loans: Loans for purchasing or constructing residential properties. Major lenders include HDFC, LIC Housing Finance, and PNB Housing Finance.
- Real Estate Investment Trusts (REITs): Investment vehicles that pool funds to invest in real estate assets. REITs like Embassy Office Parks REIT and Mindspace Business Parks REIT are prominent.

10. Forex and Treasury Services

- Foreign Exchange Services: Currency exchange and forex trading services for individuals and businesses. Banks like SBI and private forex dealers like Thomas Cook offer these services.
- Treasury Management: Services related to managing an organization's liquidity, investments, and financial risks. Specialized services are provided by financial institutions and corporate treasuries.

11. Pension and Retirement Services

- Pension Funds: Investment plans that provide income after retirement. The Employees' Provident Fund Organization (EPFO) manages a significant portion of retirement savings in India.
- Retirement Planning Products: Includes products like annuities and retirement savings accounts. Insurance companies and mutual fund houses offer these solutions.

12. Gold and Commodity Services

- Gold Loans: Loans secured by gold as collateral. Banks like ICICI Bank and non-banking financial companies (NBFCs) like Muthoot Finance offer these services.
- Commodity Trading: Trading in physical commodities such as metals, energy, and agricultural products. Platforms like MCX (Multi Commodity Exchange) facilitate these trades.

13. Regulatory and Compliance Services

- Regulatory Compliance: Services ensuring adherence to financial regulations, reporting requirements, and corporate governance. Compliance firms and consultants like KPMG and Deloitte provide these services.

14. Financial Technology (FinTech)

- FinTech Solutions: Innovative technology solutions for financial services, including robo-advisors, blockchain applications, and AI-driven analytics. Startups like Zerodha and Policy Bazaar are leading players in this sector.

This overview captures the diverse landscape of financial services in India, highlighting the range of offerings and key players in each category.

11.5 FINANCIAL SERVICE PRICING MODLES

Financial service pricing models generally include fixed fees, percentage-based fees, and performance-based fees.

Different pricing models used in financial services:

1. Fixed Fees

Description:
- Fixed fees are a set amount charged for specific services, regardless of the size of the transaction or the amount of assets involved.

Common Uses:
- Financial planning services
- Tax preparation
- Estate planning

Advantages:
- **Predictability:** Clients know exactly how much they will pay for the service.
- **Simplicity:** Easy to understand and budget for.

Disadvantages:
- **Lack of Flexibility:** May not be cost-effective for clients with simpler needs or lower asset levels.
- **No Incentive for Extra Service:** Providers may not have an incentive to go beyond the basic service.

2. Percentage-Based Fees

Description:
- These fees are calculated as a percentage of the assets being managed, the transaction value, or other relevant metrics.

Common Uses:
- Asset management
- Investment advisory services
- Brokerage accounts

Advantages:
- **Alignment of Interests:** The fee structure aligns the interests of the advisor with those of the client since the advisor benefits from the growth of the client's assets.
- **Scalability:** Can be more cost-effective for clients with varying asset sizes, as fees grow with the asset base.

Disadvantages:

- **Potential Conflicts of Interest:** Advisors might be incentivized to increase the assets under management, potentially leading to excessive risk-taking.
- **Complexity:** The total cost can be difficult to predict, especially with fluctuating asset values.
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3. Performance-Based Fees

Description:

- Fees are based on the performance of the investment or the financial outcomes achieved, often above a certain benchmark or target.

Common Uses:

- Hedge funds
- Private equity
- Some investment advisory services

Advantages:

- **Incentives for High Performance:** Advisors have a strong motivation to maximize returns for clients.
- **Alignment with Client Goals:** Fees are tied to the success of the investment or strategy.

Disadvantages:

- **Risk of High Fees:** Clients might end up paying high fees during good performance periods, which might not be justifiable if the overall service or value isn't commensurate.
- **Short-Term Focus:** Advisors may be incentivized to achieve short-term gains at the expense of long-term strategy.

4. Hourly Fees

Description:

- Clients are billed for the actual time spent working on their financial needs, typically by the hour.

Common Uses:

- Financial planning
- Consulting services

Advantages:

- **Flexibility:** Clients pay only for the time and services they use.
- **Cost Control:** Allows clients to control costs by limiting the scope of work or the number of hours billed.

Disadvantages:

- **Uncertainty:** The total cost can be unpredictable, especially if the scope of work is not well-defined.
- **Potential for Inefficiency:** The advisor may not have the same incentive to work efficiently as they are compensated based on time.

5. Retainer Fees

Description:

- Clients pay a regular, often monthly or annual, fee for ongoing access to financial services.

Common Uses:

- Comprehensive financial planning
- Ongoing advisory services

Advantages:

- **Predictability:** Regular payments can simplify budgeting for clients.
- **Access to Services:** Clients have continuous access to their advisor and ongoing services.

Disadvantages:

- **Fixed Cost:** Clients pay regardless of the amount of service needed or received.
- **Potential Overlap:** Clients may end up paying for services they don't use or need.

6. Commission-Based Fees

Description:

- Advisors earn a commission based on the sale of financial products or services, such as insurance policies or investment products.

Common Uses:

- Insurance products
- Mutual funds
- Annuities

Advantages:

- **No Upfront Costs:** Clients often don't pay directly for the advice or product, as the advisor's compensation comes from the product provider.

Disadvantages:

- **Potential Conflicts of Interest:** Advisors may have incentives to sell products that are more profitable for them, rather than what is best for the client.
- **Lack of Transparency:** Clients may not always be aware of the cost associated with the products they purchase.

Each pricing model has its own set of benefits and drawbacks, and the choice of model often depends on the nature of the financial service, the client's preferences, and the relationship between the client and the provider.

11.6 FACTORS INFLENCING PRICING OF BANKING PRODUCTS AND SERVICES

The pricing of banking products and services in India is influenced by several factors, reflecting both market dynamics and regulatory frameworks. Here's an in-depth look at how these prices are determined:

1. Regulatory Framework
   - RBI Guidelines: The Reserve Bank of India (RBI) regulates various aspects of banking pricing, including interest rates, charges on services, and lending rates. For example, RBI guidelines on base rates and Marginal Cost of Funds-based Lending Rate (MCLR) influence how banks price loans and deposits.
   - Consumer Protection Laws: Regulations ensure transparency and fairness in pricing, requiring banks to disclose fees and charges clearly.
2. Cost of Funds
   - Deposit Rates: The interest rates banks offer on deposits are influenced by the cost of funds, which includes the interest rates they need to pay to depositors. This is influenced by the overall economic conditions, inflation rates, and monetary policy.
   - Funding Sources: Banks source funds through deposits, inter-bank borrowings, and other means. The cost of acquiring these funds impacts the pricing of products like loans and credit cards.
3. Market Competition
   - Competitive Pressure: Banks price their products based on what competitors are offering. In a highly competitive market, banks may offer lower interest rates on loans or higher interest rates on deposits to attract customers.
   - Product Differentiation: Banks may price products differently based on features, benefits, and target customer segments to differentiate themselves from competitors.
4. Risk Assessment
   - Credit Risk: The perceived risk of lending to a borrower influences the interest rate. Higher risk typically results in higher interest rates to compensate for potential defaults.
   - Operational Risk: Costs associated with managing and processing transactions, including fraud prevention and compliance, also affect pricing.
5. Economic Conditions
   - Inflation and Economic Growth: High inflation or economic instability can lead to higher interest rates. Banks adjust their pricing to reflect changes in the macroeconomic environment.

- Interest Rate Trends: The broader interest rate environment, influenced by RBI's monetary policy, affects how banks set their own interest rates for loans and deposits.

6. Cost Structure
    - Operational Costs: The cost of running banking operations, including technology, staffing, and branch maintenance, impacts the pricing of services. Higher operational costs may lead to higher fees or charges.
    - Regulatory Compliance Costs: Costs associated with adhering to regulatory requirements, including AML (Anti-Money Laundering) and KYC (Know Your Customer) norms, also affect pricing.
7. Product Features and Benefits
    - Service Differentiation: Banks offer various features with their products, such as rewards on credit cards or additional services with premium accounts. These features influence the pricing structure.
    - Customization: Tailored products and services, such as personalized loan packages or wealth management services, may come with different pricing compared to standard offerings.
8. Customer Segmentation
    - Target Customer: Pricing may vary based on the customer segment. For example, premium account holders might receive lower fees or higher interest rates on deposits compared to regular customers.
    - Volume of Business: High-net-worth individuals or large corporate clients may negotiate better rates or lower fees due to the volume of business they bring.
9. Technological Advancements
    - Digital Banking: The rise of digital banking and fintech solutions can lead to changes in pricing structures. Digital channels often reduce operational costs, which can lead to lower fees for digital transactions.
    - Automation and Efficiency: Banks leveraging technology to streamline processes might offer more competitive pricing due to reduced operational costs.
10. External Factors
    - Global Trends: Global financial trends and international interest rates can influence domestic pricing. For example, changes in global interest rates might affect domestic loan and deposit rates.
    - Political and Policy Changes: Government policies, such as changes in tax laws or financial regulations, can impact pricing structures.

Examples of Pricing Determination:

1. Loan Pricing:
    - Base Rate/MCLR: Banks use base rates or MCLR as benchmarks to determine the interest rates on loans. These rates are influenced by the cost of funds and RBI's monetary policy.

- Risk Premium: Additional risk-based pricing is applied depending on the borrower's credit profile and the loan type.

2. Deposit Pricing:
    - Interest Rates: Determined based on the cost of funds, competition, and the RBI's monetary policy. Banks might offer higher rates to attract depositors or maintain a competitive edge.
3. Credit Card Fees:
    - Annual Fees: Based on the features offered, such as rewards programs and customer service. Premium cards with additional benefits typically have higher fees.
    - Interest Rates: Reflect the risk associated with lending and the cost of funds. Higher risk borrowers may face higher interest rates.
4. ATM and Transaction Fees:
    - Operational Costs: Fees for ATM transactions and account services are set to cover operational expenses and generate revenue.

By considering these factors, banks in India set prices for their products and services in a way that balances customer attractiveness, competitive positioning, and financial sustainability.

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11.7 FACTORS INFLUENCING PRICING OF INSURANCE PRODUCTS AND SERVICES

Pricing of insurance products and services in India is a complex process involving several factors that insurers consider determining the cost of premiums and charges. Here's a detailed look at how insurance pricing is determined:

1. Risk Assessment

- **Underwriting**: Insurers evaluate the risk associated with each policyholder based on factors like age, health, occupation, and lifestyle. Higher risk profiles typically lead to higher premiums.
- **Claims History**: For renewals or some types of insurance, the policyholder's previous claims history can impact pricing. Frequent claims may result in higher premiums.

2. Product Type

- **Life Insurance**: Pricing is influenced by the sum assured, term of the policy, age, health, and lifestyle of the insured. Whole life, term life, and endowment policies have different pricing structures.
- **General Insurance**: Includes health, motor, property, and travel insurance. Premiums vary based on coverage limits, deductibles, and the insured's risk

profile. For example, motor insurance premiums depend on the vehicle's make, model, and usage.

3. Cost of Providing Coverage

- **Claims Payouts**: The expected cost of claims is a major determinant. Insurers use historical data and actuarial models to estimate potential payouts and set premiums accordingly.
- **Operational Costs**: Expenses related to policy administration, customer service, and marketing are factored into pricing. Higher operational costs can lead to higher premiums.

4. Regulatory Requirements

- **IRDAI Guidelines**: The Insurance Regulatory and Development Authority of India (IRDAI) regulates insurance pricing. Insurers must adhere to regulations regarding minimum coverage, policy terms, and transparency in pricing.
- **Standardized Products**: For certain products like motor insurance, regulatory norms may set minimum coverage requirements and standardize certain aspects of pricing.

5. Market Competition

- **Competitive Pricing**: Insurers adjust their pricing based on the competitive landscape. To attract customers, insurers might offer discounts, bundled policies, or lower premiums.
- **Product Differentiation**: Pricing may vary based on additional features or benefits included in the policy. Policies with more comprehensive coverage or added benefits might have higher premiums.

6. Actuarial Science

- **Actuarial Models**: Actuaries use statistical models and historical data to predict future claims and set premiums. These models account for various risk factors and help determine the appropriate pricing to ensure financial stability.
- **Mortality and Morbidity Tables**: In life and health insurance, actuaries use tables that estimate the likelihood of death or illness to set premiums accordingly.

7. Sum Assured and Coverage

- **Sum Assured**: Higher sum assured, or coverage limits generally lead to higher premiums. For life insurance, the sum assured is the amount payable upon death or maturity.
- **Policy Features**: Additional features like riders (e.g., critical illness or accidental death benefits) can increase the premium.

8. Investment Returns

- **For Unit Linked Insurance Plans (ULIPs)**: Premiums are influenced by expected returns on investments. Insurers factor in the performance of underlying investments when determining premiums and charges.

9. Economic and Market Conditions

- **Inflation**: Inflation impacts the cost of healthcare, repair costs, and overall risk, influencing insurance pricing.
- **Interest Rates**: For life insurance, the returns on investments and the cost of holding reserves are affected by interest rates, impacting the pricing of policies.

10. Customer Segmentation

- **Age and Health**: Premiums are higher for older individuals or those with pre-existing health conditions due to higher risk.
- **Lifestyle Choices**: Factors like smoking, high-risk occupations, or frequent travel can lead to higher premiums.

Examples of Insurance Pricing:

1. **Health Insurance**:

- **Premium Calculation**: Based on age, health condition, coverage amount, and policy term. Insurers might offer discounts for wellness checks or no-claims bonuses.

2. **Motor Insurance**:

- **Premium Calculation**: Factors include the vehicle's age, make and model, the insured's driving history, and the coverage type (comprehensive vs. third-party).

3. **Life Insurance**:

- **Premium Calculation**: Based on the sum assured, age, health, and the policy term. Whole life policies typically have higher premiums compared to term insurance.

4. **Travel Insurance**:

- **Premium Calculation**: Based on travel duration, destination, and coverage options (medical emergencies, trip cancellations).

Insurance companies in India strive to balance competitive pricing with financial sustainability. They use sophisticated modeling and analysis to set prices that cover expected claims while remaining attractive to customers.

11.8 FACTORS INFLUENCING THE PRICING OF HOUSING FINANCE INDUSTRY IN INDIA

In the housing finance industry in India, pricing is determined by several factors that affect both the cost of borrowing and the structure of the financial products offered. Here's a detailed look at how pricing is determined for housing finance products, such as home loans:

1. Cost of Funds

- **Interest Rates**: Housing finance companies (HFCs) and banks determine their lending rates based on their cost of funds. This includes the interest rates they pay on deposits, borrowings, and other sources of capital.
- **Funding Sources**: The mix of funding sources, including deposits, borrowings from other financial institutions, and bond issuances, influences the pricing of home loans. Higher costs in raising funds can lead to higher lending rates.

2. Base Rate/Marginal Cost of Funds-based Lending Rate (MCLR)

- **Benchmark Rates**: Banks use benchmark rates like the Base Rate or MCLR to set their lending rates. MCLR is the minimum interest rate below which banks cannot lend, and it is revised periodically based on changes in the cost of funds.
- **Spread**: The actual interest rate charged to borrowers is the benchmark rate plus a spread that reflects the lender's margin and risk considerations.

3. Credit Risk Assessment

- **Borrower's Credit Profile**: The interest rate on a home loan is influenced by the borrower's credit score, income, job stability, and existing financial liabilities. Higher credit risk generally results in higher interest rates.
- **Loan-to-Value (LTV) Ratio**: The ratio of the loan amount to the property value impacts pricing. A higher LTV ratio indicates higher risk, which can lead to higher interest rates or additional insurance requirements.

4. Loan Tenure

- **Short vs. Long Tenure**: Interest rates may vary based on the loan tenure. Generally, shorter tenure loans might have lower interest rates compared to longer tenure loans, as the risk is lower for lenders.

5. Product Type and Features

- **Fixed vs. Floating Rates**: Fixed-rate loans have constant interest rates throughout the tenure, often resulting in higher initial rates compared to floating-rate loans, which fluctuate based on market conditions.

- **Prepayment and Foreclosure Charges**: Loans with flexible prepayment and foreclosure options might have slightly higher interest rates to compensate for the potential loss of future interest income.

6. Market Conditions

- **Economic Factors**: Inflation rates, monetary policy, and overall economic conditions affect interest rates. For example, during high inflation or economic instability, interest rates may rise.
- **Monetary Policy**: Decisions by the Reserve Bank of India (RBI) on repo rates and other monetary policies influence the cost of funds for HFCs and banks, impacting home loan rates.

7. Regulatory Guidelines

- **RBI Regulations**: The RBI's guidelines on lending rates, risk management, and consumer protection impact pricing strategies. For instance, RBI guidelines on MCLR affect how banks price their home loans.
- **Housing Finance Regulations**: Specific regulations governing housing finance companies, such as capital adequacy norms and liquidity requirements, can influence pricing.

8. Competition and Market Dynamics

- **Competitive Pressure**: Housing finance companies and banks adjust their pricing based on competitive pressures. To attract customers, they may offer lower interest rates, processing fee waivers, or other incentives.
- **Promotional Offers**: Seasonal promotions, tie-ups with real estate developers, or special offers for certain customer segments can affect pricing.

9. Operational Costs

- **Processing and Administrative Costs**: The costs associated with loan processing, documentation, and servicing are factored into the pricing. Higher operational costs can lead to higher fees or charges.
- **Risk Management Costs**: Costs related to managing credit risk, including loan monitoring and collection, also impact pricing.

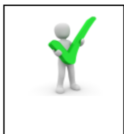
10. Loan Size and Structure

- **Loan Amount**: The size of the loan can influence pricing. Larger loans might have different pricing structures compared to smaller ones, reflecting the associated risk and cost.
- **Repayment Structure**: Pricing may also be influenced by the repayment structure, such as EMI options (fixed or variable) and the flexibility of repayment terms.

Examples of Pricing Determination:

1. **Interest Rates**:
   - **Base Rate/MCLR Plus Margin**: For example, if the MCLR is 8% and the margin is 1%, the effective interest rate for the borrower would be 9%.
   - **Fixed vs. Floating Rates**: A fixed-rate home loan might be priced at 10% per annum, while a floating-rate loan might be linked to MCLR plus a spread.
2. **Processing Fees**:
   - **Fees**: Processing fees are usually 0.5% to 1% of the loan amount and cover the cost of processing the application and documentation.
3. **Prepayment Charges**:
   - **Charges**: Prepayment or foreclosure charges can vary but are typically around 2% to 5% of the outstanding loan amount, depending on the terms agreed upon.
4. **Insurance and Other Costs**:
   - **Insurance Premiums**: Some lenders require borrowers to take property insurance or life insurance, which can add to the overall cost of the loan.

By considering these factors, housing finance companies and banks set prices for home loans that reflect their cost structures, risk assessments, and competitive strategies while ensuring compliance with regulatory requirements.



Check Your Progress-A

1. What does the Base rate represent in banking?
   a) The maximum interest rate that banks can charge
   b) The interest rate set by RBI on short term loans
   c) The average interest rate on deposits
   d) The minimum interest rate set by banks below which they cannot lend
2. Which of the following best describes an Expense Ratio in mutual funds?
   a) The percentage of the fund's assets that is used for marketing
   b) The annual fees as a percentage of average assets under management covering operational costs
   c) The percentage of returns paid to investors
   d) The fee charged for buying and selling mutual funds units
3. What is Performance Fee in investment service?
   a) A fee paid to the fund manager based on the total assets under management.
   b) A flat fee charged regardless of the investment's performance
   c) A fee based on the return achieved by an investment, often a percentage of profits over a benchmark
   d) A one-time fee for setting up an investment account.

4. Which fee is typically charged when a borrower repays their loan before the scheduled time?
   a) Processing fees
   b) Risk premium
   c) Prepayment charges
   d) Management fee

11.9 FACTORS INFLEUNCING PRICING OF INVESTMENT SERVICES

The pricing of investment services in India involves various considerations depending on the type of investment product or service being offered. Here's a detailed overview of how pricing is determined in the investment services industry:

1. Investment Products

- **Mutual Funds**
  - **Expense Ratio**: This is a key factor in mutual fund pricing. It typically ranges from 0.5% to 2.5% of assets under management (AUM) annually. It includes management fees, administrative costs, and other operational expenses.
  - **Entry and Exit Loads**: Some mutual funds charge a fee when buying (entry load) or selling (exit load) units. For example, entry loads were abolished in 2009, but exit loads can still apply, generally ranging from 0% to 3% depending on the fund and holding period.
  - **Management Fees**: These are fees paid to fund managers for their services and are included in the expense ratio. They are calculated as a percentage of the AUM.
- **Equity and Debt Instruments**
  - **Brokerage Fees**: Charged by brokers for buying or selling stocks or bonds. This can be a flat fee or a percentage of the transaction value, typically ranging from 0.1% to 0.5% of the trade value.
  - **Transaction Charges**: Exchanges like NSE and BSE may levy transaction charges on trades, which are generally a small percentage of the trade value.
- **Portfolio Management Services (PMS)**
  - **Management Fees**: Typically charged as a percentage of assets under management, ranging from 1% to 2% annually.
  - **Performance Fees**: Some PMS providers charge a performance fee based on the returns generated over a benchmark, usually around 10% to 20% of the excess returns above a predefined benchmark.
- **Real Estate Investment Trusts (REITs)**

- **Management Fees**: Fees paid to the REIT manager, which can range from 0.5% to 1.5% of AUM annually.
- **Acquisition Fees**: Charged for acquiring new properties, usually a percentage of the property value.
- **Other Operational Costs**: Include maintenance, property management fees, and administrative costs.

2. Investment Advisory Services

- **Advisory Fees**: Financial advisors typically charge a fee for their services, which can be a flat fee, hourly rate, or a percentage of assets under management (usually 0.5% to 1.5% annually).
- **Commission-Based Fees**: Some advisors earn commissions from financial products they recommend, which can influence their advice. This is often a percentage of the investment amount or transaction value.

3. Wealth Management

- **Service Fees**: Wealth management firms often charge fees based on a percentage of the client's AUM, ranging from 0.5% to 1.5% annually.
- **Performance Fees**: Like PMS, some wealth managers charge performance fees based on returns achieved over a benchmark.

4. Investment Platforms

- **Account Maintenance Fees**: Online trading platforms may charge annual or monthly fees for maintaining a trading account, typically ranging from ₹500 to ₹2,000.
- **Transaction Fees**: Fees for buying and selling securities on trading platforms, which can be a flat fee or a percentage of the transaction amount.
- **Custodian Fees**: Charged for holding and managing investment assets, typically a small percentage of the value of assets under custody.

5. Alternative Investments

- **Private Equity and Venture Capital**: Pricing involves management fees, usually around 2% annually of committed capital, and performance fees, which can be around 20% of profits above a hurdle rate.
- **Hedge Funds**: Typically charge management fees of 1% to 2% of AUM and performance fees of 15% to 20% of returns above a specified benchmark.

6. Regulatory and Market Influences

- **SEBI Regulations**: The Securities and Exchange Board of India (SEBI) regulates various aspects of investment pricing, including disclosure requirements for mutual funds, advisory services, and other investment products.

- **Market Conditions**: Economic factors, interest rates, and market volatility can influence pricing. For instance, higher market volatility might lead to higher trading fees or wider bid-ask spreads.

7. Cost of Services

- **Operational Costs**: Investment firms factor in their operational expenses, including technology costs, staffing, and compliance, which influence pricing structures.
- **Research and Analysis Costs**: Investment firms that offer research and analysis services include these costs in their pricing models, which can affect management and advisory fees.

Examples of Pricing Determination:

1. **Mutual Funds**:
   - **Expense Ratio**: If a mutual fund has an expense ratio of 1.5%, and the AUM is ₹100 crore, the annual cost would be ₹1.5 crore.
   - **Performance Fees**: A fund with a performance fee of 10% might charge this fee on returns exceeding a specified benchmark.
2. **Equity Brokerage**:
   - **Brokerage Fees**: A broker might charge 0.2% of the transaction value for buying or selling shares. For a ₹1 lakh transaction, the brokerage fee would be ₹200.
3. **PMS**:
   - **Management Fees**: A PMS provider charging 1% annually on ₹10 crore AUM would earn ₹10 lakh per year in management fees.
   - **Performance Fees**: If the performance fee is 15% of returns above a benchmark, and the excess return is ₹50 lakh, the fee would be ₹7.5 lakh.
4. **Wealth Management**:
   - **Service Fees**: A wealth manager charging 1% annually on ₹5 crore of AUM would earn ₹5 lakh per year.

Investment services pricing in India reflects a balance between costs, competitive pressures, regulatory requirements, and the value provided to clients. Providers must consider these factors to set competitive yet sustainable pricing structures.

11.10 SUMMARY

Pricing in the financial services industry in India is determined by a complex interplay of factors across various sectors. For banking products, pricing is influenced by the cost of funds, regulatory guidelines, and market competition. Interest rates on loans and deposits are shaped by benchmarks like the Base Rate and MCLR, while operational and credit risks also play a role. Insurance pricing, on the other hand, is driven by risk assessment through underwriting, regulatory requirements set by IRDAI, and the cost of claims and operational expenses. Products like mutual funds include expense ratios and management fees, while insurance premiums reflect factors such as the insured's health and coverage details. Housing finance pricing considers the cost of funds, benchmark rates like MCLR, borrower credit profiles, and regulatory influences. Investment services, including mutual funds and portfolio management, have management fees, transaction charges, and performance-based fees. Overall, each sector balances regulatory compliance, market dynamics, and operational costs to set competitive and sustainable pricing structures.

Financial service pricing models generally include fixed fees, percentage-based fees, and performance-based fees. Fixed fees are set amounts charged for specific services, percentage-based fees are typically a percentage of assets under management or transaction values, and performance-based fees are tied to the results achieved, often used in investment management. Each model has its ultimate advantages and considerations depending on the service and client needs.

11.11 GLOSSARY

Base Rate: The minimum interest rate set by banks below which they cannot lend. It serves as a benchmark for determining loan interest rates.

Expense Ratio: The annual fee expressed as a percentage of a fund’s average assets under management (AUM) that covers operational costs, including management fees.

Fee-for-Service: A pricing model where clients pay a fixed fee for specific financial services or advice, rather than a percentage of assets under management.

Management Fee: The fee charged by fund managers or portfolio managers for managing an investment fund or portfolio, usually expressed as a percentage of AUM.

MCLR (Marginal Cost of Funds-based Lending Rate): The benchmark interest rate used by banks to determine lending rates, based on the marginal cost of funds.

Performance Fee: A fee charged by fund managers based on the returns achieved by the investment fund, often a percentage of profits over a benchmark.

Prepayment Charges: Fees charged by lenders if a borrower repays their loan early, compensating the lender for lost interest income.

Processing Fee: A one-time fee charged by lenders or financial institutions for processing loan applications or other services.

Risk Premium: An additional charge added to the base interest rate to compensate for the risk associated with a borrower or investment.

Transaction Fee: A fee charged for executing trades or transactions, typically applied to brokerage accounts or investment platforms.

11.12 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (d), 2 (b), 3 (c), 4 (c)

11.13 REFERENCES

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11.14 SUGGESTED READINGS

1) https://www.rbi.org.in
2) https://www.sebi.gov.in/
3) https://irdai.gov.in/

11.15 TERMINAL QUESTIONS

1. Explain the pricing techniques used in the Service Industry.
2. Explain how the cost of funds impacts the pricing of home loan in India.
3. Explain various types of Financial Service Pricing Models.
4. Discuss the role of regulatory guidelines in shaping the pricing of insurance products in India.

11.16 CASE STUDY IN PRICING OF HOUSING FINACE IN INDIA

In India, the pricing of housing finance has evolved significantly in response to changing economic conditions and regulatory frameworks. A notable case study is the impact of the implementation of the Marginal Cost of Funds-based Lending Rate (MCLR) system by banks. Prior to MCLR, the Base Rate system was used, which did not account for the varying costs of funds over time. With MCLR, banks now adjust their lending rates based on the marginal cost of acquiring funds, which includes factors such as deposit rates, borrowing costs, and market conditions. For instance, a prominent bank introduced a home loan rate of MCLR + 0.50% to attract borrowers in a competitive market. This shift allowed for more flexible and responsive pricing, aligning rates with the current cost of funds and economic conditions. Additionally, the Reserve Bank of India's monetary policy decisions, such as repo rate changes, directly influence MCLR, thereby affecting the cost of housing loans. This case illustrates how regulatory changes and market dynamics interplay shape housing finance pricing, ultimately benefiting consumers with more competitive and transparent interest rates.

UNIT 12 MARKETING OF FINANCIAL SERVICES

12.1 INTRODUCTION

India's financial services sector is a crucial component of the nation's economy, encompassing a wide range of services provided by banks, insurance companies, investment firms, and fintech startups. This sector includes traditional banking services such as savings and checking accounts, loans, and mortgages, as well as non-banking financial services like insurance, mutual funds, and wealth management. The emergence of fintech companies has further expanded this landscape, introducing innovations such as digital wallets, peer-to-peer lending platforms, and robo-advisors.

The sector is characterized by its diversity, with a mix of large, established institutions and agile startups. The sheer scale and scope of financial services in India reflect its importance in supporting economic growth, facilitating investment, and managing financial risks.

India's financial services market has experienced significant growth over the past two decades, driven by economic reforms, increased financial inclusion, and technological advancements. The sector's growth is underpinned by several key factors:

1. Economic Growth: India's robust economic growth has expanded the middle class and increased disposable incomes, leading to higher demand for financial products and services.
2. Financial Inclusion: Initiatives such as Pradhan Mantri Jan Dhan Yojana (PMJDY) have dramatically increased access to banking services for underserved populations, creating new customer segments.
3. Digital Transformation: The rise of digital technologies, including mobile banking, online investing, and digital payments, has revolutionized how financial services are delivered and consumed.
4. Investment and Savings Culture: Growing awareness and investment in financial planning and wealth management have spurred demand for a wide range of financial products.

   The marketing of financial services in India is a dynamic field, influenced by economic trends, technological advancements, and regulatory frameworks. Understanding the landscape of this sector, along with effective marketing strategies, is essential for financial institutions aiming to thrive in this competitive and evolving market.

12.2 OBJECTIVES

After reading the unit, the learner shall be able to understand;

- Segmentation of Financial Service Industry
- Marketing Models
- Financial Market Strategy
- Marketing Mix for Financial Services

12.3 MEANING OF FINANCIAL SERVICE MARKETING

Financial services marketing refers to the strategies and practices used to promote and sell financial products and services, such as banking services, insurance, investment products, and financial planning. This type of marketing is designed to attract new customers, retain existing ones, and build a strong brand presence in a competitive and heavily regulated industry.

Key Components of Financial Services Marketing

1. Understanding the Market:
    a. Market Research: Analyzing market trends, customer needs, and competitive landscape to identify opportunities and threats.
    b. Customer Segmentation: Dividing the market into distinct groups based on demographics, psychographics, behaviors, and needs to tailor marketing efforts effectively.
2. Product and Service Offerings:
    a. Product Development: Designing financial products and services that meet the specific needs of target segments, such as tailored insurance policies or customized investment portfolios.
    b. Value Proposition: Clearly communicating the benefits and unique features of financial products, such as high returns, low fees, or comprehensive coverage.
3. Branding and Positioning:
    a. Brand Identity: Creating a strong brand image that conveys trust, reliability, and expertise. This includes brand name, logo, and messaging.
    b. Market Positioning: Differentiating the financial services from competitors through unique selling points, such as innovative features, customer service excellence, or competitive pricing.
4. Marketing Channels and Communication:
    a. Digital Marketing: Utilizing online platforms such as social media, search engine marketing (SEM), and content marketing to reach and engage customers.
    b. Traditional Marketing: Employing traditional media like television, print, and radio to build brand awareness and drive customer acquisition.
    c. Direct Marketing: Personalized communication through emails, newsletters, and direct mail to target specific customer segments.
5. Sales and Customer Acquisition:
    a. Lead Generation: Attracting potential customers through various marketing tactics, including referrals, promotions, and online campaigns.

   b. Sales Strategies: Implementing effective sales processes and techniques to convert leads into customers, such as consultative selling or providing personalized financial advice.

6. Customer Relationship Management (CRM):
   a. Customer Service: Providing exceptional support and service to address customer queries and concerns, fostering loyalty and satisfaction.
   b. Retention Strategies: Implementing loyalty programs, regular communication, and personalized offers to retain existing customers and encourage repeat business.
7. Compliance and Regulation:
   a. Regulatory Adherence: Ensuring all marketing practices comply with financial regulations and standards set by regulatory bodies like the Reserve Bank of India (RBI) or Securities and Exchange Board of India (SEBI).
   b. Disclosure and Transparency: Providing clear and accurate information about financial products and services to avoid misleading customers.
8. Performance Measurement and Analytics:
   a. Tracking Metrics: Measuring the effectiveness of marketing campaigns through key performance indicators (KPIs) such as customer acquisition cost, conversion rates, and return on investment (ROI).
   b. Data Analysis: Analyzing customer data and campaign performance to refine strategies and improve marketing efforts.

Objectives of Financial Services Marketing

1. Attract New Customers: Increasing the customer base by reaching out to potential clients and showcasing the benefits of the financial products.
2. Enhance Customer Retention: Building strong relationships with existing customers to encourage continued use of services and foster loyalty.
3. Build Brand Awareness: Establishing a recognizable and trustworthy brand in the financial services market.
4. Educate and Inform: Providing valuable information to help customers make informed financial decisions and understand the benefits of various products.

Effective financial services marketing requires a deep understanding of customer needs, a strategic approach to product and service development, and a commitment to maintaining high standards of customer service and compliance.

CHARACTERSTICS OF FINANCIAL PRODUCTS AND SERVICES

Financial products and services possess distinct characteristics that differentiate them from other types of products and services:

1. Intangibility: Financial products, like insurance policies and investment funds, are not physical items; they represent promises or contracts.
2. Risk and Uncertainty: They often involve varying degrees of risk and uncertainty, such as market fluctuations for investments or potential claims for insurance.
3. Regulation: Financial products are heavily regulated to protect consumers and ensure market stability, requiring compliance with laws and guidelines.
4. Complexity: Many financial products are complex, requiring thorough understanding and careful consideration, such as mortgage terms or investment portfolios.
5. Customization: They can be tailored to individual needs and financial goals, such as personalized investment strategies or insurance coverage options.
6. Long-term Orientation: Financial services often involve long-term commitments, like retirement planning or loans with extended repayment periods.
7. Interconnectedness: Financial products are frequently interconnected, affecting and being affected by broader economic factors and other financial products.
8. Value Proposition: They promise future value, whether through potential returns, risk protection, or liquidity, which is a key factor in their appeal.

12.4 WHO USES FINANCIAL SERVICES?

Financial services are used by a wide range of individuals and entities, including:

1. Individuals: People use financial services for personal banking, investment, insurance, retirement planning, and credit. This includes everyday consumers managing savings accounts, mortgages, car loans, and health or life insurance.

2. Businesses: Companies utilize financial services for managing cash flow, securing loans, investing in growth, and handling payroll. They also use services like corporate insurance and treasury management.

3. Institutional Investors: Organizations such as pension funds, mutual funds, and hedge funds invest in financial markets to achieve returns and manage large-scale investment portfolios.

4. Government Entities: Governments use financial services for budgeting, issuing bonds, and managing public funds. They also regulate and oversee financial markets and institutions.

5. Nonprofit Organizations: Charities and other nonprofit entities use financial services to manage donations, investments, and operational funds.

6. Financial Institutions: Banks, insurance companies, investment firms, and fintech companies themselves use financial services for internal financial management, compliance, and risk management.

Each group has unique needs and goals, which financial services are designed to meet through a diverse range of products and solutions.

12.5 SEGMENTATION OF FINANCIAL SERVICE INDUSTRY

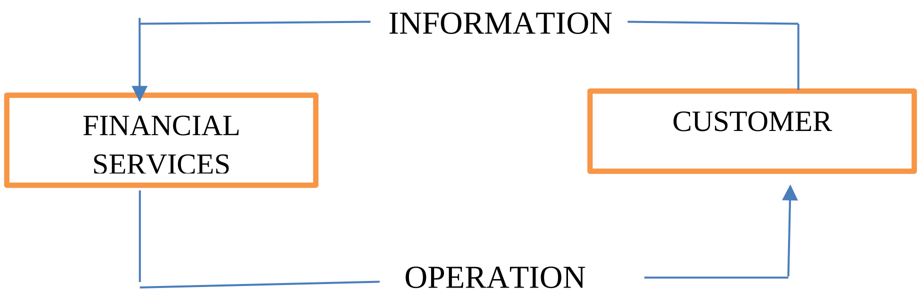
Segmentation of financial services involves dividing the market into distinct groups based on specific criteria to tailor offerings effectively. Key segmentation strategies include:

1. **Demographic Segmentation**: Based on age, income, education, and occupation. For example, retirement plans target older adults, while student loans focus on younger individuals.
2. **Geographic Segmentation**: Differentiates services by location, such as urban vs. rural areas or specific regions, to address local economic conditions and needs.
3. **Psychographic Segmentation**: Considers lifestyle, values, and interests. For instance, high-net-worth individuals may prefer wealth management services, while eco-conscious clients might be interested in sustainable investment options.
4. **Behavioral Segmentation**: Based on customer behaviors, such as spending habits, loyalty, or financial goals. This includes targeting frequent investors or customers with a high propensity for digital banking.
5. **Firmographic Segmentation**: For business financial services, segmentation is based on company size, industry, or financial status, tailoring products like business loans or corporate insurance to specific business needs.

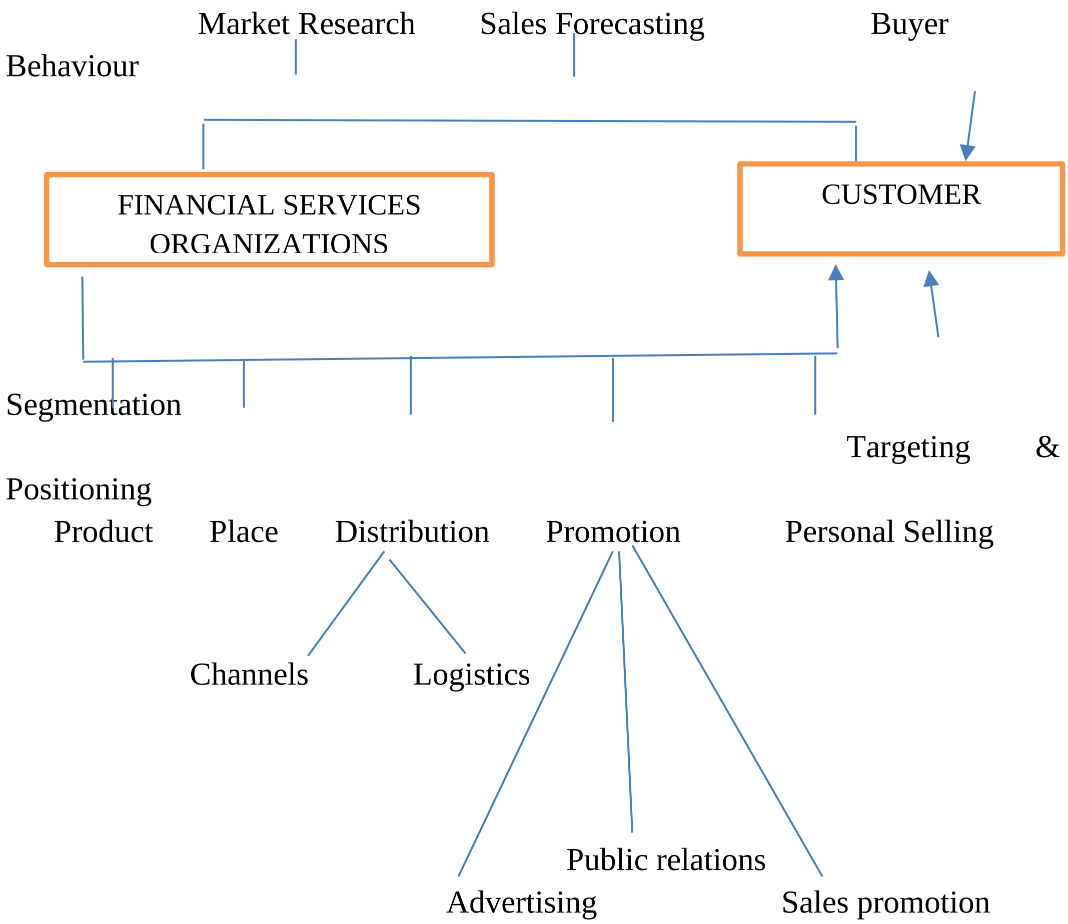
These segmentation approaches help financial institutions customize their offerings and marketing strategies to meet the diverse needs of different customer groups.

12.6 MARKETING MODELS

This is a simple diagrammatic representation of marketing. Information is gathered from customers to ensure that the products and services offered meet their needs.



Let's enhance this model to include the components of a financial service organization and integrate the elements of the marketing mix.



The bottom part of this diagram shows the elements of the marketing mix that the organization controls. These elements are adjusted to meet customer needs. Customers are grouped based on their different needs, allowing for targeted communication.

The top part of the diagram represents the information collected from customers through market research. Sales forecasting, which is crucial for marketing, relies on this data to predict future buying behaviors.

12.7 FINANCIAL MARKETING STRATEGY

The beginning of the decade 1980s brought a significant change in the concept of financial service marketing. The advent of electronic fund transfer system probably in the late 1970s, made possible Induction of Automated Teller Machines (ATMs). Direct deposit of payroll. Pay by phone system, points of sale systems, credit and debit cards, preauthorized funds transfer and automated clearing houses.

Hence, it is right to say that automation made possible a transformation in the nature and character of financial services. Thus, the new concept of bank marketing assigned due weightage to customer satisfaction. In a true sense, the hallmark of the changed concept aimed at having a full view of customer's needs, fulfilling the identification of potential customers based on market segmentation.

Creating a brand: Branding and effective advertising are two strategies which can play a decisive role. While branding helps the investor distinguish one product from another. Advertising enables the marketer to communicate based on information that an investor requires in selecting a particular product. Branding is to two types-individual branding which is one time affair like the Reliance Public Issue " Khazana" or Umbrella branding, the practice of labelling more than one product with a single brand name, e.g., Citibank's Citihome, Citimobile etc.

Developing a brand requires a great deal of long-term investment, especially advertising, promotion etc. It is quite an expensive proposition and hence it is worthwhile mostly for large public issues or long-term plans like a bank's schemes.

1. Developing the profile of target segment: Developing a target segment profile for banks or financial institutions involves creating a detailed representation of a specific customer group to tailor products, services, and marketing strategies effectively. Here's a step-by-step guide to creating this profile:
   a. Define the Segment
   b. Segment Name: Assign a name to the segment based on its characteristics, such as Young Professionals" or "High-Net-Worth Individuals."

2. Demographic Characteristics

   a. Age Range: Define the age group, e.g., 25-35 years.
   b. Gender: Note if the segment is gender-specific or balanced.
   c. Income Level: Specify income brackets, e.g., ₹5-15 lakhs per annum.

d. Occupation: Identify common professions or industries, e.g., IT professionals, entrepreneurs.
e. Education Level: Indicate typical educational qualifications, e.g., postgraduates or MBAs.

3. Geographic Characteristics

a. Location: Identify where the segment is based, e.g., metropolitan cities like Mumbai, Delhi, or Bangalore.
b. Urban/Rural: Determine if the segment is primarily urban or rural.

4. Psychographic Characteristics

a. Lifestyle: Describe the lifestyle preferences, e.g., tech-savvy, frequent travelers.
b. Values: Identify core values, such as sustainability or financial security.
c. Interests: Note interests relevant to financial products, e.g., investment opportunities, luxury goods.

5. Behavioral Characteristics

a. Financial Behavior: Outline behaviors such as savings habits, investment tendencies, or loan usage.
b. Product Usage: Specify how frequently they use financial products, e.g., daily online banking, occasional investments.
c. Customer Needs: Identify key needs and pain points, such as high returns, easy credit, or comprehensive insurance.

6. Market Needs and Preferences

a. Product Preferences: Detail preferred products and services, e.g., high-yield savings accounts, credit cards with travel perks.
b. Service Expectations: Outline expectations regarding customer service, e.g., 24/7 support, personalized advice.

7. Communication Preferences

a. Preferred Channels: Identify preferred communication channels, e.g., mobile apps, email, social media.
b. Content Type: Determine the type of content that resonates, e.g., educational articles, promotional offers.

8. Competitive Positioning

a. Current Providers: Note existing financial institutions serving this segment.
b. Differentiators: Highlight what differentiates your offerings, such as unique features or better customer service.

9. Create the Profile

Combine the above characteristics into a detailed profile. For example:

Segment Profile: Young Professionals

Age Range: 25-35 years

Income Level: ₹5-15 lakhs per annum

Occupation: IT professionals, consultants, young entrepreneurs

Location: Metropolitan cities (Mumbai, Delhi, Bangalore)

Lifestyle: Tech-savvy, frequent travelers, career-focused

Values: Financial security, personal growth, technology adoption

Interests: Investment opportunities, luxury experiences

Financial Behavior: Regularly invests in mutual funds, uses credit cards frequently, saves for short-term goals

Product Preferences: High-yield savings accounts, travel credit cards, investment advisory services

Service Expectations: 24/7 online banking, personalized financial planning

Preferred Channels: Mobile apps, social media, email newsletters

Competitive Positioning: Offers cutting-edge digital banking features and exclusive investment opportunities

This profile helps banks and financial institutions tailor their product offerings, marketing strategies, and customer engagement efforts to effectively meet the needs of the target segment.

12.8 MARKETING MIX FOR THE FINANCIAL SERVICES

The marketing mix for the financial services aims to market the financial services and schemes profitably. Generally, the need and requirements, the likes and dislikes the preferences attitudes and expectations and lifestyle remain dynamic. There are several factors influencing the process of change. Today we sell credibility and therefore a basic change in the perception of marketing is quite natural. This is essential for fulfilling the increasing level of expectations and even for increasing market share. The marketing mix, a combination of different sub mix mainly include the product mix, promotion mix, the price mix and the place mix found significant even to the banking organization. To be more specific in the service providing organizations, employees looking impressive, smart and having aesthetic sense are found more effective in attracting the customers. In the corporate world, the personal care dimension thus becomes important.

- The Financial Product Mix: While designing service mix the financial institutions can follow two guidelines, the first is related to the processing of product to market needs and the second is concerned with the processing of market needs to product. The needs of the target market are anticipated and visualized. In the second process the bank reacts to expressed needs and therefore we consider it reactive. This is because no customer would buy a product which contains technical faults. Technical perfection in service includes prompt delivery, quick disposal and presentation of right facts and figures, right filling and proper documentation and so on. A sound Portfolio creates a conductive environment and succeeds in increasing the sensitivity of marketing decisions and customer segments, The financial institutions must have a sound product portfolio and the banker is responsible for getting it done suitably and effectively.

- New Financial Product Development: New financial product development involves creating innovative financial products and services that meet the evolving needs of customers and adapt to market trends. This process requires a structured approach to ensure that new products are viable, competitive, and aligned with customer expectations.

Here's a comprehensive guide to new financial product development:

A. Market Research and Analysis
   a. Identify Market Needs: Conduct research to understand emerging customer needs, gaps in existing products, and new trends. Use surveys, focus groups, and industry reports.
   b. Competitive Analysis: Analyze competitors to identify their offerings, strengths, and weaknesses. Determine what differentiates their products and identify opportunities for innovation.

B. Idea Generation
   a. Brainstorming: Generate ideas for new products through brainstorming sessions with cross-functional teams, including marketing, finance, and technology.
   b. Customer Feedback: Gather insights from existing customers to identify their pain points and desired features.
   c. Industry Trends: Explore new technologies, regulatory changes, and market trends to inspire product ideas.

C. Concept Development
   a. Define Product Concept: Outline the core idea of the product, including its purpose, target market, and key features.
   b. Feasibility Study: Assess the technical and financial feasibility of the concept, including required resources, potential costs, and expected returns.
   c. Business Case: Develop a business case that includes market potential, revenue projections, cost estimates, and risk assessment.

D. Design and Development
   a. Product Design: Create detailed product specifications, including features, benefits, and customer experience aspects.

   b. Prototyping: Develop a prototype or pilot version of the product to test its functionality and gather initial feedback.
   c. Regulatory Compliance: Ensure the product complies with relevant regulations and standards set by authorities like the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), and Insurance Regulatory and Development Authority of India (IRDAI).

E. Testing and Refinement
   a. Market Testing: Conduct market testing with a select group of customers to validate the product concept and identify areas for improvement.
   b. Feedback Integration: Analyze feedback from testing phases and make necessary adjustments to the product design, features, or pricing.
   c. Risk Management: Evaluate and mitigate potential risks associated with the product, including operational, financial, and reputational risks.

F. Go-to-Market Strategy
   a. Pricing Strategy: Determine the pricing structure based on cost, market demand, and competitive positioning. Consider introductory offers or discounts to attract early adopters.
   b. Distribution Channels: Select appropriate distribution channels, such as digital platforms, branches, or partnerships, to reach the target audience effectively.
   c. Marketing and Promotion: Develop a marketing strategy that includes advertising, promotions, content marketing, and public relations to create awareness and drive adoption.

G. Launch and Implementation
   a. Product Launch: Execute the launch plan, including rollout activities, promotional campaigns, and customer onboarding.
   b. Training and Support: Provide training for sales and support teams to ensure they can effectively communicate the benefits and features of the new product.
   c. Customer Support: Establish support mechanisms to assist customers with inquiries, issues, or feedback related to the new product.

H. Post-Launch Evaluation

a. Performance Monitoring: Track key performance indicators (KPIs) such as sales volume, customer satisfaction, and market share to evaluate the product's success.
b. Continuous Improvement: Gather ongoing feedback from customers and stakeholders to identify areas for improvement and make iterative updates to the product.
c. Market Adaptation: Adapt the product or marketing strategy based on market changes, emerging trends, or new customer needs.

Examples of New Financial Products

a. Digital Wallets: Mobile apps that allow users to store payment information, make transactions, and manage finances digitally.
b. Robo-Advisors: Automated investment platforms that provide personalized financial advice and portfolio management using algorithms.

c. Customized Insurance Plans: Flexible insurance products that offer tailored coverage options based on individual needs and preferences.
d. Blockchain-Based Solutions: Financial products utilizing blockchain technology for secure, transparent transactions and smart contracts.

Key Considerations

i. Innovation and Differentiation: Focus on creating unique features or benefits that differentiate the product from existing offerings.
ii. Regulatory Compliance: Ensure adherence to financial regulations and industry standards to avoid legal issues and build customer trust.
iii. Customer-Centric Approach: Prioritize customer needs and preferences throughout the development process to enhance the product's relevance and appeal.

By following these steps, banks and financial institutions can successfully develop new financial products that meet market demands, drive growth, and enhance customer satisfaction.

2. **Typical Financial products:** Banks and financial institutions offer a variety of financial products designed to meet different needs and preferences. Here's an overview of typical financial products:
   a. Banking Products
      i. Savings Accounts: Interest-bearing accounts for everyday deposits and withdrawals, often with features like online banking and ATM access.
      ii. Current Accounts: Designed for businesses and individuals who need frequent transactions and may come with overdraft facilities.
      iii. Fixed Deposits (FDs): Time deposits with a fixed interest rate for a specified term, providing a safe investment with guaranteed returns.
      iv. Recurring Deposits (RDs): Savings plans where individuals make regular deposits over a period, earning interest at maturity.
   b. Loans and Credit
      i. Personal Loans: Unsecured loans for personal expenses, such as medical emergencies, vacations, or home renovations.
      ii. Home Loans: Loans for purchasing or constructing a home, often with long repayment terms and lower interest rates.
      iii. Car Loans: Loans specifically for purchasing vehicles, usually with fixed terms and interest rates.
      iv. Business Loans: Financing solutions for business needs, including working capital, expansion, and equipment purchases.
      v. Credit Cards: Payment cards offering revolving credit with features like rewards programs, cashback, and travel benefits.

c. Investment Products
   i. Mutual Funds: Investment vehicles pooling money from multiple investors to invest in stocks, bonds, or other assets, managed by professional fund managers.
   ii. Stocks and Shares: Equity investments in publicly traded companies, allowing investors to buy ownership stakes and benefit from price appreciation and dividends.
   iii. Bonds: Debt securities issued by governments or corporations, providing regular interest payments and returning the principal amount at maturity.
   iv. Exchange-Traded Funds (ETFs): Investment funds traded on stock exchanges, similar to mutual funds but with greater flexibility and liquidity.

d. Insurance Products
   i. Life Insurance: Policies providing financial protection to beneficiaries in the event of the policyholder's death, with options for term, whole, and universal life insurance.
   ii. Health Insurance: Coverage for medical expenses, including hospitalization, outpatient services, and prescription drugs.
   iii. Motor Insurance: Coverage for vehicle-related damages and liabilities, including comprehensive and third-party insurance.
   iv. Property Insurance: Protection against risks to property, including fire, theft, and natural disasters.

3. Retirement and Pension Plans

   i. **Retirement Savings Accounts**: Accounts like Provident Funds (PF) or Public Provident Funds (PPF) offering tax benefits and long-term savings for retirement.
   ii. **Pension Plans**: Insurance products providing a regular income after retirement, often with options for annuities or lump-sum payouts.

4. Wealth Management and Advisory Services

   i. **Financial Planning**: Personalized services to help clients plan and manage their finances, including budgeting, tax planning, and estate planning.
   ii. **Investment Advisory**: Professional advice on investment strategies, portfolio management, and asset allocation tailored to individual goals and risk tolerance.

5. Foreign Exchange and Remittance Services

   i. **Currency Exchange**: Services for converting one currency to another for travel or trade purposes.
   ii. **International Remittances**: Services allowing individuals to send money across borders, often with options for both online and in-person transactions.

6. Digital and Technology-Driven Products

i. **Digital Wallets**: Mobile applications for storing payment information and making transactions electronically.
ii. **Online Trading Platforms**: Digital platforms enabling users to trade stocks, bonds, and other financial instruments online.
iii. **Robo-Advisors**: Automated investment platforms providing algorithm-driven financial planning and portfolio management.

These products cater to various aspects of personal and business financial needs, providing customers with tools to save, invest, borrow, and manage their finances effectively.

PROMOTION MIX

The promotion-mix for financial products involves a strategic blend of communication and marketing tactics to effectively reach and engage target audiences. Here’s a breakdown of the key elements:

- Advertising

a. Traditional Media: Use TV, radio, and print ads to reach a broad audience. These are effective for building brand awareness and reaching potential customers in various demographics.

b. Digital Advertising: Leverage online channels such as search engine marketing (SEM), display ads, and social media ads to target specific customer segments with tailored messages.

2. Public Relations (PR)

a. Press Releases: Issue announcements about new products, company news, or financial results to media outlets to generate positive coverage and increase visibility.

b. Media Relations: Build relationships with journalists and financial bloggers to gain coverage and expert commentary on industry trends and product innovations.

c. Events and Sponsorships: Sponsor or host industry events, seminars, and webinars to position the institution as a thought leader and engage with potential customers directly.

3. Sales Promotions

a. Discounts and Offers: Provide special promotions such as reduced interest rates on loans, waived fees, or cashback offers to attract new customers or retain existing ones.

b. Limited-Time Offers: Create urgency with time-sensitive promotions to encourage quick decision-making and action from potential customers.

4. Direct Marketing

   a. Email Campaigns: Send personalized emails with product offers, updates, and financial advice to targeted customer lists based on their preferences and behavior.

   b. Direct Mail: Use postal mail to send brochures, promotional materials, and personalized offers to specific segments or geographic areas.

5. Content Marketing

   a. Educational Content: Develop and share valuable content such as blogs, articles, e-books, and infographics that educate customers about financial products and services.

   b. Videos and Webinars: Create video content and host webinars to explain complex financial concepts, showcase product features, and engage with customers interactively.

6. Social Media Marketing

   a. Engagement: Actively engage with customers on platforms like Facebook, Twitter, LinkedIn, and Instagram by sharing relevant content, responding to inquiries, and participating in discussions.

   b. Influencer Collaborations: Partner with financial influencers or bloggers to reach a wider audience and build credibility through their endorsements.

7. Personal Selling

   a. Financial Advisors: Employ trained advisors to provide personalized consultations, offer tailored product recommendations, and address individual customer needs.

   b. Branch Visits: Use in-branch representatives to promote products, explain features, and provide face-to-face customer service.

8. Digital and Online Presence

   a. Website Optimization: Ensure the website is user-friendly, with clear information on financial products and easy navigation for prospective customers.

   b. Search Engine Optimization (SEO): Optimize website content to rank higher in search engine results, making it easier for potential customers to find information about your products.

9. Referral Programs

a. Customer Referrals: Encourage existing customers to refer friends or family members by offering rewards or incentives for successful referrals.

b. Affiliate Marketing: Partner with affiliates who can promote your financial products through their networks in exchange for commissions.

Integration and Coordination

1. Consistency: Ensure messaging and branding are consistent across all promotional channels to build a cohesive brand image.
2. Cross-Promotion: Use a mix of promotional strategies to complement each other, such as running social media ads in conjunction with email campaigns.

By effectively utilizing these elements of the promotion mix, financial institutions can enhance product visibility, engage potential customers, and drive growth in a competitive market.

12.9 FINANCIAL REGULATORY MECHANISM

The financial regulatory mechanism in India is designed to ensure the stability, integrity, and efficiency of the financial system. It involves a framework of laws, regulations, and institutions that oversee and govern financial activities, protect investors, and maintain systemic stability. All functions and responsibilities of banks (both Indian and foreign) and finance companies are governed bt the regulations stipulated by the reserve Bank of India (RBI) . For banks RBI fixed the two critical elements of Cash Reserve Ratio and Statutory Liquidity Ratio. From time-to-time strictures are issued for matter such as revision of interest rates, change of policy, foreign exchange regulations. Since all Indian banks and finance companies go by the directions of Rerve Bank Of India. It becomes mandatory that pricing of all their products conform to RBI regulations.

12.10MARKETING OF FINANCIAL SERVICES

- Bank Marketing
- Insurance Marketing
- Mutual Fund Marketing

BANK MARKETING

Bank marketing is thus an approach to market the services profitably. It is a device to maintain commercial viability. It is an art to project a positive image. The marketing of banking services is concerned with product, promotion, pricing and place. In addition, a number of experts also advocate in favour of People, Process and Physical appearance. The different mixes of marketing are found influenced by changing business conditions. The marketing experts feel that to be more specific in the service generating organizations we find People playing a decisive role. This draws our attention on the quality of bankers recruited and developed by banking organization which focuses on the development of human resources for banking services. Professional excellence becomes instrumental in drawing a balance between the two opposite considerations. The qualitative transformation in the process is quite natural since the market is competitive and the customers of today are more receptive. In the present-day world, we also find marketing a social process since the strategic decisions necessitate due weightage to social considerations. The core and peripheral services are required to be designed in the face of social transformation programme and policies. The promotional measures are formulated and innovated in the face of sensitivity of a particular segment. The promotional measures are to be formulated with the motto of subserving social interests. The professionals thus found ways for social orientation which made it a social process.

A compendium of two words “Bank and Marketing thus focuses on following:

i. Bank marketing is a managerial approach to market the services
ii. It is a social process to subserve social interests.
iii. It is a fair way of making profits
iv. It is an art to make possible performance orientation
v. It is a professionally tested skill to excel orientation

THE USERS OF BANKING SERVICES

There are two types of customers using the services of banks such as:

1. General Users: Persons having an account in the bank and using banking facilitates at the terms and conditions fixed by a bank as general users of banking services. Generally, they are found small sized customers.
2. Industrial Users: Industrialists and entrepreneurs having an account in the bank and using the credit facilities and other services for the establishment and expansion of their business are known as Industrial users. Generally, they are found large sized.
3. Prospects: it is also essential to clarify the term ‘Prospects’. The general or industrial prospects do not use the banking services at present, but they have the potential to become a customer if induced or motivated in the right fashion.

Banking organizations transact with different types of customers. The behavior profile of two types of customers can not be identical. Both the customers are found important to the marketers and their professional excellence is coiled in the essence of studying and understanding the customers in the right perspective. The marketing resources instrumentalize the process into customers /users.

MARKET SEGMENTATION

Marketing segmentation for banking products and services in India involves dividing the market into distinct groups based on various criteria to better target and serve different customer needs. Here are key segmentation approaches:

1. Demographic Segmentation

- Age: Tailor products for different age groups (e.g., youth accounts, retirement plans).
- Income: Design services for different income levels (e.g., premium accounts for high-income individuals, basic accounts for lower-income groups).
- Occupation: Offer specialized services for professionals, self-employed individuals, and salaried employees.

2. Geographic Segmentation

- Region: Customize products based on regional needs and preferences (e.g., urban vs. rural areas, regional economic conditions).
- City Size: Differentiate offerings for metro cities versus smaller towns and villages.

3. Psychographic Segmentation

- Lifestyle: Develop products for various lifestyles (e.g., high-net-worth individuals, frequent travelers).
- Values and Attitudes: Create services that align with customers' values and attitudes towards finance and savings.

4. Behavioral Segmentation

- Banking Habits: Segment based on customer behaviors like transaction frequency, product usage, and online vs. offline preferences.
- Customer Loyalty: Identify and cater to loyal customers versus those who switch banks frequently.

5. Needs-Based Segmentation

- Financial Needs: Offer products based on specific financial needs (e.g., loans for home purchase, investment products for wealth growth).
- Service Preferences: Address preferences for different types of services (e.g., digital banking, personal advisory).

6. Segment-Based Products and Services

- Retail Banking: Personal accounts, savings accounts, and credit cards for individual consumers.

- Corporate Banking: Business loans, trade finance, and cash management solutions for companies.
- Wealth Management: Investment advisory, mutual funds, and portfolio management for high-net-worth individuals.

By applying these segmentation strategies, banks in India can better meet the diverse needs of their customers and enhance their service offerings.

MARKETING MIX FOR BANKING PRODUCTS & SERVICES

The bank professionals bear the responsibility of formulating a sound marketing mix such as product mix, promotion, place, process,physical evidence and attraction and people. In India, banks use different methods to cater to various customer needs. Here's how they break it down:

1. Demographic Segmentation

- Age: Banks offer special accounts for young adults, savings plans for families, and retirement products for seniors.
- Income: There are premium accounts for high earners and basic ones for those with lower incomes.
- Occupation: Services are tailored for professionals, business owners, and salaried employees.

2. Geographic Segmentation

- Region: Products are adapted to fit regional needs, whether in bustling cities or rural areas.
- City Size: Metro cities might get advanced banking solutions, while smaller towns receive more straightforward offerings.

3. Psychographic Segmentation

- Lifestyle: There are banking products designed for frequent travelers, tech enthusiasts, or those looking for premium services.
- Values: Banks create services that match customers' values and attitudes towards money and savings.

4. Behavioral Segmentation

- Banking Habits: Banks observe how often customers use their services and what they prefer, like online banking versus branch visits.
- Loyalty: They identify loyal customers and tailor rewards and benefits to keep them happy.

5. Needs-Based Segmentation

- Financial Needs: Whether you need a home loan, investment advice, or savings plans, banks provide solutions for specific needs.
- Service Preferences: Some customers want digital convenience, while others prefer face-to-face interaction.

6. Segment-Based Products and Services

- Retail Banking: Offers like savings accounts and credit cards for everyday use.
- Corporate Banking: Services like business loans and cash management for companies.
- Wealth Management: Investment advice and portfolio management for high-net-worth individuals.

By understanding these segments, banks can offer more personalized and relevant services, making banking easier and more tailored to your needs.

MARKETING MIX

The marketing mix for banking products and services, often referred to as the 4Ps (Product, Price, Place, Promotion), can be tailored to meet the unique needs of financial institutions. Here's how each element can be applied:

1. Product

a) Account Types: Offer various types of accounts such as savings accounts, checking accounts, fixed deposits, and specialized accounts (e.g., student accounts, senior citizen accounts).

b) Loans and Credit: Provide a range of loans (personal, home, auto) and credit products (credit cards, overdraft facilities).

c) Investment Services: Include mutual funds, stocks, bonds, and retirement planning services.

d) Digital Banking: Develop mobile and online banking platforms for easy access to banking services.

e) Customer Service: Offer value-added services like financial planning advice, wealth management, and customer support.

2. Price

a) Interest Rates: Set competitive interest rates for savings, loans, and fixed deposits. Rates may vary based on the product and customer segment.

b) Fees and Charges: Define account maintenance fees, transaction fees, and charges for additional services. Offer fee waivers or discounts based on account balances or customer loyalty.

c) Promotional Rates: Introduce temporary promotional rates or special offers to attract new customers or retain existing ones.

3. Place

a) Branch Network: Ensure a widespread network of branches and ATMs for physical access to services.

b) Digital Channels: Utilize online and mobile banking platforms to provide services remotely and cater to tech-savvy customers.

c) Partnerships: Collaborate with retail outlets, corporate partners, and financial advisors to reach more customers and offer banking services.

4. Promotion

a) Advertising: Use a mix of traditional media (TV, radio, print) and digital media (social media, online ads) to promote banking products and services.

b) Sales Promotions: Offer incentives like cashback, discounts, or gifts to encourage the adoption of new products or services.

c) Public Relations: Engage in PR activities to build a positive brand image and enhance customer trust.

d) Direct Marketing: Employ email campaigns, direct mail, and telemarketing to target specific customer segments with personalized offers.

5. People (Extended 5th P)

a) Staff Training: Ensure bank employees are well-trained in customer service and financial products to provide excellent support and advice.

b) Customer Experience: Focus on creating a positive and seamless experience through interactions at branches, call centers, and digital platforms.

6. Process (Extended 6th P)

a) Service Delivery: Streamline processes for account opening, loan approvals, and transactions to ensure efficiency and ease of use.

b) Technology Integration: Leverage technology to enhance service delivery, reduce processing times, and provide a better customer experience.

7. Physical Evidence (Extended 7th P)

a) Branding: Use consistent branding across branches, websites, and marketing materials to reinforce the bank’s image.

b) Facilities: Maintain clean, modern, and welcoming branch environments to enhance customer satisfaction.

By effectively managing these elements of the marketing mix, banks can better meet customer needs, differentiate themselves from competitors, and build strong relationships.

INSURANCE MARKETING

Insurance marketing in India is a dynamic and evolving field driven by the country's growing economy, increasing awareness of financial security, and advancements in technology. Here's an overview of the key aspects:

Market Overview

- Growing Demand: As India's economy expands, there is a rising awareness of the need for insurance. This is driven by increasing income levels, changing lifestyles, and greater emphasis on financial planning.
- Diverse Products: The insurance sector in India offers a wide range of products including life insurance, health insurance, auto insurance, home insurance, and travel insurance.

Regulatory Environment

- Regulation: The Insurance Regulatory and Development Authority of India (IRDAI) regulates the insurance sector, ensuring that companies comply with industry standards and protect consumer interests.
- Policies: Recent regulatory changes and policies have aimed at increasing transparency, enhancing customer service, and promoting financial inclusion.

Target Market

- Demographics: Insurance marketing in India targets a diverse demographic including young professionals, families, and the elderly. Tailoring products to different age groups, income levels, and life stages is crucial.
- Urban vs. Rural: There is a focus on urban areas where insurance penetration is higher, but there is also growing effort to reach rural populations through microinsurance and other initiatives.

Marketing Strategies

- Product Customization: Offering products that cater to specific needs such as health coverage, retirement planning, and family protection.
- Digital Marketing: Leveraging digital channels like social media, email marketing, and online ads to reach tech-savvy customers and provide easy access to insurance products.
- Traditional Methods: Using established channels such as insurance agents, brokers, and direct sales teams to build personal relationships and offer tailored advice.

5. Challenges and Opportunities

- Challenges: Low insurance penetration, lack of awareness, and customer skepticism can hinder growth. Overcoming these requires effective education and trust-building strategies.
- Opportunities: The rise of digital technology presents opportunities for innovative marketing approaches and improved customer engagement. Additionally, the increasing middle-class population provides a growing market for insurance products.

Consumer Behavior

- Awareness: Educating consumers about the benefits of insurance and the importance of coverage is key to driving demand.
- Trust: Building trust through transparent communication, reliable service, and strong customer support is essential for long-term success.

  Insurance marketing in India is adapting to a rapidly changing landscape, with a focus on innovation, customer education, and expanding reach. By understanding market dynamics and leveraging both traditional and digital strategies, insurance companies can effectively meet the needs of Indian consumers and drive growth in this promising sector.

Check Your Progress-A

1. Which regulatory body oversees the securities market in India?
   a) Reserve bank of India (RBI)
   b) Insurance Regulatory and Development Authority of India (IRDAI)
   c) Pension Fund Regulatory and Development Authority (PFRDA)
   d) Securities and Exchange Board of India
2. Which of the following is a common method used by banks to attract new customers?
   a) Offering discount on utility bills
   b) Providing high interest rates on saving account
   c) Selling personal data to third parties
   d) Limited access to customer support system
3. Which does the term brand positioning refer to in context of financial service marketing?
   a) The geographical location of a bank’s branches
   b) The process of creating a unique image and identity for a financial institution in the mind of customer
   c) The financial performance of a bank

d) The number of products financial institute offers

4. Which digital tool is commonly used by financial institutions to engage with customers and offer services?
   a) Physical brochures
   b) Telemarketing calls
   c) Social media platform
   d) In person events

MARKETING MIX

Marketing insurance products and services involves a strategic approach tailored to address the unique needs and preferences of customers. Here's how to effectively market insurance offerings:

1. Product

a) Types of Insurance: Offer a variety of products including life insurance, health insurance, auto insurance, home insurance, and travel insurance.

b) Customization: Provide options for policy customization to meet specific needs (e.g., riders for additional coverage).

c) Claims Process: Ensure a straightforward and transparent claims process to build trust.

2. Price

a) Premiums: Set competitive premiums based on coverage levels, risk factors, and market conditions. Offer flexible payment options.

b) Discounts and Bundles: Provide discounts for bundling multiple policies or for safe behavior (e.g., no-claim bonuses).

c) Cost Transparency: Clearly communicate costs and potential savings to avoid surprises and build credibility.

3. Place

a) Distribution Channels: Utilize multiple channels including insurance agents, brokers, online platforms, and direct sales teams.

b) Digital Presence: Enhance online availability through a user-friendly website and mobile app for policy purchases, renewals, and claims.

c) Local Presence: Maintain a network of local offices or partners for face-to-face consultations and support.

4. Promotion

a) Advertising: Use diverse media channels such as TV, radio, online ads, and print to reach potential customers. Highlight key benefits and unique selling points.

b) Content Marketing: Educate customers through blogs, articles, webinars, and videos about insurance products, benefits, and the importance of coverage.

c) Sales Promotions: Offer limited-time promotions, referral bonuses, or special rates to attract new customers.

d) Public Relations: Build a positive image through media coverage, community involvement, and customer success stories.

5. People

a) Agent Training: Ensure agents and brokers are well-trained in product knowledge, customer service, and ethical sales practices.

b) Customer Service: Provide excellent customer support through knowledgeable representatives who can assist with inquiries and claims.

6. Process

a) Ease of Use: Streamline processes for purchasing policies, renewing coverage, and filing claims to ensure a hassle-free experience.

b) Technology Integration: Use technology for efficient underwriting, policy management, and customer interaction.

7. Physical Evidence

a) Brand Image: Develop a strong brand presence with consistent messaging and professional materials to build trust and recognition.

b) Documentation: Provide clear, accessible documentation and policy details that reinforce the reliability of the insurance provider.

By integrating these elements, insurance companies can effectively reach and engage customers, differentiate their offerings, and build long-term relationships.

MUTUAL FUNDS MARKETING

Mutual funds are trusts or associations of public members associated in making investments in the financial instruments or assets of the business sector or corporate sector for mutual benefits of its members. Mutual Fund an investment company pooling money from the shareholders and investing in diverse activities viz stocks, bonds and short-term money market instruments or other securities. Fund managers play an important role in the process and discharging the responsibility of trading the funds, realizing capital gains or loss and collecting the dividend or interest income. The investors generally coming from small groups and from rural areas with the help and cooperative of agents, advisors and Fund managers channelize their investments in securities for getting the returns and then pass back the same to the investors. Most of the investors are found unaware of the avenues where they can get a profitable return. This requires expertise knowledge, and a Fund Manager makes available the same.

In th4e Mutual fund marketing, We find correlation matrix significant where we find organization, product and customers affecting the process. Sensitizing and persuading the savers, channelizing their investments into productive heads, generating the targeted returns and passing back the savers to cycle and recycle the process are the areas to be successfully conceptualized by the service marketers. Mutual funds Marketing is thus conceptualization of innovative marketing principles in MF’s operations.

MARKET SEGMENTATION

Market segmentation for mutual funds in India involves dividing the market into distinct groups based on various criteria to better target and serve different investor needs. Here’s a detailed look at how mutual funds can be segmented:

1. Demographic Segmentation

a) Age: Tailor mutual fund offerings to different age groups, such as young professionals (growth-oriented funds), middle-aged individuals (balanced funds), and retirees (income funds).

b) Income Level: Design products for different income brackets—high-net-worth individuals (HNWI) may prefer specialized or high-risk funds, while lower-income groups might look for safer, conservative options.

c) Occupation: Offer specialized funds for various professions, such as pension plans for government employees, or tax-saving funds for professionals.

2. Geographic Segmentation

a) Region: Customize funds based on regional economic conditions and investor preferences. For example, urban investors may be more interested in equity funds, while rural investors might prefer fixed-income or savings-oriented funds.

b) City Size: Metro cities may have a higher demand for sophisticated investment products, while smaller towns may prefer simpler, more conservative options.

3. Psychographic Segmentation

a) Lifestyle: Offer funds that align with different lifestyles, such as aggressive growth funds for those with a high-risk tolerance or socially responsible investment funds for those interested in ethical investing.

b) Investment Goals: Design funds to meet various investment goals, such as retirement planning, education savings, or wealth accumulation.

4. Behavioral Segmentation

a) Investment Experience: Segment investors based on their experience level. Beginners might prefer low-risk, diversified funds, while experienced investors might seek niche or sector-specific funds.

b) Risk Tolerance: Develop funds with varying levels of risk; high-risk equity funds for aggressive investors and low-risk debt funds for conservative investors.

c) Investment Horizon: Offer short-term funds for investors with immediate goals and long-term funds for those planning for future objectives.

5. Needs-Based Segmentation

a) Tax Benefits: Provide equity-linked savings schemes (ELSS) and other tax-saving mutual funds for investors looking to reduce their tax liabilities.

b) Income Generation: Offer funds focused on generating regular income, such as dividend-paying funds or fixed-income funds for investors seeking steady cash flow.

c) Capital Appreciation: Design funds aimed at long-term capital growth, such as growth funds and sector-specific funds.

6. Product-Based Segmentation

a) Type of Fund: Segment based on the type of mutual funds, such as equity funds, debt funds, hybrid funds, index funds, and sector-specific funds.

b) Fund Performance: Differentiate funds based on historical performance, fund manager reputation, and investment strategy.

7. Customer Segment-Based Marketing

a) Retail Investors: Use direct marketing, online platforms, and financial advisors to reach individual investors.

b) Institutional Investors: Target through dedicated channels and offer institutional-grade funds or tailored investment solutions.

By applying these segmentation strategies, mutual fund companies in India can better understand their diverse customer base, tailor their offerings, and implement more effective marketing strategies to attract and retain investors.

MARKETING MIX

The marketing mix for mutual funds, often known as the 4Ps (Product, Price, Place, Promotion), helps in effectively positioning and selling mutual fund products. Here's how each element of the marketing mix can be applied to mutual funds:

1. Product

- Types of Funds: Offer a variety of mutual funds to cater to different investor needs, such as:

  i. Equity Funds: For growth-oriented investors seeking capital appreciation.

  ii. Debt Funds: For investors looking for stable returns and lower risk.

iii. Hybrid Funds: Combine equity and debt for a balanced approach.
iv. Index Funds: Track a specific market index for passive investment.
v. Sector Funds: Focus on specific industries or sectors.
vi. Tax-Saving Funds (ELSS): Provide tax benefits under applicable tax laws.

- Fund Features: Highlight features like fund objectives, risk levels, investment strategies, and historical performance.
- Customization: Offer options for customized investment plans or advisory services to meet specific investor goals.

2. Price

a) Expense Ratios: Set competitive management fees and expense ratios to attract investors while ensuring the fund remains profitable.

b) Entry and Exit Loads: Implement entry and exit loads (if applicable) to cover transaction costs and discourage short-term trading.

c) Discounts and Promotions: Provide limited-time offers or reduced fees for new investors or large investments.

d) Performance Fees: Consider performance-based fees for funds that achieve above-average returns, aligning costs with investor success.

3. Place

- Distribution Channels: Utilize multiple distribution channels including:

a) Financial Advisors and Brokers: Leverage their networks to reach potential investors and provide personalized advice.

b) Online Platforms: Offer direct online investments through the company's website or investment portals for convenience and wider reach.

c) Banks and Financial Institutions: Collaborate with banks and financial institutions to distribute mutual fund products.

d) Investment Apps: Develop or partner with investment apps for mobile access and ease of transaction.

4. Promotion

a) Advertising: Use a mix of traditional (TV, radio, print) and digital media (social media, online ads) to reach a broad audience and highlight key benefits.

b) Content Marketing: Provide educational content through blogs, videos, webinars, and seminars to inform potential investors about mutual funds and their advantages.

c) Public Relations: Engage in PR activities to build credibility and trust through media coverage, press releases, and thought leadership.

d) Sales Promotions: Offer incentives like reduced entry loads, special rates, or promotional campaigns to attract new investors.

e) Direct Marketing: Use email campaigns, direct mail, and personalized outreach to target specific investor segments with tailored offers.

5. People (Extended 5th P)

a) Advisors and Sales Team: Ensure that financial advisors and sales representatives are well-trained and knowledgeable about mutual funds to provide excellent service and guidance.

b) Customer Support: Offer responsive customer support to address investor queries, help, and resolve issues promptly.

6. Process (Extended 6th P)

a) Investment Process: Streamline the process for investing in mutual funds, including account setup, fund selection, and transaction execution.

b) Technology Integration: Utilize technology for efficient fund management, online transactions, and real-time updates on fund performance.

7. Physical Evidence (Extended 7th P)

a) Branding: Maintain consistent branding across all platforms and communications to build a strong and recognizable image.

b) Documentation: Provide clear, accessible documentation, such as prospectuses, fund fact sheets, and performance reports, to reinforce transparency and reliability.

By carefully managing these elements of the marketing mix, mutual fund companies can effectively attract and retain investors, differentiate their products, and build a strong market presence

12.11 SUMMARY

Marketing financial services offered by banks and financial institutions involves a strategic approach to effectively reach and engage diverse customer segments. The marketing landscape is shaped by the need to address unique financial needs and preferences through a mix of targeted strategies. Banks and financial institutions utilize various tools in their promotion mix, including traditional advertising, digital marketing, content creation, and direct marketing, to build brand awareness and attract customers. They leverage customer segmentation to tailor their offerings, focusing on demographic, geographic, psychographic, and behavioral factors to develop personalized products and services. Effective marketing also involves using digital platforms, such as mobile apps and online portals, to enhance customer experience and accessibility. Additionally, these institutions emphasize the importance of building trust and credibility through transparent communication, regulatory compliance, and exceptional customer service. Innovations in financial products, like digital wallets and robo-advisors, are frequently introduced to meet evolving customer demands. Public relations efforts, including media interactions and sponsorships, play a critical role in shaping the public perception of financial institutions. To remain competitive, institutions continuously adapt their marketing strategies based on market trends, regulatory changes, and technological advancements. Overall, successful marketing in the financial sector is about aligning products and services with customer needs while maintaining a strong, trustworthy brand presence.

Banking, insurance, and mutual funds are key components of the financial services sector, each serving distinct purposes:

1. **Banking** involves financial institutions providing services such as accepting deposits, offering loans, and managing transactions. Banks facilitate everyday financial activities, offer savings accounts, checking accounts, and various loan products, and serve both individuals and businesses. They play a crucial role in the economy by providing liquidity and enabling financial transactions.
2. **Insurance** provides protection against financial losses through various types of coverage, such as health, life, auto, and property insurance. Customers pay premiums to insurers, who, in turn, provide financial compensation in the event of covered risks. Insurance helps individuals and businesses manage risk and secure financial stability in the face of unexpected events.
3. **Mutual Funds** are investment vehicles that pool money from multiple investors to invest in a diversified portfolio of assets, including stocks, bonds, and other securities. Managed by professional fund managers, mutual funds offer investors an opportunity to diversify their investments and potentially achieve higher returns. They cater to various risk appetites and investment goals, from growth to income generation.

   Together, these financial services help individuals manage their finances, protect against risks, and grow their wealth, contributing to overall economic stability and growth.

12.12 GLOSSARY

Account Management: The process of managing customer accounts to ensure satisfaction and retention, involving regular interactions and updates.

Brand Awareness: The extent to which customers recognize and recall a financial institution’s brand.

Customer Segmentation: The practice of dividing a customer base into distinct groups based on characteristics such as demographics, behaviors, or needs.

Digital Transformation: The integration of digital technology into all areas of a financial institution, changing how they operate and deliver value to customers.

Direct Marketing: Promotional activities that communicate directly with potential customers through channels such as email or direct mail.

Financial Product: Any service or instrument offered by financial institutions, including savings accounts, loans, insurance, and investment vehicles.

Integrated Marketing Communications (IMC): The coordination of various promotional tools and messages to present a consistent and unified message to customers.

Market Research: The process of gathering, analyzing, and interpreting information about a market or customer preferences to guide marketing decisions. Personalization: Tailoring marketing messages and product offerings to meet the specific needs and preferences of individual customers.
Public Relations (PR): The practice of managing and influencing the public perception of a financial institution through media and community engagement.

12.13 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (d), 2 (b), 3 (b), 4 (c)

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12.16 TERMINAL QUESTIONS

1. Explore the concept of customer experience in the context of financial service marketing. How can banks enhance the overall customer experience through marketing efforts.
2. What do you mean by Marketing of Financial Services?
3. Explain the different components of marketing mix of marketing the insurance services.

4. Explain the various bases for segmentation of marketing of mutual funds in India.
5. Explain the process of marketing segmentation of the financial service industry.

12.17 CASE STUDY

Marketing of Financial Services in India - ICICI Bank's Digital Transformation

ICICI Bank, one of India's leading private sectors banks, exemplifies the successful marketing of financial services through a strategic digital transformation. Faced with a rapidly evolving financial landscape and increasing customer demand for convenience, ICICI Bank embarked on a comprehensive digital strategy to enhance its service offerings and customer engagement.

The bank's marketing strategy focused on leveraging technology to provide a seamless customer experience. By investing in a robust digital platform, ICICI Bank introduced features like mobile banking apps, online account opening, and digital loan processing. This shift not only made banking more accessible but also aligned with the growing trend of digital transactions among Indian consumers.

ICICI Bank effectively utilized targeted digital marketing to promote its services. Through data analytics, the bank segmented its customer base by demographics, behaviors, and financial needs. This allowed for personalized marketing campaigns and product offerings tailored to specific customer segments. For instance, young professionals were targeted with digital savings accounts and investment products, while families were offered home loans and insurance products.

To further enhance its market reach, ICICI Bank collaborated with fintech companies and invested in innovative technologies like artificial intelligence and machine learning. These partnerships enabled the bank to offer advanced services such as chatbots for customer support and predictive analytics for personalized financial advice.

The marketing of ICICI Bank's financial services also emphasized customer education. The bank conducted webinars, online tutorials, and interactive content to help customers understand various financial products and make informed decisions. This educational approach not only built trust but also fostered customer loyalty.

In summary, ICICI Bank's case demonstrates how integrating digital technology with a customer-centric marketing approach can effectively address the evolving needs of the financial services market in India. By embracing digital transformation, personalized marketing, and customer education, ICICI Bank has positioned itself as a leader in the Indian banking sector, setting a benchmark for others in the industry.

Management of Financial Services
MS 407

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MS 407

School of Management Studies and Commerce

Management of Financial Services

Block III Financial Intermediaries

Block IV Latest Concepts in the Management of Financial Services

MS 407

Management of Financial Services

Block – III
Block Title- Financial Intermediaries
Block – IV
Block Title- Latest Concepts in the Management of Financial Services

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Course Contents

Course Name: Management of Financial Services

Course Code-MS407

Course Objective: This course aims at acquainting the students the understanding the nature of various financial services and managing them.

Unit XVII Housing Finance

Unit XVIII Credit Rating

Unit XIX Strategic Issues in the Management of Financial Intermediaries

Block IV Latest Concepts in the Management of Financial Services

Unit XX Venture Capital

Unit XXI Factoring and forfeiting

Unit XXII Asset Liability Management

Unit XXIII Insurance Services, Bancassurance and Reinsurance

Unit XXIV Securitization and Asset Reconstruction Companies

Unit XXV Non -Banking Financial Companies

Unit XXVI Indian and Global Perspective – Managing new challenges

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Index

Block III
Financial Intermediaries

UNIT 13 MUTUAL FUNDS

13.1 INRODUCTION

Mutual funds are the financial organisation who collect the savings from the investors and invest them into securities in capital market and earn income from it. The earning is distributed among the investors in the form of return on investment and they reinvest the some portion of their earnings again in mutual funds. Professional manages such funds for consideration. Through mutual funds, an investor can have exposure in variety of investment avenues like, money market, fixed income to high yield debts, gold and other commodities, real estate equities etc. Even investment in India and abroad is accessible through investment in mutual funds now in India.Unit trust of India was the first mutual fund in India established on 1964. Mutual fund industry in India received a boost when it was thrown open to private sector in 1993 and to foreign mutual funds in 1994. In India there are 44 mutual funds organisations which are offering number of schemes suits to each profile of investor. In this unit you will come to know the about the mutual funds and their benefits to the investors, their constituents, regulations and progress of mutual funds from their set up in India till their status by 2019.

13.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the meaning of mutual funds
- Know about the constituents of mutual fund industry
- Understand the benefits of mutual funds
- Come to know about the different schemes of mutual funds
- Progress of mutual funds in India
- Calculate absolute return and compound annual growth rate (CAGR)

13.3 MUTUAL FUNDS

Mutual funds are associations or trusts of public members who wish to make investments in the financial instruments or assets of the business sector or corporate sector for the mutual benefits of its members. The fund collects the money of these members from their savings and invests them in a diversified portfolio of financial assets such as equity shares, debentures, government securities and other fixed income securities etc. with a view to reduce risks and to maximize their income and capital appreciation for distribution to its members on a pro-rata basis. Mutual funds issue units to the members (investors) known as unit holders in accordance with the amount of money invested by them. The unit holders (investors) enjoy collectively the benefits of expertise in investment by specialists in the trust, economies of scale which no single individual by himself could enjoy, diversification of financial assets and also the risk sharing among the members. Mutual fund is thus a concept of mutual help of subscribers for portfolio investment and management of these investments by experts in the field. These funds are set up under the Indian Trusts Act. The concept of mutual funds gained momentum because of increasing complexities of capital market. Individual investors lacking expertise in the securities market prefer to invest in the stocks through the mutual funds expertise.

The Definition:

A mutual fund is nothing more than a collection of stocks and /or bonds. We can think of a mutual fund as a company that brings together a group of people and invests their money in stocks, bonds, and other securities. Each investor owns shares, which represent a portion of the holdings of the fund.

The SEBI has defined mutual fund as:

“Mutual fund” means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instruments or real estate assets”.

According to Weston J.Fred and Brigham

“Mutual Funds is a corporation which accepts money from the investors and user the same way to buy stock, long -term bonds, short-term bonds debt instruments issues by the issuers”.

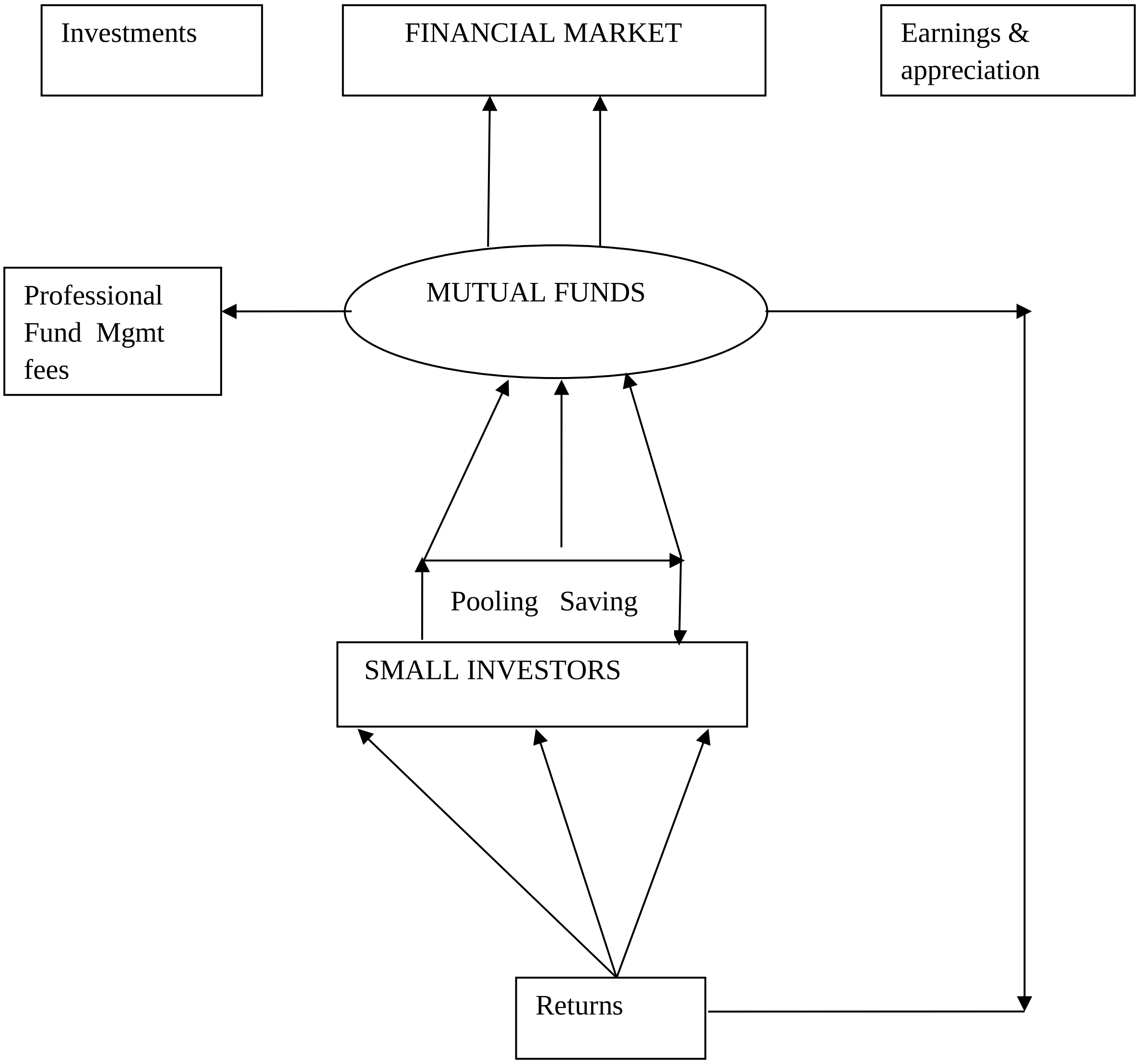
According to **(Dr. Manoj V.Dave, Lalitkumar R.Chauhan)**

“One can make money from a mutual fund in three ways:

1. Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all income it receives over the year to funds owners in the form of a distribution.
2. If the funds sell securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3. If fund holdings increase in price but are not sold by the fund manager, the fund’s shares increase in price. You can then sell your mutual fund shares for a profit. Funds will also usually give you a choice either to receive a check for distributions or to reinvest the earnings and get more shares”.

FIG-1

CONCEPT OF MUTUAL FUND



13.4 CONSTITUENTS OF MUTUAL FUNDS ORGANISATION

1. Sponsor
2. Mutual Fund Organization (Trust)
3. Asset Management Company (AMC)

4. Custodian
1. **Sponsor :** Every Mutual Fund has a sponsor which establishes the fund and hence a sponsor can be considered as similar to promoter of a company. Mutual funds organizations follow the rules laid down by SEBI. Following organization are eligible for the sponsor:
   - Banks
   - Financial institutions
   - Private and Public limited companies

An organization to become a sponsor must have a track record of profitability of at least 5 years with positive networth. And minimum 40% of capital of AMC is contributed by a sponsor.

2. **Trust :** The sponsor forms a trust in accordance with SEBI regulations. The trust has a governing body which is also appointed by the sponsor. The governing body of the trust gives direction, control and also manages the overall affairs of the mutual fund. The trustee has to be a person of high reputation and integrity. One of the members of the governing body becomes a full time executive of the trust and heads a company floated by the trust called Asset Management Company (AMC).
3. **Asset Management Company (AMC):** It is a team of professionals and experts with the knowledge of the investment activities. The AMC floats various schemes of the fund and also manages them on day to day basis. Every mutual fund has its own AMC. AMC can be a listed/non-listed company and has high standing professionals like Management Graduates, Chartered Accountants, Financial Analysts, and Engineers etc., who are expert in the job of making investments. They also see that the investments made under its various schemes are fully protected and properly accounted for. Assets Management Companies in India are broadly categorized into three types, bank sponsored mutual funds, mutual funds institutions, private sector mutual funds. There are 44 AMCs in India as of today.

Some Currently Operating AMCs:

Sr. No	**Mutual Fund**	**Launching Date**	**Number of schemes**
1	**Axis Asset Management Company Ltd.**	1994	312
2	**Aditya Birla Sun Life Asset Management Company Limited**	1994	789
3	**Baroda Pioneer Asset Management Company Limited**	1995	108

4	**BOI AXA Investment Managers Private Limited**	2007	84
5	**BNP Paribas Asset Management India Private Limited**	2004	132
6	**Canara Robeco Asset Management Company Limited**	1987	122
7	**DHFL Pramerica Asset Managers Private Limited**	2009	325
8	**DSP Investment Managers Private Limited**	1996	176
9	**ESSEL Mutual fund**	2009	91
10	**Edelweiss Asset Management Limited**	2008	176
11	**Franklin Templeton Asset Management (India) Private Limited**	1996	338
12	**HDFC Asset Management Company Limited**	2000	687
13	**HSBC Asset Management (India) Private Ltd**	2002	163
14	**IIFL Management Co. Ltd.**	2010	22
15	**IIFCL**	2012	2
16	**IL&FS**	2014	8
17	**ICICI Prudential Asset Mgmt.Company Limited**	2007	

			1255
18	**IDFC Asset Management Company Limited**	1999	352
19	**India bulls Asset Management Company Ltd.**	2011	140
20	**IDBI Asset Management Ltd.**	2010	105
21	**INVESCO Asset Management Company Private Limited**	2006	216
22	**ITI Asset Management Ltd**	2018	20
23	**JM Financial Asset Management Private Limited**	1994	415
24	**Kotak Mahindra Asset Management Company Limited(KMAMCL)**	1998	415
25	**L&T Investment Management Limited**	1997	196
26	**LIC Mutual Fund Asset Management Limited.**	1994	100
27	**Mahindra Asset Management Co. Ltd**	2016	52
28	**Mirae Asset Global Investments (India) Pvt. Ltd.**	2007	69
29	**Motilal Oswal Asset Management Company Limited**	2009	53

30	**PPFAS Asset Management Pvt. Ltd.**	2013	12
31	**Principal Pnb Asset Management Co. Pvt. Ltd.**	1994	96
32	**Quant (Escorts) Money Managers Ltd**	1996	60
33	**Quantum Asset Management Company Private Limited**	2005	30
34	**Reliance Capital Asset Management Ltd.**	1995	971
35	**SBI Funds Management Limited**	1986	586
36	**Sahara Asset Management Company Private**	1996	68
37	**SREI Mutual Fund Asset Management Pvt. Ltd.***	2012	Na
38	**Shriram Asset Management Co. Ltd.**	1994	16
39	**Sundaram Asset Management Company Limited**	1996	431
40	**Tata Asset Management Limited**	1995	239
41	**Taurus Asset Management Company Limited**	2006	42
42	**UTI Asset Management Company Ltd.**	2003	1279

43	**Union Asset Management Company Private Limited**	2011	71
44	**Yes Asset Management (India) Ltd**	2017	30

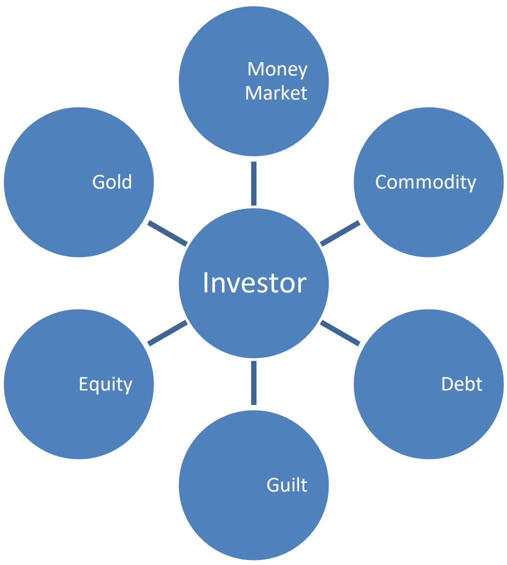
*SREI mutual fund's no scheme has been listed yet

4. **Custodian**: Custodian is the organization, which is responsible for safe keeping of various securities purchased under various schemes. Following functions are generally performed by a custodian.
    - Post trading activities
    - Safe keeping of securities
    - Collection of dividends and benefits on behalf of mutual fund
    - Maintain the account of holding

Wide Range and Options

Mutual funds provide a range of options for the investors to suit their need and capabilities. An asset management company can be a one stop solution provider for retail investors. As today in India, through mutual funds, an investor can have exposure in variety of investment avenues like, money market, fixed income to high yield debts, gold and other commodities, real estate equities. Even investment in India and abroad is accessible through investment in mutual funds now in India.

Fig-2



There is a range of mutual fund types which invest in specific asset class or combination of classes in equal or variable distribution Investors can review the fund types against his financial goal, time frame, risk appetite and economy to best judge the fund or combination of funds that suits the requirements.

Benefits of Mutual Funds

There are several benefits to invest in mutual funds. The key benefits are as follows

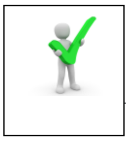
1. **Expert Money Management**

Mutual fund companies hire financial experts to manage the money pooled in a mutual fund scheme. This ensures that the investor's funds are in the hand of experts and they do not have to fret on it. Its fund manager's duty to decide to which securities funds to be invested.

2. **Low-cost investment**
   Mutual funds offer variety of schemes which are available for every kind of investor. Investors with limited income can start investment with as low as just Rs. 500 per month and investors who have high income with them can invest a lump sum and seek benefits as well as high returns.
3. **Systematic Investment Plan (SIP)**
   As mentioned above mutual funds schemes are available for every profile of investor. Systematic investment plans are for those investors who do not want to make a onetime investment. Through the facility of SIP the investors can make small and manageable investments in installments every month.
4. **Lock-in-period**
   Every mutual fund has different lock-in-period. This could be one must or none at all. ELSS is one mutual fund scheme that has the shortest lock-in-period of 3 years for good returns. However, the holding period of investment is directly proportionate to the return receive. The longer investor stay invested the higher will be returns. Also, an investor can withdraw any time when he or she has invested in open ended mutual funds.
5. **Flexibility to Switch Funds**
   Fund managers invest the money of investors in different securities. Due to market conditions or volatility in the market may be some securities do not perform well. So the fund manager has the right to switch. In such case they sell those securities which are not performing well and can add in the portfolio those securities which are doing well in the market.
6. **Flexibility Terms of Tenure**
   Most of the mutual funds schemes have no time boundations. For instance, ELSS is a tax saving scheme which has a lock-in-period of 3 years minimum. Other investment schemes have flexible tenure depending on investor's financial goals.
7. **Liquidity**
   Mutual funds are highly liquid. Investors can get their money any time they want.
8. **Tax efficiency**
   Mutual fund investments are highly tax efficient. Many of the mutual fund schemes have proven to be very tax efficient and have generated high returns in comparison to any other traditional form of investment.

9. Diversification

Mutual funds enable the investors to successfully "buy the market". Being so extensively diversified by investing in shares, bonds and different company sizes investors try to manage the risk of loss. It is not easy to select the investments that will work well. Rather than attempting to invest in a single security, it is usually safer to be well diversified throughout the market. The general effect of variation is that investor can control the unpredictability and can smooth out the returns as time passes. The recommended number of entities to invest in is 5 as then it might become complicated to monitor the funds.



Check Your Progress-A

Q1. What are Mutual Funds?

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Q2. Discuss the benefits of Mutual Funds.

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Q3. What range of options mutual funds provides to their investors?

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……………………………………………………………………………………………

Q4. Discuss the constituents of mutual fund organization.

Q5. What is SIP ?

Q6. What are the functions of custodians?

13.5 REGULATIONS OF MUTUAL FUNDS IN INDIA

Every mutual fund operated in India, is subject to the following regulations specified by SEBI.

1. Formation and Registration
2. Document
3. Regulation of schemes
4. Investment by mutual fund
5. Advertisement code of conduct
6. Disclosure of NAV
7. Winding up

1. **Formation and Registration**
   All the constituents discussed above, should be registered with SEBI. All the constituents should fulfill the eligibility criterion set by the SEBI. All the constituents must be registered with SEBI before the starting of their respective functioning. SEBI requires the fulfillment of various formalities for registration and payment of requisite fee too.
2. **Document for Schemes**
   Offer document contain information to enable investors to make an informed investment decision, including disclosure regarding the maximum investment proposed to be made by the scheme in the listed securities of the group companies of the sponsor. The SEBI can suggest modification in the offer document, in the interest of investors, which would be binding on the AMC. If no modification is suggested by SEBI within 21 working days from the date of filing, it may issue the offer document to the public.
3. **Regulation of Schemes**
   Mutual funds schemes are classified into a) Open-ended, and (b) Close-ended schemes. At the time of launching, SEBI regulates the size of the scheme in terms of its corpus, which is as follows:
   - An open-ended scheme should have a minimum corpus of Rs.50 crore. This is counted as the amount collected during the first 45 days of the launch of the scheme.
   - A close- ended scheme should have a minimum corpus of Rs.20 crore.

Unless a mutual fund achieves these minimum corpus targets, it cannot issue the units to applicants; rather money is to be refunded to them.

4. **Investment by Mutual Fund**
   Following are the regulatory provisions for the investment to be made by mutual fund:
   - Mutual fund may invest money collected under any of its schemes only in (a) securities (b) money market instruments, (c) privately placed debentures, (d) securities debt instruments (e) gold/gold related instruments, (f) real estate assets or (g) infrastructure debt instruments. The investments should be in accordance with the investment objectives of the relevant scheme. Money collected under the money market scheme of mutual fund should invest only in money market instruments only. Similarly, money collected under the gold exchange traded fund scheme should invest in only gold/ gold related instruments.
   - No mutual fund, under all its schemes, should own more than 10% of any company's paid-up capital carrying voting rights.
   - A scheme may invest in another scheme under the same AMC or any other mutual fund without charging any fees.
   - A mutual fund scheme should not invest in a) any unlisted security (b) or any security issued by way of private placement of any associate/group company of the sponsor (c) listed security of group companies of the sponsor in excess of 25% of the net assets.
   - No mutual fund scheme would make any investment in any fund of funds scheme.
5. **Advertisement Code of Conduct**
   Every mutual fund should follow the code of conduct while advertising for the schemes as directed by SEBI.
   The advertisement should be 1) true, fair, accurate, clear, complete, unambiguous and concise; 2) not contain statements which are false/ misleading/biased/deceptive; 3) should not be designed as such which would misunderstood/ disguise the significance of any statement. Further, the advertisement for the schemes shall give full details about the sponsor- its background, past track record, affiliation etc. The offer document shall also contain information about the functioning of scheme, AMC, custodian and other activities of the mutual fund organization. The mutual fund should mention about 'risk factors' if investment is made in the scheme.
6. **Disclosure of NAV**
   Mutual funds organizations are required to disclose NAV of all the schemes at a regular time interval as specified by SEBI from time to time.

$$\text{NAV} = \frac{\text{Market value of investment under the scheme+Net receivables+cash}}{\text{Number of units under the scheme}}$$

7. **Winding up**

   Close ended scheme

   A close-ended scheme is wounded up on the expiry of the duration fixed in the scheme, on the redemption of the units, unless it is rolled over for a further period.

   Open ended scheme

   An open ended scheme does not have any maturity period; therefore, in normal circumstances, there is no winding up of such a scheme. Such a scheme can be wounded up compulsorily, if at any time corpus of the scheme falls below 50% of the original corpus. By original corpus, we mean the funds pooled during the initial 45 days of the opening of the subscription for the scheme.

13.6 CLASSIFICATION OF MUTUAL FUNDS SCHEMES

Mutual Fund Schemes in broad sense can be classified either as Open end vs. Closed end schemes or Income schemes vs. Growth schemes. Under such broad classification any amount of permutations and combinations are possible.

Open ended and Closed Ended fund

Open-Ended Fund

An Open-ended fund or scheme is one under which an investor can buy or sell units on continuous basis i.e., the scheme has perpetual existence. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at Net Asset Value (NAV) that is declared on a daily basis. The important feature of open end scheme is liquidity. Open ended funds can issue and redeem units any time during the life of the scheme on the other hand the closed end schemes remains open for subscription for limited period only. Hence, unit capital of open-ended fund can fluctuate on daily basis while that is not the case for close ended scheme. Another way of explaining the difference is that new investors can join the scheme by directly applying to the mutual fund at applicable new asset value related prices in case of open-ended schemes while that is not case in close-ended schemes. New investors can buy the units from secondary market only at the market prevailing prices and not at NAV.

Closed Ended Funds

A close-ended funds or scheme has a stipulated maturity period. The fund in open for subscription only during a specified period at the time of launch of the scheme. Investors can invest in the scheme at the time of initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchases at NAV related prices.

Logically closed end schemes should perform better than the open end ones as managers of closed end schemes have better control over investments. i.e., the scheme does not suffer from continuous repurchase or sales. On the other hand in case of open end scheme a big portion of corpus has to be invested in short term instruments including cash as a cushion against regular redemptions/repurchase. Since the return from a short term investment cannot match that of a long term performance of the open end scheme suffers to that extend. It is worthwhile adding that the biggest losers are those schemes which become open ended after starting off as closed ended as those funds not only have to change their investment strategies but are also forced to show the performance of a closed end fund even after the switch.

Growth and Income schemes

Growth Scheme

Growth schemes aim at generating long term capital appreciation for its investors. This is done by investing the resources raised from the investors in high growth equity shares which give good returns when the markets are rising. However a lot of risk is also attached to such stocks and their returns can also be zero or even negative when the market return bearish. So such schemes are meant for bold and daring investors who can afford to take risks on the stock markets.

Income Schemes

Income schemes on the other hand aims at generating and distributing regular returns to the investors. Such schemes invest their funds in safe and income earning instruments like Public Deposits, Bonds, and Debentures etc. Since they provide a reasonable return on regular basis along with reasonably safety of funds it is favoured by investors who want fixed regular incomes like pensioners, retired persons, senior citizens etc. Income funds can be either bond funds or monthly income plans.

Whereas the former invests in government securities, corporate bonds and debentures of the different companies with zero equity exposure, the latter also invests in these instruments but also has a little equity exposure too, say around 5-6% of the total corpus. However there is no assurance of fixed income under the income funds. In India approx. 70% of schemes are income oriented.

Nowadays, capital markets are flooded with scheme which are not purely growth or income but either a combination of two or variant of the two. The need for such different schemes is being felt because of the changing perception of the investors towards the stock market. Because the pure schemes of mutual funds are not up to the mark so the need was felt to design such schemes which are tailor made as per the requirement of the investors. Some of the schemes are:

a) **Equity Linked Saving Scheme**: Also called 'Tax savings via Growth', such schemes invest in equity shares of the companies and hence fall in the category of growth schemes but also do provide tax savings to individual under the tax savings scheme.

b) **Specialised Sector Schemes:** Certain sectors like Pharmaceuticals and consumer goods have always outperformed the traditional sector like textiles, Iron and Steel. Because of this reason, the mutual funds have launched from time to time specialised sector schemes which are growth schemes but with respect to investment, focus only a particular sector.

c) **Guilt &Liquid Schemes:** A variant of an income scheme is GUILT scheme which concentrates mainly on long term government securities. A liquid scheme on the other hand usually invests in short term instruments with short maturities say up to one year.

d) **Balanced Schemes**: Such schemes usually strike a balance between the growth and income schemes by putting their money in somewhat equal proportion in equity and debt instruments. Some of the balanced schemes follow a certain criteria for allocating funds between equity and debt i.e., higher the Sensex level lower shall be the equity component in their schemes and vice-versa.

e) **Index Schemes:** Index Schemes or index funds mimic the market index i.e., the fund manager allocates the corpus in proportion of the different securities in the index be it BSE Sensex, NSE Nifty or any other index. These funds are also passively managed meaning that once the fund manager has allocated the resources according to the index most of his job is over and therefore the charges for the management fees are also minimal as the fund manager does minimum of research work to find out which shares are expected to outperform the others.

f) **Exchange Traded Schemes:** Such schemes are similar to the index fund scheme represent a basket of securities but are listed on the stock exchange.(Note: Index schemes are usually not listed on exchanges). One can buy and sell the units of ETF at their NAV on any time during the trading hour. The ETFs also give an option to the investors to exchange their scrips which they own with the units of the fund. The advantage to the investor is that no cash investment is required to buy additional units of Exchange Traded Funds but fund exchanges it with the stock held by investor.

g) **Mid Cap Schemes:** Such a scheme invests in the shares of those companies which have a market capitalisation between 1500 to 5000 Crores i.e. Mid Cap Shares. The reason why fund managers invest in these mid cap shares is that there is general belief that such companies have good potential and may get transformed to the large cap companies.

h) **Gold ETF:** With India being the largest consumer of the gold jewellery in the world, Gold ETF hold tremendous potential in this country. Gold ETF has certain advantages firstly it helps in unlocking the physical gold lying with the households. Under this their physical gold and jewellery is converted into small sized units which can be traded on stock exchanges, moreover there is a promise of earning a little more. Secondly investment in Gold ETFs is possible with very low amount of investment, thirdly underlying commodity i.e., gold is pure to the extent of 24 carats.

i) **Extended Cash Fund Schemes**: Such schemes are very short term schemes say one to three months and the target customers are those with surplus cash only for few months. These funds usually give better return than a pure cash fund.

j) **Contra Fund**: In case of this fund, the focus is on those securities which are currently out of flavour and hence do not deliver the normal PE to the investor.

k) **Capital Protection Fund Scheme**: Capital Protection Fund Schemes promises preservation of initial investment. Such schemes are very popular in US. This may be in the form of guarantee given by the trustee or even backed by the insurance policy. The charges of these schemes are higher.

l) **Fund of Funds Scheme**: Under this scheme the mutual fund instead of investing in stock markets invests in the units/schemes of other mutual funds and it is called Fund of Funds scheme. Thus Fund of Funds scheme is essentially a repackaging idea. For many it is a dynamic alternative to the balanced fund. The fund manager after doing thorough research can select the better performing equity funds and their likely performance in future. Similarly he can do the same exercise for the debt funds and thus he can make a portfolio of mutual funds for investing his corpus under the fund of funds scheme.

13.7 PROGRESS OF INDIAN MUTUAL FUND INDUSTRY

The progressive liberalization of economic policies has led to a rapid growth of capital market, money market and financial services industry. Consistent with this evolution of the financial sector, the mutual fund industry has also come to occupy an important place in India. It forms an important part of capital market, providing the benefits of a diversified portfolio and expert fund management to a large number of investors, particularly small investors. The industry has witnessed starling growth in terms of the products and services offered, returns churned, volumes generated and also the contributions of international players in this growth. Today the industry offers different schemes ranging from equity and debt to fixed income and money market. The mutual fund industry offers diverse products such as Gold funds, Exchange Traded Funds, Index Funds and Capital protection oriented funds and even thematic funds. With the improvement in deployment of investment through markets, the need and scope for mutual fund operations has increased tremendously. UTI was the first mutual fund set up in India in the year 1963 by Government of India. During the last 50 years, UTI has grown to be a dominant player in the industry with assets of over Rs 69450.3972 Crores. (as on 31-Mar-2013) and total number of schemes it offers are 472 till 30th April 2013.The assets has been increased to 87390.13 Crore at the end of 2014 and the number of schemes rose to 1232. (Source: indiainfoline) UTI Mutual fund is promoted by the four of largest public sector institutions SBI, LIC, Bank of Baroda and Punjab National bank with each of them presently holding a 18.5 percent stake. US-based T Rowe Price has acquired a 26% stake in UTI Asset Management Company Ltd which runs UTIMF. Mutual funds gained momentum in India since 1987 when public sector banks and insurance companies made an entry by floating different schemes. In 1987 public sector banks and insurance companies were permitted to set up mutual funds and accordingly since 1987, 6 public sector banks have set up mutual funds. Also the two insurance companies LIC and GIC established mutual funds. At the end of 1993, the mutual fund industry had assets under management of Rs 47004 Crores. (**Source; AMFI**). Mutual funds received more boost when in 1993 Government policy was changed to allow private sector mutual funds also to operate on equal terms with public sector mutual fund. With the entry of private sector funds in, a new era started in the Indian mutual fund industry, giving the Indian investors a wide choice of fund families.

1964- India's first mutual fund launches *i.e.,* US 64

1987- Amendment to the banking regulation Act in 1983, which empowered the RBI to permit the entry of banks to carry on mutual fund business. SBI (June1987) and Canara bank (December1987) made an entry in mutual fund world

1993- SEBI regulations for mutual funds industry (except UTI) come in to force first time and also in the same year industry is open to Private sector and foreign sector giving the Indian investors a wider choice of mutual funds products.

1995- Money market mutual funds set up.

1998- Mutual funds in troubled waters. CRB MF closes shop. Funds underperform index. US 64 flop shop.

2000- Shakeout imminent. Myth about safety and liquidity of investment in UTI broken.

2001- US 64 to be redeemed as per pre-determined rate scheme. Charitable institutions allowed keeping their surplus money in mutual funds. Committee formed to evolve benchmark for performance appraisal of debt schemes by SEBI and AMFI.

2002- SEBI to control UTI also

2003- In Feb-03, following the repeal of the Unit Trust of India Act 1963, UTI was bifurcated into two separate entities which include Specified Undertaking of UTI and the UTI Mutual Fund, sponsored by SBI, Punjab National Bank (PNB), Bank of Baroda (BOB) & LIC.

2004- Mutual funds allowed to invest in overseas securities.

2006- SEBI amended custodian of securities Act.

2007- Gold ETFs introduced by Benchmark AMC

2009- Entry load was abolished by SEBI

2012- SEBI introduced several progressive measures to " re-energize" the mutual fund industry and increase MFs penetration.

2016- The Number of SIP accounts crossed 1crore mark and currently each month retail investors contribute around Rs. 3500 crore via SIP. The Industry's AUM crossed the milestone of Rs.10 Lakh Crore for the first time as on 31st May 2014 and in a span of two years the AUM size has crossed **Rs. 15 lakh crore** in July 2016.

2019- Assets under Management (AUM) as on 31st July 2019 reached Rs.2453626 crore.

The total number of accounts (or folios as per mutual fund parlance) as on July 31, 2019 stood at 8.48 crore (84.8 million), while the number of folios under Equity, Hybrid and Solution Oriented Schemes, wherein the maximum investment is from retail segment stood at 7.62 crore (76.2 million).

13.8 RETURN METHODS

There are many ways to calculate return from the mutual funds investments. Absolute return and Annualized returns are two most popular method of measuring returns.

Absolute Return

Absolute return is the simple increase or decrease in investment calculated in terms of percentage. It does not consider the time taken for this change. So if investment's current value is Rs.620000 and initial investment was Rs. 300000 then the absolute return will be

$$\text{Absolute Return} = \frac{\text{current value} - \text{previous value}}{\text{previous value}} \times 100$$

$$= \frac{620000-300000}{300000} \times 100$$

$$= \mathbf{106.67\%}$$

In the above calculation you must observed that the date of investment and date of redemption both are irrelevant. So ideally, investor should use the absolute returns method if the investment period is less than 1 year.

For period more than one year annualized return which means to find out what the rate of return is per annum.

Annualized Return (CAGR)

A compound annual growth rate is the geometric average of annual growth. It measures the rate of return over an investment period. It is a smoothened rate because it measures the growth of investment as if it had grown at a steady rate on an annually compound basis.

CAGR = (Final Amount/initial amount) ^ (1/no. of years) -1

NAV's of Mutual Funds

S.No	Mutual Fund	March 31,2011	March 31,2012	March 31,2013	March 31,2014
1	**SBI Mutual fund**	525	530	569	834
2	**Quantum Mutual**	530	539	585	697
3	**Kotak Mutual**	540	538	583	671
4	**Canara Robeco**	70	72	74	94

*(imaginary figures)

In the above table NAV's of some mutual funds are given. By using the above formula we can calculate the absolute return and CAGR of the mutual funds can calculate. Learners must notice that to calculate the return of one year i.e. March 2012, we used the formula of absolute return. And to calculate the returns of 2013 and 2014 we used the formula of compound annual growth rate (CAGR). CAGR provides the constant rate of return over the time period.

Calculation of CAGR

S.No	Mutual Fund	Return on March 31,2102	CAGR on March 31,2013	CAGR on March 31,2014
1	**SBI Mutual fund**	0.95 %	4.1%	16.8%
2	**Quantum Mutual fund**	1.70%	5.0%	9.5%
3	**Kotak Mutual Fund**	-0.37%	3.9%	7.5%
4	**Canara Robeco Mutual fund**	2.85%	2.8%	10.3%

13.9 SUMMARY

India is the emerging economy as there is lot of potential in the financial sector of India. Mutual funds are dynamic financial institutions (FIs), which play a crucial role in an economy by mobilising savings and investing them in the capital market, thus establishing a link between savings and the capital market. Mutual fund units are investment vehicles that provide a means of participation in the stock market for people who have neither the time, nor the money, nor perhaps the expertise to undertake direct investment in equities successfully. On the other hand they also provide a route into specialist market where direct investment often demands both more time and more knowledge than an investor may possess. First mutual fund in India was UTI set up in 1963. Mutual funds gained momentum in India since 1987 when public sector banks and insurance companies made an entry by floating different schemes. Till now there are 44 mutual funds companies providing different schemes for the different profile of investor. With the entry of private sector funds, a new era started in the Indian mutual fund industry, giving the Indian investors a wide choice of fund families.

13.10 GLOSSARY

Mutual fund - It is an investment vehicle, which pools the saving of small investor with the aim to invest funds in the different securities. The returns thus generated shall be distributed among the investors.

NAV – The total value of a company’s assets less the total value of its external liabilities is its net asset value (NAV).

Assets under Management- Asset under management is the amount of fund managed by a fund manager or asset management company for the mutual fund. It also refers to the clients’ fund that a fund manager is responsible to manage. With the help of this, the size of the business of AMC is measured.

Open-ended fund- An open-ended fund is a mutual fund scheme that is available for subscription and redemption on every business throughout the year. An open -ended scheme is perpetual and does not have any maturity date.

Close-ended fund- A close-ended fund is open for subscription only during the initial offer period and has a specified tenor and a fixed maturity date.

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13.13 TERMINAL QUESTIONS

1. Discuss the progress of Indian Mutual Fund Industry?
2. What are absolute returns?
3. What is CAGR?
4. Explain how mutual funds are regulated in India?
5. Discuss open ended and closed ended funds?
6. What are Gold ETFs ?
7. What is the difference between ETFs and index funds?
8. What are mid-cap schemes?

UNIT 14 MERCHANT BANKING

14.1 INTRODUCTION

Merchant Banks primarily offer fee-based securities advisory services to corporations and governments. Merchant banks differ from commercial banks because they do not accept deposits from people or businesses. Merchant banks generally perform various other activities such as financing foreign trade, underwriting equity issues, portfolio management, undertaking foreign security business as well as foreign loan business, project appraisal, etc. However, not all merchant banks need to offer all these services. Merchant banking provides specialized financial services tailored to large corporations' needs, with a significant return earned through fees. Merchant banks are financial institutions capable of providing capital, financial advice, and loans to large enterprises, especially to those engaged in international trade. These banks are professionals in managing large-scale company operations and ensuring the economy's growth by funding global corporations and major corporate organizations within the country. Unlike general banks, merchant banks serve only businesses and large organizations. A merchant banker is likely to assist in the subscription of securities and plays a vital role in leading activities such as private placements, handling public security issues, stockbroking, and providing international financial advisory services.

14.2 OBJECTIVES

- After going through this unit, the learners will be able to:
- Get an overview of the concept and evolution of merchant banking.
- Able to explain the regulatory functions of merchant banking.
- Understand the code of conduct and duties of merchant bankers.

14.3 MEANING OF MERCHANT BANKING

According to SEBI, a Merchant banker is engaged in issue management either by making arrangements regarding buying, selling, or subscribing to a security manager consultant advisor or rendering corporate advisory service concerning such issue management.

14.4 HISTORY OF MERCHANT BANKING

Going back to the history of merchant banking In the United States, it is known as an investment bank, whereas in the United Kingdom, it is called an issuing house. India experienced the requirement of merchant banking services and was found to be important with the accelerating growth phase in the number of issues made in the primary market. In India, National Grind lays Bank began offering merchant banking services in 1969. Then in 1970, Citibank entered into the financial services market. The State Bank of India is likely to be the first and only Indian commercial bank that established a distinct Merchant Banking Division in 1972, and ICICI followed it in 1974. Later, the Bank of India, Bank of Baroda, Punjab National Bank, Canara Bank, and UCO Bank also set up the Merchant Banking Division.

14.5 FEATURES OF MERCHANT BANKING:

Here are the key features of Merchant Banking:

Being a specialized form of banking these banks focus on delivering customized financial services and guidance to the field of corporations, government, and to those individuals who possess high-net-worth as per the need.

- Merchant bankers execute as an intermediary between their customers and the financial markets and assist customers in raising capital, managing the probability of risks, and investing more wisely.
- Merchant banking services accompanied by underwriting, syndication, mergers and acquisitions, portfolio management, restructuring corporate, and project financing.
- Merchant bankers are competent at accurately analyzing financial data, assessing different trends in the market, and even identifying sustainable investment opportunities for their respective clients.
- Merchant banking needs a very high level of expertise in their field and experience in the financial markets to build strong relationships with other financial institutions, regulators, and key stakeholders.

Merchant banking functions:

Generally, Merchant banking operations in India are regulated by the Securities and Exchange Board of India (SEBI) Regulations, 1992.

14.6 FUNCTIONS OF MERCHANT BANKING

1. Corporate Counseling: This counseling is regarded as the beginning of corporate consulting merchant banking services. Every industrial unit, whether new or already existing has its requirements. Corporate consulting covers a diversified area encompassing a wide range of merchant banking activities including service project consultancy, project management, loan syndication, working capital management, capital restructuring, public issue management, fixed deposits, and lease financing.

2. Project Counseling: It deals with project finance and also comprises preparing project-related reports, the cost of the project, and the arrangement of financing patterns. The Projects are evaluated and appraised based on factors including project location, marketing, technical, and financial feasibility of the project.

3. Loan Syndication: It refers to a loan organized by a bank for a borrower, most frequently a huge company, which can be a local authority, or it can be a government department. So, in this scenario, the merchant banker first of all needs to settle the project's cost before asking a financial institution for term loans. After that, the merchant banker should create the capital structure, fix -the promoter's contribution, and estimate approximate amount to be raised. It even ensures that the project follows finance standards for industrial projects. Merchant bankers provide complete loan syndication services for all types of agreements. Loan Syndication It helps customers obtain loans from banks and financial institutions.

4. Management of Capital Issues: The sale of securities, likely to be equity shares, preference shares, debentures, and bonds, to investors has been involved in the management of capital issues. Merchant bankers in practice prepare action plans and budgets for the total expenditure for the issue, Draft the prospectus get the letter of consent publicity, coordinate underwriters, and select advertising agencies for pre-issue and post-issue, merchant bankers also advise the issuer company related to the kind of securities to be issued. For the issue to be successful, the merchant banker needs to maintain close contact and coordination with multiple agencies involved in public issues. Preparation of the issue for ensuring a full subscription is considered to be a prime responsibility of merchant bankers It is the core responsibility of the merchant banker to prepare the issue for ensuring a full subscription.

5. Corporate Advisory Services: Merchant bankers set up corporate advisory service branches to provide specialized services to their corporate clients. In India, SEBI guidelines used to insist that all issues be managed by at least one of the authorized merchant bankers. The issue's success depends on selecting the right type of security. Therefore, the expert's advice is of utmost need for merchant bankers to ensure success and security.

6. Portfolio management: It refers to risk minimization and return maximization. Therefore, portfolio management term can apply only to shares and debentures Generally, merchant banking deals with advising investors in making investment decisions. Merchant banks provide portfolio management assistance to investors by trading securities on their behalf. Merchant bankers offer portfolio management services to their clients and assist investors choose the appropriate kind of securities that are safe ensuring liquidity and profitability. Therefore, merchant bankers need to keep regular records of market information and regular economic surveys all the time.

7. Advisory Services to Mergers and Takeovers: A merger involves combining two companies so that only one will survive and the other will go out of existence. whereas, a takeover involves purchasing one company from another, acquiring and controlling an interest in the share capital of another involved existing company. A merchant banker acts as an intermediary between the two companies, protecting their interests. It gets approval from government financial institutions or RBI.

8. Leasing: In lease transactions, the merchant banker provides necessary services for arranging lease finance facilities to renowned leasing companies, advising on optimal structuring of the transaction, legal documentation and even required for tax counseling.

9. Foreign Currency Financing -. The prime areas covered in the field of merchant activity are as follows:

- **A.** Assisting in analyzing the study of turnkey and construction contract projects.
- **B.** Assisting with working groups, and liaising with RBI, ECGD, and other leading institutions.
- **C.** Assisting in the opening and operation of bank accounts abroad. Assisting in receiving export credit facilities from the EXIM bank for the export of

capital goods as well as obtaining the relevant government approvals and clearance. Managing the forward protection for exchange risk.

D. Guiding the forward protection for exchange risk.

E. Assisting exporters in arranging foreign currency guarantees and performance bonds for exporters.

10. Providing Venture Capital Financing- Merchant bankers assist companies in getting venture capital financing to finance their innovative and new strategies.

11. Broking -Brokers are persons who are primarily concerned with the procurement of subscriptions to the issue from prospective investors. The appointment of brokers is not mandatory and the companies can appoint any number of brokers.

12. Act as Debenture Trustee-Person who are appointed to safeguard the interest of debenture holders are known to be debenture trustees. They are to be appointed prior to the issue of debentures by a company. No one can act as a debenture trustee unless they have obtained a certificate of registration from SEBI for the purpose.

13. Promotional Activities—As the leading sector merchant bank, we also support the promotion of business organizations in their beginning phase. This enables the organization to work on its business ideas and access them to get approval from the government.

14. New business opportunities: Merchant banking provides many support and innovative opportunities for new businesses, which has a positive impact on the country's economic growth.

15. Raising funds for customers -Apart from acting as a tool for customers to raise funds. It can raise funds from the domestic and international markets by purchasing securities with the help of merchant banks.

14.7 CATEGORIES OF MERCHANT BANKING

Merchant banking is divided into four categories:

1. Category I: This carries on several activities initially, starting with the preparation of the prospectus and other documents associated with the security issue, decision on financial structure, contracting with most leading financiers, final allotment process and the subscription refund, acting as an adviser, performing as an underwriter, consultant, portfolio manager, or other manager.

2. Category II: In this category, the merchant banker can serve as an adviser, consultant, co-manager, underwriter, and portfolio manager. It implies that the merchant banker is unable to undertake issue management on their own.

3. Category III: The merchant banker area is restricted to performing as the underwriter, adviser, and consultant for an issue. In this category, they are not allowed to undertake issue management, cannot perform as co-managers, and do not have the right to conduct portfolio management business.

4. Category IV: This category restricts performing merely as an adviser or a consultant for an issue and the merchant banker cannot involved in fund-related activities.

14.8 REGISTRATION OF MERCHANT BANKING

The merchant banking activities such as project counselling, bill acceptance, and discounting, merger and amalgamation, mutual fund, and venture capital do not require registration under these regulations and these activities require SEBI's registration but under their specific regulations. Merchant bankers that fall under category I are only registered under SEBI regulations of merchant banking. A prescribed format is followed for the submission of the application. To obtain the certificate and registration and operate as a merchant banker the two wide sets of criteria need to be fulfilled:

Operational capabilities: Being operating as a merchant banker and having a certificate the related agency should be competent in the respected parameters.

A few of them are:

1. As defined under the Reserve Bank of India Act, 1934 the applicant shall be a corporate body other than a nonbanking financial company.

2. The applicant must possess the required infrastructure such as sufficient space in the office, adequate equipment, and suitable manpower for performing the activities effectively.

3. There must be at least two people as applicants who should have experience in conducting business as the merchant banker.

4. The applicant must possess qualifications with a professional degree from a recognized reputed institution.

5. According to the criteria of SEBI regulation the applicant must meet the conditions outlined in SEBI regulations.

The SEBI's duty is that the kind of registration should be in the favor of investors.

Capital adequacy: Another criterion is capital adequacy. SEBI should desire that the applicant must have capital in adequate amount and expressed in terms of the value of capital that has been contributed to the business that is net worth and free reserves. A sum of 50000 fees is to be paid while registration but the fee is non-refundable. An amount of Rs 5 crore needs to be maintained for the life of the registration. The registered merchant banker needs to submit a fee of Rs 20 lakhs to receive the certificate finally. The time duration for granting registration is five years at one time. Those applicants who fulfill these criteria have been granted registration.

To keep the registration in regulation a merchant bank with the certificate of registration needs to pay nine lakh rupees fee every three years from the commencement of the sixth year, and from the date of registration grant of the certificate, for the registration not to break the application need to be made within one month before the certificate expiry. Although it is called renewal, the application is processed for new registration.

14.9 CODE OF CONDUCT OF MERCHANT BANKING

As the registration process has been done, adhering to a proper code of conduct specified in the regulations is required. For acting as a merchant banker there are some significant provisions of the code as follows:

1. All efforts should be made by merchant bankers to safeguard the investor's interest.

2. A high standard of integrity and dignity needs to be maintained in the conduct of the business.

3. All the obligations should be fulfilled in a professional, and prompt manner.

4. To avoid conflict and confusion in the job description the merchant banker should perform the responsibilities of the intermediaries appointed by it.

5. An adequate disclosure maintained to the investors by the merchant banker on time avoiding any misleading claims.

6. The merchant banker shall make none of the untrue statements.

7. The merchant banker must follow good corporate policies and governance.

14.10 DUTIES OF MERCHANT BANKER

Every issue is handled by one merchant banker who serves as the 'lead manager'. A lead manager is not necessary if the issue is right. The merchant banker serving as lead manager must sign an agreement with the company outlining mutual rights and duties related to this issue.

Various duties of merchant bankers have been laid down by SEBI regulation so that parties get fair treatment of those involved in public issues. Some of the merchant banker duties are below:

1. If there is a case where there is more than one merchant banker involved then the merchant banker has to surpass their duties as well as responsibilities and, in this case, one month before the opening of the issue the information about the statement of division of job and responsibilities should be furnished to SEBI.
2. In case the activities where division is sought based on both the pre-issue and post-issue activities then SEBI should ensure that post activities need to be the responsibility of a lead manager. The required follow-up steps are confined such as multiple applications weeding out, instruments listing, refunds, certificate dispatch,

and all.

3. It is a provision that the lead manager must accept a minimum of five percent underwriting obligation of the total underwriting or Rs 25 lakh whichever amount is less.

4. The lead manager is entitled to continue as lead manager with the issue by the time the subscribers have gained the certificate or repayment of excess money.

5. There is a case where a lead merchant banker cannot be associated with an issue if another merchant banker without a certificate is involved with the issue.

6. There is a rule where the lead manager has joint and multiple responsibilities for a certain activity, a designated coordinator from among the lead managers must provide SEBI with a report, and feedback. on situations concerning joint responsibility.

Check Your Progress-A

Q1. Define the concept of Merchant Banking.

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Q2. Explain any two duties of a merchant banker.

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………………………………………………………………………………………

Q3. What are the features of a merchant bank?

………………………………………………………………………………………
………………………………………………………………………………………
………………………………………………………………………………………
………………………………………………………………………………………

Q4. MCQs

1. When did merchant banking originate in India?

a).1975

b).1986

c).1969

d).1990

2 In the light of the below statement choose the right option:

Statement I: In category II, the merchant banker can serve as an adviser, consultant, co-manager, underwriter, and portfolio manager.

Statement II: In category III, the merchant banker is restricted to acting as the underwriter, adviser, and consultant for an issue.

a). Both statement I and II are correct.

b). Both statement I and II are incorrect.

c). Statement I is correct, but statement II is incorrect.

d). Statement I is incorrect, but statement II is correct.

14.11 WORKING OF MERCHANT BANKING

- Merchant banks commonly engage with reputed and large, established corporations that need assistance with mergers and acquisitions, IPOs, and other sophisticated financial transactions.
- Merchant banks may offer services including underwriting, corporate finance, securities trading, and advising services.
- Investment management, asset management, and wealth management are some of the popular services that merchant banks may offer to individuals with high net worth including families.
- Due to the special nature of their working process, these banks demand more fees for their services as compared to other general banks.
- Merchant banks can take ownership of holdings in the companies they typically operate, potentially resulting in increased revenues and better investment opportunities.
- These banks mostly operate independently or are considered to be part of huge financial organizations like commercial banks or investments.
- The merchant banking business has seen itself evolve drastically with time and new legislation and market dynamics have impacted the way of operation of merchant banks and serving their customers.

SIGNIFICANT PARAMETERS OF MERCHANT BANKER-

The parameters that are broadly classified in evaluating merchant bankers:

1. Qualitative
2. Quantitative

1. Qualitative deals with the factors confined to the quality of service that has been rendered by the merchant banker. It emphasizes the skills of the staff with the merchant banker. The employed officials must have specialized knowledge and expertise in the area of finance, evaluation of marketing, and projects with the

knowledge of operation research. Apart from this the employed should be updated continuously about international practices and must have a creative approach, honesty, friendly behavior, transparency towards work, and a problem-solving attitude.

2. Quantitative by the name itself this factor deals with the number measured in quantity terms. It covers the statistical facts likewise- the amount of funds, the total number of issues, and the size to be handled. This parameter also covers the number of professionals including the staff members who are qualified and the merchant banker treated to be efficient possessing high net worth.

Check Your Progress-B

Q1. Describe in detail the various functions of merchant banking.

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Q2. Explain the two significant parameters of merchant banking.

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Q3. MCQs

1. Choose Portfolio management means:

a). Risk minimization

b). Return maximization

c). Lease financing

d). Bill discounting

A) a and b only B) a only

C) a, b and c only D) d only

2. Assertion A: Qualitative emphasizes the skills of the staff with the merchant banker.

Reason R: Quantitative deals with the factor, which deals with the number measured in quantity terms.

A). Both A and R are correct, and R is the correct explanation of A.

B). Both A and R are correct, and R is not the correct explanation of A.

C). A is correct, but R is not correct.

D). A is not correct, but R is correct.

3. Statement I: Merchant banks do not offer services including underwriting, corporate finance, securities trading, and advising services.
Statement II: Investment management, asset management, and wealth management are some of the popular services that merchant banks may offer.

In the light of the above statement choose the right option:

a). Both statement I and II are correct.

b). Both statement I and II are incorrect.

c). Statement I is correct, but statement II is incorrect.

d). Statement I is incorrect, but statement II is correct.

14.12 SUMMARY

Indian merchant banking has a significant impact on the country's economy. Project and issue management, portfolio management, loan syndication, underwriting of public issues, stock exchange brokering, lease finance, mutual funds, non-resident investment advice, and corporate advice are all examples of merchant banking services. They also serve as a channel for distributing concerns. All merchant banks in India are registered by the Securities and Exchange Board of India (SEBI). With rapid economic expansion, complicated procedures, and spectacular industrial development, the need for expert advice and guidance from specialists or professionals in the field of finance has become very necessary. It has also needed a slew of regulations for industry, capital, issues, foreign investment and collaboration, amalgamations, the Companies Act, SEBI, and government policies on backward area development, export promotion, and import substitution, among others. This is where merchant bankers come into the scenario and its importance has been recognized. The policies of SEBI have resulted in effective regulatory procedures for disciplining the operation of merchant bankers in India. The goal is to control financial markets, and therefore, streamline the development of India's capital market. The growth of India's economy is aided by merchant banking. It acts as a safety net for enterprises venturing into international markets. Both the investing and non-investing activities help the businessman to start up a new venture and develop the industrial sector. Improving investment climates and expanding capital markets are the primary goals of merchant banking. Thus, Merchant banking acts as a critical component of the Indian financial system.

14.13 GLOSSARY

Acquisition: Takeover of one entity by another

Amalgamation: Action or process of merging two or more things.

Broker: Act as an intermediary between a client and a security exchange.

Disclosure: Documents that make information known.

Feasibility: Possibility that something can be done.

Leasing: A contract where one party grants a right to use an asset for an agreed period.

Merger: Two separate entities combine to create a new, joint organization.

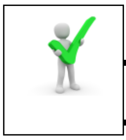
Mutual fund: It is an investment fund that pools money from many investors to purchase securities.

Procurement: Action of obtaining something.

Stockbroking: Activity of buying and selling stock or equities.

Underwriter: A person who plays a critical role in assessing and evaluating risk.

Venture capital: Is a type of funding that provides funds to start-ups or, emerging companies in exchange for equity.



14.14 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

1. c 2 a

Check Your Progress-B

Q3. MCQs

1.a 2 b 3d

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14.16 SUGGESTED READINGS

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14.17 TERMINAL QUESTIONS

1. What is merchant banking? Explain the functions of merchant banking.
2. Describe the categories of merchant banking.
3. Explain in detail the registration process of merchant banking.
4. Explain the duties of merchant banking.
5. Discuss the code of conduct laid down for merchant bankers by SEBI.
6. Describe the significant parameters of merchant banking.

UNIT 15 LEASING AND HIRE PURCHASE

15.1 INTRODUCTION

During the last few decades, the global financial services have been witnessing several significant developments. One among them is the initiation of the process of leasing. Leasing is a method of financing the acquisitions of capital equipment. In addition to debt and equity financing, leasing has emerged as a third important source of intermediate and long-term financing of corporate enterprises during the recent few decades. It is widely used in western countries to finance investments. Prior to 1950, leasing was primarily concerned with real estate, i.e., land and buildings. But today all types of fixed assets can be leased.

In India leasing is a recent development and equipment leasing was introduced by First Leasing Company of India limited in 1973 only. For several years, this company remained the only company in the country until 20th Century Finance Corporation was set up around 1980. Several medium to large sized companies, financial institutions like ICICI, IRCI, SICOM and GIC have also entered the field of leasing.

15.2 OBJECTIVES

After reading the unit, the learner shall be able to learn;

- Types of Leases
- Difference between a Financial Lease and Operating lease
- Forms of Financial Lease
- Advantages of Lease
- Disadvantages of Lease
- Origin and Development of Hire Purchase
- Meaning and Features of Hire Purchase

15.3 MEANING AND DEFINITION OF LEASING

- Leasing is an arrangement that provides a firm with the use and control over assets without buying and owning the same. It is a form of renting assets. Leasing refers to a contract under which the owner of an asset allows another person or party to use the asset in return for some rent. The Owner of the asset is the lessor and one who pays the rental and uses the asset is the lessee. The lease contract is regulated by the terms and conditions of the agreement. The lessee pays the lease rent periodically to the lessor as regular fixed payments over a period. The rentals may be payable at the beginning or end of a month, quarter, half year or year. Leasing essentially involves the divorce of ownership from the economic use of an asset/equipment. It is a device of financing the cost of an asset. It is a contract in which specific equipment required by the lessees is purchased by the lessor (financier) from a manufacturer/ vendor selected by the lessees. The lessees have possession and use of the asset on payment of specified rentals over a predetermined period of lease. At the end of the period of the contract (lease period), the assets/equipment revert to the lessor unless there is provision for the renewal of the contract.

- The assets given under lease could be any product e.g., machinery used to produce steel pipes. or a service, e.g., providing transportation by an automobile agency. Parties the lease arrangement may be individuals, partnership firms, corporate bodies and financial institutions which lease assets, equipment etc. to the lessees under a contract of lease for a predetermined lease rental.

DEFINITIONS

- The Internation Accounting Standards Committee has defined a lease as," an arrangement whereby the lessor conveys to the lessees in return for rent, the right to use an asset for an agreed period of time."
- "Lease is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive rights to use the asset usually for an agreed period of time in return for the payment of rent." James C, Van Horne
- "A contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee has the possession and use of the asset on payment of specified retain over the period."Equipment Leasing Association of UK

15.4 ESSENTIAL ELEMENTS OF LEASING

1. No. of Parties to the contract: There are always two parties to a contract of lease financing.
   a. The owner or the lessor
   b. The user or lessees
2. Asset: The subject matter of a lease financing contract may be an asset, service property or equipment e.g. plant machinery, land and building etc.
3. Consideration: the right to use an asset is given to the lessee for a consideration called lease rentals. Lesse rental is determined by the lessor taking into consideration the amount invested in the asset, depreciation, interest on capital, repairs etc.
4. Terms of the Lease: The term of the lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period otherwise it will be legally inoperative. It may sometimes spread over the entire economic/ useful life of the asset. At the expiry of the lease period the asset reverts to the lessor who is the legal owner of the asset.

5. Ownership separated from user: The essence of a lease financing contract is that during a lease tenure ownership of the asset vests with lessor and its use is allowed to the lessee. On the expiry of the lease period, the asset reverts to the lessor.
6. Modes of terminating Lease: The lease contract comes to an end after the expiry of the lease period. After termination:
   a. The contract many be renewed for another definite period
   b. The lessee may buy the asset
   c. The assets revert to the lessor who can further lease to third party.

15.5 STEPS INVOLVED IN LEASING TRANSACTION

The steps involved in a leasing transactions are mentioned below:

1. First, the lessee must select the type of asset to be taken out for lease. He must select the lessor as well. Usually, a lessee selects a lease on the basis of the lease payments, epuration of the lessor, terms of guarantees and warranties, installation, services and time taken by the lessor to finalize a deal. Then a lessee approached the leasing company for lease financing.
2. The lessee then enters into a lease agreement with the lessor. A deal between a lessor and lessee is formalized in the form of lease agreement. It contains the complete details of the lease transaction and specifies the legal obligations of the lessor and lessee. It is a commercial transaction which is in conformity with the existing legislation. A lease agreement contains the following terms and conditions:
   a. The agreement specifies whether a lease is an operating lease, financial lease or leveraged lease.
   b. The basic lease period during which is lease is irrevocable.
   c. The agreement specifies the procedure for paying the lease rentals by lessee to the lessor at a specific rate. The advance and guarantee required are included as well. Late payment charges are also mentioned, and a lessor may charge a specific rate of interest on the defaulted amount for an overdue period.
   d. Details regarding payment of cost of maintenance and repairs, taxes, insurance and other expenses.
   e. At the end of lease period the agreement provides either for the renewal of the contract, or return of the asset or sale of the asset to lessee by the lessor
3. After the lease agreement is signed, the lessor contacts the manufacturer and requests him to supply the assets to the lessee. The lessor makes payment to the manufacturer after the asset has been delivered and accepted by the lessee.

15.6 TYPES OF LEASE

1. **FINANCE LEASE:** A finance lease is a method of equipment financing. It is a non-cancellable lease contract or medium term. A lessor extends credit to a lessee and transfers all responsibilities of ownership such as maintenance, insurance and taxes to a lessee for the period equal to the economic life of the asset. A lessee may either purchase the asset or return it to the lessor at the termination of the lease contract. The lessee uses the equipment exclusively, maintains it, insures and avails after sale service and warranty backing it. He also bears the risk of obsolescence as it stands committed to pay the rental for the entire lease period.

Under a financial lease, the rate of lease would be fixed based on the kind of lease, the period of lease, periodicity of rent payment and the rate of depreciation and other tax benefits. The leasing company also charges nominal services charges to cover legal and other costs. The leasing company may also insist on collateral or bank guarantee in individual cases. In many cases, the financial leases are used as financing-cum-tax planning tool. The financial lease may contain a non-cancellable clause which means that the lessor transfers the titles to the lessees at the end of the lesser period.

CHARACTERSTICS OF FINANCE LEASE:

a) A lessee selects the equipment and a lessor. A lessor may recommend alternate equipment, but the final decision is with the lessee.
b) A lessee uses the equipment for the purpose of business. Equipment leasing generally excludes consumer finance and hire purchase activities.
c) The equipment is purchases by a lessor
d) A lessor keeps the title to the equipment throughout the tenure.
e) As compared to the operating lease, a financial lease is for a longer period.
f) The finance lease is non-cancellable. This means that if lessee terminates the lease either voluntarily or by default, he has to a sum of penalty as compensation.
g) A lessee has the exclusive right to use the equipment. The third party does not have any right to it. A lessee and lessor both should agree on a sub leasing agreement.
h) The present value of total lease rentals payable during the period of lease exceeds or is equal to substantially the whole of the fair value of the leased asset. It implies that within the lease period, the lessor recovers his investment in the asset along with an acceptable rate of return.

2. **OPERATING LEASE:** An operating lease is also known as a service lease, short term lease or true lease. In this lease, the contractual period between the lessor and lessee is less than the full expected economic life of the equipment. This means that the lease is for a limited period may be a month, six months, a year or few years. The lease is terminable by giving stipulated notice as per the agreement. Operating lease generally remains in effect for a short term to medium term.

An operating lease is one which is not a finance lease. It is a simple agreement between the owner of the equipment (lessor) and end user (lessee) which provides the exclusive use of the equipment by a lessee for a monthly fee.it is an arrangement to rent the equipment to be used for a fixed period. In an operating lease, a user (lessee) will have to return the equipment to the lessor at the end of the lease term without an obligation for a residual value. Hiring of computers with operators and hiring of a taxi for travel with driver services, fuel and provision for maintenance are example of operating lease.

CHARACTERSTICS OF OPERATING LEASE: An operating lease is usually characterized by the following features:

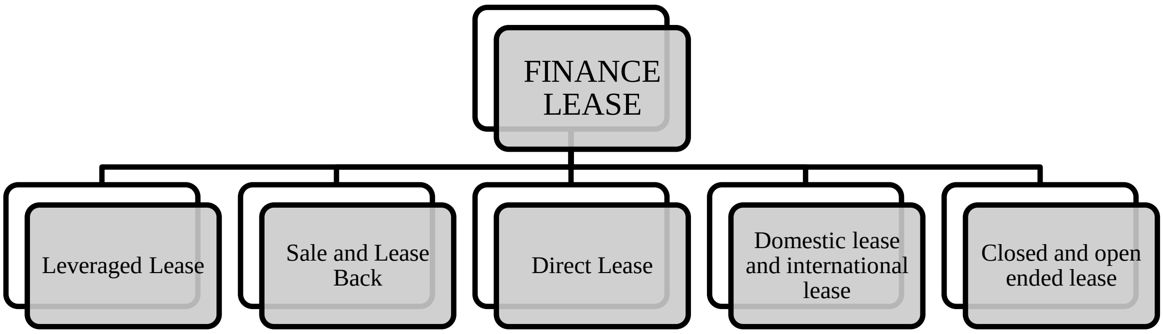
i. It is short term lease on a period-to-period basis. The lease period in such a contract is less than the useful life of the asset.
ii. The lease is usually cancellable at short notice by the lessee.
iii. As the period of an operating lease is less than the useful life of the asset, it does not necessarily amortize the original cost of the asset. The lessor must make further leases or sell the asset to recover his cost of investment and expected rate of return.
iv. The lessee usually has the option of renewing the lease after the expiry of the lease period.
v. The lessor is generally responsible for maintenance, insurance and taxes of the assets. He may also provide other services to the lessees.
vi. As it is a short-term cancellable lease, it implies higher risk to the lessor but higher lease rentals to the lessees.

15.7 DIFFERENCE BETWEEN A FINANCIAL LEASE AND OPERATING LEASE

FINANCE LEASE	OPERATING LEASE
1. A financial lease is like an installment loan. It is a legal commitment to pay for the entire cost of the equipment plus interest over a specified period. The lessee commits to a series of payments which in total exceed the cost of equipment. 2. The risk of obsolescence is assumed by the lessees	1. An operating lease is a rental agreement. The lessee is not committed to paying more than the original cost of the equipment during the contractual period. 2. Leasing company assumes the risk of obsolescence. 3. Contract period ranges from intermediate to short term

3. Contracts period ranges from medium to long term 4. Contracts are usually non-cancellable 5. It exudes provision for maintenance or taxes which are paid separately by the lessee 6. The lease involves a financial commitment like a loan by a leasing company. It places the lessees in a position to borrow 7. The lessor fulfills the financial function 8. The full cost is recovered from one lessee. 9. Aircrafts, land and building, heavy machinery are leased.	4. Contracts are usually cancellable either by the lessor or by the lessee. 5. Operating lease provides for maintenance expenses and taxes of the lessor. 6. The financial commitment is restricted to regular payments. The rentals find a place in the P& L A/C of the lessee. 7. The lessor fulfills service function. 8. The full cost is recovered from many leases. 9. Computers, office equipment, automobile, trucks etc. are leased.

15.8 FORMS OF FINANCIAL LEASE



LEVERAGED LEASE: This type of lease is mainly used to provide finance for equipment assets which require a huge capital outlay. The assets leased through leveraged lease are large ticket items which include aeroplanes, satellites, ships, power generation plants etc. Since the assets are of high cost, finance requirement is also heavy. A leasing company generally purchases the equipment by providing 20 to 40 percent of the cost of equipment. The remaining amount is borrowed from financial institutions/banks etc.

A leveraged lease is an arrangement under which the lessor borrows funds, for purchasing the asset, from a third party called a lender which is usually a bank or a finance company. The loan is usually secured by the mortgage of the asset and lease rentals to be received from the lessee. The loan is paid back out of the lease rentals, may be directly by the lessee by paying the excess amounts to the lessor. The lessor acts as the owner as well as the borrower and lender are usually a bank, insurance company, financial institutions or a private financing company.

SALE AND LEASEBACK: A sale and leaseback arrangement involves the sale of an asset already owned by a firm (vendor) and leasing of the same asset back to the vendor from the buyer. This form of lease arrangement enables a firm to receive cash from the sale of asset and also retain the economic use of the asset in consideration of periodic lease payments. This type of lease is beneficial to the lessor and lessee. The lessor gets the benefits due to depreciation and lessee gets immediate cash inflows and his liquidity position improves. Companies having short term liquidity crisis adopt this type of leasing, for example the bank sells the safe deposit vaults to the leasing company. The company leases it back to the bank on a long- term basis. The safety locker is sub leased to the customers.

DIRECT LEASE: A direct lease can be defined as any lease transaction which is not a sale and lease back. A direct lease may be arranged either by supplier/ manufacturer directly or through leasing company. Hence a direct lease can be of two types:

a) Bipartite lease: It consists of two parties, the equipment supplier-cum lessor and the lessees.
b) Tripartite lease: It involves three different parties - an equipment supplier, a lessor and a lessee. Most of the equipment lease transactions fall under this category.

DOMESTIC LEASE AND INTERNATIONAL LEASE: In domestic lease, all the parties to the transaction, namely the equipment supplier, lessor and lessee are domiciled in the same country. If these parties are domiciled in different countries, the lease transaction is called an international lease.

CLOSED AND OPEN-ENDED LEASE: A close lease is arranged on a net basis and equipment is released to the lessor in the end. Loss of residual value is with lessor. Open - ended leases are generally net leases. Where the title of the equipment passes to lease upon exercising the purchase option or upon payment of guaranteed residuals. A part of the risk of loss of residual value is passed to the lessee. The possibility of ownership is also open to the lessee.

15.9 ADVANATAGE OF LEASE

Leasing is beneficial to the lessee and lessor in different aspects. Some of advantages are:

TO THE LESSEEE:

The lessee has the following advantages:

1) **Permit alternative use of funds**: A leasing arrangement provides a firm with the use and control over assets without incurring huge capital expenditure. The firm is

required only to make periodical rental payments. It saves considerable funds for alternative uses which otherwise are tied in the fixed capital.

2) **Cash flow Benefits:** Rentals are fixed when the lessee and lessor enter into agreement. This helps to have proper capital budgeting and forecasting of cash flow as the scarce resources could be used for investment in other assets and for working capital needs.
3) **Easy source of finance**: Leasing provides one of the easiest sources of intermediate and long-term financing, It does not require any mortgage of the assets because the ownership of asset leased remains with the lessor and not with the lessee. Moreover, various restrictive provisions imposed in term loan financing are avoided. The initial cost of raising finance through leasing is also much less than that of raising long-term loans.
4) **Flexibility:** Leasing arrangement may be tailored to the lessee’s need more easily than ordinary financing. Lease rental can be structured to match the lessee’s cash flows. It can be skipped during the months when the cash flows are expected to be low.
5) **Protection against obsolescence**: A firm can avoid the risk of obsolescence by entering operating lease arrangement. This is highly useful in respect of assets which become obsolete at a faster rate.
6) **No restrictive covenants**: The restrictive covenants such as debt-equity ratio, declaration of dividend etc. which are usually imposed debenture or loan agreement are absent in a lease agreement.
7) **Hundred per cent financing**: Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So, hundred per cent financing is assured to the lessee
8) **Hedge against inflation**: The rentals are prefixed and are not affected by inflation. It also provides a hedge against obsolescence when machinery is funded by own or borrowed funds and proves to be a loss to the owner on becoming obsolete within one or two years. In the case of debt financing, the interest rate may increase along the rate of inflation and hence it is not a good hedge against inflation.
9) **Promoter’s control:** the promoter ‘s control over the company is diluted of the required finance is raised through equity of debenture instead of leasing.
10) **Boon to small firms**: The firms which are either small or have uncertain records of earnings can obtain the use of assets through lease financing. It is a boon to small firms and technocrats who can make promoter’s contribution as required by financial institutions

TO THE LESSOR

A lessor has the following advantages:

I. **Better profitability**: The income earned through leasing is greater than in direct lending finance. If a lessor carries out his business with borrowed capital, the rate of return is more than what he pays as interest.

II. **Tax benefits:** The lessor being the owner of the asset can claim various tax benefits such as depreciation, investment allowances etc. In fact, leasing has been successfully employed by the leasing companies to reduce their tax liabilities.

III. **Safe Financing:** A lessor is the owner of the asset. If a lessor fails to pay the lease rentals as per the lease agreement, a lessor can repossess the asset.

IV. **Quick return:** The lessor gets quick return in the form of lease rentals as compared to investments in other projects which have a longer gestation period.

V. **Increased sales:** lease financing through third parties has helped manufacturers to increase their sales. The lessors are also able to demand certain concessions from the manufacturers.

15.10 DISADVANTAGES OF LEASE

Disadvantages of leasing for the lessee:

i. **Loss or moratorium:** The lease rentals do not take care of the gestation period. It usually takes a long time before the asset generates funds to pay it back. The term loan provides a certain moratorium period in repayments for that reason. but no such moratorium is permitted under lease arrangements.

ii. **Risk of being deprived of the use of the asset:** The lessee may be deprived of the use of the asset due to deterioration in the financial position of the lessor or winding up of leasing company.

iii. **Penalties on termination of lease:** The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.

iv. **No alteration or change in asset:** As the lessee is not the owner of the asset, he can not make any substantial changes in the asset. Contrary to it, in case of outright purchase the buyer can modify or alter the asset to increase the utility.

v. **Loss of ownership Incentives:** There are certain advantages of owning the assets such as depreciation and investment allowance. In the case of lease, the lessee is not entitled to such benefits.

vi. **Loss of salvage value of the asset:** An asset generally has a certain salvage value at the expiry of useful life. As the lessor does not become the owner of the asset. He can not realize the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

Disadvantages to the lessor

i. **High risk of obsolescence:** The lessor has to bear the risk of obsolescence especially in the present a era of rapid technological developments.

ii. **Competitive Market:** As several leasing companies have emerged in recent years in India, the lessor must face a tough competition from India as well as foreign companies. Due to this competition the lessor may not be able to obtain sufficient lease rentals to recover the cost of the asset and his expected profit on investment as well as taking the risk.

iii. **Management of cashflows:** The success of a leasing business depends largely upon efficient use of cash flows, which are very difficult to manage because of unexpected market fluctuations.

iv. **Long term investments:** It usually takes a long time to recover the cost of the lessor in the capital outlays through lease rentals.

v. **Price level changes:** Despite the increase in prices of assets due to inflation the lessor gets only fixed rentals based on previous costs.

15.11 ORIGIN AND DEVELOPMENT OF HIRE PURCHASE

The growth and development of the hire purchase system can be traced back to the advent of industrial development in UK. Henry Moore, a Bishopsgate piano maker introduce the system of hire purchase in 1846 in UK. Cowperthwait & Sons, a furniture dealer introduced hire purchase system in the US in 1807. The Singer manufacturing company started selling sewing machines under a hire purchase agreement. The idea was developed by Wagon Companies which were formed to finance the purchase of wagons by collieries. The wagon companies bought the wagons and then let them out collieries under hire purchase agreement.

In India Hire purchase finance started only after World War 1. However, it was only after World War II that its growth assumed visible dimension. The concept of hire purchase was not quite popular in the pre-independence period though a few were endeavoring to increase the volume of their business with the provision of extending credit to intending buyers. With the increase in economic activities, many non-banking financing companies entered the scene in fifties and sixties.

The pioneers in the field were commercial credit corporation Limited, Motor and General Finance Limited and investment supply limited. These companies were set up predominantly to finance the road transport sector. Today, about 25 percent of commercial vehicles are accounted for by hire purchase. In addition to commercial vehicles, purchase of consumer articles like household appliances, air conditioning, refrigerators, office furniture and equipment are financed through hire purchase.

The institutions engaged in the hie purchase business in organized sector include commercial banks, cooperative banks, State Finance Corporations, National Small

Industries Corporations and in the unorganized sector they comprise many partnership firms and individuals.

Purchase and sale of goods under the Hire -Purchase system is governed by the Hire -Purchase Act,1972. The act was passed on 8th June,1972 and came into force w.e.f. September 1,1973. Here the, word "hirer" denotes , the sum payable periodically by the hirer under a hire purchase agreement. Under the Hire Purchase System, the owner of the goods lets his goods on hire and gives a option to the hirer to purchase the goods in accordance with a specific agreement called Hire Purchase Agreement.

15.12 MEANING AND FEATURES OF HIRE PURCHASE

Hire purchase means a transaction where goods are purchased and sold on the terms that

i. Payment will be made in instalments.
ii. The possessions of the goods is given to the buyer immediately,
iii. The property (ownership) in the goods remains with the vendor till the last instalment is paid.
iv. The seller can repossess the goods in the case of default in the payment of any instalment and
v. Each Instalment is treated as hire charges till the last instalment is paid.

FEATURES OF HIRE PURCHASE

The main characteristics of a hire purchase agreement are as follows:

i. The payment is to be made by the hirer (buyer) to the hiree, usually the vendor, usually the vendor, in installments over a specified period.
ii. The possession of the goods is transferred to the buyer immediately.
iii. The property in the goods remains with the vendor (hiree) till the last instalment is paid. The ownership passes to the buyer (hirer) when he pays all installments.
iv. The hirer or the vendors can repossess the goods in case of default and treat the amount received by way of instalments as hire charged for the period.
v. Usually, the hire charges interest on flat rate.
vi. The instalment in hire purchase includes interest as well as repayments of principal.

15.13 LEGAL POSITION OF HIRE PURCHASE

As per section 2 of the Hire Purchase Act,1972, "Hire Purchase Agreement is defined as 'an agreement under which the goods are let out on hire and under which the hirer has the option to purchase them in accordance with the terms of agreement and includes an agreement under which:

i. Possession of the goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodic installments and
ii. The property in the goods is to pass such person on the payment of the last of such instalments and
iii. Such person has a right to terminate the agreement at any time before the property to passes

Section 3 of the act provides that every hire purchase agreement must be in writing and signed by all parties thereto.

15.14 CONTENTS OF HIRE PURCHASE AGREEMENT

According to Act, every hire purchase agreement shall state:

a) The Hire -Purchase price of the goods to which the agreement relates
b) The cash price of the goods, the price at which the goods may be purchased by the hirer for cash
c) The date on which the agreement shall be deemed to have commenced
d) The number of the instalments by which the hire purchase is to be paid, the amount of each of those instalment and date or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable
e) The goods to which the agreement relates, in a manner sufficient to identify them

15.15 TERMINATION OF HIRE PURCHASE AGREEMENT

The hire purchase agreement can be terminated in any of the following ways: -

1. In terms of the agreement: The hire purchase agreement stipulates the circumstances in which the agreement can be terminated. The agreement is generally terminated by the return of the goods by the hirer, notice of termination by the owner on account of hirer's breach of condition or notice of termination by the hirer.
2. By performance: the hire purchase agreement is terminated by performance on the exercise of the option to purchase the goods by the hirer
3. By renewal: The parties to an agreement may enter into a fresh agreement terminating the hire purchase agreement, which has not already been terminated.
4. Notice by either party: The hire purchase agreement can be terminated by notice given by either party.

5. By acceptance of repudiation by other party: An agreement is terminated when a party to an agreement renounces his future obligations under the agreements of commits a breach of the agreement which indicates that he does not want to remain bound by its provisions and other party accepts the renunciation or breach as discharging the contract.
6. By release: Wher3 one party to an agreement releases the other party from the performance by the obligations by him under the agreement, the agreement comes to an end.
7. By frustration: when performance of the agreement becomes impossible by reason of some act or event occurring after the formation of the agreement, comes to an end and the parties will be discharged from further obligations under the agreement.
8. By efflux of time: When the hirer is given time to exercise option to purchase the goods within a stated period and he does not exercise the option within the said period, the agreement comes to an end.

Remedies in Case of Breach:

In case of breach of the hire purchase agreement, the owner is entitled to

i. Recover the goods by physical possession or
ii. To abandon any claim to the goods and sue for damages

Registration: The registration of a hire purchase agreement is not necessary, as no immoveable property is conveyed to the hirer.

Check Your Progress-A

1. The term leasing involves
    a) Credit sale
    b) Instalment sale
    c) Renting of assets
    d) None of the above
2. Hire Purchase system is governed by
    a) Sale of goods act 1930
    b) Installment Act
    c) Properties Registration Act
    d) Hire Purchase Act,1972
3. Under Hire Purchase system, the agreement can be -----any time.
    a) Endorsed
    b) Renewed
    c) Terminated
    d) Registered

4. What is transferred to Hirer under hire purchase system?
    a) Possession of the asset
    b) Ownership of the asset
    c) Ownership and possession of asset
    d) None of the above
5. The type of lease that includes a third party, a lender is called as which of the following?
    a) Direct leasing arrangement
    b) Sale and leaseback
    c) Operating lease
    d) Leveraged lease
6. The user of a leased asset is referred to as the
    a) Vendor
    b) Lessor
    c) Hiree
    d) Lessee

15.16 DIFFERENCE BETWEEN HIRE PURCHASE AND LEASE

OWNERSHIP: Leasing ownership lies with the finance company, the lessor and it is usually never transferred to the lessee, the user but in Hire Purchase: property of the good is transferred to the hirer on the payment of the last instalment.

DEPRECIATION: Lessor and not the lessee is entitled to claim depreciation tax shield in the leasing. But in Hire purchase: the hirer is entitled to claim

TAX BENEFITS: The entire lease rental is tax deductible expense. Only the interest component of the hire purchase installment is tax deductible.

DOWN PAYMENT: No downpayment is required for acquiring the use of leased assets. In Hire purchase: down payment is made for acquiring the assets

SALVAGE VALUE: The lessee not being the owner of the asset does not enjoy the salvage value of the asset. The hirer in purchase being the owner of the asset enjoys salvage value.

METHOD OF FINANCING: Leasing is a method of financing business assets whereas hire purchase is a method of financing both business assets and consumer articles.

MAINTENANCE OF ASSET: Where the lessee must maintain the leased asset in case of financial lease, in case of operating lease it is the responsibility of lessor. But in the case of HP the hirer’s responsibility to ensure the maintenance of the asset bought.

NATURE OF THE ASSET: An asset given on lease by a leasing company is considered as the fixed asset of the lessor. But in the HP the hire vendor normally shows the assets let under HP as stock in trade or as receivables.

REPORTING: The asset on hire purchase is shown in balance sheet of th4 hirer.

The leased assets are shown by way of foot note only.

DEPOIST: Lease is not required to make any deposit, whereas 20 percent deposit is required in hire purchase.

RENT-PURCHASE: With lease, we rent and with hire purchase we buy the goods

EXTENT OF FINANCE: Lease financing is invariably 100 per cent financing, it requires no immediate down payment or margin money by the lessee. In hire purchase, a margin equal to 20-25 percent of the cost of the asset is to be paid by the hirer.

15.17 HIRE PURCHASE AND CREDIT SALE

There is difference between credit sale and hire purchase transaction. In case of actual sale , the title in the property ,i.e., ownership and possession is transferred to the purchaser simultaneously. But in case of hire purchase the ownership reaming with the seller until last installment is paid.

15.18 HIRE PURCHASE AND INSTALLMENT SALE

Hire purchase transaction is different installment system. In the case of an installment system, it is not only the possession but also the ownership of goods which is transferred to the buyer immediately at the time of agreement. Further, when the buyer stops making payment of the remaining amount, the seller has no right to repossess the goods. He has the only right to sue the buyer for non-payment by returning the goods but has the right of disposing of the goods in any manner as he likes. Any loss of goods should be borne only by the buyer as risk lies with the ownership.

15.19 SUMMARY

- Leasing is a contract whereby the owner of an asset (lessor) grants to another party (lessee) the exclusive right to use the asset, for an agreed period in return for the payment of rent. At the end of the lease period the assets revert to the owner. Leasing essentially involves the divorce of ownership from the economics use of an equipment/asset.
- The process of leasing consists of lease selection, lessor's approval, acceptance of the offer and documentation.
- Operating lease is an agreement between the owner of the equipment (lessor) and the end user (lessee) providing for the exclusive use of the equipment by the lessee for a monthly fee.
- A lessee will have to return the equipment to a lessor at the end of lease term without an obligation for a residual value.
- In a finance lease, the lessor extends credit to the lessee and transfers all the responsibilities of ownership such as maintenance, insurance, taxes etc. to the lessee for a period fo time equal to the economic life of the asset.
- The Hire Purchase Act,1972 defines a hire purchase agreement as " an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement and includes an agreement under which:

i. condition that such person pays the agreed amount in periodic installments and
ii. The property in the goods is to pass such person on the payment of the last of such instalments and
iii. Such person has a right to terminate the agreement at any time before the property to passes

Section 3 of the act provides that every hire purchase agreement must be in writing and signed by all parties thereto.

15.20 GLOSSARY

Agreement: An agreement is made when two parties agree to something.
Activities: The power or ability to do something
Maintenance: keeping something in good condition
Obligations: The state of having to do something because it is a law or duty or because one has promised
Process: A process is a set of activities that interact to produce a result
Transferability: the fact that something can be moved from one person, place or use to another

Repossession: the action of taking possession something, in particular when a buyer defaults on payments

15.21ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (c), 2 (d), 3 (c), 4 (a) ,5 (d), 6(d)

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15.24 TERMINAL QUESTIONS

1) What do you understand by leasing? State its advantages and limitations.
2) Explain the different kinds of leasing.
3) Differentiate between operating and financial lease
4) Explain the features of hire purchase.
5) Distinguish between hire purchase and lease.

15.25 CASE STUDY

ABC limited has recently leased assets worth Rs 3,000 lakh from XYZ Limited. The following facts are available:

1) . Lease period 9 years of which 6 years constitute the lease term
2) Annual Lease rates: First 6 years, Rs 360/Rs 1,000: next 3 years Rs 15/Rs 1,000
3) Incremental borrowing rates for ABC Limited 14 per cent
    a) Assuming 14 years as the average economic life of the equipment, is the lease a finance or an operating lease
    b) Assuming further
        i. Physical life of 14 years
        ii. Technological life of 9 years
        iii. Product market life of 11 years, how will you classify the lease.

UNIT 16 DEBT SECURITIZATION

16.1 INTRODUCTION

The financial system all over the world is in the process of rapid transformation. As a result, the capital market, money market and the debt market are widening and deepened. Along with the equity market, there is bound to be natural growth in the debt market also. Development of debt market increases the efficiency of a capital market to a great extent. New instruments and new products are emerging in the debt market too. Thus, it is obvious that a debt market should have both primary and secondary market. Securitization is one of most innovative techniques introduced in the debt market to achieve capital formation.

Securitization has been one of the prominent developments in the financial services. Traditionally, financial institutions held the loan made by them till they became due. A loan is simply a transaction where a borrower wants the money, and a lender gives it an interest rate. In the secured loan, a borrower offers collaterals such as real estates or machinery. The interest is paid until the loan is repaid. In some cases, however, the borrower may be unable or unwilling to pay back the loan. In case of default, creditors can seize the asset and sell them to recover their money, However, the seizure of the asset is a lengthy process. Therefore, these receivables are securitized now. The concept of securitization originated in the US in the 1970s like most other financial innovations. Today, the mortgage-backed securities market run into trillion and securitization which is the subset of the debt market is gaining popularity in Indian Financial markets too.

16.2 OBJECTIVES

This unit aims to:

- Explain the concept and significance of debt securitization in the financial system.
- Identify and describe the roles of various parties involved in the securitization process.
- Explore the types of assets that are eligible for securitization.

16.3 MEANING OF DEBT SECURITISATION

- Securitization is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in or secured by a segregated income producing asset or pool of assets. The pool of assets collateralizes securities. These assets are generally secured by personal or real property such as automobile, real estate or equipment loan but in some cases are unsecure, for example credit card debt and consumer loan.
- Securitization is conversion of existing or future cash flow into tradeable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, mortgaged backed receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc., are transformed into securities.
- So, we can define Securitization in simple terms as the process of liquefying assets comprising loans and receivables of a financial institution through issuance of negotiable certificates to potential investors.
- Thus, securitization fundamentally involves conversion of long-term assets into cash/ liquid assets. It is a process of removing long-term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the issue of securities against them. Under securitization a financial institution pools its illiquid, non-negotiable and long-term assets, creates securities against them, get them rated and sells them to investors. It is an ongoing process in the

sense that assets are converted to cash, cash into assets and assets into securities and so on. It is worthwhile to note that the entire transaction relating to securitization is carried out on the asset side of the balance sheet. That is one asset (illiquid) is converted into another asset (cash)

- For example, a finance company with a portfolio of housing loans can raise funds by selling these loans to another entity. A finance company can securitize its housing loan portfolios into instruments with a fixed return which is based on the maturity profile of the housing loans. If the company has Rs 100 crores worth of housing loans and is due to earn 12 percent income on them. It can securitize these loans into instruments with 11 percent return with safeguards against default. These could be sold by one finance company to another if it needs funds before these loan repayments are due. The principal and interest repayment on the securitized instruments are met from the assets which are securitized. Thus, illiquid financial assets are transferred into a more liquid form of assets and distributed to a broad range of investors through the capital market. Securitization is backed by a wide variety of assets such as vehicles, construction equipment, real estate and personal loans.

16.4 DEFINITION OF SECURTISATION

The concept of securitization can be defined as follows:

'A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities.'

According to Hendersen, J and Scott, J.P., " Securitization is the process which takes when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and are funded instead ,by investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse ,or in some cases with limited recourse to the original lender."

Thus, financial assets can be made liquid through securitization i.e. through packaging loans and selling them in the market. It is very clear from the above definition that securitization is nothing but the packaging of a pool of financial assets into marketable securities. In brief, illiquid assets are converted into tradeable securities.

Securitization is different from 'factoring' in that factoring involves transfer of debts without transformation thereof into securities.

16.5 PARTIES TO THE SECURITISATION TRANSACTION

The process of securitization involves six basic parties namely:

1. The Originator: Any financial institution, bank or any other entity which has decided to adopt securitization of assets is known as the originator. It is the prime mover of the deal, e.g., it sets up the necessary structure to execute the deal. The originator sells the assets on its books and receives the funds generated from such sale.
2. Special Purpose Vehicle: The special purpose vehicle is an entity with defined purposes and activities. It is that entity that would buy the assets to be securitized from the originator. It is established to isolate the receivables and perform other functions (e.g., restructuring of cash flows and provision of credit enhancement and liquidity support). The pool of assets is transferred to SPV, and it converts the receivables/loans into securities. It issues them in the capital market to the investors. The capital base of SPV is generally low, it is usually constituted as a trust under Indian Trust Act or as a company under the companies Act. The originator may float SPV as a subsidiary in the form of limited company.
3. The Investor: The investor may be individuals or institutional investors like financial institutions, mutual funds, provident funds, insurance companies etc. They buy the securities issued by SPV and receive their payments in the form of interest and principal as per the agreed terms.
4. The obligor: The original borrower is the obligor. The amount due from the obligor is the securitized asset. The original borrower should meet his commitments on due date, otherwise cash flows would be affected. Therefore, the whole process greatly depends on the integrity of the original borrower.
5. Credit Rating Agency: Since the investors take the risk on the asset pool than the originator, an external credit rating agency plays an important role. The rating process would assess the strength of the cash flow and the mechanism designed to ensure full and timely payment by:
   a. Selecting the loans of appropriate credit quality
   b. Assessing the credit and liquidity support required

The rating agency will also examine whether the legal security has been perfected or not.

6. Administrator: it collects payment due from the original debtors and passes them on to the SPV. The administrator takes follow up action on defaulting borrower and pursues available legal remedies. He is also called the receiving and paying agent because of his function of receiving and paying instalments to special purpose vehicles.
7. Trustee: It accepts the responsibility for overseeing that all the parties to the securitization deal perform in accordance with the securitization agreement. Basically, it is appointed to look after the interests of the investors.

8. Credit Enhancer: A bank or insurer that provides credit support through a letter of credit, guarantee or other assurance is called a credit enhancer.
9. Legal Counsel: He goes into the legalities of various aspects of the deal and give an opinion on whether requirements of true sale have been met or not and whether the security has been legally perfected.

16.6 ASSETS TO BE SECURITIZED

Any pool of assets that has clearly defined predictable cash flow with historical information on payment, defaults and loss pattern can be securitized. The assets should have similar features in terms of the payment pattern, documentation and nature of loan. Any form of receivables like housing loans, consumer loans, lease rentals receivables could be securitized. The housing loan receivable are the most favoured asset for securitization. Credit card loans, government receivables and trade receivables are also securitized. For assets to be securitized, a few below given characteristics are essential.

1. Assets should have consistent cash flow
2. Default rate should be low
3. Principal should be amortized at maturity
4. There should be diverse obligators so that risk is diversified
5. Underlying assets should be standard documentation

16.7 PROCESS OF SECURITIZATION

For the operational mechanics of securitization, the following parties are required:

i. The originator
ii. A special purpose vehicle (SPV) or a trust
iii. A merchant or investment banker
iv. A credit rating agency
v. A servicing agent-Receiving and Paying Agent (RPA)
vi. The original borrower or obligors

Securitization of assets involves a series of steps which are mentioned below:

1. Identification process: The lending financial institution, either a bank or any other institution for that matter which decides to go in for securitization of its assets is called the originator. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator must pick up a pool of assets of homogenous nature considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolio for securitization is called identification process.

2. Transfer Process: After the identification process is over, the selected pool of assets are then passed to another institution which is ready to help the originator to convert those pool of assets into securities. This institution is called the Special Purpose vehicle (SPV) or the trust. The pass-through transaction between the originator and SPV is either by way of outright sale i.e., full transfer of assets in question for valuable consideration or by passing them for a collagenized loan. Generally, it is done on an outright sale basis. This process of passing through the selected pool of assets by the originator to a SPV is called transfer process and once this transfer process is over, the assets are removed from the balance sheet of the originator.
3. Issue Process: After the transfer process is over, the SPV takes up the task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV splits the package into individual securities of smaller values, and they are sold to the investing public. The SPV gets reimbursed out of sale proceeds. The securities issued by the SPV is called different names like ‘Pay through Certificates.’ Pass through Certificates.’ Interest only certificates, Principal only certificates etc. The securities are structured in such a way that maturity may synchronize with the maturities of securitized loans or receivables.
4. Redemption Process: The redemption and payment of interest on these securities are facilitated by the collections received by the SPV from the securitized assets. The task of collection of due is generally entrusted to the originator or a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due, and he must pay special attention to delinquent accounts. Usually, the originator is appointed as a collection agent. If the originator is appointed as a servicer, his role is minimized to a collection agent under securitization. Pass through certificate holders hold the SPV responsible for payment of their principal and interest.
5. Pass through Certificates: In this structure, certificates are issued against pooled mortgages or assets and undivided interest. Undivided interest means that each certificate holder has a proportionate interest in the cash flow generated in the pool. The cash flow received from the underlying mortgages is passed through to the investors. Services charges for the payment of interest, principal and prepayment if any are deducted from the payment. The pass-through structure certificate is matched with the tenure of the underlying asset. The pass-through structure enables the investors to have direct exposure to the performance of the securitized assets.
6. Credit Rating Process: Since the pass through certificates have to be publicly issued, they require a credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence, these certificates are rated at least one credit rating agency on the eve of the securitization. The issue could also be guaranteed by external guarantor institutions like merchant bankers which

would enhance the creditworthiness of the certificates and would be readily acceptable to investors. The rating of instrument provides an indication to the investor about the strength of the issuer to make timely payment of the principal and interest.

7. Timing of the issue: Once the certificates are rated, merchant bankers helps in determining the timing of the issue, their pricing, marketing and underwriting etc.
8. Payment: The Investor subscribe to the issue by making payments to the SPV
9. Collection: The originator may continue to service the securitized assets (i.e. to collect amount due from borrowers etc. with or without servicing for the same).
10. Credit Enhancement: A usual feature if securitization is credit enhancement i.e. an arrangement which is designed to protect the holders of the securities issued by a special purpose entity (SPE) from losses.

16.8 STRUCTURE OF SECURITY

The structure of the securities vary from one another in accounting techniques and legal standing. Some of the major structure of the given below:

Pass through certificates: In this structure, certificates are issued against pooled mortgages or assets and undivided interest. Undivided interest means that each certificate holder has a proportionate interest in the cash flow generated in the pool. The cash flow received from the underlying mortgages is passed through to investors. Service charges for the payment of interest, principal and pre-payment if an are deducted from the payment. The tenure of the certificate is matched with the tenure of underlying asset. The pass-through structure enables the investors to have a direct exposure to the performance of the securitized assets.

Pay through certificates: In this investor has a charge against the securitized assets, while the assets themselves are owned by the SPV. The SPV issues secured debt instruments of different maturities in response to an investor's demand. Cash flows from two or more assets are pooled together and distributed to the security holders according to the maturity pattern of the securities. If the underlying security is of single type, it may be structured in a way to facilitate varying maturity patterns. In pay through structure, the SPV has the discretion to a limited extent to reinvent short term surpluses -a power that is not available in the pass through securities. Also, different issues of securities can be priced differently according to their maturity periods.

Preferred Stock Certificates: These certificates are issued against the trade debts and consumer receivables. A subsidiary company buys the trade debts and receivables of the parent company and issues short term securities after securing a guarantee from the merchant banker.

Stripped Structures: Interest and principal component of the securitized instrument is stripped into 'interest only and principal only' securities. The holder of the strips can enjoy the benefits from one stream of receivables, either interest or principal payment. The change in market interest rate affects the value of both the strips. If there is a decline in the market interest rate, the obligator may pre-pay the existing loan and take the fresh loans because taking fresh loans at lower interest is profitable for them. This shortens the maturity period, and investors receive the repayment earlier than anticipated. However, this situation adversely affects the 'interest only' stripes as less interest is collected for payment on the underlying mortgages. This leads to a fall in the value of securities.

16.9 TYPES OF SECURITISATIONS

Securities issued by the SPV are backed by:

- Assets
- Mortgages

➢ **Assets -backed Securities (ABS):** Securitization against the current and moveable fixed asset is known as securitization "backed by assets". These securities issued by SPV in a securitization transaction are known as ABS because investors rely on the performance of the assets that collateralize the securities.

➢ **Mortgage-Backed Securities (MBS):** The securitization based on immoveable fixed assets is known as "backed by mortgage". Hence securitization is backed by real estate property where the lender has the right to sell the property if the borrower defaults. The common example is securities backed by mortgage housing loans.

16.10 ASSETS FOR SECURITIZATION

All assets are not suitable for securitization. For instance, trade debts and receivables are not generally suitable for securitization whereas they are not generally suitable for securitization., where as they are readily acceptable to a factor. Only in rare cases, they are securitized. Example: Preferred Stock

The following assets are generally suitable for securitized by financial institutions:

i. Term loans to financially reputed companies
ii. Receivables from Government department and companies
iii. Credit Card receivables
iv. Hire Purchase like vehicle loans
v. Lease finance
vi. Mortgage loan etc.

16.11 ASSETS CHARACTERSTICS

The assets to be securitized should have the following characteristics: -

i. Cash Flow: A principal part of the asset should be the right to receive from the debtor(s) on certain dates, that is the asset can be analyses as a series of cash flows

ii. Security: If the security available to collateralize the cash flow is valuable, then this security can be realized by a SPV

iii. Distributed Risk: Assets either to have a distributed risk characteristic or be backed by suitably rated credits support

iv. Homogeneity: Assets must be relatively homogeneous, that is there should not be wide variation in documentation.

v. No Executory Clause: The contracts to be securitized must work even if the originator goes bankrupt.

vi. Independence From the originator: The ongoing performance of the assets must be independent of the existence of the originator.

16.12 CREDIT ENHANCEMENT

Investors in securitized instruments take a direct exposure on the performance of underlying collateral and have limited and no recourse to the originator. Hence, they seek additional comfort in the form of credit enhancement. It refers to the various means that attempt to buffer investors against losses on the assets collateralizing their investment. These losses may vary in frequency, severity and timing and depend on the asset characteristics, how they are originated and how they are administered. Credit enhancements are often essential to secure a high level of credit rating and for low costing funding. By shifting the credit risk from a less known borrower to a well-known ,strong and large credit enhancer. Credit enhancements correct the imbalances of information between lenders and borrowers. They are either external (third party) or internal (structural or cash flow driven)

External Credit Enhancements: They include insurance, third party guarantee and letter of credit.

- Insurance: Full insurance is provided against losses on the assets. This is tantamount to 100 percent guarantee of a transaction's principal and interest payments. The issuer of the insurance looks to an initial premium or other support to cover credit losses.
- Third Party Guarantee: This method involves a limited /full guarantee by a third party to provide a letter of credit for a nominal amount. This may provide either full or partial cover of the issuer's obligation.

Internal Credit Enhancements: Such form of credit enhancement comprises the following

- Credit Trenching (Senior /subordinate structure): The SPV issues two (or more) tranches of securities and establishes a predetermined priority in their servicing, whereby first losses are borne by the holders of subordinates tranches (at times the originators itself).

Apart from providing comfort to holders of senior debt, credit trenching also permits targeting investors with specific risk-return preferences.

- Over-collagenization: The originator set aside more than the collateral required to be assigned to the SPV. The cash flows from these assets first meet any overdue payments in the main pool, before they can be routed back to the originator.
- Cash Collateral: This works in much the same way as the over collateralization. But since the quality of cash is self-evidently higher and more stable than quality of assets yet to be turned into cash, the quantum of cash required to meet the desired rating would be lower than assets over collateral to the extent.
- Spread Account: The difference between the yield on the assets and the yield to the investors from the securities is called excess spread. In its simplest form , a spread account traps the excess spread (net of all running costs of securitization) with in the SPV up to a specified amount sufficient to satisfy a given rating or credit equity requirement. Only realization in excess of this specified amount are routed back to the originator. This amount is returned back to the originator after the payment of principal and interests to the investors.
- Triggered Amortization : This works only in structures that permit substitution (for example, rapidly revolving assets such as credit cards). When a certain preset level of collateral performance are breached, all further collections are applied to repay the funding. Once amortization is triggered substitution is stopped and early repayment becomes an irreversible process. The triggered amortization is typically applied in future flow securitization.

Check Your Progress-A

1. The process by which a financial intermediary liquify its illiquid assets through systematic issuance of financial instruments is called
    a) Future contract
    b) Leasing of goods
    c) Option contract
    d) Securitization
2. The concept of Securitization is associated with
    a) Capital market

b) Debt market
c) Foreign Exchange Market
d) Money Market

3. The assets generally not suitable for Securitization is
    a) Receivables from Government Department
    b) Trade Receivables
    c) Hire Purchase finance receivables
    d) Mortgage loans

4. Which one of the following is a short-term debt Securitization is
    a) Preferred Stock Certificates
    b) Pass through certificate
    c) Asset based commercial paper
    d) Principal only certificate

16.13 BENEFITS OF DEBT SECURTISATION

Securitization offers a number of advantages to the seller, investor and debt markets. Securitization increases the number of debt instruments in the market for financial system. It also widens the market by attracting new players on account of the availability of superior assets.

TO ORIGINATOR:

The benefits of securitization to the originators are:

1. Improves liquidity: There is no need for an originator to hold onto the asset portfolio till it matures. The asset and trade receivables can be securitized. The relative illiquid assets are transformed into cash flow, long dated mortgage are converted into cash through securitization.
2. Better asset liabilities management: securitization improves the balance sheet of an originator. It removes the assets from the balance sheet of the originator and thus liberates the capital for other uses, it enables the restructuring of the balance sheet by reducing the large exposures or sectoral concentration. An originator acts as a service for securitization, receives fees for his service and improves financial position as well. The fees received are large when a large asset portfolio is securitized.
3. No opportunity cost of capital: The additional revenue generated through securitization enables the originator to take advantage of more profitable investment opportunities. At the same time, its customer relationship is retained as well.
4. Provides market Access: Borrowers have a better access to the market through securitization. Non-investment grade financial institutions and originators can fund

themselves at investment pricing grade. Credit enhancement provides an added comfort to the investor. This helps the originators to take advantage of more profitable investment opportunities at the same time, its customer relationship is retained as well.

5. Low-cost funding: Better market access results in low cost funding. Credit enhancement and diversification of risk enables the originator to raise the funds at low cost. Asset backed securities are generally welcomed by the investors. Thus, securitized debts are cheaper than other forms of debt.
6. Risk dispersal: The sale of existing debt reduces the risk of the issuer and helps in spread over a large section of public investors. It enables to repack the portfolio risk namely credit risk and expected losses. The originator absorbs the credit risk for expected loss by second and third in the line of risk are the credit enhancer and the investor respectively.

FOR INVESTORS

The benefits of securitization to the investors are:

- More avenues: Securitization essentially provide an avenue for relatively risk-free investment. Credit enhancement provides good quality assets.
- Reduces risk: at the pool of assets is spread over a large geographical area comprising several units, the risk of failure is reduced. Credit enhancement and credit rating also reduce the risk. The prevalence of a secondary market also offers liquidity.
- Better Financing management: since a securitized instrument carries regular monthly cash flows. It also provides an opportunity for matching cash flows.

16.14 FACTORING AND SECURITISATION

Even though both deal with assets. They are different from each other in the following ways:

Difference between Factoring and Securitization

FACTORING	SECURITISATION
Associated with book debts of manufacturing and trading companies	Mainly associated with financing companies
Deals with trade debts and trade receivables	Deals with loans and receivables of hire purchase and services
Short term in nature	Medium and long term in nature
Securities are not issued based on loans	Securities are issued based on underlying assets

Collection work carried by the factor	Collection work is carried out by the originator or administrator
Entire credit risk is passed (without recourse)	A part of the risk is absorbed by originator

The above-mentioned differences are general in nature. However, the specific differences depend on the type of factoring and securitization

16.15 REGULATORY FRAMEWORK

In India there are currently three regulatory framework which govern securitization:

1. Master Direction-Reserve bank of India (Securitization of Standard Assets) Directions, 2021 (SSA Directions)
2. SEBI (Issue and Listing of Securitized Debt Instrument and Security Receipts) Regulations,2008 (SDI Framework)
3. Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002

Section 115 TCA of the Income Tax Act, which outlines the provisions for taxing income earned by investors from securitization trusts also acknowledges the regulations mentioned above.

16.16 SUMMARY

Securitization is the process of transforming loans and other receivables of a lending institution into tradeable securities that can be sold to investors. Illiquid assets are converted into liquid assets. The receivables to be secreted should have similar features in terms of payment, documentation and nature of loans. An originator, i.e., the lending institution identifies the pool of assets and transfer to to a special purpose vehicle. Special purpose vehicle structures the issue either as pass through or pay through certificates as rated by a credit rating agency and places with investors. Investors comprise financial institutions, provident fund, insurance companies and mutual funds. To ensure marketability, credit enhancement in the form of third-party guarantee or insurance is carried out. The issued security is serviced as per the agreement. As the illiquid assets are removed from the balance sheet, it improves the balance sheet and debt equity ratio. It is a source of low cost funds for originators.

Operational Mechanism in brief:

The following procedure is followed:

i. The lender institutes create loan assets in its books

ii. As per credit standing of the borrower, some loans are segregated for selling to the issue of securities
iii. The issuer pays the loan amounts to the lender institution, net of discount/charges/fees
iv. The issuer converts these loans into pool of security for issuing PTCs (Pass through certificates)
v. The PTCs are sold to the individual investors, waiting to make investments
vi. Meanwhile, the original lending institution receives payments
vii. Lender institution keeps sending prorata amount of instalments to the issuer
viii. Issuer passes on the recovery amount to individual investors

16.17 GLOSSARY

Asset -backed Securities: Securities issued against assets like utility vehicles, machinery and personal loans.

Credit Rating: an opinion on the failure ability and legal obligation of an issuer to make timely payments of principal and interest on a specific fixed income security

Credit Trenching (Senior/subordinate structure): Securitizes instrument issued in two or more tranches with predetermined priority in servicing.

Default Risk: The risk of the issuer who is unable to make payments of the interest and principal amount of debt instrument.

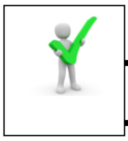
Originator: Any financial institution, bank or any other entity, which has decided to adopt securitization of assets is known as originator

Pass through Certificates: Certificates issued against pooled mortgages or assets and the undivided interest

Pay through Certificates: In these, investor has a charge against the securitized assets, while the assets themselves are owned by the special purpose vehicle

Securitization: It is a process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors

Special Purpose Vehicle: It is an entity with defined purpose and activities



16.18 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Answer to 1 is (d), 2 (b), 3 (b), 4 (a)

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16.21 TERMINAL QUESTIONS

1. Define debt securitization and discuss its process.
2. Bring out clearly the various benefits of Securitization
3. Explain which assets are suitable for Securitization.
4. Differentiate between Securitization and factoring.

16.22 CASE STUDY

One of the early and notable examples of securitization in India involves ICICI Bank. In the early 2000s, ICICI Bank, one of India's largest private sector banks, began actively securitizing its mortgage loan portfolio. This move was strategic, aimed at managing the bank's credit risk and freeing up capital for further lending.

Structure of the Securitization

ICICI Bank pooled its mortgage loans and sold them to a Special Purpose Vehicle (SPV), which then issued securities backed by these assets to investors. The investors received regular interest payments from the cash flows generated by the underlying mortgage loans. ICICI Bank benefited by reducing its risk exposure and raising immediate funds, while investors gained access to a new class of financial instruments.

Regulatory Developments

The success of early securitizations like that of ICICI Bank led to more comprehensive regulatory frameworks. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, provided a legal basis for the securitization process and empowered financial institutions to recover bad debts efficiently.

Challenges and Risks

Despite the benefits, securitization in India has faced challenges, including regulatory complexities, limited investor appetite, and the risk of underlying asset quality deterioration. The global financial crisis of 2008, triggered partly by subprime mortgage-backed securities in the U.S., highlighted the risks associated with poorly managed securitization processes.

UNIT 17 HOUSING FINANCE

17.1 INTRODUCTION

It is essential for human development and welfare to have access to reasonably priced homes. It provides people with the seclusion, comforts, safety, and shelter they require to lead respectable lives. People cannot live the lives they desire and realize their full potential without adequate housing. While inadequate housing has detrimental effects including illness, immorality, and juvenile delinquency, good housing is a reflection of the community's overall well-being.

India's housing need has skyrocketed due to the country's population expansion, the dissolution of traditional joint households, and rural-to-urban migration. India's housing crisis, which is particularly severe in metropolitan areas, is getting worse due in part to the information technology revolution and the country's fast expansion of knowledge-based enterprises. Home construction is substantially hindered by the large financial outlays that are necessary.

According to the Reserve Bank of India (RBI), there is a nationwide demand for homes as evidenced by the rise in home loan outstanding, which rose from 17.26 Lacs crore in March 2022 to 27.22 Lacs crore in March 2024.

The financial structures and methods that enable the acquisition, development, or improvement of residential properties are referred to as housing finance. It comprises a range of financial services and tools, including:

1. Mortgages: Loans intended exclusively for the purchase or renovation of a home, usually secured by the real estate.

2. Home loans are loans secured by a current residence and are frequently used for repairs or other financial needs.

3. Home renovation loans are geared toward property maintenance or upgrades.

4. Government Programs: State-run endeavors providing homebuyers with grants, subsidies, or low-interest loans, among other forms of financial assistance or incentives.

5. Investment entities that provide access to real estate investments, particularly residential properties, through the purchase of shares are known as Real Estate Investment Trusts, or REITs.

In general, housing finance refers to a wide range of financial options meant to increase the accessibility and affordability of real estate investing and homeownership for both individuals and families.

17.2 OBJECTIVES

Upon completion of this unit, you will be capable of:

- Describe what housing finance means.
- Describe the advantages of home financing.
- Describe the different kinds of loans that housing finance businesses offer.
- Distinguish between housing and banking finance
- Recognize the role that the National home Bank plays in the expansion of home financing enterprises.

17.3 DEVELOPMENT OF HOUSING FINANCE IN INDIA

The development of housing financing in India shows a dramatic shift from an undeveloped and disjointed system to a more organized and user-friendly framework. In the past, there was little institutional funding available for homes in India, and informal lending methods dominated the market. But its evolution is marked by a number of significant phases:

1. Early Years (Pre-1947): Prior to India's independence, the country's housing financing system was primarily unorganized and had no institutional backing. The majority of home loans came from personal savings or from neighborhood moneylenders.
2. Initiatives After Independence (1947–1960s): Following its independence, India saw the creation of a number of organizations with the goal of enhancing its citizens' access to home financing. The establishment of the Housing and Urban Development Corporation (HUDCO), which focused on long-term financing for housing and urban development projects, in 1970 marked a significant advancement toward organized housing finance.
3. Liberalization and Growth (1970s–1990s): A number of organizations and laws were implemented in the 1970s and 1980s in an effort to enhance the home financing sector. The National Housing Bank (NHB) was established in 1988 with the intention of supervising and providing financial support to home financing companies. Furthermore, during this period, a wider range of financial products were created, and prominent figures in the private sector emerged.
4. Reforms and Modernization (1990s–2000s): The housing finance industry saw substantial transformation as a result of the economic liberalization that took place in the 1990s. the implementation of changes meant to boost competition, enhance legal frameworks, and broaden access to home financing. In order to promote cutting-edge financial products and regulate housing finance companies, the National Housing Bank was instrumental.
5. Current Developments (2000s–Present): The home finance industry has experienced tremendous expansion and modernization in recent years. The scene has changed due to the emergence of digital platforms, the growing involvement of commercial financial institutions, and government programs like the Pradhan Mantri Awas Yojana (PMAY). The goals of these initiatives are to increase financial inclusion and provide affordable housing. Technological and data analytics developments have also helped the industry, increasing accessibility and efficiency.

17.4 IMPORTANCE OF HOUSING FINANCE

Through its facilitation of home ownership and residential property development, housing finance plays a critical role in the economic and social development of societies. Its importance goes beyond just financing the purchase or construction of dwellings; rather, it affects economic stability, personal welfare, and urban development. Here is a detailed analysis of its significance:

1. Encourages Ownership of a Home

For many, owning a home is a significant accomplishment that housing finance makes possible for people and families. Housing financing enables those who lack the entire down payment to buy property by providing loans for home acquisitions, construction, and restoration. Considering that home ownership is frequently linked to long-term investment and personal success, this promotes a sense of stability and security.

2. Encourages Economic Development

One important factor propelling economic growth is the housing sector. Housing investments increase demand for labor, building supplies, and other related services, which accelerates economic growth. Increased activity in adjacent industries like building, interior design, and home remodeling results from real estate investment.

3. Boosts the Stability of Society

By enhancing living conditions and giving families a sense of security, housing finance can play a role in maintaining social stability. Better neighborhood and property maintenance brought about by home ownership can promote social integration and community cohesion. Residents who live in stable homes also tend to do better in terms of their health and education.

4. Promotes Urban Development

By facilitating the construction of residential units and the revitalization of existing regions, housing finance promotes urban growth. It is essential for controlling urban growth and solving housing shortages. Strategic approaches to housing finance can result in the creation of services and infrastructure that improve metropolitan regions' quality of life.

5. Promotes Investment in Real Estate

Housing finance promotes real estate investment by offering financial instruments including loans for mortgages and loans for investment properties. These financial products can be used by developers and investors to start new projects, make renovations to existing homes, or grow their real estate holdings. In addition to providing benefits to specific investors, this investment helps the real estate industry as a whole expand.

6. Enhances Access to Finance

By granting credit to those who might not otherwise be able to enter the formal financial system, housing financing helps promote financial inclusion. Housing financing helps integrate more people into the economy and promotes their financial stability by offering loans to a wider range of people, particularly those in lower income groups or living in rural areas.

7. Backs Government Housing Initiatives

In order to accomplish their objectives, government programs that support affordable housing frequently rely on housing financing mechanisms. Programs like India's Pradhan

Mantri Awas Yojana (PMAY) aim to give low- and middle-income families financial support for building or purchasing a home. In order to put these policies into action and ensure that the target communities can access them, housing financing institutions are essential.

8. Offers Tax Benefits

Tax benefits, including as principal and interest payback deductions, are often attached to housing finance instruments. These advantages encourage more people to invest in real estate and take out loans for housing by making home finance more alluring and affordable for borrowers.

9. Promotes the Creation of Wealth

One of the most important ways that people can accumulate wealth is usually through home ownership. With the help of housing finance, individuals can make real estate investments that can increase in value over time and add to their overall financial portfolio. For many households, this possibility for asset growth is a critical component of their financial plan.

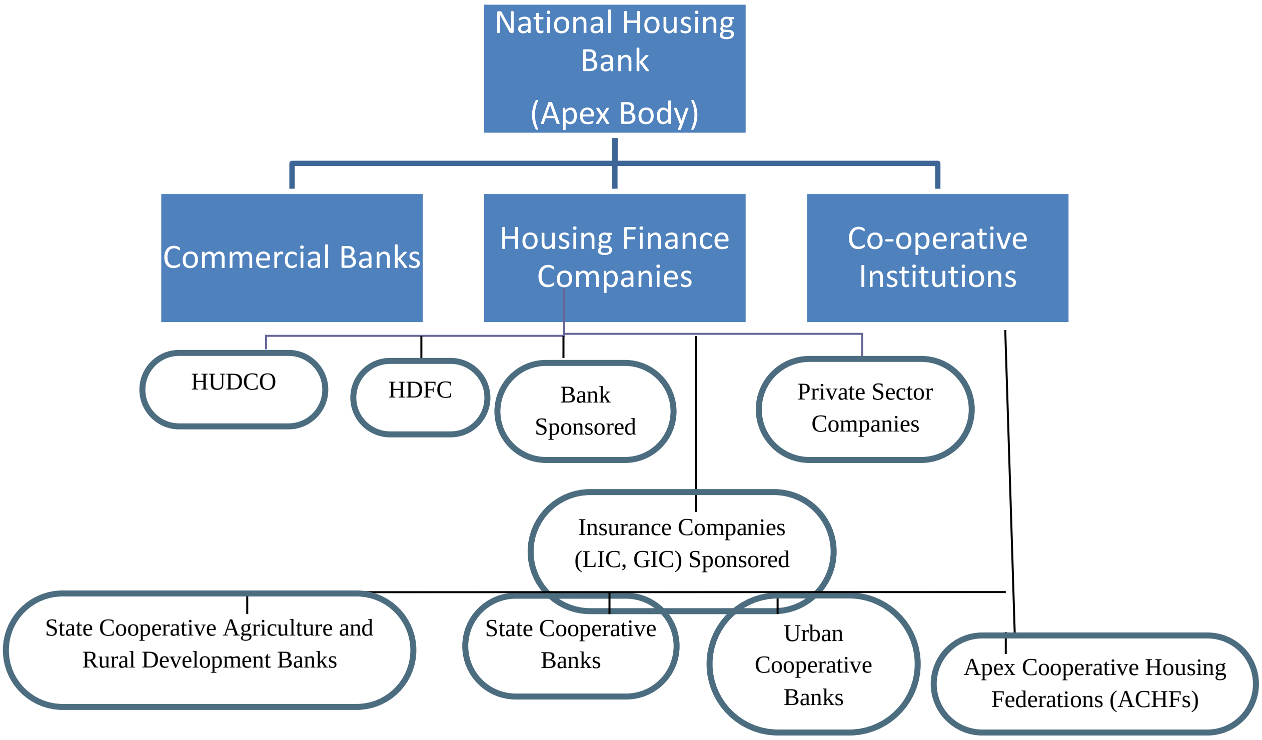
10. Promotes Ecological Growth

An increasing amount of contemporary housing finance techniques are geared at promoting environmentally friendly and sustainable development. These days, a lot of financial institutions provide products that encourage the development of environmentally friendly structures or the application of energy-saving equipment. The trend toward sustainability encourages responsible development methods and aids in addressing environmental issues.

17.5 SYNOPSIS OF INSTITUTIONAL FRAMEWORK OF HOUSING FINANCE IN INDIA

India's home finance industry has changed dramatically over the years, molded by a sophisticated institutional structure intended to meet the wide range of demands of the country's citizens. This framework is made up of several actors, rules, and financial tools that work together to provide housing accessibility and guarantee the stability and expansion of the industry.

The following are important organizations in the housing financing sector:



1. National Housing Bank (NHB): Founded in 1988, the NHB is the premier organization in India for housing finance and plays a crucial role. Housing finance corporations (HFCs) are subject to regulations, oversight, and financial support from this entity. Among the NHB's responsibilities include loan refinancing, supplying HFCs with liquidity, and carrying out government initiatives for affordable housing.
2. Housing Finance Companies (HFCs) provide long-term loans for the purchase or development of residential real estate. They offer a range of products, such as home loans and loans backed by real estate, and they are controlled by the regulatory structure of the NHB. Prominent Housing Finance Companies in India include LIC Housing Finance, Bank Sponsored, Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), and private sector entities.
3. Commercial Banks: Significant banks from the public and private sectors are also essential to the financing of homes. They provide house loan packages with terms and interest rates that are frequently competitive. The Reserve Bank of India (RBI) regulates banks, which play a major role in the home finance industry. In the home finance industry, the State Bank of India (SBI) and its affiliates are significant players. They participate frequently in housing projects run by the government and provide a large selection of home loan packages.
4. Cooperative Institutions: These organizations are local in scope and generally offer home finance to its members. They are especially important in semi-urban and rural

areas where access to formal financial services may be restricted. State cooperative banks, Urban Cooperative Banks, Apex Cooperative Housing Federations (ACHFs), and State Cooperative Agriculture & Rural Development Banks are examples of significant co-ops.

Check Your Progress-A

Q1. State the benefits of housing finance?

Q2. Explain the institutional structure of housing finance in India?

17.6 HOUSING FINANCE AND BANKING FINANCE DISTINCTIONS

S. No.	Point of Difference	Housing Finance	Banking Finance
1	Goal and Focus	Lending and other financial services pertaining to residential real estate are the specific focus of housing finance. This covers funding for real estate purchases, building new residences, remodeling old ones, and using real estate as collateral for other loans. The goal of housing financing is to encourage	A wider range of financial services offered by banks, such as credit cards, investment services, personal and company loans, checking and savings accounts, and credit cards, are collectively referred to as banking finance. Although house loans are a part of banking finance, the field's purview is far broader, encompassing a range of financial services

		property development and home ownership.	and products for both individuals and corporations.
2	Financial Products	Loans against property, balance transfer loans, construction loans, renovation loans, and purchases loans are the main offerings in the housing finance industry.	Among the numerous products provided by banking finance are credit cards, mortgages, business loans, auto loans, student loans, savings and deposit accounts, and credit cards.
3	Regulatory Bodies	India's home finance industry is primarily governed by the National home Bank (NHB), which oversees Housing Finance Companies (HFCs) and ensures they follow appropriate lending standards.	Banking financing is regulated by the Reserve Bank of India (RBI), which also sets interest rates, monetary policy, and regulatory criteria for all banking activities.
4	Lending Institution	Housing Finance Companies (HFCs) are specialist lenders that only offer loans connected to housing. Examples of HFCs are HDFC and LIC Housing Finance.	Many different types of institutions, such as commercial banks, cooperative banks, and public sector banks, offer banking finance.
5	Loan Disbursement and Terms	Loans for housing finance are frequently long-term, with up to 30-year payback terms.	Bank loans come in a range of durations, from long-term mortgages to short-term personal loans. In accordance with the nature of the loan and the requirements of the borrower, banks also offer flexible payback terms.
6	Interest Rate and Repayments	Depending on the type of loan and the borrower's profile, interest rates on housing finance products might change and are impacted by the current	In banking finance, monetary policy, market dynamics, and specific borrower risk profiles all affect interest rates. Banks offer a range of loan

		market rates. In order to draw in buyers, HFCs frequently provide attractive rates.	packages with variable interest rates, such as choices with fixed and variable rates.
7	Customer Focus	Individuals and families looking to purchase or renovate residential property are the main focus of the home finance industry.	Banks serve a wider range of clients, including people, companies, and organizations.

17.7 TYPES OF LOAN OFFERED BY HOUSING FINANCE COMPANIES

India's Housing Finance Companies (HFCs) provide a range of credit packages designed to satisfy various housing industry demands. The purpose of these loans is to help with home ownership, upgrades, and other costs associated with housing. Below is a summary of the main loan categories offered by HFCs:

1. Loans for the Purchase of a Home

Home Purchase Loans are intended for those who want to purchase a residential property, either new or old. These loans, which often have attractive interest rates, pay for the cost of buying a house. These funds can be used by borrowers to buy houses from developers, builders, or already-owned homeowners. Typically, the applicant's income, credit score, and the property's valuation are used to calculate the loan amount.

2. Loans for Home Construction

Those who wish to construct a new home on land they currently own can apply for home construction loans. These loans supply the money required for building costs, such as supplies, labor, and other associated charges. building loans are typically provided in stages, contingent on the status of building, in contrast to home purchase loans, which are disbursed in one big payment.

3. Loans for Home Renovation

Homeowners who want to upgrade or renovate their current property can apply for home renovation loans. A variety of modifications are covered by this kind of financing, from small fixes to large additions like extra rooms or kitchen remodels. These loans allow homeowners to improve a property's functioning and worth without having to take money out of savings.

4. Property-Based Loans (LAP)

Borrowers can use their current residential or commercial property as collateral to get a loan through the use of a loan against property, or LAP. Other than buying or building a new home, this kind of loan is usually utilized for debt consolidation, business development, or educational expenses. The property's valuation and the borrower's ability to repay the loan are the factors that decide the loan amount.

5. Home Extension Credits

Home Extension Loans are meant for people who want to add on to or extend their current property. This may entail constructing more floors, rooms, or other additions to satisfy expanding family requirements or raise the property's worth. While they primarily focus on structural additions rather than general repairs or improvements, these loans are comparable to renovation loans.

6. Loans with Balance Transfers

With a balance transfer loan, borrowers can move their current home loan balance from one lender to another, usually to benefit from lower interest rates or better terms. Lower monthly payments or lower total interest expenses may arise from this. HFCs frequently provide balance transfer loans with extra perks like less processing costs or improved features.

7. Home Loans in NRI

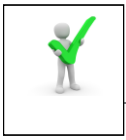
For non-resident Indians (NRIs) who want to purchase, build, or remodel a home in India, NRI Home Loans are designed specifically for them. These loans are comparable to standard home loans, but they are tailored to NRIs' specific requirements, including currency exchange and fund repatriation. Complying with particular legislation pertaining to foreign investments and submitting additional documentation may be required during the application process.

8. Joint Mortgages

Multiple candidates that submit a joint loan application are eligible for Joint Home Loans. This can apply to friends, family, or business associates. The combined income of the applicants for a joint loan may boost eligibility for a larger loan amount. Furthermore, there is a shared interest burden and potential tax savings and improved loan terms for borrowers.

9. Specialized Mortgages for Accessible Properties

The purpose of specialized loans for affordable housing is to assist middle-class and lower-class families in purchasing their own houses. These loans, which aim to increase housing accessibility for the less fortunate segments of society, frequently have government-backed guarantees or subsidized interest rates. This includes programs run under government initiatives such as the Pradhan Mantri Awas Yojana (PMAY).



Check Your Progress-B

Q1. Explain types of loan provided by housing finance companies.

Q2. Write a short note on Housing Finance.

Q3. Distinguish between housing finance and banking finance.

17.8 NATIONAL HOUSING BANK’S CONTRIBUTION IN THE DEVELOPMENT OF HOUSING FINANCE COMPANIES

8.1 Bank for National Housing

The National Housing Bank (NHB) is a major participant in the development and regulation of the housing finance sector in India. The National Homes Bank Act of 1988 saw the establishment of the National Housing Bank (NHB), whose main goals are to improve general home accessibility and ease housing finance for Indian inhabitants. Below is a summary of the NHB's objectives, responsibilities, and significance.

The National Housing Bank's goals:

1. Encourage Housing Finance: The NHB's primary goal is to uphold and improve India's housing finance framework. It seeks to support the overarching objective of supplying enough housing by making housing loans more accessible and affordable for both individuals and families.
2. Control Housing Finance Companies: The National Housing Bank (NHB) is responsible for overseeing and controlling Housing Finance Companies (HFCs) to make sure their operations are secure, sound, and supportive of the expansion of the housing finance industry.
3. Refinance Housing Loans: HFCs and other lending institutions that provide housing loans are eligible to receive assistance with refinancing from the National Housing Bank (NHB). As a result, these financial institutions are able to extend a greater number of loans, which contributes to the maintenance of a stable home financing market. HFCs and other lending institutions that provide housing loans are eligible to receive assistance with refinancing from the National Housing Bank (NHB). It is because of this that these institutions are able to extend a greater number of loans, which in turn serves to maintain the liquidity of the housing finance market.
4. Promote New Financial Products and Practices that Can Increase Access to Housing Financing and Boost System Efficiency: The NHB promotes new financial products and practices that can increase housing finance system efficiency and accessibility.

The National Housing Bank's operations:

1. Refinancing Facility: Providing banks and HFCs with refinancing is one of the NHB's primary responsibilities. These institutions can better manage their financial resources and preserve liquidity with the use of this facility. To enable them to provide more home loans, the NHB refinances a percentage of the loans that these organizations grant.
2. Regulation and Supervision: The NHB oversees the observance of sensible procedures and regulatory standards by HFCs and regulates them. This include establishing policies for how they will operate, keeping an eye on their financial situation, and, if needed, taking corrective measures to protect borrowers' interests and the stability of the home finance industry.
3. Development of Housing Finance Markets: Through the introduction of new products, the enhancement of infrastructure, and the encouragement of the adoption of best practices, the NHB endeavors to develop and improve the housing finance markets. Initiatives to promote affordable housing and the growth of housing finance into underdeveloped areas fall under this category.
4. Development and Implementation of Policies: The NHB is involved in the development and implementation of housing finance policies. It works along with

the government and other relevant parties to develop and implement plans that encourage the construction of new homes and alleviate the scarcity of existing ones.

5. Research and Data Gathering: The NHB carries out studies and gathers information on market dynamics, borrower requirements, and trends in housing finance. Understanding market dynamics and using that knowledge to guide policy and regulatory decisions are two benefits of this research.

The National Housing Bank's significance:

1. Support for Affordable Housing: Refinancing and supporting HFCs is a critical function of the NHB in order to increase the accessibility of housing finance, particularly for lower- and middle-class households. Its programs aid in closing the gap between supply and demand in the housing market, especially with regard to affordable housing.
2. Stability and Growth: The NHB supports the stability and expansion of the home finance industry by regulating HFCs and offering refinancing. Stability plays a crucial role in preserving trust in the housing financing system and guaranteeing its smooth operation.
3. Improvement of Financial Inclusion: The NHB's initiatives to raise awareness of housing finance products and broaden its customer base contribute to an improvement in financial inclusion. It assists people and families in obtaining home ownership and enhancing their living conditions by making housing finance more accessible.
4. Facilitation of Housing Development: The NHB promotes the construction of housing infrastructure through a number of programs and activities. This entails encouraging sustainable housing practices, renovating current dwellings, and assisting the building of new ones.
5. Partnership with Government Initiatives: A number of government housing projects, such as the Pradhan Mantri Awas Yojana (PMAY), receive assistance from the National Housing Bank (NHB1). In order to promote the effective implementation of housing policies and programs, the National Housing Board (NHB) ensures that its operations are aligned with the goals of the government.

8.2 NHB's Contribution to Housing Finance Companies' Growth

The National Housing Bank (NHB) has played a major role in the growth and development of Housing Finance Companies (HFCs) in India. The NHB has played a major role in influencing the housing finance landscape as the industry's premier regulatory and developmental organization. Here's a summary of the NHB's responsibilities, backed up by information and instances.

1. Control and Guidance

Creating Standards: The NHB has been instrumental in creating standards for HFCs since its founding in 1988. More than 80 HFCs were registered with the NHB as of March 2023; they included well-known companies like LIC Housing Finance and HDFC Ltd. Through the enforcement of regulatory standards pertaining to capital adequacy, asset quality, and corporate governance, the NHB makes sure that these businesses run responsibly and openly.

Compliance Monitoring: To make sure HFCs follow legal requirements, the NHB regularly audits and inspects facilities. For instance, the NHB inspected more than 100 HFCs in the fiscal year 2022–2023 to make sure they complied with its regulations and to remedy any operational or financial problems.

2. Facilities for Refinancing

Support for Liquidity: The refinancing facilities offered by the NHB are essential for preserving liquidity in the housing finance industry. In 2022, the NHB gave different HFCs and financial institutions refinancing help totaling ₹48,000 crore. These businesses are able to better manage their cash requirements and provide more loans to clients thanks to the refinancing support.

Operational Efficiency: The NHB helps HFCs become less reliant on expensive finance sources by providing refinancing choices. This makes them more efficient in their operations and allows them to provide competitive interest rates. One of the biggest HFCs, HDFC Ltd., for example, has benefited from NHB's refinancing facilities to provide competitive rates on house loans.

3. Development and Building of Capabilities

Training Programs: To help HFCs become more proficient operators, the NHB arranges capacity-building and training initiatives. More than 1,000 professionals from HFCs across the nation benefited from more than 50 workshops and training sessions that the NHB held in the last year on subjects like risk management and customer service.

Promotion of Best Practices: The NHB pushes HFCs to use best practices in technology, customer service, and loan underwriting. For instance, the NHB has advocated for the adoption of digital loan application and processing systems in order to improve client satisfaction and efficiency.

4. Innovation and Market Development

Promoting Innovation: The NHB encourages the creation of cutting-edge home financing solutions. With an initial budget of ₹500 crore, the NHB launched the Housing Finance Market Development Fund in 2022 to foster innovation and the creation of new financial products for the housing industry.

Increasing Market Reach: The NHB has played a significant role in bringing housing finance to underprivileged communities. For example, the NHB's measures have boosted the penetration of housing financing in rural areas; in 2023, the share of rural housing finance climbed from 15% in 2020 to 22%.

5. Working together on government initiatives

Supporting Government Programs: The NHB assists in the execution of government housing programs. Since the start of the Pradhan Mantri Awas Yojana (PMAY), the NHB has made it easier for subsidies of ₹1.5 lakh crore to be disbursed for affordable housing developments.

Policy Implementation: To develop and carry out housing policies, the NHB works with the government. For instance, the Credit Linked Subsidy Scheme (CLSS) under PMAY, which attempts to give interest subsidies on home loans to qualified recipients, was designed with significant involvement from the NHB.

6. Investigating and Analyzing Data

Research: The NHB carries out a thorough analysis of market dynamics and developments in housing financing. The housing finance sector has been expanding its reach, as evidenced by the 10% year-over-year growth in disbursements in 2022, according to the NHB's annual report that outlined market trends.

Providing Market Insights: HFCs can benefit greatly from the research reports and data analysis produced by the NHB. The 2023 NHB report indicated a 12% rise in loans for affordable housing, which directed HFCs to concentrate on this expanding market.

17.9 DOCUMENTS REQUIRED FOR OBTAINING HOME LOAN

A house finance business will normally need a few essential papers in order to process your application quickly when you apply for a home loan. These records aid the lender in determining your eligibility, confirming your stability financially, and guaranteeing a seamless loan application process. An outline of the crucial paperwork you'll require is provided below:

1. Identity Proof: This refers to documents that have been issued by the government, like an Aadhar card, passport, or driver's license. This document is used to verify your citizenship and identity.

2. Address Proof: You may be required to present proof of your current residential address, such as utility bills, bank accounts, or rental agreements.

3. Income Proof: Pay stubs from the previous six months, bank statements, and income tax returns can all be used as evidence of income. Profit and loss statements, balance sheets, and tax returns from the previous several years are usually needed for self-employed people.

4. Employment Details: It could be required to obtain a letter from your company attesting to your status, title, and pay information. Applicants who are self-employed could be required to provide a certificate of practice or their business registration paperwork.

5. Property Documents: It's important to have documents pertaining to the property you plan to buy. These usually consist of the property tax receipts, the sale and title deeds, and, if relevant, a no-objection certificate from the builder or society.

6. Loan Application Form: You must complete the application provided by the housing finance firm, including specific details about your financial situation and the property you are purchasing.

7. Photographs: In order to complete the application process, passport-sized photos are frequently needed.

8. Bank Statements: The lender can assess your cash flow and financial stability by reviewing recent bank statements covering the last six to twelve months.

9. Credit Report: In order to evaluate your creditworthiness and loan payback history, a recent credit report or credit score could be needed.

It's advisable to inquire with the lender about their precise documentation needs as each house finance company may have different criteria or differences in what documents are needed. Having these records prepared and organized will help your home loan application get approved more quickly.

17.10 SUMMARY

Introduction: Housing finance is essential to human wellbeing and growth since it offers the seclusion, comfort, and security required for a respectable existence. The significance of finance in this sector has been brought to light by the increasing need for housing in India, which is being driven by urban migration and the growth of knowledge-based firms.

Goals: The goals of housing finance are to define it, outline its advantages, outline the kinds of loans that are accessible, set it apart from banking finance, and comprehend how the National Housing Bank (NHB) has contributed to its expansion.

The evolution of housing financing in India has resulted in a more structured framework, replacing the previous fragmented system.

1. Early on (before to 1947): Mostly informally with neighborhood moneylenders.
2. Post-Independence Initiatives (1947–1960s): 1970 saw the founding of organizations such as HUDCO.
3. Growth and Liberalization (1970s–1990s): 1988 saw the introduction of NHB and the emergence of the private sector.
4. Modernization and Reforms (1990s–2000s): Better regulatory frameworks and economic liberalization.

5. Current Developments (2000s–Present): PMAY government programs and digital platforms.

Housing Finance's Significance

1. Encourages Home Ownership: Provides the means to become a homeowner.
2. Promotes Related Sectors Like Construction and Stimulates Economic Growth.
3. Improves Living Conditions and Strengthens Social Stability.
4. Encourages building and renovation in order to facilitate urban development.
5. Promotes Real Estate Investing: Offers financing instruments for real estate ventures.
6. Expands Access to Credit: Provides credit availability to a wider range of individuals.
7. Supports government housing policies by putting PMAY programs into action.
8. Offers Tax Benefits: Allows interest payments to be written off.
9. Promotes Wealth Creation: Permits the accumulation of assets via real estate.
10. Encourages green building efforts and sustainable development.

Institutional Framework: Important figures in the housing finance sector in India are:

1. The National Housing Bank (NHB) is the highest authority overseeing HFCs.
2. Long-term home loans are the area of expertise for home Finance Companies (HFCs).
3. Major providers of home loan products are commercial banks.
4. Institutions that promote cooperation are crucial in semi-urban and rural settings.

Loan Types Offered by HFCs:

1. Home Purchase Loans: For the purchase of either a new or old home.
2. Home building loans: For constructing homes on privately owned property.
3. Loans for home renovation: For improvements and repairs.
4. Using property as collateral is known as a loan against property (LAP).
5. Loans for home extensions: To build extra floors or rooms.
6. Loans with balance transfers: transferring lenders to get better conditions.
7. Home loans for non-resident Indians (NRIs) who wish to purchase real estate in India.
8. Loans for joint homes: For more than one applicant.
9. Affordable housing specialized loans for middle-class and lower-class households.

Function of the National Housing Bank (NHB): The NHB oversees and advances housing finance by:

1. Refinancing Facility: Preserves HFC liquidity.
2. Prudent procedures are ensured through regulation and supervision.
3. Development of Housing Finance Markets: Promotes the creation of affordable housing and introduces new products.
4. Co-develops and implements policies: Works with others on housing development projects.
5. Research and Data Gathering: Contributes to understanding of markets and policy decisions.

17.11 GLOSSARY

Financial services and goods: Financial services and goods used to finance the acquisition, development, or renovation of residential real estate are referred to as housing finance. It covers loans such as mortgages, home equity loans, and loans for house renovation.

National Housing Bank (NHB): The premier housing finance organization in India, NHB was founded in 1988. It encourages the growth of the housing finance market and controls housing finance businesses (HFCs).

Home purchase loans are credit provided to people by housing finance companies (HFCs) to buy new or pre-owned homes.

Home construction loans: These are loans given to people so they can build a new home on land they already own.

Loans intended to finance repairs or enhancements to an existing property, increasing its market value and usefulness, are known as home renovation loans.

Loan Against Property (LAP): A kind of loan wherein borrowers receive financing for reasons other than buying or building a new property by using their current property as collateral.

Home Extension Loans: These are loans meant for people who want to add more floors or rooms to their current property.

Loans: Loans that enable borrowers to move their current home loan balance from one lender to another, frequently in order to benefit from better terms or interest rates, are known as balance transfer loans.

Home loans: Home loans designed specifically for non-resident Indians (NRIs) who wish to purchase, build, or remodel real estate in India.

Joint Home Loans: Loans for which several borrowers apply together in order to increase their aggregate income eligibility and qualify for a larger loan amount.

Specialized loans for affordable housing: These are loans with government-backed guarantees or subsidized interest rates that help low- and middle-class households buy homes.

Mortgages: Loans intended exclusively for the purchase or renovation of a home, usually secured by the real estate.

Investment structures: Investment structures that offer access to residential buildings and other real estate investments through the purchase of shares are known as Real Estate Investment Trusts, or REITs.

The Pradhan Mantri Awas Yojana (PMAY) is an Indian government program designed to give low- and middle-class families access to affordable homes.

Refinancing is the procedure through which a bank or home finance firm gets new capital to pay off old debts, usually in order to keep up liquidity or provide more loans to clients.

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17.14 TERMINAL QUESTIONS

1. How has India's history of home finance, which dates back to before the country's independence and includes more recent advancements, influenced the housing market and the various alternatives available for home financing in the country?
2. What are the most important advantages of housing financing for people as well as for the economy as a whole, and how do these advantages help to the expansion of the economy as well as the maintenance of social continuity?
3. Explain how the National Housing Bank (NHB), Housing financing Companies (HFCs), commercial banks, and cooperative organizations are the individual components that make up the institutional architecture that governs housing financing in India.
4. Which types of loans are offered by home Finance Companies (HFCs), and how do these companies cater to the various requirements of borrowers, such as those who are looking for home that is within their price range?
5. Describe the ways in which the National Housing Bank (NHB) contributes to the growth of the housing finance sector and the government's implementation of housing policy in India by contributing to the promotion and regulation of housing finance.

UNIT 18 CREDIT RATING

18.1 INTRODUCTION

There is a large amount of fund, which is raised from different companies, financial institutes, local bodies, public sector enterprises or it may be raised from both domestic as well as international markets. The funds can be brought up either through debt or through equity securities, so all the agencies who rate the securities are called credit rating agencies. The process of such rating is called credit rating.

The process of credit rating is important as it helps in making financial decisions concerning the amount of credit that could be raised from the market. It also indicates the status of free payment of credit on time along with the assessment of solvency of the borrower.

The term rating is a symbolic grade which is provided to the estimated worth or value of securities, which are used in the market.

Credit ratings play a crucial role in the financial world, providing an evaluation of the credit risk associated with a borrower. They serve as an essential tool for investors, lenders, and other stakeholders to make informed decisions about extending credit or investing in securities. This comprehensive overview will explore what credit ratings are, how they are determined, their significance, and their impact on the financial markets.

There are certain symbols which are provided by the reading agencies, which indicate the certain characteristics of security and it gives a facility to understand the risk of credit related to the security. The credit rating does not recommend a direct indication about buying or selling of security, but it only communicates about the degree of risk involved in making an investment in such security. Therefore, the decision of investing in a certain form of security and financial instrument largely depends on such credit rating agencies. It is not necessary that the investor should completely depend on these rating symbols, but they are a kind of instrument that provides a suggestion about credit worthiness of financial assets and the amount of risk involved in them. So by the help of these symbols, it becomes easy for the investor to make a direct decision about investment.

At a certain point of time, there are different alternative credits rated instruments which are available in the market, by which investable funds can be diverted to the most profitable avenues. They also provide a wide choice for the investor to create diversified plans about investment portfolios. The greatest benefit of credit rating agencies is that they continuously keep an eye on investment instruments of different companies. The agencies are prominent in downgrading the rating of instruments, if the financial performance of companies is not satisfactory or they suffer continuous loss. The aim of these agencies is to protect investor from any casualty that can take place due to an internal or external change in the position of the company.

18.2 OBJECTIVES

After learning this unit, following objectives shall be achieves-

- Enable to understand the meaning, benefits, scope and limitations of credit rating.
- To know about the process of credit rating.
- To understand about the norms and regulations of credit rating in India.
- Enable to know about the different credit rating agencies and their symbols.

18.3 DEFINING CREDIT RATING

A credit rating is an assessment of the creditworthiness of an individual, corporation, or government. It is a measure of the likelihood that the borrower will not default on their debt obligations. Credit ratings are typically expressed as letter grades, with higher grades indicating lower risk. For example, a rating of AAA signifies the highest level of creditworthiness, while a rating of D indicates default.

18.4 BENEFITS OF CREDIT RATING

18.4.1 BENEFITS TO ISSUER COMPANY

There are various advantages for those companies, who get their securities related from credit rating agencies. Such advantages can be listed as under-

1. **Reduction in cost of borrowing -** Those companies, whose security or public deposit is provided with a higher rank, shall always enjoy a position of reduction in cost of borrowing. As they could easily rate a lower rate of interest on their debenture or fixed deposit the investor shop invests in this security, as they enjoy lower credit risk in these securities.

2. **Large number of investors**- A good rated company will always find more number of investors approaching for their debt securities. It becomes easy for them to mobilise their savings and raise large amounts of financial resources. The investors from different groups of societies shall make an investment in the securities who provide a better credit rating.

3. **Strategy of marketing**- The use of rating instruments is done by the companies to improve their image and propagate a better marketing of their securities amount, creditors, customers and investors. The investor will feel an essence of confidence by investing in those companies, who have a good market worth.

4. **Disciplinary workout**- The companies are encouraged by good ratings to enhance a better system of accounting financial reporting and their pattern of management. The companies are also provided with a motivation to make an improvement in their practices, so that they can match the competitive standard of a dynamic financial environment.

5. **Less expense in public issues**- Highly rated companies find it easy to attract more investors and raise funds easily with least efforts in the market. Those companies who issue debt securities find it easy to reduce the cost of public issues including advertisement publicity media coverage.

6. **Growth motivation**- A better grading for the company also provide different growth opportunities in new market and new product. The promoters of the company are confident about their efforts and may take decisions about extension

and expansion of new operations in the company. It also becomes easy for highly rated companies that companies may mobilise their funds easily from different financial institution and from institutional lenders.

18.4.2 BENEFITS TO FINANCIAL INTERMEDIARIES

Not only companies but financial intermediaries are also well benefited from the ratings provided to securities, the highly rated instruments are easily sold in the market with minimum efforts of the brokers. The position of credit of a company makes the investor convince about safety of his investment and generating a better return on time. The instruments which are well rated by different agencies explain on their own about the financial strength of the company and shall reduce the cost of issue. It also saves time and energy and requirement of manpower, so as, the securities can be easily sold in the market. The other benefit available to the intermediaries' are-

1. **Know about strength and weakness of company**- It also becomes easy for the intermediaries and investors to understand about various strength and weaknesses of the company, which can make the investment more risky and unsound. Those companies who have a low credit rating are required to improve their performance, so that a healthy convocation can be maintained in the market. The credit rating of the company creates corporate governance which helps in improving the standards of company in the international market.
2. **Liquidity of security**- The rating of debt securities helps to understand their market ability and to know about maintenance of the liquidity. The symbols or grades which are provided by credit rating agencies are used to fix a range of prices in the market. Therefore easy market ability and higher liquidity act as the base of rating security in the market.
3. **Influence on capital market**- The rating of security helps in creating an improvement in the functioning of companies. Therefore, it creates a positive impact on both investors and management. The improvement in functioning of a company is also beneficial for a smooth working of capital as well as primary market.

18.5 CREDIT RATING AGENCIES IN INDIA

The credit rating agencies in India have been actively working for the evaluation of different securities, including debt and equity securities. So, four prominent credit rating agencies work for these corporates.

Credit ratings are assigned by credit rating agencies (CRAs), which are specialised organisations that evaluate the financial health and credit risk of borrowers. The three major CRAs are Standard & Poor's (S&P), Moody's, and Fitch Ratings. These agencies use proprietary methodologies to assess the creditworthiness of borrowers, including an analysis of financial statements, economic conditions, and other relevant factors. These credit rating agencies are

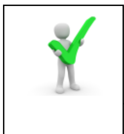
1. **Credit rating information service of India limited (CRISIL)** - This is one among first credit rating agencies in the country, which was established in the year 1987 with the joint efforts of ICICI and UTI. The shareholders of these agencies include LIC, HDFC, State Bank of India, Asian development Bank etc. The CRISIL is considered to be one among four largest credit rating agencies in the world. Its activities include rating of corporate debt, rating of working of banking or non-banking institute, to give rate to boring program of government and non-government bodies, to give rating to structured finance instruments and microfinance instruments. This agency is meant for providing an analytical tool of risk management and look after the valuation of different services provided by corporate houses. The agency also undertakes to conduct research on the performance of companies, industries and economy. It provides an advisory service to various non-corporate and corporate clients. The agency has rated over 4700 debt instruments which are used by nearly 2200 companies.
2. **Investment information and credit rating agency of India limited (ICRA)** - This organisation was floated by IFCI limited, so as to meet the needs of different companies located in North India. The beneficiaries of this organisation are State Bank of India, UTI, LIC, Punjab National Bank and various other promoters working for the company. The objective of this agency is the rating of such debt instruments whose denomination is measured in terms of rupees. So, it includes commercial bank, financial institutions, manufacturing companies, non-banking financial companies, public sector undertakings, different local bodies etc. This agency also takes up the assignment of providing credit rating to different organisations for some specific purposes like purchase and sale. It also provides services for general assessment by which potential investors can make a decision of investment. It also undertakes research, which is based on the study of different features of the organisation, depending on the requirements of clients. It includes assessment of equity shares, industrial analysis, study of market etc. Not only the above, but the agency also provides advisory services to different financial companies, manufacturing companies, local bodies, regulatory authorities, local bodies, government and Bank concerning policy formulation and risk management.
3. **CARE Ltd.** - The credit analysis and research limited is one of the credit rating agencies, who provide its services to different companies. This organisation was incorporated by the Industrial Development Bank of India with the joint efforts of various investment institute banks and financial companies. It started its functioning in October 1993 to perform the functions of rating various types of debt instruments, including long and short term securities. It provides information about different companies, industries and those sectors, which are involved in trading in

securities. It also conducts research of different listed and unlisted securities with functioning of middle stock exchange.

18.6 REGULATION OF CREDIT RATING AGENCIES

The credit rating agencies in India are being regulated and controlled by the Securities Exchange Board of India. These regulations can be evaluated on the basis of following conditions-

1. **Registration of credit rating agencies**- It is a must requirement for all the credit rating agencies, to get registered with Security Exchange Board of India and they should obtain a certificate of their registration from the agency. The issue of certificates is done on the basis of the condition that the agencies should comply with all the provisions and they must abide by all the guidelines and regulations issued by SEBI from time to time. If any of the information provided to SEBI is found to be false or misleading, then the agency must inform about the same in writing to the governing body of SEBI as soon as possible. The certificate issued to the credit rating agency is valid for duration of 3 years after which a further renewal is required.
2. **Eligibility for the promoter of a credit rating agency**- Any credit rating agency can be promoted by any of the organisation or a group of organisations including all the public financial institutes which are defined under section 4 of companies' act 1956 and schedule bank.



Check Your Progress-A

Q1. What is the role of credit rating agencies in Indian Financial System?

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Q2. Discuss regulation of Credit Rating Agencies.

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Q3. What are credit rating agencies in India?

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18.7 SCALE OF RATING

Credit ratings are generally categorised into two main groups: investment grade and non-investment grade (or speculative grade).

1. **Investment Grade AAA to BBB (S&P and Fitch) or Aaa to Baa (Moody's):** These ratings indicate lower credit risk and are typically assigned to borrowers with strong financial health and stable revenue streams. Investment-grade ratings suggest a high likelihood of timely debt repayment.
2. **Non-Investment Grade: BB to D (S&P and Fitch) or Ba to C (Moody's):** These ratings indicate higher credit risk and are often referred to as "junk" ratings. Borrowers with these ratings may have weaker financial positions and are more susceptible to economic downturns. Non-investment grade ratings suggest a higher risk of default.

18.8 FACTORS AFFECTING CREDIT RATING

There are a large number of factors, which influence the rating of security rated by credit rating agencies. These agencies shall consider several factors, while determining a borrower's credit rating:

1. **Financial Health**: In the process of rating, the financial health of the organisation plays a vital role, as the financial condition is reflected by the financial statements. Position statement which is the balance sheet of a company shall provide the following information about the organisation

- **Liquidity**: liquidity is said to be the borrower's ability to meet short-term obligations. This liquidity is better provided by a borrowed fund as compared to an owner's fund. Therefore, those investors who are intended to maintain their status of liquidity are required to invest more in debt funds as compared to equity forms of investment.

- **Leverage:** The ratio of debt to equity and the borrower's overall debt burden is said to be leverage. The fixation of leverage largely depends upon the amount of funds and their composition raised by the organisation. So, it is necessary that the proportion of debt and equity must be fixed as per the requirements of financial sources.

- **Profitability:** The borrower's ability to generate consistent profits is stated by profitability. The total amount of profit generated over sales is said to determine the amount of profit generated by the firm. The profit acts as a base for evaluating the performance of a security in the market.

- **Cash Flow**: The stability and predictability of cash inflows and outflows is reflected by the preparation of cash flow, the cashless statement of a company. It is considered to be one of the integral parts of financial statements. Therefore the amount of cash circulating among different activities is one of the factors affecting the rating of security in the market.

2. **Economic Conditions**: The economic conditions include all the economic policies framed for control and management of different profit making institutes in the country. So, the prevailing economic conditions are required to be understood before providing grades to the security this economic conditions include-

- **Macroeconomic Trends**: The overall health of the economy, including GDP growth, inflation rates, and employment levels are included in macroeconomic forces. These forces are responsible for making a considerable enrichment in the grades provided to securities of an organisation.

- **Industrial Conditions**: The stability and prospects of the borrower as per the growth of industry, is included in the industrial conditions. These conditions are responsible for generating profits and execution of sales of the organisation. The consideration of industrial conditions is necessary in credit rating, as it enables us to know about the future prospects of security.

3. **Quality of management**: The integral qualities of management of the organisation are also responsible for enhancing the value of securities in the market. The management is held responsible for undertaking all the essential decisions including sales and profit.

- **Leadership**: The effectiveness of the borrower's management of the team, in navigating financial and operational challenges is reflected in his leadership skills. Such skill is responsible for better future prospects of the organisation, by which better profit can be generated. A higher profit earning organisation is always considered to be a better rated organisation

- **Corporate Governance**: The borrower's adherence to best practices is a part of corporate governance. Most organisations that follow better corporate governance shall provide fruitful results in the form of well synchronised organisations. Therefore, it is necessary that the organisations must follow a system of rules and regulations.

4. **External Factors**: There are various external factors, which affect the performance of organisations and are further responsible in rating of security these factors include

- **Political Stability:** The impact of political conditions on the borrower's operations, as per functioning of organisation stability in political condition, creates a better ecosystem for various organisations to groom and develop.

- **Regulatory Environment**: The influence of regulatory changes on financial health helps an organisation for evaluation of securities. The companies which are registered under companies act are required to follow the regulatory aspects of law and must abide by the regulations. These companies find better grades as compared to any other organisations.

A credit rating is an assessment of the creditworthiness of a borrower, typically expressed as a letter grade. These ratings are used by lenders and investors to evaluate the risk of lending money to, or investing in, a particular entity.

18.9 PURPOSE OF CREDIT RATING

1. **For Investors**: To assess the risk and potential return on investment. It is necessary for the investor to understand the return generated from investments which can be analysed by credit rating and grading the credit rating of the company enables investor to know about the worth of his investment
2. **For Lenders:** To decide on interest rates and terms of lending. The lender can easily understand about the need of investor who race funds from the market at a reasonable rate of interest the lender can also decide the risk associated with amount provided as a loan to the investor
3. **For Issuers**: To gauge borrowing costs and access to capital markets. Credit rating is important for assessment of value of securities and will help in understanding the default risk associated with bonds and other debt instruments.
4. **Interest Rates**: Higher ratings usually result in lower borrowing costs. It is because high rated security can easily find investors in the market and they do not involve any huge transaction cost
5. **Market Confidence**: Ratings can influence investor and lender confidence in an organisation. It also becomes easy for the companies and investors to gain the confidence of general public in analysis and valuation of security
6. **Process Data Collection**: Gathering financial and operational information about the organisation is essential for executing the rating of security sach data enables the agency to provide a prominent grade to the security
7. **Analysis:** Evaluating the data using quantitative models and qualitative judgement is the technique of credit rating these grades are quantitative values which are provided to the security on the basis of their performance in the market
8. **Rating Committee**: It is a committee that reviews the analysis and assigns the rating of securities. The committee is meant for publication of code of conduct for companies and norms under which securities will be graded.

9. **Publication**: The rating is published and regularly updated based on new information available about securities. Such publication is done for both investors and potential investors.
10. **Corporate Bonds**: Companies issuing bonds to raise capital are called corporate bonds. These are general bonds which are used as a debenture to raise loans from the general public.
11. **Sovereign Bonds**: Governments borrowing funds through bonds are called sovereign bonds. These bonds are more secure as compare to corporate bonds the rating of This bonds is also higher than any other security in the market it is due to their assurance of repayment of principal and interest
12. **Municipal Bonds**: Local governments and municipalities raising funds from the public are done in the form of municipal bonds. These bonds are generally issued to the local public, from whom funds can easily be raised.

Understanding credit ratings is crucial for anyone involved in lending, investing, or financial analysis as it provides insights into the risk and return profile of various debt instruments.

18.10 PROCESS OF CREDIT RATING

The process of credit rating shall be done by the request of an issuing company, to the credit rating agency, which is further followed by various decision making processes and finally concludes with providing a credit rating symbol. There are various steps involved in the process which are as under-

1. **Meeting with management**- The credit rating agency shall have an open communication with the company's management, so that the best interest of investors can be provided. They are provided with a range of issues, which are discussed, including the strategies of business, financial policy, competitive position, future outlook etc. Not only the above but the element of business risk is equally included in the rating of a company.
2. **Collection of data** - The credit rating agency gathers financial and operational information about the borrower. This may include audited financial statements, management discussions, and industry reports. Such information is collected from reliable sources or may either be taken from the internal sources of the company. The information is a sum of all the material facts which may influence the decision of the investor.
3. **Committee for rating** - Analysis team shall prepare a report about the functioning of the company with his future prospects provided to the rating committee. Such a committee shall approach for an optimum assignment of rating symbol, so that the

objective of rating can be fulfilled. The committee includes a group of experienced professionals, who look after providing some new or additional information as well as material facts, on the basis of which the grades can be revised. It is possible that the client may participate in completing the rating process, which is completely kept confidential.

4. **Publication and Monitoring-** The assigned credit rating is published and made available to the public. The agency continuously monitors the borrower's financial health and may adjust the rating, if there are significant changes in the borrower's circumstances. The final rating accepted by the issuing company is then publicised in both domestic as well as international media, so that the investor may have a benefit of such rating.
5. **Information to SEBI-** it is also required that the credit rating agency must provide the information about grade of a company to SEBI and introduce them about the grading symbol provided to the company.

18.11 SCOPE OF CREDIT RATING

Credit ratings are such financial tools that assess the creditworthiness of entities, including corporations, governments, and other organisations. These ratings influence borrowing costs, investment decisions, and overall economic stability. Here's a detailed look at the scope of credit ratings:

1. **Evaluate performance of company**- The area of credit rating covers the evaluation of performance of an organisation, particularly a company who is intended to raise its maximum funds from the general public. So, it becomes important that the company must understand its financial position and convey it to the potential investor.
2. **Evaluation of worth of security-** It is also important that the market value of securities must be evaluated and analysed on the basis of performance of the company. The security is graded in such a way that it becomes easy for the investor to know which investment can generate reward in future.
3. **More emphasis on borrowed fund-** The credit rating agencies are meant for providing grades to the debt securities in which a fixed rate of interest is paid to the investor. So the companies are intended to go for good grades, so that their creditworthiness is enhanced in the market.
4. **Valid for large investors-** Those investors who invest a large amount of their holdings in securities are cleaner to know about the performance of the security in the market. Therefore, in order to attract these investors, the companies are bound to get their security valued by credit rating agencies.

5. **Norms of SEBI-** It is also mandatory for companies to get their security related and make them known to different bodies of SEBI. The organisation is required to analyse their financial condition so that optimum grade can be generated and then conveyed to the securities board of India.

18.12 FUNCTIONS OF CREDIT RATING

Credit ratings primarily serve to evaluate the likelihood that a borrower will default on debt obligations. They provide a quantitative measure of credit risk, aiding investors in making informed decisions. High ratings (e.g., AAA) indicate low risk, while lower ratings (e.g., B or C) suggest higher risk.

1. **Risk Assessment**: Credit ratings provide investors and lenders with a standardised measure of credit risk. This helps them make informed decisions about whether to invest in or lend to a particular borrower.
2. **Interest Rates**: Borrowers with higher credit ratings typically enjoy lower borrowing costs. Lenders and investors demand lower interest rates from borrowers perceived to have lower credit risk, as they are more likely to repay their debts.
3. **Market Confidence**: Credit ratings can influence investor and lender confidence. A high credit rating can enhance a borrower's reputation and facilitate access to capital markets.
4. **Regulatory Compliance**: Many financial institutions and investment funds are subject to regulatory requirements that dictate the types of securities they can hold based on credit ratings. For example, certain institutional investors may only be allowed to invest in investment-grade securities.

18.13 TYPES OF CREDIT RATING

There are two main types of credit ratings:

- **Issuer Credit Ratings**: These assess the overall creditworthiness of the issuing entity.

- **Issue-Specific Ratings**: These focus on individual financial instruments, like bonds or loans, assessing their specific risk.

18.14 IMPACT OF CREDIT RATING AGENCIES

Major rating agencies, including Standard & Poor's (S&P), Moody's, and Fitch Ratings, dominate the credit rating industry. These agencies employ sophisticated models and methodologies to analyse financial data, economic conditions, and qualitative factors.

1. **Impact on Borrowers**-For borrowers, credit ratings directly impacts the cost of borrowing. Higher ratings typically enable access to capital at lower interest rates, facilitating investment and growth. Conversely, lower ratings can increase borrowing costs and limit access to financing.
2. **Investor Decision-Making**-Investors rely heavily on credit ratings to assess the risk-return profile of potential investments. Ratings influence portfolio allocation, risk management strategies, and compliance with regulatory requirements. For instance, many institutional investors are restricted to holding only investment-grade securities.
3. **Regulatory and Compliance Framework**-Credit ratings play a pivotal role in regulatory frameworks. Financial regulators use ratings to set capital requirements for banks and insurance companies, ensuring systemic stability. Ratings are also crucial for compliance with investment guidelines and legal mandates.
4. **Global Financial Markets**-In global financial markets, credit ratings facilitate cross-border investments by providing a standardised measure of credit risk. They enable investors to compare the creditworthiness of entities across different countries and regions, thus promoting international capital flow.

18.15 LIMITATIONS OF CREDIT RATING

Despite a large number of advantages provided by credit rating with their importance for the investor, they have faced criticism and scrutiny. Such limitations are listed as under-

1. **Conflicts of Interest**- Agencies often receive fees from the entities whom they rate. So, potentially they are compromising with the grades which create a partiality. It cannot be said that a well rated company is always good in credit worthiness, but the credits are enforced to be granted to the companies. Credit rating agencies are often paid by the entities they rate, leading to potential conflicts of interest. This has raised concerns about the objectivity of ratings.
2. **Model Risk bearing**- Ratings are based on models that may fail to capture extreme events or rapid changes in market conditions. Such agencies are not considered to be remarkable or they do not follow the guidelines provided for a better grading of security.
3. **Failure in evaluation**- High-profile defaults and financial crises has highlighted instances where ratings did not accurately predict credit risk. Any change in the

market condition is not considered while grades are provided to the securities. The grading agency also does not consider any kind of casual changes that may take place in the market. Therefore, it becomes difficult for the investor to completely rely on the credit rating agency.

4. **Misrepresentation-** There is so many circumstances which indicate that the credit rating agencies have proved to be a burden on the capital market. The buyer's ratings on the basis of subjectivity or fake information do not result in an efficient rating of securities. These agencies who are involved in the process of credit rating must not make a link between people and companies in which investment is made. The companies having lower grades are not bound to make an advertisement for the use of such rating for making an investment.
5. **Study in a static manner**- The ratings which are done for the company are based on latest data which is static in nature. The grades which are provided to the company shall disclose about its healthy functioning which is single time exercise. So, such investment which is based on credit rating may prove to be insufficient in the criteria of risk, existing in the financial market. The rating of securities is subject to change in economic environment, political conditions or even in a change in government policy framework.
6. **Lack of material information**- Due to lack of material information available for the credit rating agencies, it becomes difficult to give an appropriate grade which reflects the risk involved in investment. Critics argue that rating agencies have sometimes failed to accurately assess credit risk, particularly during financial crises. The 2008 financial crisis highlighted the limitations of credit ratings in predicting default
7. **No guarantee of financial strength**- It may not be said that those companies which are well credit rated shall guarantee about a certain fixed return from the market. It is possible that the quality of management may not support the credit provided to the company.
8. **Downgrade**- Once a company has been graded of being in satisfactory and its financial position it becomes difficult to improve the market image and generate more funds from public. Downgrades in credit ratings can have significant market impacts, triggering sell-offs and increasing borrowing costs for the affected entities.
9. **Transparency** - The methodologies used by credit rating agencies are often complex and not fully transparent, making it difficult for stakeholders to understand the basis of ratings.

The credit rating landscape is evolving with the emergence of new rating agencies and methodologies. Innovations include greater transparency in rating criteria, increased emphasis on qualitative factors, and the integration of environmental, social, and governance (ESG) considerations into credit assessments.

18.16 SUMMARY

Credit ratings are a vital component of the financial ecosystem, providing a standardised measure of credit risk that helps investors, lenders, and other stakeholders make informed decisions. While they play a crucial role in facilitating access to capital and assessing creditworthiness, it is important to recognize their limitations and potential biases. Understanding the intricacies of credit ratings, including the factors influencing them and the processes involved in their determination, is essential for anyone involved in the financial markets.

Credit ratings are indispensable in the modern financial system, providing essential insights into credit risk and influencing a wide array of financial activities. While they offer significant benefits in terms of risk assessment and market efficiency, on-going reforms and improvements are essential to address their limitations and enhance their reliability. The scope of credit ratings encompasses a broad spectrum of financial and economic domains, playing a crucial role in the stability and functioning of global financial markets.

18.17 GLOSSARY

Credit Rating- A credit rating is an assessment of the creditworthiness of an individual, corporation, or government. It is a measure of the likelihood that the borrower will not default on their debt obligations.

CRISIL- the CRISIL is considered to be one among four largest credit rating agencies in the world. Its activities include rating of corporate debt, rating of working of banking or non-banking institute, to give rate to boring program of government and non-government bodies, to give rating to structured finance instruments and microfinance instruments.

ICRA- This organisation was floated by IFCI limited, so as to meet the needs of different companies located in North India. The beneficiaries of this organisation are State Bank of India, UTI, LIC, Punjab National Bank and various other promoters working for the company.

CARE- The credit analysis and research limited is one of the credit rating agencies, who provide its services to different companies. This organisation was incorporated by the Industrial Development Bank of India with the joint efforts of various investment institute banks and financial companies.

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18.20 TERMINAL QUESTIONS

1. Explain the objectives and meaning of credit rating?
2. Define credit rating?
3. What are the benefits of credit rating?
4. Write a note on “Credit rating agencies in India”.
5. Discuss about regulation of credit rating agencies.
6. Explain scale of rating in your own words.
7. Explain the factors affecting credit rating.
8. What is the basic purpose of credit rating?
9. Discuss the process of credit rating?
10. Elaborate the scope of credit rating?
11. What are the functions of credit rating?
12. Explain the types of credit rating?
13. What is the impact of credit rating agencies on grading of securities?
14. Discuss about the limitations of credit rating ?

UNIT 19 STRATEGIC ISSUES IN THE MANAGEMENT OF FINANCIAL INTERMEDIARIES

19.1 INTRODUCTION

Because they make it easier for money to move efficiently between savers and borrowers, financial intermediaries are essential to India's economic system. By bridging the gap between people who need capital and those who have extra money, these organizations support economic growth and stability.

The financial intermediary industry in India is made up of a wide variety of organizations, such as insurance firms, mutual funds, banks, and non-banking financial companies (NBFCs).

The growth of financial intermediaries in India has been greatly impacted by economic liberalization and regulatory changes. The primary regulatory agencies that keep an eye on these institutions and guarantee stability, openness, and investor protection are the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

All things considered, financial intermediaries are essential to the functioning of India's financial system since they direct savings into profitable ventures and improve financial inclusion throughout the nation. Their changing role keeps reshaping the financial sector in India, encouraging innovation and increasing access to financial services.

19.2 OBJECTIVES

Upon completion of this unit, you will be capable of:

- Describe the Indian Financial System's structure.
- Describe how regulatory bodies oversee financial institutions.
- Gain knowledge of risk management techniques related to financial organizations.
- Examine and evaluate banking firms' financial statements.

19.3 FINANCIAL INSTITUTION: MEANING AND PURPOSE

3.1 Financial Institutions: Definition

Financial institutions are organizations that offer a variety of financial services to people, companies, and governmental bodies. Usually, these services consist of taking deposits, making loans, overseeing investments, and providing insurance. By facilitating the flow of credit, money, and other financial instruments, financial institutions play a crucial role in the economy by permitting the effective allocation of resources and promoting economic progress.

Commercial banks, investment banks, credit unions, insurance providers, brokerage houses, pension funds, mutual funds, and insurance companies are a few examples of financial institutions. Although each kind of institution focuses on a distinct area of financial services, taken as a whole, they guarantee the efficient operation of the financial system and promote general economic stability.

3.2 The Financial Institutions' Objective

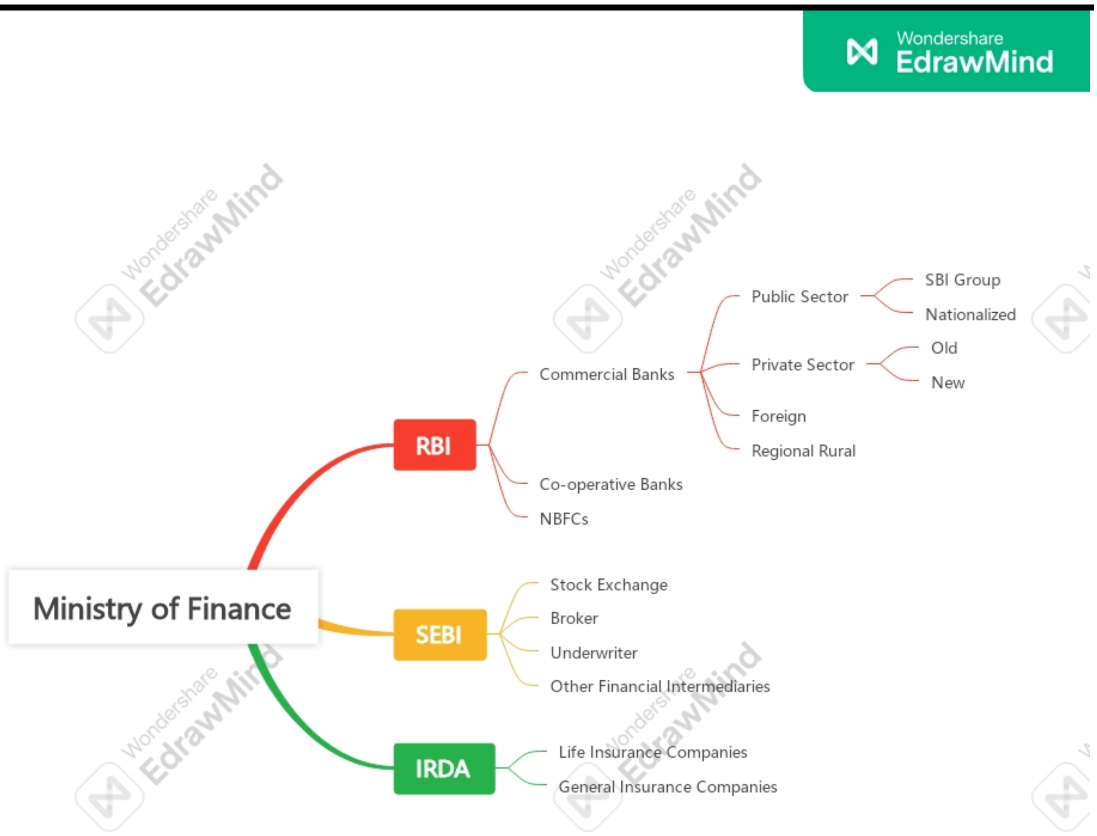
Financial institutions function for the following stated reasons in any economy:

1. Channeling Funds: Financial intermediaries take money from investors and savers and give it to borrowers or companies in need of funding. Their ability to combine resources from several sources allows them to provide more capital than any one person could on their own.
2. Risk management: They assist in controlling and reducing the risks connected to lending and investment. To disperse risk, for instance, banks and insurance companies do so in a way that minimizes individual financial losses and preserves financial stability.
3. Financial intermediaries process information by collecting and evaluating data on investors, borrowers, and market circumstances. This facilitates decision-making

and lessens any ambiguity and information asymmetry that lenders or individual investors may experience.

4. Provision of Liquidity: These organizations offer a range of financial services and products that are easily convertible into cash in order to provide liquidity. Banks, for instance, provide checking and savings accounts that let depositors easily access their money.
5. Investment diversification: Financial intermediaries such as mutual funds and pension funds can build diversified portfolios by pooling the funds of multiple participants. Spreading risk and possibly increasing profits for investors are two benefits of diversity.
6. Financial Innovation: Their contribution to the creation and provision of novel financial services and products is noteworthy. Intermediaries are frequently the source of innovations in financial instruments, payment systems, and investment vehicles as they work to satisfy changing market demands.

19.4 OVERVIEW OF INDIAN FINANCIAL SYSTEM



Ministry of Finance

The highest authority in charge of the whole Indian financial system is the Ministry of Finance. It is in charge of financial regulation, government spending, economic policy, and general economic stability.

Regulatory Organizations

1. Reserve Bank of India (RBI): As the nation's central bank, the RBI oversees and regulates financial institutions to preserve financial stability in addition to directing monetary policy and issuing currency.
   a. Commercial Banks: These financial institutions offer a variety of services, such as taking deposits, making loans, and providing investment goods. They fall under the following categories:

- Public sector banks are those that are held by the government. This comprises:
- State Bank of India and its affiliated banks comprise the SBI Group.
- Banks that have been nationalized in the past include Bank of Baroda and Punjab National Bank.
- Private sector banks are those that are owned by private companies. They are separated into:
- Old Private Sector Banks: These include Catholic Syrian Bank, which was founded prior to the liberalization of the 1990s.
- New Private Sector Banks: Following deregulation, banks like HDFC Bank and ICICI Bank were established.
- Foreign banks, like HSBC and Citibank, are foreign banks that have branches in India.
- Regional Rural Banks (RRBs) are financial institutions that prioritize lending and other financial services to rural communities in order to support rural and agricultural development.

b. Cooperative Banks: These are cooperative societies, such as urban cooperative banks and rural cooperative banks, that were founded to offer financial services to its members.

c. Non-Banking Financial Companies (NBFCs): Although they lack a banking license, these organizations offer financial services comparable to those offered by banks. Among them are businesses like Mahindra & Mahindra Financial Services and Bajaj Finance.

2. The Securities and Exchange Board of India (SEBI) is in charge of overseeing the country's securities industry, protecting investors, and encouraging ethical business practices.

   a. Stock exchanges: Online marketplaces for the trading of securities like bonds and stocks. The National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) are two significant exchanges.

   b. Brokers: Salespeople and middlemen who help investors purchase and sell stocks.

   c. Companies that evaluate and take on the risk of underwriting new securities are known as underwriters.

   d. Other Financial Intermediaries: This category includes organizations that are essential to the securities market, such as credit rating agencies, depositories, and mutual fund companies.

3. The Insurance Regulatory and Development Authority of India (IRDAI) oversees the regulation of the insurance market in India, protecting policyholders and fostering the growth of the sector.
    a. Life Insurance Companies: These businesses offer financial protection against death to individuals through life insurance products. The Life Insurance Corporation of India (LIC) and HDFC Life Insurance are significant participants.
    b. General Insurance Companies: These businesses provide non-life insurance coverage, including property, auto, and health insurance. ICICI Lombard and New India Assurance are two examples.

An in-depth analysis of financial institutions and their functions

1. Banks that deal with commerce
    a. Government-owned Public Sector Banks (PSBs): By offering banking services to underserved areas, PSBs contribute significantly to the financial inclusion drive.
    b. Private Sector Banks: Well-known for their effectiveness and customer-focused offerings, these banks are significant participants in metropolitan and semi-urban regions.
    c. Foreign Banks: These banks offer specialized services and introduce international banking procedures, mostly targeting high net worth people and corporations.
    d. Regional Rural Banks (RRBs): RRBs support rural development by lending money to agricultural laborers, small farmers, and artisans.
2. Cooperative banks: Provide lending facilities to small borrowers, such as farmers, small enterprises, and individuals, in order to support local communities in both urban and rural areas.
3. Non-Banking Financial Companies (NBFCs): These companies are essential to financial inclusion because they offer loans to groups that traditional banks do not sufficiently service, including small and medium-sized businesses (SMEs), undocumented immigrants, and rural residents.

Regulatory bodies' roles and responsibilities

1. Reserve Bank of India(RBI)
    a. Controls credit availability and money supply to preserve economic expansion and price stability.
    b. Maintains oversight over and controls NBFCs and banks to guarantee the stability and security of the financial system.
    c. Oversees the nation's gold and foreign exchange holdings.

2. Securities and Exchange Board of India (SEBI)
    a. Guards the interests of investors by upholding laws that forbid unethical behavior in the securities industry.
    b. Encourages the growth of the securities market by launching fresh goods and services while maintaining efficiency and openness.
    c. Enforces fair trading procedures by regulating underwriters, brokers, stock exchanges, and other middlemen.
3. Insurance Regulation and Development Authority of India (IRDAI)
    a. Verifies the stability of insurance companies' finances and their ability to fulfil their duties to policyholders.
    b. Encourages innovation and competition in the insurance industry, guaranteeing that customers have access to a wide range of insurance products.
    c. Keeps an eye on and controls intermediaries' and insurers' behavior to guarantee moral behavior.

19.5 REGULATORY FRAMEWORK OF FINANCIAL INSTITUTIONS OF INDIA

India's financial institution regulatory framework is a well-organized system intended to preserve the integrity and stability of the financial industry. It consists of a number of laws, rules, and oversight organizations that guarantee the efficient operation of banks, capital markets, insurance providers, and non-banking financial firms (NBFCs).

Reserve Bank of India (RBI)

The Reserve Bank of India (RBI) is India's central bank and the main body in charge of banking sector regulation. The RBI was founded in 1935 and is in charge of managing monetary policy, supervising the country's financial stability, and controlling the issuance of currency. Regional rural banks, cooperative banks, commercial banks, and NBFCs are all under RBI regulation. It guarantees that these organizations uphold appropriate capital levels, exercise caution when making loans, and conform to standards for asset quality, liquidity, and risk management.

Securities and Exchange Board of India (SEBI)

In 1988, the Securities and Exchange Board of India (SEBI) was founded, and in 1992, it was granted formal authority. It oversees the capital markets in India, which include brokers, mutual funds, stock exchanges, and other securities industry participants. The main goals of SEBI are to safeguard investor interests, encourage the growth of the securities market, and guarantee its efficient operation. To preserve openness and equity in the market, it upholds laws pertaining to takeovers, insider trading, and corporate governance.

Insurance Regulation and Development Authority of India (IRDAI)

In order to oversee and advance the insurance industry in India, the Insurance Regulatory and Development Authority of India (IRDAI) was founded in 1999. IRDAI monitors insurance firms, both life and non-life, to make sure they run profitably. It creates rules pertaining to client protection, solvency margins, and insurance product offerings. Additionally, IRDAI encourages the growth of the insurance industry in India as well as the penetration of insurance.

Pension Fund Regulation and Development Authority (PFRDA)

To oversee and advance the pension industry in India, the Pension Fund Regulatory and Development Authority (PFRDA) was founded in 2003. It is in charge of managing the National Pension System (NPS) and pension fund operations. PFRDA guarantees the effective operation, transparency, and subscriber interests' protection of pension funds.

Ministry of Finance

An important part of India's financial institution regulatory structure is the Ministry of Finance. It develops financial markets, taxation, and public finance policy. The Ministry is also in charge of regulating the operations of important financial institutions such as the PFRDA, RBI, SEBI, and IRDAI. It also has a role in regulating financial firms and banks in the public sector.

Additional Regulating Authorities

Apart from the previously mentioned entities, there exist multiple more regulatory agencies that are involved in shaping the regulatory landscape of financial institutions in India. These include the Small Industries Development Bank of India (SIDBI), which encourages the expansion of micro, small, and medium-sized firms (MSMEs), and the National Housing Bank (NHB), which oversees housing finance companies. To preserve financial stability, the Financial Stability and Development Council (FSDC) works with other regulatory organizations to coordinate actions.

Check Your Progress-A

Q1. Give a concise summary of the functions that financial institutions fulfil.

Q2. Talk about the RBI's role in financial institution management.

19.6 RISK ASSOCIATED WITH FINANCIAL INSTITUTIONS

Financial institutions face a variety of intricate hazards that are indicative of the vast range of activities they undertake and the economic settings in which they function. Effective risk management is crucial to the long-term viability of these institutions since these risks have the potential to impair their stability, profitability, and solvency. An overview of some of the major hazards that financial institutions face is provided here.

1. Credit Danger

The potential for a loss resulting from a borrower's inability to make loan repayments or fulfill contractual obligations is known as credit risk. It is among the biggest hazards that banks and other lending organizations have to deal with. The institution may forfeit principle, interest, or both in the event of a borrower's default. Setting lending limits, evaluating borrower creditworthiness, and keeping sufficient reserves for bad debts are all part of credit risk management.

2. Market Danger

The possibility of suffering losses as a result of changes in market prices, such as those of interest rates, currencies, stocks, and commodities, is referred to as market risk. This risk is especially present for financial organizations that trade or hold assets that are prone to market swings. For instance, an increase in interest rates may cause bonds to lose value, and changes in exchange rates may have an effect on the worth of foreign assets or obligations.

3. Risk in Operations

Operational risk results from both external occurrences and malfunctions in internal systems, controls, or processes. Risks include fraud, cybersecurity threats, system malfunctions, and human error are included. Operational risk can result in large-scale monetary losses, legal obligations, and harm to one's reputation. Operational risk must be reduced, and this requires strong internal controls, risk management frameworks, and disaster recovery plans.

4. Risk to Liquidity

The danger that a financial institution won't be able to satisfy its short-term obligations because it won't be able to swiftly turn assets into cash without suffering a large loss in value is known as liquidity risk. Mismatches in the maturity profiles of assets and liabilities may give rise to this risk. Extreme liquidity risk situations may result in insolvency.

Institutions carry out stress tests, keep liquid reserves, and diversify their funding sources in order to mitigate liquidity risk.

5. Risk of Interest Rates

Interest rate swings give rise to interest rate risk, which has the potential to adversely affect the earnings or economic worth of financial institutions. A bank's profitability may be impacted, for example, if its liabilities are mostly short-term and interest rates rise faster than the returns on its long-term assets. Interest rate derivatives, matching the tenure of assets and liabilities, and regular reevaluations of interest rate exposure are some of the tactics used in managing interest rate risk.

6. Legal Risk and Compliance

Legal and compliance risk is the possibility of suffering monetary losses or harm to one's reputation as a result of breaking rules, laws, or corporate guidelines. Financial institutions are subject to strict regulations, and failure to comply with these regulations may result in penalties, legal repercussions, and reputational harm. Institutions must create strong compliance systems, stay up to date on regulatory changes, and make sure that all operations comply with the law in order to mitigate this risk.

7. Risk to Reputation

The possibility of a financial institution's reputation being harmed by unfavourable public opinion, unfavourable media coverage, or unethical behavior is known as reputational risk. A damaged reputation may result in dwindling share prices, a decrease in consumer base, and restricted access to capital markets. Reputation risk management entails upholding the highest moral standards, being open and honest with one another, and acting quickly in times of emergency.

8. Systemic Risk

The possibility that the failure of one financial institution could set off a domino effect that would cause other institutions to fail and result in a wider financial crisis is known as systemic risk. In interconnected financial systems, where the failure of one business can have far-reaching effects, systemic risk is especially important. In order to mitigate systemic risk, regulatory monitoring, capital adequacy requirements, and risk-sharing systems are essential.

19.7 MITIGATION OF RISK ASSOCIATED WITH FINANCIAL INSTITUTIONS

To ensure the stability, profitability, and long-term viability of financial institutions, it is imperative to mitigate the risks connected with them. A diversified approach is required because of the wide range of risks that these institutions confront, including operational, reputational, and credit and market risks. Identifying possible risks, evaluating their implications, and putting policies in place to control or lessen them are all necessary components of effective risk mitigation techniques. The main techniques for reducing risks in financial organizations are listed below.

1. Mitigation of Credit Risk

There are numerous ways to reduce credit risk, or the chance of borrower default:

- Comprehensive Credit Assessment: Making educated loan decisions is aided by carrying out thorough credit evaluations, which include analyzing the collateral, financial statements, and credit history of the borrower.
- Diversification of Loan Portfolio: By distributing credit exposure throughout different industries, regions, and borrower types, defaults by certain industries or borrowers can be lessened in impact.
- Credit derivatives and securitization: By transferring credit risk to other parties, these financial tools let institutions better control their exposure.
- Collateral and Loan Covenants: Putting in place collateral requirements and loan covenants can give you more security against borrower default.

2. Mitigation of Market Risk

Market risk, which results from changes in pricing in the market, can be controlled by:

- Asset-Liability Management (ALM): ALM entails controlling the balance sheet of the organization in order to reduce the effect of fluctuations in interest rates and market prices. This involves balancing the asset and liability maturity profiles.
- Hedging Techniques: By using derivatives like futures, swaps, and options, one can lessen the impact of unfavourable changes in commodity prices, interest rates, or exchange rates.
- Investment diversification: Organizations can lessen their exposure to particular market risks by investing across a wide variety of asset classes and geographical marketplaces.

3. Reducing Operational Risk

Operational hazards resulting from malfunctions within the organization or from outside sources can be reduced by:

- Strict Internal Controls: Fraud, mistakes, and other operational failures can be avoided by putting in place strict internal controls and routinely auditing these procedures.
- Technology and Cyber security: To guard against system outages and online attacks, it's critical to invest in dependable IT infrastructure and cyber security safeguards.

- Employee Development and Training: Consistent training initiatives guarantee that staff members are knowledgeable about operational hazards and prepared to use best practices in their day-to-day work.

4. Reducing Liquidity Risk

Risks associated with liquidity, such as the inability to pay short-term obligations, can be controlled by:

- Maintaining Liquid Reserves: In times of hardship, the institution can fulfill its responsibilities if it has enough cash and liquid assets on hand.
- Diversifying Funding Sources: The danger of an unexpected cash withdrawal is decreased by relying on a variety of funding sources, including capital markets, interbank loans, and deposits.
- Contingency Funding Plans: Establishing and maintaining these plans on a regular basis helps institutions be ready for unforeseen liquidity shortages.

5. Mitigation of Interest Rate Risk

One way to reduce the danger of interest rates is to:

- Interest Rate Matching: This technique reduces the effect of changing interest rates on net interest income by matching the interest rate sensitivity of assets and liabilities.
- Interest Rate Derivatives: Interest rate fluctuations can be hedged against with the use of derivatives such as floors, swaps, and caps.
- Frequent Stress Testing: By doing frequent stress tests, institutions can proactively modify their strategy by evaluating the possible effects of interest rate fluctuations.

6. Mitigation of Legal Risk and Compliance

To reduce risks related to legal compliance, institutions should:

- Establish Robust Compliance Programs: An institution can be confident it complies with legal and regulatory obligations by putting in place comprehensive compliance programs that include policies, procedures, and training.
- Keep an Eye on Regulatory Changes: Remaining up to date on modifications to rules and regulations enables organizations to promptly adjust and steer clear of possible legal problems.
- Legal Counsel and Support: You can avoid legal problems and guarantee compliance by hiring legal professionals to examine contracts, agreements, and business procedures.

7. Reputational Hazard Reduction

One can reduce the risk to one's reputation by:

- Preserving Ethical Standards: Preserving the institution's reputation and fostering confidence are achieved by upholding high ethical standards in all business processes.
- Transparent Communication: Trust is maintained and public perception is managed when there is open and honest communication with stakeholders, particularly in times of crisis.
- Crisis Management strategies: By creating and practicing these strategies, organizations can react to reputational threats quickly and successfully.

8. Mitigation of Systemic Risk

In order to reduce systemic risk, organizations can:

- Take Part in Regulatory Initiatives: Reducing the risk of a systemic collapse can be achieved by participating in industry-wide initiatives to increase the resilience of the financial system, including as capital adequacy rules and stress testing.
- Cooperation with Regulators: Ensuring that an institution's operations are in line with larger initiatives to uphold financial stability requires strong collaboration with regulatory bodies.

Check Your Progress-B

Q1. Describe the methods used to reduce credit risk.

Q2. Compose a brief memo regarding interest rate risk.

19.8 BASEL NORMS FOR INDIAN BANKING SYSTEM

The Basel Committee on Banking Supervision (BCBS) created the Basel norms, a set of international banking regulations, to improve bank regulation, supervision, and risk management. Many nations, including India, have embraced these standards in order to guarantee the safety and soundness of their financial institutions. Basel I, Basel II, and Basel III are the three primary stages in which the Basel norms—which mainly address capital adequacy—have developed, each with a progressively higher degree of coverage and complexity.

Basel I

Basel I, which was implemented in 1988, was centered on the capital sufficiency of financial institutions, specifically with credit risk. It established the Capital Adequacy Ratio (CAR), a minimum capital requirement that banks had to uphold. Due to the CAR's 8% setting, banks were required to maintain capital equal to 8% of their risk-weighted assets. To improve financial stability, the Reserve Bank of India (RBI) in India required Indian banks to have a higher CAR of 9%.

Basel II

Basel II was implemented in 2004 with the goal of improving risk sensitivity and adding more risks to the framework established by Basel I. Its three pillars were as follows:

1. Minimum Capital Requirements: Similar to Basel I, Basel II mandated that banks maintain a minimum capital adequacy ratio (CAR). However, the framework was expanded to include operational and market risks as well as more complex risk-weighting methods for credit risk
2. Supervisory Review Process: This pillar encouraged banks to improve their internal risk management procedures by highlighting the role of national regulators in evaluating a bank's capital adequacy and risk management procedures.
3. Market discipline was intended to be exerted by market players through better-informed decision-making, which was made possible by Basel II's increased transparency in banks' financial statements.

Basel II was progressively implemented in India, and banks had to abide by these regulations by March 2009. Banks were given instructions by the RBI on how to apply the basic indicator method for operational risk and the standardized approaches for credit risk.

Basel III

Basel III was developed in response to the 2008 global financial crisis, which revealed serious flaws in the regulatory framework. Its goal is to lessen the likelihood of systemic crises by enhancing the banking sector's capacity to withstand shocks from financial and economic strain. The following are Basel III's main features:

1. Greater Capital Requirements: Basel III created the Capital Conservation Buffer (CCB) and the Countercyclical Capital Buffer (CCyB), two additional capital buffers, and raised the minimum CAR. These buffers mandate that banks maintain higher levels of capital in order to guard against potential losses during times of rapid credit expansion.
2. Leverage Ratio: To prevent the accumulation of excessive leverage in the financial system, a non-risk-based leverage ratio was implemented. The risk-based capital requirements are supported by the leverage ratio.
3. Basel III established two new liquidity ratios, the Net Stable Funding Ratio (NSFR) and the Liquidity Coverage Ratio (LCR), as part of its liquidity standards. While

the NSFR encourages longer-term funding stability, the LCR makes sure banks have enough high-quality liquid assets to last through a 30-day stress test.

4. Strengthened Capital: Common equity and retained earnings, which are regarded as the greatest quality of capital, are given more weight under Basel III's reinterpretation of the capital components.

Implementing Basel III standards in India has been done so proactively by the RBI, with a phased deployment beginning in 2013. By March 2019, Indian banks had to be completely compliant with Basel III. However, in order to give banks more time to raise capital, the implementation dates for several components—like the CCB—were extended in response to the COVID-19 outbreak.

Effects on Banks in India

Indian banks have benefited greatly from the adoption of Basel standards, which have improved their general resilience, risk management procedures, and capital adequacy. As a result of Basel III's stricter risk management guidelines and increased capital requirements, Indian banks have strengthened their balance sheets and used more advanced risk assessment methods. The banking industry has become more stable as a result of these standards, but they have also raised the cost of compliance, especially for smaller banks that may find it difficult to fulfill the strict requirements.

19.9 ANALYSIS OF FINANCIAL STATEMENTS OF BANKING COMPANIES

In order to evaluate Indian banks' operational effectiveness, risk management prowess, and overall financial health, it is essential to examine their financial statements. In this research, financial ratios are important since they provide information about many facets of a bank's performance. The balance sheet, income statement, and cash flow statement—the three main parts of a bank's financial statements—as well as the application of significant financial ratios that follow industry standards are covered in this research.

1. Analysis of Balance Sheets

The balance sheet, which lists a bank's assets, liabilities, and shareholders' equity, gives a quick overview of its financial situation.

- Assets: Cash balances, investments, and loans and advances usually make up the majority of an Indian bank's assets. Important analysis metrics consist of:

  a. Credit to Deposit Ratio (CDR): This ratio expresses how much of a bank's total deposits are made up of advances and loans. A higher CDR denotes a higher percentage of deposits utilized for lending, which may raise risk but also boost profitability. While there is no set standard CDR, a range of 70–80% is frequently seen to be ideal.

b. The percentage of a bank's gross non-performing assets to its total advances is determined by the gross non-performing assets (GNPA) ratio. A healthy GNPA ratio is typically understood to be less than 5%, though this might vary based on the state of the economy and the bank's willingness to take on risk.

- Liabilities: Deposits, loans, and other commitments are the main types of liabilities.

  a. Cost of Funds: This figure shows the typical interest rate that the bank pays on loans and deposits. A reduced cost of money suggests that liabilities are used more effectively, which raises profitability.

  b. Equity: The bank's net worth is reflected in the equity held by shareholders.

  c. The Capital Adequacy Ratio (CAR) determines the proportion of a bank's risk-weighted assets that are allocated to capital. A minimum CAR of 9% is required by the Reserve Bank of India (RBI), while Basel III requirements need an extra buffer. A robust capital base is indicated by a greater CAR, which lowers the chance of insolvency.

2. Analysis of Income Statements

The income statement highlights a bank's revenue, expenses, and net profit while providing a financial picture of the institution over a given time frame.

- Interest Income and Expense: The main sources of income and expenses for banks are these.

  The calculation of Net Interest Margin (NIM) involves dividing the difference between interest income and interest expense by the total number of earning assets held by the bank. It is a crucial sign of the profitability of the main banking operations. In the context of Indian banking, a NIM of 3–4% is seen as strong.

- Non-Interest Income: Commissions, fees, and other non-interest income fall under this category.

  The ratio of fee income to total income indicates the revenue diversification of the bank by calculating the percentage of non-interest income to total income. A greater percentage indicates a less dependent revenue base on interest income due to diversification.

  Operating expenses encompass costs associated with salaries, rent, and additional administrative undertakings.

  The cost to income ratio compares operational expenses to operating income to determine how efficient the bank is. A ratio of less than 50% is seen as efficient, meaning the bank is successfully controlling its expenses in relation to its revenue.

- Profitability: The best indicator of a bank's success.

  a. The calculation of Return on Assets (ROA) involves dividing net profit by the total amount of assets. It shows how well the bank makes use of its resources to turn a profit. For banks, a ROA of 1% or higher is generally regarded as favorable.

b. Divide net profit by shareholders' equity to get return on equity (ROE). It displays the profit made on the investments made by shareholders. For banks in India, a ROE of 15–25% is generally regarded as strong.

3. Analysis of Cash Flow Statements

With its comprehensive breakdown of cash flows from financing, investing, and operating activities, the cash flow statement offers valuable insights into the bank's cash management and liquidity policies.

- Operating Activities: Cash flows from regular banking operations, such as interest paid and received.

  The Operating Cash Flow to Total Assets Ratio is a metric that evaluates the amount of cash generated by the bank's operations in relation to its total assets. Strong cash generation from core business is indicated by a greater ratio.

- Investing Activities: Cash flows from capital expenditures and investments.

  The investment to assets ratio shows what percentage of total assets are allocated to different bonds and securities. A ratio that is balanced suggests careful investing techniques.

- Financing Activities: Cash flows from dividend payments, borrowings, and equities.

  The dividend payout ratio quantifies the percentage of net earnings that is disbursed as dividends. An acceptable dividend payment ratio of 20–30% denotes a harmony between providing shareholders with growth potential and holding onto profits.

4. Important Ratios in Finance

A number of financial ratios are essential for assessing the general health and stability of banks:

a. Ratios of Gross and Net Non-Performing Assets: The Gross Non-Performing Assets Ratio shows the proportion of non-performing assets to total advances. Provisions made against NPAs are taken into account by the Net NPA Ratio. Better asset quality is indicated by a lower ratio, which is desirable.

b. The amount of providing against non-performing assets (NPAs) is gauged by the Provision Coverage Ratio (PCR). A PCR between 70 and 75 percent is seen as sufficient, indicating the bank's ability to withstand possible losses.

c. Liquidity Coverage Ratio (LCR): This ratio assesses how well-equipped a bank is to handle short-term liabilities by maintaining an adequate amount of high-quality liquid assets. The minimum LCR of 100% required by the RBI guarantees that banks can withstand stressful situations.

d. Leverage Ratio: This non-risk-based ratio calculates the proportion of the bank's total exposure to its tier-1 capital. Basel III regulations mandate a leverage ratio of 3% or greater in order to prevent excessive leverage.

5. Peer comparison and trend analysis

a. Trend Analysis: Trends in asset quality, profitability, and liquidity can be found by examining financial data over a number of time periods. An increasing non-performing asset (NPA) ratio over multiple quarters could be a sign of declining asset quality.

b. Peer Comparison: A bank's performance can be seen in context by contrasting its financial ratios with industry averages or top banks. It aids in determining whether a bank is performing better or worse than its competitors.

19.10 SUMMARY

The chapter examined the crucial strategic issues that financial intermediaries must deal with, with special attention to India's Non-Banking Financial Companies (NBFCs). It examines many aspects of the financial industry, such as legal frameworks, NBFC development and expansion, and the overall economic influence on these establishments. The significance of corporate governance, risk management, and technology in boosting financial intermediaries' competitiveness are also emphasized in the document.

Important topics covered include how the regulatory environment affects NBFC operations, how to strategically manage operational and financial risks, and how innovation is essential in a financial sector that is evolving quickly. It also highlights the need of financial inclusion, the difficulties in preserving profitability, and the tactics for long-term growth in a cutthroat industry.

All things considered, the paper offers a thorough summary of the strategic factors that are essential to the efficient operation and expansion of financial intermediaries, especially in light of India's changing economic landscape.

19.11 GLOSSARY

The Basel Committee on Banking Supervision (BCBS) created the Basel Norms, which are international regulatory frameworks that set minimum standards for the supervision, risk management, and capital adequacy of banks.

Compliance risk-The risk that a financial institution faces when it violates laws, rules, or internal policies is known as compliance risk. This risk can take the form of financial loss, reputational damage, or legal or regulatory penalties.

Credit Risk: Credit risk is the possibility of suffering losses if a borrower defaults on a loan or doesn't fulfill their end of the bargain.

Diversification: Diversification is a risk management technique that lessens the impact of any one asset or risk by combining a wide range of investments into a portfolio.

Financial intermediaries: Organizations that transfer money from savers to borrowers and investors, such as banks, insurance companies, and pension funds, helping the economy's capital flow.

Interest rate risk: Interest rate risk is the possibility that changes in interest rates will have a detrimental effect on the economic value or profitability of a financial institution.

Liquidity risk: Liquidity risk is the possibility that a financial organization won't be able to pay its short-term debts because it won't be able to swiftly turn assets into cash without suffering a substantial loss.

Market risk: Market risk is the possibility of losses in a financial institution's trading book as a result of shifts in equity, interest rate, and currency exchange rates, among other market prices.

NBFCs: Financial organizations that offer banking services without possessing a banking license are known as non-banking financial companies, or NBFCs. Among them are businesses like Mahindra & Mahindra Financial Services and Bajaj Finance.

Operational risk: Operational risk is the possibility of suffering a loss as a result of insufficient or unsuccessful systems, personnel, programs, or external circumstances like fraud or cyberattacks.

Reputational risk: Reputational risk is the possibility that unfavorable public opinion would lower a financial institution's worth, which will result in a loss of clients and restricted access to capital markets.

Reserve Bank of India (RBI): The nation's central bank, it is in charge of monitoring financial stability and setting monetary policy.

The Securities and Exchange Board of India (SEBI): The Securities and Exchange Board of India (SEBI) is the regulatory body that oversees the Indian securities market. Its duties include safeguarding investor interests and fostering the market's growth.

Systemic risk: Systemic risk is the possibility that the demise of one financial institution could set off a series of events that would cause other institutions to fail and result in a more widespread financial catastrophe.

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19.14 TERMINAL QUESTIONS

1. How can asset-liability management (ALM) assist financial organizations in controlling interest rate and liquidity risks?
2. Describe the significance of the Basel Norms for financial intermediary regulation.
3. Talk about the function of non-banking financial companies (NBFCs) in the banking sector in India.
4. What kinds of risks do financial intermediaries confront, and how might these risks be lessened?
5. In order to maintain the stability of the financial system, how is the Reserve Bank of India (RBI) regulating financial intermediaries?

Block IV

Latest Concepts in the Management of Financial Services

UNIT 20 VENTURE CAPITAL

20.1 INTRODUCTION

In the era of complex and dynamic financial environment, Venture Capital has emerged as a catalyst for the innovation and expansion of businesses. Venture capital has now become prerequisites for the financial ecosystem. It is one of the most important factors for driving economic growth and prosperity in economic development. Venture capital plays a vital role in providing all types of financial facilities for new enterprises and start-ups.

This unit covers all the important aspects of the Venture capital; meaning, objectives, importance, stages of venture capital, methods of venture capital and regulatory framework governing the industry.

Venture capital is a type of financial instrument wherein financial assistance is provided to early-stage, potential start-ups and small enterprise in exchange of equity.

These ventures typically possess innovative ideas or disruptive technologies but lack the necessary funds to scale their operations. Venture Capitalists (VCs) take on the role of financial backers and strategic partners, guiding and supporting the growth of these startups, with the expectation of generating substantial returns on their investments.

In the mid-20th century, American banks and private investors began to fund high-risk projects. Over the years, the sector has matured and evolved, with numerous government initiatives and institutional setups designed to encourage venture investments. The development of technology hubs and incubators has played a pivotal role in fostering a conducive environment for entrepreneurial ventures.

Venture Capital distinguishes itself from traditional forms of financing by its willingness to take on high risks in exchange for potentially high returns. It involves active involvement by investors in the decision-making and strategic direction of the startup. Additionally, VC funding often follows a staged investment approach, providing capital in rounds as the business achieves key milestones.

The primary objective of Venture Capital is to seek out and invest in startups with the potential for rapid growth and significant market disruption. VCs aim to identify innovative ideas and businesses that could become the next industry leaders and generate substantial profits for both the entrepreneurs and the investors.

Venture Capital plays a crucial role in bridging the funding gap that early-stage startups face. Besides providing financial resources, VCs offer valuable expertise, mentorship, and access to an extensive network of contacts, which can significantly enhance a startup's chances of success. Furthermore, Venture Capital fuels technological advancements, boosts job creation, and fosters economic development by promoting entrepreneurship.VC financing typically occurs in several stages, including seed funding, early-stage financing (Series A, B, C, etc.), and later-stage financing. Each stage represents different levels of risk and investment amounts, depending on the startup's development and market validation.

Venture Capitalists employ various financing methods, such as equity financing, convertible notes, and preferred stock offerings, to structure their investments in startups. Each method carries its unique features and implications for both the entrepreneurs and the investors. Evaluating Venture Capital opportunities requires a thorough and systematic approach. Analyzing factors like market potential, team expertise, competitive advantage, and financial projections is essential in making informed investment decisions.

Venture Capital operations are subject to regulatory guidelines and compliance measures to safeguard investor interests and ensure transparency. Understanding the regulatory framework is critical for both entrepreneurs seeking funding and investors looking to participate in the VC market.The exit mechanism refers to the process through which Venture Capitalists realize their returns on investment like Initial Public Offerings (IPOs), and secondary market sales.

Through this exploration of Venture Capital, aspiring entrepreneurs, investors, and industry enthusiasts will gain a comprehensive understanding of this dynamic and impactful domain, paving the way for informed decisions and successful engagements in the world of entrepreneurial funding and growth.

20.2 LEARNING OBJECTIVES

After studying this unit, students should be able to:

- Explain Meaning and features of Venture Capital.
- Understand objectives and Evolution of Venture Capital.
- Explain the role and importance of Venture Capital
- Write stages and methods of Venture Financing
- Describe the Exit mechanism
- Discuss methods of Venture Financing

20.3 MEANING AND DEFINITION

Sufficient availability of finance is the important pre-requisites for the establishment of business unit. The situation becomes more challenging when fresh and technically weak professional have competitive and an innovative idea to develop new products/ services but unable to create a successful commercial venture due to lack of available funds. Such Financial requirements are riskier as the innovative ideas have yet to be performed practically. If the venture gets successful, it may have high returns on investment and if the project gets fail then there will be huge losses. Due to lack of availability funds from own sources the entrepreneur finds it hard to perform the entrepreneurial activity. The issue is sources of finance cannot be tapped to meet the business requirements. Now the matter is how fund will be raised, what the other sources funds available who will take the risk of capital and return on investment.

Venture capitalist is available to fund various financial requirements of the entrepreneurs by providing risk bearing capital known as "Venture Capital". Venture capital is along-term investment that has potential for major growth and financial returns. Apart from the conditional loans and conventional loans, venture capital is also provided in the equity. It may be concluded that Venture capitalist is not merely an investor, but also a risk taker and his return on investment depend on the scale of success achieved by the enterprise. Due to the uncertainty associated with the enterprise, higher returns are expected than normal returns.

Venture capital encourages Entrepreneurial culture, Innovation, and Economic growth. It is types financing that includes early-stage investments, companies with high-potential and the generating substantial returns in future. Venture capital is provided by Venture Capital Company, specialized in providing venture capital funds to startups and small businesses that have convincing business ideas, but they do not have required capital to utilise.

In India, the concept of Venture capital is growing very speedy manner and financial institutions are doing commendable work to promote industries by meeting the financial needs of the enterprise.

Over a period of time, few new institutes are becoming attraction as sources of finance to industries like Mutual fund and Hire purchase companies etc. but do not facilitate in risky and less known entrepreneurs. These institute only provides debt finance and other schemes like seed capital, risk capital etc. to the promoters.

Now, India is growing with new category of entrepreneurs with professional temperament and technical knowhow. Financial support is most essential to make entrepreneurs of successful business venture. Over the last 2-3 decades there has emerged the need of setting up of venture capital financing companies.

1. **According to the Harvard Business Review**, Venture Capital refers to the financing of startups and small businesses that show high growth potential, but may also carry a higher risk of failure. Venture capitalists are not just financial backers; they often provide strategic advice, mentorship, and industry connections to the companies they invest in.
2. **The National Venture Capital Association (NVCA)** defines Venture Capital as "a pool of professionally managed capital, available for investment in new, rapidly growing companies with the high growth potential." The NVCA carefully select and nurture promising startups with the help of specialized team of professionals in getting full market potential.
3. "Venture capital is a type of private equity investment that offers funding facility to startup companies and small businesses with high growth potential. Venture capitalists (VCs) invest in these early-stage companies in exchange for an equity stake, and they often take an active role in guiding the company's strategic direction and growth.
4. **Entrepreneur and author Guy Kawasaki** defines Venture Capital in his book "The Art of the Start 2.0" as "money provided by professionals who invest alongside management in young, growing companies that have the capacity to develop into economic contributors."
5. **The European Private Equity & Venture Capital Association (EVCA**) describes Venture Capital as "an important source of funding for innovative, early-stage companies that often lack access to traditional forms of financing." The EVCA emphasizes the role of Venture Capital in fostering innovation and supporting the growth of dynamic new businesses.
6. In academic literature, **Professor Paul Gompers and Josh Lerner** define Venture Capital as "a subset of private equity focusing on investments in entrepreneurial companies with high growth potential." Their research has contributed significantly to understanding the role of Venture Capital in promoting innovation and economic development. (Source: "The Venture Capital Cycle" by Paul Gompers and Josh Lerner).
7. **According to the Bank of England Quarterly Bulletin of 1984**, 'Venture Capital investment is defined as an activity by which investors support entrepreneurial talent

with finance and business skills to exploit market opportunities and thus obtain long-term capital gains.

These investors usually look for opportunities in innovative and other business ventures, in exchange for ownership equity or a share of the company. The primary goal of venture capital is to support the growth and expansion of these startups, providing not just financial assistance but also strategic guidance and industry expertise to help them succeed in the market.

20.4 EVOLUTION AND INITIATIVES OF VENTURE CAPITAL

Venture capital (VC) is a vital element of the entrepreneurial ecosystem, providing funds and support to innovative start-up companies with high growth potential. Over the years, venture capital has undergone significant transformations, driven by changes in technology, economic trends, and regulatory frameworks.

a) Early Roots of Venture Capital: With the establishment of American Research and Development Corporation (ARDC) in 1946, founded by Georges Doriot, Venture capital is considered the first formal venture capital company in the United States (Tyebjee& Bruno, 1984). It set the stage for modern venture capital by investing in start-ups like Digital Equipment Corporation (DEC) and fostering the concept of active involvement in portfolio companies.

b) Silicon Valley and the Rise of Venture Capital: The 1970s and 1980s saw a significant surge in venture capital activity, largely driven by the growth of Silicon Valley. As technology companies flourished, venture capital firms emerged to capitalize on these opportunities. Notable firms such as Sequoia Capital, Kleiner Perkins, and Accel Partners became influential players in the VC landscape (Bygrave & Timmons, 1992).

c**) Government Initiatives and Legislation:** Government initiatives and legislation played a pivotal role in the expansion of venture capital. In 1978, the United States implemented the Revenue Act, which introduced the concept of capital gains tax reduction for long-term investments in small businesses. This tax incentive encouraged more individuals and institutions to invest in venture capital funds (Lerner, 1999).

d**) Dot-Com Bubble and Its Impact:** The late 1990s and early 2000s witnessed the dot-com bubble, characterized by excessive speculation and valuations of internet-based companies. This period saw a massive influx of venture capital into tech start-ups, but many investments proved to be unsustainable, leading to a significant market correction (Eichholtz et al., 2015).

e**) Corporate Venture Capital (CVC) and Strategic Investments:** Corporate venture capital emerged as a significant initiative where established companies started investing in start-ups to gain access to innovative technologies and maintain a competitive edge. By aligning strategic objectives, CVCs became instrumental in fostering collaboration between start-ups and established corporations (Gompers & Lerner, 2001).

f**) Globalization of Venture Capital:** As technology and communication advanced, venture capital became a global phenomenon. Silicon Valley remained a dominant hub, but venture capital activity expanded to other regions such as Europe, Asia, and Israel. Cross-border investments and international collaborations became more prevalent (Cumming & Johan, 2009).

g**) Impact of the 2008 Financial Crisis:** The 2008 financial crisis had a significant impact on venture capital. Funding became scarce, and investor risk aversion increased. Despite the challenges, venture capital persisted, with renewed focus on efficiency, lean business models, and sustainable growth (Lerner, 2009).

20.5 FEATUERS OF VENTURE CAPITAL

There are several unique features of venture capital that set apart from other type of investment option. Some of the key features are as follows:

1. **Risk Tolerance and High Returns:** Venture capital investors are willing to take on high levels of risk by providing funding to startups in their early stages when the success of the business is uncertain. They expect significant returns on their investments if the venture succeeds (Gompers & Lerner, 2004).
2. **Equity Financing:** Unlike traditional loans, venture capital investments typically involve purchasing equity stakes in the startup, granting the investor ownership in the company (Bottazzi & Da Rin, 2002).
3. **Active Involvement:** Venture capitalists play a significant and an active role in the managing the startup, providing valuable expertise, guidance, and industry connections (Kaplan & Stromberg, 2004).
4. **Long-Term Investment Horizon:** Venture capital investments are enduring capital with a longer investment horizon, often taking several years to realize returns as startups take long time to stabilize, grow and become profitable (Lerner, 1999).
5. **Sector Focus:** Venture capital firms often specialize in specific industries or sectors, such as technology, green energy, bio-technology, or permitting them to have better understanding about the exceptional challenges and prospects in these sectors (Gompers & Lerner, 2001).
6. **Exit Strategies:** After a time-span of growth, Venture capitalists try to exit their investments either through an initial public offering (IPO) or acquisition by a big corporate group, realizing their returns and enabling the startup to continue growing (Cumming & MacIntosh, 2006).
7. **Limited Liquidity:** Venture capital investments are illiquid during the early stages, as there is no established market for selling equity in private startups (Sahlman, 1990).

8. **Geographical Concentration:** Venture capital tends to be concentrated in specific geographic regions, such as Silicon Valley in the United States or other tech hubs, where a thriving ecosystem of startups and investors exists (Harris & Gibson, 2018).
9. **Diverse Investment Portfolio:** Venture capital firms often invest in multiple startups to diversify their risk exposure, as not all startups are expected to succeed (Kaplan & Schoar, 2005).
10. **Innovative Financing Structures:** Venture capital deals can involve various financing structures, such as convertible notes, preferred stock, and staged funding rounds, tailored to meet the needs of startups at different growth stages (Sahlman, 1990).

These features collectively contribute to the distinctive nature of venture capital as a form of investment that fuels entrepreneurship and facilitates the growth of innovative companies.

20.6 OBJECTIVES OF VENTURE CAPITAL

The purpose of venture capital organizations includes several aspects that contribute to the overall success of their investments and in the invested organisation. The key objectives of venture capital are:

1. **Capital Infusion and Funding:** One of the primary objectives of venture capital is to provide the necessary financial resources to startups and emerging companies. These funds enable entrepreneurs to develop and scale their innovative ideas into viable products or services.
2. **Risk Investment and Diversification:** Venture capital firms are willing to take on high-risk investments in return for potentially high rewards. They diversify their investment portfolio across various startups and industries to spread risk and increase the likelihood of finding successful ventures.
3. **Equity Ownership and Exit Strategy:** VCs search for attaining equity ownership in the invested companies. As the startups grow and succeed, the value of their equity increases, leading to substantial returns on investment. Venture capitalists also plan their exit strategies, aiming to sell their stakes through initial public offerings (IPOs) or acquisitions.
4. **Strategic Supervision and Mentorship:** Apart from the financial assistance, venture capital firms often provide strategic supervision and mentorship to the entrepreneurs they support. Venture capitalists provide valuable as well as required industry insights, management expertise, and networking opportunities to help startups navigate challenges and grow efficiently.
5. **Promoting Innovation and Technology:** Venture capitalist companies aggressively search for innovative and unique technologies that have the potential to revolutionary transformations in the industries. By investing in such technologies, they contribute to technological advancement and economic development.

6. **Value Addition and Business Growth:** Venture capital firms aim to add value to their portfolio companies by supporting their growth strategies. They help startups access resources, identify market opportunities, and improve operational efficiency, which can accelerate business expansion.
7. **Financial Returns and Performance:** To achieve attractive financial returns is the core objective of venture capital for their investors. Successful investments that generate significant profits compensate for the high risks associated with early-stage ventures.

20.7 ROLE AND IMPORTANCE OF VENTURE CAPITAL

Venture capital (VC) plays a significant role in regulating world economy by fostering entrepreneurship and innovation. It serves as an important source of funding with the necessary capital to turn their ideas into huge potential businesses.

1. **Financing Innovation and Growth:**

Financing the innovative and prospective businesses is one of the primary roles of venture capital. Venture capitalists have more inclination towards taking higher risk in the businesses with comparatively enormous prospects as compared to Traditional lenders like banks. Banks are often risk-averse and hesitant to provide funding to unproven business concepts. Their investments inject much-needed capital into startups, enabling them to develop and scale innovative products or services.

2. **Nurturing Entrepreneurship:**

Venture capitalists not only provide financial support but also offer valuable supervision from professionals and mentorship to entrepreneurs. The expertise, experience, and industry networks can help the invested company to navigate challenges, improve their business plans, and accelerate growth. This nurturing aspect of venture capital enhances the likelihood of a startup's success.

3. **Fostering Technological Advancements:**

By offering financial assistance to the projects with innovative technologies, venture capital performs a significant role in encouraging technological developments. And this technological progress is beneficial not only for the company but the market and the customers are also getting advantage.

4. **Bridge between Startups and Public Markets:**

Venture capital develops a strong relationship between the startups and public markets by allowing them to design their business models, scalability, and present future prospects. After the successful establishments these enterprises raise further finance through Initial Public Offering (IPO) with wide opportunities for good returns.

20.8 STAGES OF VENTURE CAPITAL FINANCING

As we have discussed the various role and importance of Venture capital, now we must understand the process of venture capital. The venture capital process typically consists of several stages, each corresponding to different phases of an entrepreneur’s growth and development.

The stages of Venture Capital can be broadly classified into two, viz. (i) Early-stage financing, and (ii) Later stage financing. Both of them is further sub-categories into a number of stages.

1. **Early-stage Financing**: *(i) Seed-capital stage, (ii) Start-up stage, and (iii) Second-round financing.*
2. **Later-stage Financing**:*(i) Expansion finance, (ii) Replacement finance, (iii) Turn around, (iv) Buyout deals.*

1. **Early-Stage Financing**

   Early-stage financing in venture capital refers to the funding provided to young, promising, and often innovative startups that are in their initial stages of development. These startups are usually in the pre-revenue or early revenue phase, and they require financial support to grow their businesses, develop their products, and gain market traction. Venture capital firms, play a vital role in offering Early-stage financing to the early-stage startups.

   Early-stage financing in venture capital is a critical and significant phase for startups, as it provides the required funds for growth and development. Successful investments in startups at this stage can lead to substantial returns for venture capital firms while supporting innovation and entrepreneurship in various industries. However, it's worth noting that early-stage investing is also associated with higher risks, as many startups fail to achieve the desired level of success. Therefore, venture capitalists carefully evaluate each opportunity to identify the startups with the highest potential for success.

   Early-stage financing can be divided into three main stages, each corresponding to different phases of a startup's growth:

   i. **Seed Capital Stage:** This one of the most important and first stage of early-stage financing that focuses on research and development activities only. It may include testing of concept, idea, and process related to technology or innovation at a laboratory scale. A maintained laboratory trial, a prototype development is supervised, as well as prospective commercial productions of the merchandise are identified.

      At this stage, the risk profile of investment is relatively high and limited capital funds is invested in development. Startups use this capital to conduct market research, build a Minimum Viable Product (MVP), and attract a founding team. The investment amount in the seed stage is relatively lower compared to later stages.

Investors at this stage take significant risks, as the startup is still unproven and has a high likelihood of failure. Seed capital is used to conduct market research, develop the product further, and validate the business model.

ii. **Startup Stage:**

The start-up stage is the second type of Early-stage Financing venture capital finance that is provided to projects/business ideas that have been promoted for commercial production. This refers to funding the idea that includes product launching in the market that has been taken out from the laboratory testing. But then again, such products must have prospective demand and potential market in the home nation.

Before making investments, Venture capital companies evaluate the management capability, competencies and the commitment of entrepreneur to make the project idea, If it is essential, the venture capital funds offer managerial expertise, experience, and manage the execution to achieve operational efficiency. Investors in the startup stage are looking to support the company's growth and scalability. Funding at this stage is crucial for marketing, expanding the team, enhancing the product, and entering new markets.

iii. **Second Round Finance (Series A and Beyond):**

This is third type of Early-stage financing, after the product commercialization, additional funds are required as still the business has not achieved the profitability and the new investors do not find its attractive due to high risky nature. In this type of financing the Venture capital funds provide finance to business ideas that is less risky than *Seed-Capital Stage* and *Startup Stage*. This type of finance is also provided in the form of debt that provides a regular income. This type involves successive rounds of financing, generally referred to as Series A, Series B, Series C, and so on. After reaching a certain stage, achieving progress and assurance of continuous growth potential, there is need for raising next round of funding.

Series A funding is basically the first institutional funding round and is aimed at expanding the startup's operations. Later rounds like Series B and Series C are focused on further scaling, market dominance, and potential acquisitions.

a) Series A:

Once a startup has proceeded beyond the idea or prototype phase and has some preliminary prospects in the market. Series A funding is used to scale-up the business further, increase the team, and improve the product based on consumer’s feedback. The investment amount in Series A is higher than in the seed stage and comes from venture capital firms that believe in the startup's potential.

b) Series B: Once a startup has achieved significant growth and has a proven business model, it may seek Series B funding to scale operations, enter new markets, and strengthen its position. At this stage, the startup is expected to have a more established customer base and a clear path to profitability.

2. **Later Stage Financing:** Later stage financing, also known as growth or expansion stage financing, comes into play when a company has already demonstrated significant market traction, achieved product-market fit, and is poised for rapid expansion. Companies seeking later stage financing have already proven their product or service in the market and have a substantial customer base.

   Later stage companies typically require capital to scale their operations, expand into new markets, or develop new product lines. Investors look for businesses with a clear plan for growth and a high probability of generating substantial returns.

   Valuation at the later stage is often based on a combination of tangible performance metrics (e.g., revenue, profitability, market share) and intangibles like brand value and competitive advantage. Investors entering at the later stage anticipate the possibility of a liquidity event, such as an IPO (Initial Public Offering) or acquisition, which allows them to realize their returns on investment.

i. **Expansion Finance:**
In order increase the production capacity an enterprise may be need of raising funds after it has gained market share successfully and has huge prospects of growth in demand. The Expansion may be in the form of a gradual and natural growth through merger, acquisition or takeover. In this process, the businesses hold maximum equity holdings and the venture capitalists may have considerably higher share depending on the net worth of the acquired business, its purchase price, and the funds already raised by the company from the venture capitalists.

ii. **Replacement Finance:**
In this, the Venture Capitalist purchases the shares of the existing shareholders who are willing/ready to exit from the company. This is the general tendency adopted with the investors (shareholders), and the promoters do not wish to list their shares in the secondary market, the Venture Capitalist assume the growth in the company from 3 to 5 years and expecting to earn capital gain in short-term.

iii. **Turn Around:**
Turnaround financing, also known as distressed investing or restructuring, is a specialized form of venture capital that focuses on providing financial support and strategic guidance to struggling companies. These distressed businesses face operational, financial, or market challenges that hinder their growth and viability. Venture capital firms are engaging in turnaround financing aim to revitalize such companies by injecting fresh capital, implementing operational improvements, and formulating effective restructuring plans. This note will delve into the key aspects of turnaround financing in the venture capital realm.

The primary objective of turnaround financing is to rescue distressed companies that show potential for recovery and growth with the right assistance. Rather than abandoning struggling businesses, venture capitalists undertake an active role in reviving them, which can yield substantial returns on investment if successful. There are two types of Distressed Companies: a. Troubled Startups: Early-stage companies facing operational or market challenges that threaten their survival. b. Mature Distressed Companies: Established businesses experiencing financial difficulties due to market changes, management issues, or excessive debt.

iv. **Buyout Deals:**

"Buyout Deals" refer to a specific type of investment transaction in which a venture capital firm acquires a substantial ownership stake or complete control of an established company or a division of a larger corporation. These deals are commonly associated with mature or well-established businesses, as opposed to early-stage startups or companies in the growth phase.

A VCs may also offer funds for buyout deals and also called “Buyout financing”. When the shares of one set of inactive shareholders, are been purchased by another set of actively involved shareholders in the business operations, it is called Management buyout. Venture capitalists provide funds to fulfill the needs of the shareholders.

Check Your Progress-A

1. **What do you mean by venture capital? Explain role and importance of Venture capital**

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2. **Discuss the role do venture capitalists in the startup ecosystem, and how do they contribute to the expansion of new businesses?**

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3. **Explain the stages of funding that startups undergo during with venture capital funding, from seed funding to series A, B, and beyond?**

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4. **Examine common challenges that a company may experience while working with venture capitalists, and how can these challenges be overcome?**

- -
- -
- -

5. Multiple Choice questions (Select the correct option)

A. The term 'Venture Capital' means.

a) A kind of financial investment in well-established organisation.

b) Subsidy provided by a government to small businesses

c) Funding provided to early-stage start-ups with high growth potential

d) A loan given to organisation with low credit scores

B. What is the primary objective of Venture Capital firms?

a) To acquire majority ownership in established companies

b) To provide long-term loans to small businesses

c) To offer financial assistance to non-profit organizations

d) To achieve significant financial returns by investing in high-potential startups

C. How do Venture Capitalists typically exit their investments and realize returns?
a) Through public offerings (IPOs) or acquisitions
b) By taking operational control of the startup
c) By providing long-term loans to the startup
d) By selling their shares on the secondary market

D. What type of startups are most attractive to Venture Capitalists?
a) Startups with low growth potential and stable revenues
b) Startups in niche industries with limited market potential
c) Startups with disruptive technologies and high growth potential
d) Startups in the decline stage looking for turnaround strategies

E. Which of the following is a potential risk for startups receiving Venture Capital funding?
a) Limited access to mentorship and guidance
b) Dilution of ownership and control
c) Reduced pressure to achieve growth targets
d) Easier access to traditional bank loans

6. State whether the statement is TRUE/FALSE

a) Venture capital is a source of raising funds provided to early-stage, high-potential startups.
b) Venture capitalists primarily invest in well-established companies with a proven track record.
c) Venture capital is always provided in the form of equity, giving investors partial ownership of the company.
d) Venture capital firms are only interested in short-term returns on their investments.
e) Venture capital is only available to tech startups and software companies.
f) The main goal of venture capitalists is to nurture and grow companies until they become profitable and can go public or get acquired.
g) For the organisation Venture capital is a low-risk investment strategy.
h) Venture capital is mainly sourced from individual angel investors.

20.9 METHODS OF VENTURE CAPITAL

Venture capitalists (VCs) typically invest in return for equity in the company and aim to realize significant returns when the company succeeds. There are several methods through which venture capital is provided to startups:

The different modes/instruments provided by the venture capital funds can be divided into:

(i) Equity
(ii) Debt instruments.

Generally, the Investment is done partly by equity and partly as debt. The selection of mode /instrument of finances done on the basis of three factors i.e. *The stage of financing, the degree of risk involved,* and *the nature of finance required*.

a) **Equity Instruments:**

This is one of the most common means of investment by venture capitalists to invest in emerging businesses. It represents ownership stakes in the businesses and offer share of ownership to the investor, and participate in the company's policies, and potential growth.

Equity instruments are also called ownership instruments/documents that offers the rights of the owner to the investor/VCFs. They are:

i. **Ordinary Shares:**

Ordinary shares, also known as common shares or equity shares represent the basic ownership units in a company. When individuals or investors purchase ordinary shares, they become partial owners or shareholders of the company, which entitles them to certain rights and benefits. These shares are widely held and traded on stock exchanges. Ordinary shareholders are eligible to receive dividends, which are distributed to its shareholders in case of profit only and the amount of dividends paid per share is usually proportional to the number of shares owned. The ordinary share holders are entitled to a portion of the remaining assets after all debts, preferred shares, and other obligations have been satisfied. Shareholders' liability is generally limited to the amount they have invested in the company through the purchase of ordinary shares. Ordinary shares are usually freely transferable, allowing shareholders to buy and sell them on stock exchanges or through private transactions.

ii. **Preference Shares:**

Preference shares, also known as preferred stock or preference stock, are a type of equity instrument commonly issued to raise capital. These shares signify ownership in a company, just like a common share only, but they come with specific rights and preferences that distinguish them from ordinary shares. Preference shares have a hybrid nature, possessing characteristics of both equity and debt instruments. If the company declares dividends, preference shareholders are entitled to receive a fixed rate of dividend before any dividend is paid to common shareholders. In the event of the company's liquidation or winding up, preference shareholders have a preferential claim over common shareholders on the company's assets. Unlike common shareholders who have voting power in company decisions, preference shareholders typically do not have the right to vote on corporate matters.

Convertible preference shares provide the option for shareholders to convert them into a predetermined number of common shares after a specific period or event, providing an opportunity for capital appreciation. The company has the option to buy them back from shareholders after a certain period. On the other hand, irredeemable preference shares have no fixed maturity date and are considered perpetual.

b) Debt Instruments:

Debt instruments are financial instruments that represent a contractual obligation for the borrower to repay the lender under specific terms and conditions. These instruments are essential tools used in financial markets to raise capital and finance various projects. Among the different types of debt instruments, three prominent ones are conditional loans, convertible loans, and conventional loans. Each of these loans has distinct features and characteristics, making them suitable for different financing needs.

i. **Conditional Loans:** Conditional loans are a type of debt instrument that includes specific conditions or covenants that the borrower must fulfill during the loan term. These conditions are typically related to the borrower's financial performance or operational activities. The lender sets these conditions to mitigate risk and ensure the borrower's creditworthiness. If the borrower fails to meet any of the stipulated conditions, the lender may have the right to accelerate repayment or take other agreed-upon actions.

The conditions in conditional loans may include financial ratios, capital expenditure limits, dividend restrictions, or other performance metrics. The conditional loans are also offered when the borrowing company's financial conditions are unpredictable and borrowers are expecting an additional potential measure against default conditions.

ii. **Convertible Loans:**
These are types of debt instrument that offers the venture capitalist company to loan into equity at a predefined terms and conditions. The convertible loans are converted into equity borrowing under certain circumstances. The terms and conditions under the convertible loans are as per the pre-determined situations only. The policy and provisions of the convertible loan offers flexibilities to both the parties involved; Financing Company and the borrowing organization.

iii. **Conventional Loans:**
These are the ordinary debt instrument that does not have any conversion of loans and there are no conditions in the terms and policy. These are the traditional loans that has fixed rate of interest, specific repayment schedule and conditions, and there is lack of flexibilities in repayment agreements.
Conventional loans are types of debt financing that covers many sectors, like real estate, corporate borrowing and personal finance. These types of loans are mostly offered by financial institutions with clarity in the terms and conditions. There rate of interests in the conventional loans are depending as per the agreement of loan.

In conclusion, debt instruments are vital tools for raising capital and funding projects in the financial world. Among the various types of debt instruments, conditional loans, convertible loans, and conventional loans offer different features and benefits to borrowers and lenders. Understanding the characteristics of each type is crucial for making informed financing decisions that align with the specific needs and goals of the borrowing entity.

20.10 EXIT MECHANISM

In the world of venture capital, an essential aspect that both investors and entrepreneurs carefully consider is the "Exit Mechanism." The Exit Mechanism refers to the strategies and methods used by venture capitalists to realize their investment returns and withdraw their funds from a particular investment. For entrepreneurs, understanding the exit mechanism is crucial because it ultimately determines how and when investors will cash out their investments, influencing the overall success of the venture.

Importance of Exit Mechanism: The primary objective of venture capitalists is to generate substantial returns on their investments. Since venture capital involves high-risk investments in startups and early-stage companies, the exit mechanism becomes crucial for mitigating risks and providing a viable way for investors to achieve their desired returns. Entrepreneurs also benefit from a detailed exit strategy as it highlights the investors' commitment to maximizing the worth of the venture.

Common Exit Mechanisms: Exit mechanisms are commonly employed in venture capital:

1. **Initial Public Offering (IPO):** An IPO involves taking the company public by listing its shares on a stock exchange. This can provide significant returns for investors as they can sell their shares at a premium to the public. However, an IPO requires a company to be mature, have a proven track record, and meet stringent regulatory and financial requirements.
2. **Acquisition (Trade Sale):** In a trade sale, the venture-backed company is acquired by another company. This could be a strategic acquisition by a competitor or a larger company seeking to enter a new market. The acquirer pays a premium for the company's assets, technology, or market position, providing an exit opportunity for the venture capitalists.
3. **Secondary Sale:** In a secondary sale, venture capitalists sell their ownership stakes to other investors, such as private equity firms or institutional investors. This allows the original venture capitalists to cash out while providing an opportunity for new investors to participate in the company's growth.
4. **Buyback or Recapitalization:** Sometimes, the company itself may repurchase the shares held by the venture capitalists. This buyback can occur when the company has accumulated enough profits or raised additional funds to buy out the investors, providing them with an exit.
5. **Merger:** A merger involves combining the venture-backed company with another company to form a new entity. This can be an exit option for venture capitalists if they receive shares in the new company or cash as part of the merger deal.

Timing of Exit: The timing of the exit mechanism is critical and varies depending on the company's growth and the market conditions. Typically, venture capitalists aim to exit within three to seven years after the initial investment to realize their returns.

Conclusion: In the realm of venture capital, the exit mechanism is a crucial element that both investors and entrepreneurs must carefully plan and consider. Having a well-defined exit strategy not only allows investors to achieve their desired returns but also enhances the overall confidence in the investment, making venture capital an attractive source of funding for startups and early-stage companies. Entrepreneurs, gets benefit from aligning their long-term goals with the investors' exit objectives, thereby creating a mutually rewarding partnership in the journey of building a successful venture.

20.11 SUMMARY

Venture Capital (VC) is a financial investment instrument that providing funds to high-potential startups and prospective small companies with ensured growth. The goal of venture capital is to foster innovation and support entrepreneurial ventures that have the potential to disrupt industries, create new products, and generate significant returns on investment.

Venture capitalists, also known as VCs, are individuals or firms that invest in these startups in exchange for an ownership stake in the company. They typically invest in industries that show high growth potential, such as technology, biotechnology, clean energy, and other emerging sectors. Unlike traditional forms of financing, venture capital investments involve a high level of risk because of the early stage of the companies being funded.

The process of venture capital involves few stages; finding potential investment prospects, assessing the potential and feasibility of the startup with due diligence, negotiating investment terms, and providing ongoing support and mentorship to the invested companies. Successful venture capitalists not only provide financial resources but also offer expertise, industry connections, and guidance to help the startups scale and reach their full potential.

Venture capital plays an important role in promoting innovation and developing entrepreneurial culture, generating job opportunities and contributing in economic growth. It facilitates competent startups to overcome initial financial crises and develop their products.VC funding is often a stepping stone for these companies to attract further funding from other sources, such as private equity or public markets.

While venture capital investments have the potential for substantial returns, they also carry inherent risks, as many startups fail to achieve their intended goals. As a result, venture capitalists must diversify their portfolios to minimize the impact of unsuccessful investments.

In recent years, the venture capital landscape has witnessed notable changes, including an increased focus on sustainability and impact investing. Additionally, new technologies and innovative financing models, such as crowdfunding and angel investing, have added further dynamism to the industry.

Overall, venture capital remains a crucial component of the global economy, driving innovation, shaping industries, and supporting the growth of transformative startups that can reshape the future.

20.12 GLOSSARY

Turnaround financing: Turnaround financing, also known as distressed investing or restructuring, is a specialized form of venture capital that focuses on providing financial support and strategic guidance to struggling companies.

Later stage financing: Later stage financing, also known as growth or expansion stage financing, comes into play when a company has already demonstrated significant market traction, achieved product-market fit, and is poised for rapid expansion.

Early-stage financing: Early-stage financing in venture capital is a critical and significant phase for startups, as it provides the required funds for growth and development.

20.13 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress-A

Question 5 MCQ

Correct answer: A- c) Funding provided to early-stage startups with high growth potential

Correct answer: B- d) To achieve significant financial returns by investing in high-potential startups

Correct answer: C- a) Through public offerings (IPOs) or acquisitions

Correct answer: D- c) Startups with disruptive technologies and high growth potential

Correct answer: E- b) Dilution of ownership and control

Question 6 True/ False

1. Answer a): True
2. Answer b): False
3. Answer c): True
4. Answer d): False
5. Answer e): False
6. Answer f): True
7. Answer g) False
8. Answer h) False

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20.16 TERMINAL QUESTIONS

1. Describe the meaning of Venture Capital? Discuss its important features.
2. Discuss the importance of Venture capital.
3. Examine various stages of the venture capitalist finance process.
4. Write scope of Venture capital in India.
5. Discuss the various methods of Venture Capital.
6. Explain the term Exit mechanism
7. How conditional loans are different than convertible loans and explain their significance.

20.17 CASE LETS/CASES

Caselet: Venture Capital Case Study: Supporting Tech Innovations in the AI Sector

Introduction:

This case study revolves around "TechConnect," a early-stage startup working on cutting-edge artificial intelligence (AI) technology. TechConnect's founders, Sarah and Alex, had developed a revolutionary AI-based platform that could streamline and enhance data analysis processes for businesses. The platform's potential attracted significant attention from the market, prompting the need for substantial capital to fuel growth. As traditional funding options were insufficient, Sarah and Alex decided to seek venture capital (VC) investments to scale their business.

1. The Need for Venture Capital:

TechConnect had reached a crucial stage where it required substantial funds to conduct market research, refine its product, build a strong team, and launch an aggressive marketing campaign. However, traditional financing avenues like bank loans and personal savings fell short due to the high-risk nature of the tech startup. This situation necessitated venture capital, a financing option well-suited for high-growth, high-potential startups.

2. Seeking the Right Venture Capital Firm:

   Sarah and Alex embarked on a quest to find the perfect venture capital firm to invest in TechConnect. They began by conducting extensive research on prominent VC firms that specialized in AI and technology. After several meetings and presentations, they successfully secured a meeting with "Innovation Capital Partners" (ICP), a renowned VC firm with a strong track record of supporting disruptive tech startups.

3. The Pitch:

   The founders prepared a compelling pitch to impress ICP. The pitch included:

   a. A clear explanation of TechConnect's AI technology and its potential impact on the data analytics market. b. A detailed business plan outlining the company's growth strategy and revenue projections. c. An analysis of the competitive landscape and how TechConnect differentiated itself. d. The team's credentials and expertise in the AI field. e. A breakdown of the fund required and its distribution.

4. Due Diligence Process:

   ICP was impressed with TechConnect's pitch and due diligence process initiated. This includes a critical investigation of TechConnect's financials, legal format, technology, market opportunities, and scalability. Expert professional from ICP's team evaluated the risk-reward status and evaluate TechConnect's scope for attaining high returns on investment.

5. Negotiating policy:

   Once the due diligence process is successful completed, Innovation Capital Partners (ICP) offered to fund of $10 million in TechConnect in exchange for a 30% equity stake. Through the negotiations process, the owner of company aims to identify the investment terms, including valuation of the company, board members, and protecting the interest of both the Ventures Capitalists firm and the company to be funded.

6. Investment and Growth:

   After finalizing the terms, TechConnect received the investment from ICP. The startup used the funds to accelerate its product development, expand its team, and launch a marketing campaign. With ICP's expertise and guidance, TechConnect rapidly gained traction in the market.

7. Challenges and Achievements:

   TechConnect faced several challenges during its growth journey, including fierce competition, talent acquisition, and technological refinements. However, its breakthrough AI platform enabled the company to secure partnerships with major tech firms, boosting market credibility and driving further growth.

Questions:

1. What factors made venture capital the most suitable funding option for TechConnect's growth?
2. How did Sarah and Alex identify the right venture capital firm to approach, and why was ICP chosen?
3. Describe the key components of TechConnect's pitch that impressed the VC firm during the initial meeting.
4. What steps were involved in the due diligence process, and how did it impact the investment decision?
5. How did TechConnect utilize the venture capital investment to scale its operations and drive growth?
6. What were some of the challenges faced by TechConnect during its growth journey, and how were they addressed?

UNIT 21 FACTORING AND FORFEITING

21.1 INTRODUCTION

Factoring and forfaiting are financial options that help companies handle cash flow and reduce risks related to receivables. Factoring includes selling short-term accounts receivable to a third party at a discount, giving instant liquidity to the company. This procedure also shifts the risk of not being paid to the factor. Factoring is commonly utilized by companies to enhance cash flow, control credit risk, and delegate collection services. It offers both options of recourse and non-recourse, based on whether the company remains responsible for unpaid invoices. Forfaiting, on the contrary, entails selling medium to long-term receivables, usually from global commerce, to a forfaiter. The forfaiter buys these invoices at a reduced price, offering the company instant money. This financial tool aids companies in handling risks linked to global transactions, such as political and currency risks. Forfaiting is advantageous for exporters wanting to guarantee payment and enhance balance sheet health by transforming receivables into cash. Both factoring and forfaiting provide vital financial options for businesses aiming to maximize working capital, lower credit risk, and concentrate on core activities without the hassle of handling receivables.

While factoring is better for local and quick deals, forfaiting is perfect for global and extended payments.

21.2 OBJECTIVES

This unit will help you to:

- Explain the meaning and scope of Factoring, Forfaiting and Services;
- Operations in respect of Factoring and Forfaiting Services
- Difference between Factoring and Forfaiting Services
- Understand the reasons for Growth of Factoring and Forfaiting Business in Indian market; and;
- To know the characteristics or features of Factoring and Forfaiting.
- Comprehensive Insight into Financial Tools: Understand factoring and forfaiting as instruments aiding businesses in receivables management and cash flow improvement.

21.3 MEANING AND DEFINITION OF FACTORING AND FORFAITING

21.3.1. FACTORING

Factoring comes from the Latin word "facere" which translates to 'to create or perform' Factoring involves breaking down a number into its smaller components .A financial institution purchasing a company's trade debts sale. The factor is a person who purchases the money owed to a company by its customers and clients. Financing receivables helps a company with cash flow for day-to-day operations. One benefit of factoring is that it fulfils requirements for both small and large businesses obtains temporary funding (working capital) for covering daily expenses.

In a report submitted to the Reserve Bank of India,

"A continuing arrangement under which a financing institution assumes the credit and collection functions for its clients, purchases receivables as they arise (with or without recourse for credit losses, i.e., the customer's financial inability to pay), maintains the sales ledgers, attends to other book-keeping duties relating to such accounts, and performs other auxiliary duties"[1].

The company manages credit and collection tasks for its customers and acquires outstanding receivables immediately. without the ability to recover from credit losses caused by the customer's inability to pay, continues manages other financial tasks related with the sales accounts carries out additional tasks. It is the most ancient type of financial service involving the administration and funding of debts provided by banks and other

[1] Mr. C.S. Kalyansundaram

financial organizations. In this scenario, a business sells its outstanding invoices for a profit. The discount is transferred to a third party who takes on the credit risk of the debtors and collects cash as the debtors pay off their debts.

3.2. FORFAITING

Forfaiting is when the exporter gives up their possession of receive payment for the goods and services provided to the importer in return for cash from the forfaiter. By utilizing forfaiting, the exporter can effortlessly transform a credit transaction into a cash transaction, without being liable themselves or involving their forfaiter.

Forfaiting agreements require trade receivables related to durable goods to be funded without recourse for up to 100%. Managing negotiable instruments can be a portion of the arrangements.

Forfaiting is defined as "the non-recourse purchase by a bank or any other financial institution of receivables arises from an export of goods and services"[2] . Moreover, it involves buying of international trade receivables such as the bill of exchange or promissory notes at a discount, on a 100% without recourse basis. This means that the seller (client) is eligible for complete credit protection and the exporter has no liability if the importer defaults in the payment.

21.4 CHARACTERISTICS OF FACTORING AND FORFAITING

21.4.1. FACTORING

(i) Credit Protection: The factor assumes the client's risk and provides credit through advances to cover the client's credit.

(ii) Progress in the case: The element provides clients with cash advances within one day of receiving the necessary documents.

(iii) Recording sales in the ledger: All transaction details are automatically computerized and stored when numerous documents are exchanged.

(iv) Service for collecting items: When the factor purchases the receivables from the client, they then become the debts of the factor, and the factor takes care of collecting cheques and handling other follow-up procedures for their own benefit.

(v) Give valuable guidance : The factors offer important guidance on risks specific to each country and customer. This is a result of the factors enhanced comprehension of the companies in their country compared to the exporter's customers.

FORFAITING

[2] "Forfeiting for Exporters" – Global Trade and Finance, Ripiley London International Tompson, 1996.

1. High-Cost Orders : Forfaiting as a tool is usually associated with orders and transactions of larger values. Although it is common for forfeiting to be utilized for a transaction above $100,000, in most cases, a typical transaction involves a minimum amount payable that falls between$ 250,000 and $ 500,000, if not more.

2. Credit Term : It is usually medium or long-term projects that use forfaiting. As a result, the credit terms also fall in the medium and long credit horizon, ranging from 6 months to several years, based on the project.

3. Contractual Nature : Forfaiting acts as a contract for goods and services drawn among the exporter, importer, and forfaiting entity. It involves a letter of guarantee or credit extended on the importer's behalf by a financial firm.

4. Complex : Due to the nature of foreign trade and the intricacies of currency exchange, the forfaiting process generally comprises complex transactions. Forfaiting firms typically also extend more nuanced and complex services, such as providing competitive pricing and handling all the collection and documentation processes.

5.Risk : One of the distinguishing features of forfaiting is the benefit of complete risk absorption that it extends to exporters. Assuming the credit risk of the exporter's buyers allows the business to focus its energies on doing business instead of payment collection and invoice formalities.

21.5 TYPES OF FACTORING AND FORFAITING

21.5.1. FACTORING

Different types of factoring exist in financial services, and businesses can select the most appropriate one based on factors such as collateral, location of services, payment terms, and the company's track record.

1. Recourse and Non-recourse Factoring

In recourse factoring, the factor does not take on the credit risk or default risk of the customer. The risk of customers failing to meet their payment obligation is known as credit risk. If the customer fails to pay the dues by the due date, the factor will pursue action against the client and enforce the right to retrieve the amount from the client. The factor offers services for managing sales ledgers, but the client assumes the credit risk.

In non-recourse factoring, the factor takes on the credit risk along with offering other services. Therefore, the factor is unable to demand repayment from the client in case of default on the due date. Of course, non-recourse factoring services have higher fees compared to recourse factoring services because they include the cost of assuming the risk of customer non-payment.

2. Full-Service Factoring

In full-service factoring (also called full factoring), the factor provides a comprehensive range of services, such as managing a sales ledger, sending regular account statements to the client, collecting receivables, and overseeing credit - assessing the customer's creditworthiness, setting credit limits and offering credit insurance to manage credit risk.

Old Line Factoring is another term for full-service factoring. Businesses favor it because it reduces burden on the accounting department and releases the company's limited resources for better utilization. Among all these services offered, this type of factoring has the highest rates for its services. In addition to the discount charges (interest charges), the administrative expense of factoring fluctuates from 0.5% to 2.5% of receivables.

3.Domestic and Export Factoring

Domestic factoring includes three parties - the client (seller), the customer (buyer), and the factor (financial institution). All of the gatherings are situated under the same area. It is much simpler to manage and carry out domestic factoring due to the similarities in cultural, legal, and trade barriers between the parties involved.

In export factoring, there might be an extra entity - the import factor (located in the customer's area) along with the client, customer, and export factor (in the client's area). The key factor involves services such as determining the customer's creditworthiness and credit limit, collecting money from the client on the due date, and sending it to the export factor.

4.Spot versus Regular Factoring

Spot factoring refers to a factoring contact that the customer and the factor for a particular transaction only.

In a factoring agreement, the factor and the client maintain a continuous relationship. Typically, factoring has a set limit that is accepted. The client is able to request an early reimbursement from the bills that have been issued, up to this specified maximum amount. Normally, a factor favors consistent factoring and views it as less risky than a spot factoring agreement.

5.Maturity and Advance Factoring

Also called wholesale factoring, maturity factoring is when the supplier performs as a wholesaler in the market.

Maturity factoring is another term for collection factoring. In this kind of factoring, the element is accountable for collecting payments from the customer. It transfers the agreed share to the customer typically on the maturity date of every month's sales invoices.

6.Disclosed and Non-disclosed Factoring

Disclosed factoring is also called as bulk factoring or notified factoring. In disclosed/bulk/notified factoring, the factor promptly reveals the client's transfer of debt to the buyer/importer.

The seller includes a message on the invoice to notify the buyer/importer to send payment directly to the factor. This is commonly known as the Assignment Notice.

In a non-disclosed factoring agreement, the buyer has no knowledge of the vendor's financing arrangement with the factoring company.

7. Bank Participation Factoring

In the majority of factoring options, suppliers do not receive the full invoice amount. The factor usually maintains a reserve amount and provides up to 80% to the invoice value in advance.

Although generally acceptable to most exporters or suppliers, sometimes suppliers must access a larger range of resources to address a shortage in working capital.

8. Limited Factoring

Selective factoring, also called limited factoring, involves the factor handling specific invoices from the client rather than all of them. The factor bases discounts on selected invoices, sending cash only for those invoices.

9. Supplier Guarantee Factoring

This form of factoring is also called 'drop shipment factoring' or vendor guarantees factoring or supply chain factoring. Supplier guarantee factoring, a tri-party agreement, includes a third party - the supplier of the borrower.

The supplier might provide raw materials for a large order, while the client could act as a distributor. The factor will make payment to the supplier after the borrower's buyer accepts the delivered goods.

10. Reverse Factoring

This type of factoring is started by the purchaser or the person importing goods. Supply chain financing is another term for it. The client organizes the relationships between factors to ensure upfront financing of invoices. At times, the customer may have to cover the costs for the same.

Reverse factoring is commonly observed in deals involving a medium to large customer and a small to medium client.

21.5.2. FORFAITING

1. Importers provide promissory notes, which act as a formal promise to pay back the exporter.

2. Bills of exchange, similar to promissory notes, are written directives that guarantee an importer will pay the agreed amount to an exporter.

3. Account receivables represent the money that the exporter is owed and is recorded as income yet to be collected on the financial statements.

4. The banks of the importer issue letters of credit, ensuring that the payment will be made even if the importer does not pay.

21.6 PROCESS OF FACTORING AND FORFAITING

21.6.1. FACTORING

For invoice purchase, the company enters into a factoring agreement with a factor, which is typically a financial institution.

• When products are sold on credit, an invoice is generated and forwarded to the factor in duplicate.
• The client is informed of the transfer of the firm's outstanding debt to the factor by assignment.
• The factor collects the amount from the customer on the due date.

• The factor sends the remaining money to the firm after keeping the service fees.

a. Upkeep of book loans A factor assumes accountability for upholding a corporate institution's debtors' accounts.

b. Coverage of credit The seller can focus on his primary company since the factor assumes the risk of losing bad debts.

c. Advances of cash approximately 80% of the total the client receive the amount of accounts receivable as advance cash.

d. The service of collection Factoring services includes sending out reminders, accepting partial payments, and picking up checks.

g. Guidance for customers the factor can provide advice about a customer's creditworthiness, how they view the client's products, and other things based on their prior debtor history.

- The seller provides the buyer with the goods and issues an invoice to the client.
- The invoice is then sent from the seller to the factor for financing. The factor confirms the information bill.
- After confirmation, the factor reimburses 75 to 80 percent to the customer/merchant.
- The factor then holds off until the customer pays him.
- Upon receiving the payment from the customer, the factor disburses the balance owing for the customer.
- Fees or interest charged by a factor can be payable in advance or it can be overdue. The outcome hinges on the specific type of factoring contract.
- Non-recourse factoring, the factor assumes the responsibility for any bad debt. In that scenario, the rate of commission for factoring would be relatively elevated.
- The interest rate of factoring commission, factor reserve, and the rate of interest, all of them are negotiable. These are decided depending upon the financial situation of the client.

21.6.2. FORFAITING

1. The exporter (seller) sells the goods to the importer (buyer) as a deferred payment for three to five years.

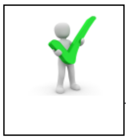
2. The importer issues several bills in favor of the exporter for the amount owed in the future, which also includes the interest amount.

3. In addition, the guarantor of the issued bonds is a recognized international bank, often also the importer's banker. The guarantor bank guarantees that it willcovert the potential payment default of the buyer.

4. The exporter sells the used tickets to the forfaitist (banker of the exporter) at a discount without the right of return to the seller.

5. Now, when a counterfeiter buys these notes, he can hold the notes until they mature, or sell them to a group of investors who may be interested in buying an unsecured loan with high yield potential or a freely tradable debt instrument.

6. Unconditional bills and notes have legal enforceability which gives security to the expired or subsequent purchaser of the instrument. These instruments can have a maturity of one month to ten years.



Check Your Progress-B

Q1. What is factoring?

Q2.What are the main benefits of factoring for businesses?

Q3.What is the difference between recourse and non-recourse factoring?

Q 4.What kind of businesses typically use factoring?

Q5.How does the factoring process work?

Q6.What is forfaiting?

Q7. What are the main benefits of forfaiting for exporters?

Q8. What types of transactions typically use forfaiting?

Q9. How does forfaiting differ from factoring?

Q10.How does the forfaiting process work?

21.7 ADVANTAGES AND DISADVANTAGES OF FACTORING AND FORFAITING

21.7.1. FACTORING

21.7.1.1. ADVANTAGES OF FACTORING

Advantages of Factoring are as follows:

1. **Immediate cash flow**: This type of financing reduces the time needed to collect funds. It facilitates the quick realization of money by selling ads to the author. Having liquid cash can often be a factor in seizing and diverting an opportunity. The financial bonus offered by factoring is readily available for investments, completing a new order or meeting an unexpected condition.

2. Focus on business and growth: By selling invoices, business owners can free themselves from collecting payments from customers. Claims department resources can be directed to business operations, financial planning and future growth.

3. Debt avoidance: Two categories exist for factoring: retroactive and nonretroactive. In the event that credit losses, the author bears the loss without the right of recourse. Therefore, the seller is not responsible for the seller's claims arising from the sale.

4. Fast financial arrangements: borrowers offer funds faster than banks. Compared to other financial institutions, factoring offers a faster application, less documentation and faster cash withdrawal.

5. No collateral requirement: Advance payments are made based on the strength of the claims and credibility. Unlike cash credit and overdraft, factors do not require a guarantee or mortgage. New companies and startups with significant claims can easily get an advance payment. Factoring, unlike typical bank loans, does not require the use of an apartment or other real estate as collateral.

6. Customer Analysis: Factors provide the seller with important guidance and insights into the creditworthiness of the party from whom the receivers are being paid. This helps to negotiate better terms between the parties to the future contracts.

7. Save time: Factoring can save a company time and effort that would otherwise be spent collecting from consumers. This energy can be used for other business building tasks such as sales, marketing and customer development.

8. Low cost source of finance: It is an inexpensive funding source than any other medium like banking.

9. No expenditure incurred on assets: No expenditure is incurred on assets.

7.1.2. DISADVANTAGES OF FACTORING

Disadvantages of factoring are:

1. Expensive: It could be a costly source of funding if there are many invoices and less number.

2. Higher rate of interest: The advance given is usually accessible at a higher interest rate than usual.

3. Third Party: The perpetrator is the client third party, who might not feel at ease interacting with them.

21.7.2. FORFAITING

21.7.2.1. ADVANTAGES OF FORFAITING

Forfaiting offers several advantages to exporters:

1. Risk reduction: Exporters are able to safeguard themselves from possible losses arising from default or insolvency of the buyer by transferring the risk of non-payment to the forfaiting agent. They are able to concentrate on the company's core business additionally, concurrently confidently expand their external business activities.

2. Improved cash flow: By converting medium and long-term receivables into cash, de-cashing provides immediate cash flow to exporters. This increase in funds can cover working capital needs, fund new initiatives or engage in research and development.

3. Better financial planning: Since forfaiting allows early payment of export claims, exporters can better estimate their cash flow. This allows the business to plan their budgets, manage costs and make strategic business decisions on a more reliable financial basis.

4. No collection problems: Forfaiter collects the payment from the importer. Thus, the exporter does not have to spend money and time tracking costs, legal proceedings or resolving delays or disputes.Forfaiter's expertise in international trade finance ensures efficient and successful collection methods.

5. Expand the market area: With the help of forfaiting, exporters can offer their buyers more favorable payment terms, such as longer credit terms. This can attract new customers and expand their market, increasing their competitiveness and meeting the financial requirements of buyers in different locations.

6. Maintenance of balance sheet: Since forfaiting is retrospective financing, exporters can remove their export requirements from the balance sheet. It improves financial ratios, increases creditworthiness and increases capital of banks or financial institutions for additional business needs.

7. Flexibility in financing options: Forfaiting offers flexibility in financing options, allowing exporters to choose between multiple structures, interest rates and currencies. This customization allows exporters to tailor the flat rate arrangement to their needs and maximize financial benefits.

21.7.2.2 DISADVANTAGES OF FORFAITING

In examining the advantages of forfaiting, this is important to consider the disadvantages associated with this financial technique, which are as follows:

1. Limited applicability: Forfaiting is generally suitable for a medium and long-term debt base. business transactions. Instruments such as promissory notes or promissory notes. It may not be suitable for short-term or small business contracts where factoring or other financing solutions are available.

2. High transaction costs: Forfaiting incurs various fees and charges, including discount fees, processing fees and administrative fees. These fees can be significant compared to alternative financing options and can affect the exporter's overall profitability.

3. Limited Market Area: Forfaiting has a limited market area because it is mainly used in international trade, which focuses on transactions between exporters and importers of different countries. If the exporter's main market is the domestic market, the options for forfeiture may be limited.

4. Strict documentation requirements: Forfait transactions require various documents such as invoices, bills of exchange and other legal documents. The exporter must ensure the availability of relevant documents, which may take time and require legal expertise.

5. Limited flexibility: When the export requirements are gone, the exporter's debt management options are limited. Forfaiting is a complete transfer of rights and obligations, unlike factoring, where the exporter controls the requirements, changes the terms or negotiates with customers.

6. Effect on customer relations: Counterfeiting can affect customer relations because the authority transfers by the exporter to collect payment for the counterfeiter. Some importers may prefer direct relationships with exporters and are hesitant to make deals.

7. Dependence on the credit worthiness of the importer: The success of the Forfait transaction strongly depends on the importers creditworthiness. It is assumed that the importer does not pay or gets into financial difficulties. In this case, the difficulties faced by the exporter in receiving the total amount due by the forfeiter.

21.8 DIFFERENCE BETWEEN FACTORING AND FORFAITING

1) The primary purpose of factoring services is to finance and collect receivables from short-term credit transactions, such as those lasting up to 180 days. In contrast, forfaiting is intended to finance credit transactions involving longer than one year's deferred credit duration.

2) Depending on the specifics of the factoring contract between a client and a factor, a factoring arrangement may be with or without recourse. In contrast, a forfeiter who engages in a forfaiting transaction assumes the credit risk and is never entitled to remedy.

3) Factoring services are appropriate for both export and domestic transactions. In opposition to this Forfaiting deal is solely taken into account for export related transactions.
4) Sales invoices are the sole basis for factoring. Conversely, forfeiting entails using one of the readily accessible negotiable instruments, such as a promissory note or bill of exchange.

5) A 5-20% margin is maintained in a factoring arrangement. Stated differently , financing is granted promptly upon invoice acquisition, up to a maximum of 80-95% of the invoice value. In contrast, a forfeiter does not retain any profit and discounts the full sale value of the export transaction.
6Sales ledger, administration, receivables collection, and other consulting services are included in factoring services. Conversely, however, forfeiting is a purely monetary agreement.

7) Forfaiting can be done on a transaction basis, but factoring is done on a whole turnover basis.

The main difference between the two is that factoring can be used for domestic and international business, while forfaiting applies only to international business financing. Here are eight more key differences between factoring and forfait:

S.N	**BASIS OF DIFFERENCE**	**FACTORING**	**FORFAITING**
1.	PROCESS	A financial arrangement where business owners sell their unpaid invoices (accounts receivable) to a third party (factoring companies, lenders). or banks) for quick cash.	Forfaiting Refers to export financing where the exporter sells his receivables to a forfaiter in order to receive an immediate cash payment.
2.	PROGRAMMING	Factoring deals with short-term receivables that are usually due in 90 days or less.	Forfaiting: deals with medium and long-term receivables.
3.	SALE OF RECEIVERS	In Factoring Sale of receivables is usually done with regular products or services.	In Forfaiting Receivables are sold with capital goods.
4.	PERCENTAGE OF FINANCING RECEIVED	In Factoring Merchants typically receive 80-90% of funding.	In Forfaiting Financing of exporters by financing Hundred percent of the value of exported goods

5.	NEGOTIABLE INSTRUMENTS	In Factoring Trading of negotiable instruments such as promissory notes and promissory notes.	Forfaiting Does not deal with freely tradable instruments.
6.	GUIDELINES VS. NON-RECURSION	Factoring can be regressive or non-regressive	Forfaiting are Always non-refundable.
7.	FUNCTIONAL MARKETS	In Factoring there is no secondary market.	In Forfaiting There is a secondary market that increases the liquidity of forfaiting.
8.	WHO PAYS THE COSTS	In Factoring Billing costs are paid by the seller or the customer.	In Forfaiting The foreign buyer pays the cost of forfaiting the compensation..

21.9 SUMMARY

In this section we have covered financial services ie. factoring and forfaiting. Factoring includes both domestic and international trade finance and collection of accounts receivable. This service is provided by a factor that finances book debts, collects cash against receivables, manages sales records, protects against credit losses, etc. There are three parties to the factoring contract: the buyer of the goods, who must pay for the goods purchased under credit terms, the seller of the goods, who must realize the credit sale of the buyer. andtegur, who acts as agent and executes the sale of the buyer. Forfaiting is a source of trade finance that allows exporters to receive compensation from the forfaiter when they transfer the right to collect debts from the importer. This means buying commercial or promissory notes from a bank or financial institution not going to the seller. Bill payments are a source of short-term business financing. This is known as an acceptance concession, where one party accepts a commercial obligation to a third party.

21.10 GLOSSARY

Accounts Receivable (AR): The money owed to a business by its customers for goods or services delivered but not yet paid for.

Advance Rate: The percentage of the accounts receivable value that a factor advances to the business upfront.

Credit Risk: The risk of a buyer defaulting on payment obligations.

Discount Rate: The interest rate charged by the factor or forfaiter for advancing funds or purchasing receivables.

Factor: A financial institution or company that buys accounts receivable from businesses at a discount.

Factoring: The process of selling accounts receivable to a third party (factor) to improve cash flow and reduce the burden of managing receivables.

Forfaiter: A financial institution or entity that purchases medium to long-term receivables from exporters, assuming all associated risks.

Forfaiting: A financing arrangement where exporters sell their receivables to a forfaiter, typically for international trade transactions, to receive immediate payment and transfer risk.

Non-recourse Financing:A type of financing where the lender or buyer of receivables assumes the risk of non-payment, with no recourse to the seller if the debtor defaults.

Recourse Factoring: A factoring arrangement where the business selling its receivables retains the risk of non-payment by the customers.

Non-recourse Factoring: A factoring arrangement where the factor assumes the risk of non-payment, relieving the business of any liability if customers default.

Invoice: A document issued by a seller to a buyer listing the goods or services provided and the amount owed.

Liquidity: The availability of cash or easily convertible to cash assets to meet short-term obligations.

Maturity Date: The date on which the payment of a financial obligation is due.

Political Risk:The risk of loss due to political instability or changes in a country that could affect the ability to collect receivables.

Receivables: Money owed to a company by its customers for goods or services delivered.

Risk Mitigation: Strategies used to reduce or manage the risk associated with financial transactions, including factoring and forfaiting.

Trade Credit:Credit extended by a seller to a buyer allowing the buyer to pay for goods or services at a later date.

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21.13 TERMINAL QUESTIONS

1. What do you mean by factor and factoring services?
2. What do you mean by without recourse and maturity factoring?
3. Explain the benefits and disadvantages of factoring services.
4. Explain the mechanism of factoring services.
5. Explain the various types of export factoring arrangement.
6. Define Forfaiting services?
7. What are the differences between factoring and Forfaiting services?
8. Comment on factoring and Forfaiting services in India.

21.14 CASES STUDY

21.14.1. CASE STUDY : FACTORING FOR SMALL AND MEDIUM ENTERPRISES (SMEs)

COMPANY BACKGROUND

XYZ Manufacturing Ltd. is a small manufacturing company based in Chicago that produces specialized machine parts for various industrial clients. Despite a steady stream of orders and a growing customer base, XYZ faced cash flow issues due to long payment terms (typically 60-90 days) offered to clients. These extended payment periods strained their ability to meet operational expenses, pay suppliers, and invest in growth opportunities.

PROBLEMS

The primary challenge for XYZ Manufacturing was maintaining sufficient working capital to cover day-to-day operations. Their traditional bank financing options were limited due to stringent credit requirements and slow approval processes. As a result, XYZ was unable to leverage their accounts receivable to meet immediate cash needs.

SOLUTION

XYZ Manufacturing decided to explore factoring as a solution to their cash flow problems. They partnered with a reputable factoring company, Factoring Solutions Inc., which offered a flexible and straightforward approach to financing.

PROCESS

Selection of Invoices: XYZ selected invoices worth $200,000 from their most reliable clients for factoring.

Submission to Factor: These invoices were submitted to Factoring Solutions Inc. for approval.

Approval and Advance: The factor conducted credit checks on XYZ's clients and approved the invoices. Factoring Solutions Inc. advanced 85% of the invoice value ($170,000) to XYZ Manufacturing within 24 hours.

Collection: Factoring Solutions Inc. took over the collection process, managing the receivables and following up with XYZ's clients for payments.

Final Payment: Once the clients paid their invoices in full, Factoring Solutions Inc. released the remaining 15% ($30,000) to XYZ, minus a factoring fee of 3%.

RESULTS

Improved Cash Flow: By factoring their receivables, XYZ Manufacturing received immediate cash, which significantly improved their liquidity and allowed them to meet operational expenses and supplier payments on time.

Growth Opportunities: With better cash flow, XYZ was able to take advantage of bulk purchasing discounts from suppliers and invest in new equipment, which increased production capacity.

Reduced Administrative Burden: The factor managed the collections, allowing XYZ's management team to focus more on core business activities and growth strategies.

CONCLUSION

Factoring provided XYZ Manufacturing Ltd. with a practical solution to their cash flow challenges. By leveraging their accounts receivable, they were able to maintain smooth operations, invest in growth, and reduce the administrative burden associated with managing receivables. This case study highlights how factoring can be a valuable financial tool for SMEs facing similar cash flow issues.

21.14.2. CASE STUDY : FORFAITING IN INTERNATIONAL TRADE

COMPANY BACKGROUND

ABC Electronics is a mid-sized company based in Germany that manufactures high-quality electronic components. They have a strong presence in the European market and are looking to expand their operations into emerging markets, specifically targeting large buyers in India. The company received a significant order from an Indian distributor for a contract worth €2 million, with payment terms extending over 18 months.

PROBLEMS

While the contract presented a great opportunity for growth, ABC Electronics faced several challenges:

Credit Risk: The long payment terms and economic volatility in the emerging market increased the risk of non-payment.

Cash Flow: Financing the production and shipping of the order without immediate payment strained ABC's working capital.

Currency Risk: Fluctuations in exchange rates could affect the final amount received in euros.

SOLUTION

ABC Electronics decided to use forfaiting as a solution to mitigate these risks. They partnered with a forfaiter, Global Forfaiting Services, which specialized in international trade finance.

PROCESS

Negotiation and Agreement: ABC Electronics and Global Forfaiting Services negotiated terms, agreeing to discount the receivables from the Indian distributor at a rate of 5% per annum.

Issuance of Promissory Notes: The Indian distributor issued promissory notes for the €2 million contract, payable in installments over 18 months.

Sale of Receivables: ABC Electronics sold the promissory notes to Global Forfaiting Services at a discount. The forfaiter paid ABC Electronics €1.8 million upfront (the discounted value of the promissory notes).

Transfer of Risk: Global Forfaiting Services assumed all risks associated with the receivables, including credit risk, political risk, and currency risk.

Collection: The forfaiter managed the collection of payments from the Indian distributor according to the agreed schedule.

RESULTS

Immediate Cash Flow: ABC Electronics received €1.8 million upfront, allowing them to finance production and shipping without straining their working capital.

Risk Mitigation: By transferring the credit, political, and currency risks to the forfaiter, ABC Electronics was protected against potential non-payment and exchange rate fluctuations.

Focus on Core Business: With the receivables sold and risks mitigated, ABC's management could focus on production and expanding their market presence instead of worrying about collections and financial risks.

CONCLUSION

Forfaiting provided ABC Electronics with a robust solution to manage the financial risks and cash flow challenges associated with their international expansion. By leveraging forfaiting, they secured immediate payment for their large export order, mitigated various risks, and were able to concentrate on growing their business in new markets. This case study illustrates how forfaiting can be an effective tool for companies engaged in international trade, especially when dealing with long-term receivables and high-risk markets.

UNIT 22 ASSET LIABILITY MANAGEMENT

22.1 INTRODUCTION

Over the past few years, the financial market in India has undergone massive and rapid changes. Fierce rivalry for business that involves resources as well as liabilities, as well as increasing volatility in domestic exchange rates and interest rates pressure bank management to keep healthy equilibrium between margins, profitability and n long-term viability. These pressures require not just ad hoc measures, but systematic and thorough ones as well. Corporate strategy should serve as the foundation for a dynamic, integrated risk management system and procedure that bank management uses to make business choices. Banks face numerous significant risks in their business operations, including credit risk, interest rate risk, currency risk, stock/commodity price risk, liquidity risk, and operational risk.

Asset-liability management or ALM for short is the management of financial risks arising from asset-liability mismatches as part of a financial accounting investment strategy.

ALM is between strategic planning and risk management. In contrast to minimizing immediate hazards, it concentrates on the long term and is a method of optimizing asset to satisfy complicated liabilities that might boost profitability.

ALM comprises asset allocation and management, equity, interest rate and credit risk, including leverage, and the modification of enterprise wide tools within these risk frameworks to optimize and manage the local regulatory and capital environment.

Frequently, the fully hedge ALM method merely matches assets to liabilities and leaves the surplus for asset management.

Depending on the business model being utilized, the precise responsibilities and purview of ALM might differ greatly amongst banks (or other financial institutions) and can include a number of hazards. As the two biggest risks affecting an investment, interest rate risk and liquidity risk are the main focus of traditional ALM program organization's balance sheet (because they require the reconciliation of assets and liabilities).

22.2 OBJECTIVES

Once you've finished this unit, you ought should be capable of:

- Understand the scope and Role of Asset-liability Management (ALM)
- Identify the Key Concept of ALM
- Understand the Process of ALM
- To know the Techniques of ALM
- Identify the Technologies involved in ALM; 6. Describe the linkage of ALM to other areas of risk management.

22.3 SCOPE AND ROLE OF ASSET LIABILITY MANAGEMENT (ALM)

22.3.1. SCOPE OF ALM

we explore the wide scope of ALM :

1. Liquidity risk management

One of the main focuses of ALM is liquidity risk management. This includes assessing the bank's capacity to fulfill their short-term financial obligations, maintaining an adequate liquidity buffer and developing strategies to deal with liquidity shortfalls.

2. Interest rate risk management

ALM assesses and manages interest rate risk brought on by fluctuations in interest rates that have an impact on the asset and liabilities of the bank. It monitors and manages the impact of interest rates on the bank's profitability and interest margin.

3. Funds Transfer Pricing (FTP)

FTP is a key component of ALM that helps banks allocate costs and profits to different business units and products. This ensures that the price of loans, deposits and other financial instruments reflects the underlying cost of assets.

4. Balance sheet structure and optimization

ALM examines the makeup of the bank's balance sheet, including the types of assets and liabilities held, their maturities and sensitivity to interest rates. Its objectives are to optimize the balance sheet to satisfy the banks tolerance for risk and profit targets.

5. Capital Management

Managing capital effectively is essential to ALM. Banks must assess their solvency and allocate capital to support business while meeting regulatory requirements.

6. Stress testing and scenario analysis

ALM includes scenario analysis and stress testing to assess the bank's resilience to adverse financial conditions and market disturbances. This aids in locating any weaknesses and informs contingency plans.

7. Regulatory Compliance

Banks need to make sure that their ALM practices comply with regulatory guidelines and requirements. This includes compliance with regulations such as Basel III, which establishes minimal standards for liquidity and solvency.

8. Asset quality management

ALM assesses the standard of the bank's assets, including loans and investments. It assesses credit risk and assesses the impact of changes in asset quality on the bank's financial position.

9. Profitability analysis

ALM is involved in profitability analysis by evaluating the impact of different ALM strategies on the bank's overall financial performance. It helps identify opportunities to improve profitability while managing risk.

10. Contingency Planning

ALM involves the development of contingency plans that describe the actions to be utilized during a liquidity or rate of interest crisis. These plans may include obtaining emergency financing, selling assets, or adjusting pricing strategies.

11. Communication and Reporting

Effective communication is essential in ALM. The framework ensures that relevant information is communicated to senior management, the board and regulatory authorities. Regular reporting and transparency are key factors.

12. Strategic planning

ALM participates in the bank's strategic planning, matching ALM strategies with the institution's overall goals and risk appetite. It helps guide decisions related to business expansion, product offering and risk management..

22.3.2. Role of ALM

1. Nature of Asset Liability Management

ALM, to put it briefly, is the process of matching a banks liabilities and assets in order to reduce risk and increase profitability. This calls for thorough preparation, ongoing observation, and flexible thinking. The objective is to guarantee that the banks source of funding appropriately correspond with the utilization of its money, considering variable like interest rates, liquidity, credit quality, and regulatory obligations.

2. Mitigating Interest Rate Risk

Interest rate risk is one of the key risks that ALM manages. Banks own a variety of interest sensitive liabilities and assets. A bank might, for instance, have fixed rate investment and variable rate loans. Interest income and expenses may not line up as a result of interest rate fluctuations. By proactively altering the mix of assets and liabilities effective ALM aids banks in becoming ready for such situations. Risk management for liquidity another big worry for banks is liquidity risk. The danger that liquid assets will not be enough to cover short term or immediate obligations is mentioned in this. Like that circumstances may result in monetary trouble and harm the banks standing. ALM makes ensuring banks have adequate liquid assets on hand to cover their responsibilities even in the case of unforeseen circumstances or downturns in the economy.

3. Strategic Allocation and Profitability

Beyond just lowering risk ALM also has an impact on the banks profitability. The allocation of five assets and liabilities strategically allows banks to increase investment returns. Banks for instance can arrange their debt in three different ways to finance long term loans that yield larger returns. This increase revenue while simultaneously providing protection against possible losses for ALM.

4. Adapting to regulatory changes

A number of laws in place for the financial industry with the goal of safeguarding consumers and preserving stability.ALM assist banks in navigating the constantly changing regulatory landscape. Banks can stay in business and avoid penalties by abiding by the regulations.

22.4 KEY CONCEPT OF ASSET LIABILITY MANAGEMENT

Asset Liability Management (ALM) is a critical practice in financial institutions that focuses on mitigating financial risks arising from asset-liability mismatches. Here are the key concepts:

1. Risk Management: ALM aims to manage risks such as interest rate risk, liquidity risk and credit risk. By mitigating these risks, institutions can ensure that they have sufficient funds to meet their obligations and optimize the return on funds.

2. Profitability and stability: ALM aims to balance the profitability and stability of the institution. It involves the strategic allocation of assets and liabilities to maximize returns and reduce volatility in various market conditions.

3. Cash flow management: It is very important to ensure that cash flow schedules and amounts are consistent with the institution's obligations. This includes forecasting and managing cash flows to avoid liquidity problems and ensure obligations are met when they are due.

4. Compliance: ALM also includes compliance with regulatory requirements on capital adequacy and liquidity. Credit institutions and investment firms must maintain sufficient capital to deal with adverse financial scenarios and comply with regulatory standards.

5. Interest Rate Management: Managing the impact of interest rate changes is an important part of ALM. This includes strategies for dealing with the difference between deposit rates and loan rates.

22.5 PROCESS OF ASSET LIABILITY MANAGEMENT

The process of Asset Liability Management (ALM) includes several important steps to ensure the financial stability and risk management of institutions such as banks, insurance companies and pension funds. Here is a detailed overview of the ALM process.

1. Define objectives and risk tolerance: The first step involves clear objectives for the ALM strategy and determining the institution's risk tolerance. This involves understanding the balance between risk and return that the institution is willing to accept.

2. Data collection and analysis: It is important to collect and analyze data related to the institution's assets and liabilities. This includes information on cash flows, interest rates, maturity and other related financial indicators.

3. Gap Analysis: Perform a gap analysis to identify differences between assets and liabilities. This analysis helps to understand the timing and size of cash flows and to identify potential liquidity and interest rate risks.

3. Modeling and scenario analysis: Use financial models to simulate different scenarios and assess their impact on the institution's balance sheet. Scenario analysis helps to understand how changes in market conditions (e.g.: fluctuations in interest rates) affect the financial position of the institution.

4. Strategy development: Based on the analysis, develop strategies to mitigate risks. This may include interest rate risk management strategies such as duration matching and liquidity risk management such as maintaining a buffer of high quality liquid assets.

5. Implementation: Implement selected strategies by making changes to the institution's portfolio of assets and liabilities. This may include rebalancing the portfolio, using hedging instruments or adjusting the financial structure.

6. Monitoring and Reporting: Continuously monitor the financial health of the institution and the effectiveness of ALM strategies. Regular reporting to stakeholders is essential to ensure transparency and make necessary adjustments to changing market conditions.

7. Compliance: Ensuring compliance with regulations related to solvency and liquidity. This requires compliance with guidelines issued by regulatory authorities and maintaining sufficient capital to cover potential losses.

22.6TECHNIQUES OF ASSET LIABILITY MANAGEMENT

6.1. STATIC ALM TECHNIQUES:

Static ALM techniques are used to manage the balance between risks and assets and liabilities at a moment in time without considering future changes or scenarios. Here are the main static ALM techniques.

1. Maturity Matching: This method involves aligning the maturity of possessions and obligations to ensure that they mature in addition time. By matching maturity, credit institutions and investment companies can minimize the risk of having to refinance their debts at unfavorable interest rates or reinvest funds with a lower yield.

2. Duration matching: Similar to term matching but more complex, duration matching provides duration (weighted average). The time to reach the cash flows between possessions and obligations is the same. This helps lower interest rate risk since the values of liabilities and assets respond to interest rate fluctuations in a comparable way.

3. Gap Analysis: This method involves analyzing the differences between assets and liabilities that mature in certain time groups (eg. 0-3 months, 3-6 months) or are revalued. A positive difference indicates more revaluation of assets than liabilities, while a negative difference indicates the opposite. Institutions use this analysis to control the risk associated with interest rates and liquidity.

6.2. DYNAMIC ALM TECHNIQUES:

Dynamic ALM techniques involve continuously adjusting the portfolio of assets and liabilities to changing market conditions and future expectations. Here are some key dynamic ALM techniques:

1. Rebalancing: regularly adjusting the structure of a portfolio of assets and liabilities to maintain the desired risk profile and duration. This includes the sale or purchase of assets and the adjustment of liabilities to reflect market movements furthermore, a shift in the financial standing of the institution.

2. Scenario analysis and stress testing: different the state of the market and extreme scenarios are simulated to understand their potential impact on the state of the organizations finances institution. Health this technique helps assess vulnerability and prepare for adverse conditions.

3. Rolling Horizon Planning: Continuously updating the ALM strategy based on new information and market developments. This requires regular review and adjustment of ALM plans to reflect changes in interest rates, economic conditions and other factors.

4. Interest rate hedging: Using derivatives such as interest rates, futures and options to manage interest rate fluctuations. These instruments help stabilize cash flows and protect the institution against adverse interest rate changes.

5. Dynamic Gap Management: Continuously monitors and adjusts differences in relation to liabilities and assets that mature or are priced throughout time. This technique ensures that the institution can quickly react to changes in interest rates and other market conditions.

6. Liquidity management: active management of an institution's liquidity position to ensure that it currently has sufficient liquid resources to satisfy immediate needs and obligations. This includes maintaining a buffer of superior quality liquid assets and using various funding sources when necessary.

Check Your Progress-A

Q1. What is Asset Liability Management (ALM)?

Q 2. What are the main risks that ALM manages?

Q 3. How does gap analysis help in ALM?

Q4. What is the purpose of ALM duration analysis?

Q 5. Define liquidity risk.

22.7 REGULATORY FRAMEWORK

Important rules and policies:

1. RBI'S ALM System Guidelines

All Indian Commercial banks are required to put up an ALM system, and the RBI has issued guidelines outlining the framework for the system's construction and administration. Important elements of these rules consist of:

Asset-Liability Committees or ALOs:

Are mandated by law to be constituted by banks and tasked with managing risk management procedures generally.

Liquidity Risk Management:

To effectively manage liquidity risks, banks need to have a strong framework in place. This framework should include keeping an eye on projected cash flow needs and keeping sufficient liquidity buffers.

Interest Rate Risk Management:

In accordance with the standards, banks must assess and control how sensitive their assets and liabilities are to fluctuations in interest rates. For this, It is advised to use tools such as simulation models, gap analysis, and duration analysis.

Reporting Conditions:

It is necessary to disclose ALM holding on a regular basis to the RBI and the bank's board. This ensures that data on trading risks, interest rate risk, and liquidity is regularly examined and take appropriate action.

2. Basel III Norms

Basel III standards, which were introduced in response to the flaws in financial regulation exposed by the global financial crisis of 2007-2008, enhance oversight, regulation and risk management in the banking industry worldwide, including in India. Important factors influencing ALM include:

Need for Adequacy of Capital:

These specifications guarantee that banks have enough capital to endure difficult times. One of the most important components of ALM risk mitigation is the use of capital buffers.

Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR):

LCR makes ensuring banks have adequate liquid, high-quality assets on hands to meet their entire net cash outflows over a 30 –Day period. Because of NSFR, banks have to keep a consistent financing profile with respect to the makeup of their assets and off -balance sheet holdings.

Leverage Ratio:

Designed to limit the accumulation of leverage in the banking industry, this is an additional measure to the risk-based capital requirements.

3. Guidelines for Managing Liquidity Risk

To help banks improve their framework for managing liquidity risk, the RBI has released detailed guidelines on the subject. This entails establishing a strong governance framework for liquidity, conducting frequent stress tests in a range of conditions, and keeping a varied finance plan.

4. Coordinated Risk Administration

In order to promote a thorough risk management culture, the RBI advises banks to use an integrated approach to risk management across a number of risk categories, including credit, market, operational and liquidity risks.

22.8 RISK MANAGEMENT STRATEGIES IN ALM

Banks must maintain effective asset-liability risk management(ALM) in order to meet their short and long term obligations and preserve their financial stability. Interest rate risks, liquidity risks and credit risks are the three primary hazards associated with ALM. For each of these risks to be managed effectively, particular tactics and resources are needed. Risk of interest rates Quantification and control.

Interest rate risk

The risk associated with interest rates stem from the potential impact that fluctuations in these rates may have on the banks financial standing. Main strategies used to manage this risk are as follows:

Gap analysis: This instrument assesses how susceptible a financial institutions position is to 5-7 variations in interest rates. Interest sensitive assets and liabilities are categories into several time periods 21 based on their maturity or revolution.

The difference, or gap between these assets and liabilities in each group represents the banks risk. A negative gap indicates fragility while a positive gap indicates the benefits of rates hikes.

Duration Analysis: Duration analysis is a more intricate statistic that calculates the impact of changing interest rates on the price of an asset or liability. Duration makes it possible to calculate how sensitive a bank's total assets and liabilities are to changes in interest rates.

Liquidity risk

Understanding and preparing for future cash flows is necessary for effective liquidity management so that the bank can always fulfill its obligations

Cash flow forecasting: It involves taking into account both incoming and outgoing cash flows over various time periods. This assists banks in determining possible excess and shortages of liquidity so they can adjust their lending and investing plans appropriately.

Contingency funding plans: Plans for contingency funding are proactive measures that outline what the banks will do in the event of an unforeseen liquidity crisis. These consist of asset sales; prearrange credit lines, and other remarkable methods to boost liquidity under challenging circumstances.

ALM credit risk

Credit risks effect on asset return credit risk in asset-liability management (ALM) pertains to the potential for the banks borrower to default on its commitments in a way that is not predetermined, hence impacting the assets return.

Credit Rating of the Borrower: An ongoing assessment of the borrower's capacity to fulfill his financial commitments. Analyzing credit ratings, Financial accounts, and other pertinent data is part of this.

Monitoring and adjustment of credit risks: Credit risk is continuously monitored, with adjustment made to credit limits and contingencies for credit losses as needed. Asset Creditworthiness is also continuously evaluated.

Credit spread risk

Credit spread risk is the possibility that changes in the credit market will affect the interest rate differential between securities with varying credit quality.

Management techniques: Using credit derivatives to offset prospective losses, diversifying the credit portfolio, and keeping enough cash on hand to cover unforeseen losses are some examples of management strategies.

22.9 TECNHOLOGIES USED IN ASSET LIABILITY MANAGEMENT (ALM)

9.1. Software Tools

In the finance industry, asset liability management, or ALM focuses on controlling they risks associated with discrepancies between financial organizations assets and obligations. Important technology and software tools utilized in ALM include:

ALM Software Solutions:

- Asset Liability for Oracle financial Services Management: Oracle ALMSAS
- Asset and Liability Management: SAS ALM
- Mysis Fusion Risk: Fusion Risk

Risk Management Tools:

- Moody's Risk Frontier: Moody's Risk Frontier
- AxiomSL: AxiomSL

Business Intelligence and Analytics:

- Tableau: Tableau
- QlikView: QlikView

Data Management and Integration:

- Informatica: Informatica
- IBM InfoSphere Information Server: IBM InfoSphere

Simulation and Modeling:

- MATLAB: MATLAB
- R: R
- Python (with libraries like Pandas and NumPy): Python

Regulatory Reporting:

- Wolters Kluwer OneSumX: OneSumX
- AxiomSL: AxiomSL

Treasury Management Systems (TMS):

- FIS Quantum: FIS Quantum
- Calypso: Calypso

9.2. Data Analysis

In order to properly manage risks, Asset Liability Management (ALM) requires a great deal of data analysis. The following data analysis tools are frequently used in ALM, along with resources for more research:

Tableau: An effective tool for data visualization that allows financial institutions to produce shared and interactive dashboards.

QlikView: Provides business intelligence and capabilities for data visualization, allowing users to analyze and interpret complex data sets.

MATLAB: Frequently employed in quantitative analysis modeling, and simulation in finance, including ALM scenarios.

R: A programming language and software platform for statistical analysis and graphics, extensively used in financial analysis and risk management.

Python (with libraries like Pandas and NumPy): Python is adaptable for analyzing, manipulating and visualization, making it popular in financial analytics and ALM.

SAS: Provides advanced analytics, business intelligence, and data management solutions tailored for financial institutions.

IBM InfoSphere Information Server: Offers data integration, quality, and governance solutions crucial for managing and analyzing large datasets in ALM.

22.10 FUTURE TRENDS IN ASSET LIABILITY MANAGEMENT (ALM)

10.1. Emerging Risks

The Emerging Asset Liability Management (ALM) risks are constantly evolving as financial institutions navigate a complex environment. These are some important future trends and associated risks and references for further reading:

Climate Change Risks:

- Physical Risks: The impact of extreme weather events on physical assets.
- Transition risks: regulatory changes and market changes to sustainable investments..

Climate Change Risks Cyber Security:

Risks include data breaches, ransomware attacks and malfunctions.

Regulatory Changes:

Evolving regulations affecting solvency, liquidity and stress testing.

Financial Uncertainty:

Volatility in financial markets, interest rate volatility and macroeconomic changes.

Demographic changes:

The aging of the population affects pension liabilities and pension fund management.

Technological Innovation :

Risks to Innovation Fintech Adoption, AI and Blockchain in ALM.

Pandemics and Geopolitical Risks:

Impact of Global Pandemics, Geopolitical Tensions and Business Uncertainties: World (WHO) - COVID -19 sustainability: and ESG Integrating ESG criteria into ALM strategies and management of sustainability risks.

22.10.2.Innovations

Future trends in Asset Liability Management (ALM) are increasingly driven by innovations that improve risk management, operational efficiency and strategic decision-making. These are some important innovations influencing the course of ALM :

Advanced data analytics and artificial intelligence: Using machine learning and AI for predictive analytics in ALM, improving risk modeling and scenario analysis. Reference: McKinsey and Company - AI in Banking

Blockchain Technology: Implementing Blockchain to increase transparency, security and efficiency in asset and liability management processes. Reference: Deloitte - Blockchain in Financial Services

RegTech Solutions: Deploying Regulatory Technology (RegTech) to automate compliance tasks, simplify reporting and improve regulatory risk management. , including portfolio management and risk assessment. Reference: PwC - RegTech Trends

Quantum Computing:Exploration of quantum computing's potential to solve complex optimization problems in ALM, including portfolio management and risk assessment.Reference: IBM - Quantum Computing.

Cloud-based solutions:Migration towards cloud-based ALM platforms for scalability, agility, and cost-efficiency in managing a substantial amount of financial data.Reference: Gartner - Cloud Computing Trends.

Natural Language Processing (NLP):Integration of NLP for sentiment analysis, regulatory compliance, and gaining understanding from unstructured data in ALM.Reference: Forbes - NLP in Finance

Robotic Process Automation (RPA):Deployment of RPA to automate routine tasks in ALM operations, improving efficiency and reducing operational risks.Reference: UiPath - RPA in Banking

Digital Twins and Simulation Modeling: Using Digital Twins and Simulation Modeling to Make Real Copies. -world scenarios, optimize the allocation of assets and assess risks in ALM. Reference: Accenture - Digital Twins

22.11 SUMMARY

All three ALM risks are closely related. When choosing and using risk measures, the relationship between them must be considered. One should exercise caution while assuming anything regarding cross-domain risks, in particular credit risk, since they might be improper unless otherwise confirmed. Two significant developments that can generally improve risk management skills is the start of derivatives. Derivatives provide an unbalanced sheet opportunity to accurately hedge risks, immediately and in the most affordable manner. It is not unexpected that they are now central to our country. Many banks are adjusting their procedures and improving their frameworks to use these products. Undoubtedly, derivatives could change the banking landscape in the coming years, as has happened in several countries of the industrialized globe.

22.12 GLOSSARY

Asset-Liability Management (ALM): A strategic process to mitigate financial risks arising from differences between the assets and liabilities of an institution.

Interest rate risk: The risk that a change in interest rate will negatively affect the value of assets and liabilities and will affect the income and capital of the institution.

Liquidity risk: The risk that the institution will not be able to meet its short-term financial obligations, because it will not be able to convert money into cash quickly and without significant losses.

Currency risk: The risk of adverse changes in exchange rates affecting the value of assets and liabilities denominated in a foreign currency.

Gap Analysis:A technique used to compare the differences between maturity and revaluation dates of assets and liabilities to assess exposure to interest rate risk.

Duration: The sensitivity of the price of financial assets to changes in interest rates, expressed as a number of years.

Scenario analysis: The process of evaluating the potential impact of various hypothetical scenarios on the institution's financial position in order to identify vulnerabilities and prepare contingency plans.

Stress testing: A risk management tool used to assess the robustness of an institution's financial position under extreme but plausible adverse conditions.

Net interest income (NII): The difference between income from interest-bearing assets and the cost of servicing interest-bearing liabilities

Revaluation risk: The risk of changes in interest rates at the deadline of revaluation of assets and liabilities, which affects the net interest margin.

Yield curve: A graph that represents the interest rates of bonds with the same creditworthiness but different maturities and is used to analyze the term structure of interest rates.

Basic risk: The risk that the interest rates of different financial instruments or markets do not move in parallel, which affects the financial results of the institution

Liquidity Coverage Ratio (LCR): The standard by which financial institutions must hold sufficient high-quality liquid assets (HQLA) to cover their net cash flows during a 30-day stress period.

Solvency: The adequacy of an institution's capital in relation to its risk-weighted assets, which ensures that it can absorb reasonable losses.

Inoculation: A strategy to protect a portfolio from interest rate risk by matching the duration of assets and liabilities.

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22.15 TERMINAL QUESTIONS

1. Define liquidity risk and explain how it is managed in ALM.

2. Explain the concept of Asset Liability Management (ALM) and its importance in financial institutions.

3. Describe the process and importance of ALM gap analysis.

4. What is duration analysis and how does it help manage interest rate risk in ALM?

5. Appreciate the importance of scenario analysis and stress testing in ALM. Give examples of scenarios that can be tested.

6. Discuss the various risks managed using ALM and the techniques used to mitigate them.

7. Explain the role, scope and objectives of ALM.

8. How does liquidity risk arise and what are its components?

22.16 CASE STUDIES

Background:

Founded in 1965, British bank Northern Rock became one of the UK's largest mortgage lenders in the early 2000s. The bank was particularly known for its aggressive growth strategy, relying heavily on wholesale financing to expand its mortgage portfolio.However, this strategy led to a major liquidity crisis in 2007.

Growth Strategy:

Crowd funding: Northern Rock used the short-term crowdfunding market to finance its long-term mortgage. This approach allowed it to quickly grow its mortgage portfolio, outperforming traditional competitors who relied more on retail deposits.

Securitization: The bank also securitized its mortgages and sold them to investors as mortgage-backed securities (MBS). This increased liquidity but introduced significant complexity and risk.

Key ALM Issues:

1.Liquidity Risk:

Reliance on Wholesale Funding: The bank's reliance on short-term wholesale funding has created a mismatch with its long-term mortgage assets. The wholesale market can be very volatile and sensitive to market sentiment.

Market Conditions: In 2007, global financial markets began to experience turmoil due to the US subprime mortgage crisis. This led to a sharp decline in the availability of short-term financing.

2.Interest rate risk:

fixed vs. Variable: Many of Northern Rock's mortgages had a fixed interest rate, while financing costs fluctuated. This opened the bank to interest rate risk, where an increase in short-term interest rates could raise the cost of funds without a corresponding increase in mortgage income.

3.Credit Risk:

Loan Quality: Northern Rock's rapid expansion included lending to riskier borrowers. As the housing market began to weaken, the risk of default increased, affecting the quality of these mortgage securities.

4.Crisis Blows:

Market Panic: In September 2007, when the credit crunch took hold, the wholesale financial market froze. Northern Rock was unable to pay its short-term debt, leading to a liquidity crisis.

Bank Run: Liquidity problems quickly became public, causing a bank run. Customers who feared for their deposits had to withdraw their money. This exacerbated the liquidity crisis as the bank had to honor these statements with its limited liquid assets.

5.Regulations and Government Response:

Bank of England: The Bank of England engaged in emergency financing to provide liquidity support. However, this intervention was not enough to restore confidence.

Nationalization: In February 2008, after failing to find a private buyer, Northern Rock was nationalized by the UK government. It was the first nationalization of a British bank since the 1970s.

Lessons Learned:

1.Liquidity Management:

Decentralized Funding: Banks must maintain a decentralized financial base, relying not only on the wholesale market but also on stable retail deposits. A balanced mix of funding sources can provide resilience to market disruptions.

Liquidity buffers: Maintaining sufficient high quality liquid assets (HQLA) is critical to meet unexpected cash flow needs. Since then, regulatory frameworks such as the Liquidity Coverage Ratio (LCR) have been established to control this.

2.Interest Rate Risk Management:

Matching Durations: Properly matching the durations of assets and liabilities can reduce interest rate risk. The use of interest rate swaps and other derivatives can help align the interest rate profiles of assets and liabilities.

Dynamic ALM: Active monitoring and management of interest rates using techniques such as range and duration analysis is essential to adapt to changing market conditions.

3.Credit Risk Management:

Smart Lending: Adhering to strict credit standards and not compromising loan quality is critical to growth. This requires thorough credit evaluation and stress testing of loan portfolios.

Securities Practices: Transparency and proper risk assessment of securities practices are critical. The structure of securitized assets should ensure that they do not excessively expose the institution to market and credit risks.

4.Regulatory Oversight:

Strengthened Regulation: The post-crisis regulatory framework has been significantly improved. Institutions must now maintain higher capital ratios and more effective risk management.

Stress testing: Regular stress testing under various scenarios is now standard practice to ensure institutions' ability to withstand financial shocks.

Conclusion:

The Northern Rock crisis is a key case study in asset-liability management, highlighting the critical importance of liquidity, interest rate and credit risk management. The failure of Northern Rock underscores the need for strong ALM practices, diverse funding sources and strong regulatory oversight to ensure the stability and sustainability of financial institutions.

UNIT 23 INSURANCE SERVICES, BANCASSURANCE AND REINSURANCE

23.1 INTRODUCTION

Insurance is a contract between two parties in which one commits to pay for the other party's loss in exchange for a predetermined amount known as a "premium". The party promising to pay is called the "insurance company", and the people or property at risk are called the "insured". An insurance policy is the agreement that provides for insurance coverage. In the previous unit you learnt about the asset liability management. In this unit you will learn about the meaning, principles and advantages of insurance and you will also study about the kinds of insurance, importance of bancassurance and reinsurance and various tax benefits of insurance

23.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the meaning of insurance
- Explain the principles of insurance.
- Describe the advantages of insurance.
- Classify the kinds of insurance.
- Differentiate between life, fire, and marine insurance.
- Analyze the importance Bancassurance and Reinsurance.
- Describe the tax benefits of insurance.

23.3 INSURANCE: MEANING AND DEFINITION

Insurance is a contract between two parties against specified risks in exchange for payment. The payment made by one party in exchange of risk is known as premium. The fundamental purpose of insurance is to mitigate the financial impact of unexpected events or losses. There are some risks which can be transferred to specialized institutions known as insurance companies. Here's a breakdown of its key components:

Components of Insurance

1. **Protection**: Insurance offers coverage against risks such as accidents, natural disasters, illness, and death, among others. It acts as a safety net by compensating policyholders for losses incurred under covered circumstances.
2. **Premium**: The amount that the policyholder must pay to the insurance provider on a regular basis in order to keep coverage is called premium. The quantity of the insurance premium is decided by criteria such as the level of coverage and the degree of risk insured.
3. **Policy**: A contract between the insurer (insurance company) and the insured (policy owner) that outlines the terms and conditions of insurance coverage. It defines what is covered, limitations, exclusions and limitations for both parties.
4. **Risk Pooling:** Insurance operates on the principle of pooling risk. Many individuals or entities pay premiums into a pool, out of which claims are paid to those who experience covered losses. This spreads the financial impact of losses across a larger group, making it more manageable for individual policyholders.
5. **Types of Insurance**: There are various types of insurance tailored to different needs, such as life insurance, health insurance, property insurance (including home and car insurance), liability insurance, and more specialized forms like travel insurance or pet insurance.

Overall, insurance provides peace of mind by transferring the financial burden of certain risks from the insured to the insurer, in exchange for a predictable premium payment. This helps individuals and businesses manage uncertainty and protect their assets and financial well-being.

23.3.1 Insurance Policy

A formal written document that includes the insurance contract's terms and conditions is known as insurance policy. The insurer issues the policy to the policyholder. It is stamped and duly signed by the insurer. In case of marine insurance, contract of insurance shall not be valid unless it is evidenced by a formal marine policy. In the case of other kinds of insurance the existence of a policy is not necessary for the validity of a contract of insurance. Though the policy is not signed by the insurer yet he is bound by it and can also enforce his rights under it provided he has done everything required of him.

23.3.2 Insurance versus Gambling

Insurance is generally confused with gabling he system of work in both the cases is similar but the object is different.

S. N.	Insurance	Gambling
1	In insurance, the unfortunate one is paid to compensate the loss.	In gambling, a lucky person gets the money. It is meant for a notable cause
2	The purpose of insurance is to protect the insured from losses caused by unknown events.	The goal of gambling is to make speculative gains.
3	A contract of insurance is enforceable by law.	Gambling being opposed to public policy is not enforceable by law.
4	In insurance the loss or damage caused by an insured event may vary.	In gambling, the amount won or lost is fixed.

23.3.3 Insurance and Assurance

Generally, the words insurance and assurance are considered to mean the same thing but their meaning is different.

S. N.	Insurance	Assurance
1	The word insurance is used for fire and marine insurance.	The word assurance is used for life assurance policies.
2	As per the provisions of the insurance arrangement, the risk is unclear, and liability may or may not emerge.	The contract of assurance states that the guaranteed must be paid sooner or later.
3	In insurance contract, the sum assured will be payable only if there is loss. If a factory godown is insured against	Under life assurance the payment is made either on maturity or on the death of the insured, whichever is earlier.

	fire and in case godown is destroyed by fire, then a liability will arise.	
4	The liability under insurance contract may or may not arise.	The company will have to make the payment of the policy, it is only a question of time.

23.4 PRINCIPLES OF INSURANCE

The insurance principles are fundamental criteria that regulate how insurance contracts work and the relationship between the insurer (insurance company) and the insured (policyholder). These principles ensure that the insurance sector operates fairly, transparently, and reliably. Here are the key principles:

1. **Utmost Good Faith (Uberrimae Fidei):** In this contract, it is generally relies that both parties behaving in good faith. This notion requires both the insurer and the insured to provide all necessary information regarding the insurance contract in a truthful and thorough manner. The insured must submit accurate information regarding the risk being insured, while the insurer must supply all relevant policy terms and conditions. Any material facts that are suppressed or misrepresented may invalidate the policy.

2. **Insurable Interest**: Another important principle of the insurance is that there must have a legitimate financial interest of the insured in the subject matter of the insurance policy. The ownership of the property is not necessary for establishing insurable interest. Without insurable interest the insurance contract is void.

3. **Indemnity**: This principle guarantees that a person with insurance will only receive financial compensation equal to their actual financial loss. Except life insurance, it applies to all types of insurance. In the event of a loss, indemnity is a guarantee to compensate the loss only and the basic purpose of the insurance is to compensate the insured not to provide profit for them.

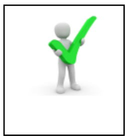
4. **Proximate Cause**: The cause of the loss that triggers coverage under the insurance policy is determines under this principle. The insurance policy typically covers losses that are directly caused by covered perils or events. It excludes losses caused by unrelated or remote events.

5. **Contribution**: The principle of contribution applies when an insured person has multiple insurance policies that cover the same risk. If the insured gets compensation from one insurer, they are unable to earn profit by claiming the identical loss from another. Each insurer pays a proportionate share of the loss based on the sum insured under their respective policies.

6. **Subrogation**: This principle applies to all types of insurance except life insurance. If the insured party receives compensation for his loss, he cannot recover the same amount from any other party. This principle ensures that the insured does not receive more than the actual loss incurred.

7. **Loss Minimization**: After an insured event happens, the policyholder should make reasonable efforts to reduce losses and safeguard the insured property from additional harm. If they fail to do so, the insurer may offer less compensation.

The purpose of these principles ensure that all the insurance contracts are fair and effective. They form the basis for the legal and ethical framework within which insurance operates globally.



Check Your Progress-A

Q1. Explain the meaning of term ‘Insurance’.

Q2. Distinguish between Insurance and Assurance.

Q3. Describe the components of insurance.

Q4. What are the various principles of insurance?

Q5. Fill in the Blanks with appropriate word or words.

I. ……………………….. is a financial arrangement that provides protection against specified risks in exchange for payment.
II. ………………. defines the terms and conditions of the insurance coverage.
III. The principle of ……………………… ensures that an insured person receives compensation (financial reimbursement) only to the extent of their actual financial loss.
IV. The object of …………………….. is to earn speculative gains.
V. The word …………………………. is used for life assurance policies.

23.5 ADVANTAGES OF INSURANCE

Insurance offers several advantages to individuals, businesses, and society as a whole. Here are some key advantages:

1. **Financial Security and Stability**: There is always a fear of sudden loss. There may be a fire in the factory, storm in sea or loss of a life. It becomes very difficult to bear the loss in all these cases. It assists individuals and businesses in reducing the financial effect of these disasters by providing compensation or reimbursement for covered losses. This stability helps people to plan for the future without worrying about major financial setbacks.

2. **Risk Management**: To distribute risk over a wide number of people is the fundamental principle of insurance. A huge number of people purchase insurance plans and pay premiums to their insurer. Insurance enables individuals and businesses to transfer the risk of potential losses to an insurance company. By paying a relatively small premium, policyholders can protect themselves against potentially large and unforeseen expenses. This risk management function is crucial for businesses, allowing them to operate with confidence and pursue growth opportunities.

3. **Promotes Savings and Investment**: Insurance not only protects against dangers, but also serves as an investment avenue. Insurance encourages savings and investment by offering long-term financial planning products such as life insurance and retirement annuities. Policyholders contribute premiums regularly, which are then invested by the insurance company. This not only builds a financial cushion for the insured but also contributes to economic growth by channeling funds into productive investments.

4. **Supports Economic Growth:** Insurance plays a vital role in economic development by providing stability and security to businesses and individuals. Insured businesses are more likely to recover quickly from unexpected losses, maintain operations, and

continue contributing to the economy. Insurance also facilitates international trade by mitigating risks associated with goods in transit and promoting confidence among trading partners. International trade involves many risks in transporting goods from one country to another. In the absence of insurance policies the traders will always be worried for the safe arrival of goods.

5. **Encourages Risk-Taking and Innovation**: Insurance reduces the fear of failure associated with taking risks, thereby encouraging entrepreneurship and innovation.
6. **Social Stability and Peace of Mind**: Assurance regarding necessary medical care, repair or replace damaged property, and maintain their standard of living during difficult times provides peace of mind to individuals and families. This stability fosters healthier communities and reduces societal burden on public assistance programs.
7. **Legal and Contractual Requirements**: In many cases, insurance is a legal or contractual requirement. For example, drivers are typically required to have car insurance to operate a vehicle legally. Similarly, lenders often require insurance coverage to protect their investments in homes, businesses, or other financed assets.

Overall, insurance is a critical component of modern economies, offering protection, stability, and opportunity for individuals, businesses, and society at large. Hence, insurance enables effective risk management, promotes economic growth, and improves general quality of life by offering security and peace of mind.

23.6 KINDS OF INSURANCE

It covers a wide range of risks and purposes, resulting in numerous insurance products. Some of the most common types of insurance are as follows:

1. Life Insurance:

In the case of the insured's death, it pays monetary benefits to beneficiaries. Life insurance also It can assists by replace the lost income and pay off debts etc. Term life insurance, whole life insurance, universal life insurance, and variable life insurance are the classification of life insurannce.

2. Health Insurance:

Health insurance covers medical expenses incurred by the insured, such as hospitalization, surgery, prescription drugs, and preventive treatment. It assists people and families in managing the high costs of healthcare and provides access to vital medical services without financial hardship. Employers can provide health insurance or employees might acquire it on their own.

3. Property Insurance:

Property insurance protects against damage to or loss of physical property, such as homes, buildings, vehicles, and personal belongings. It typically covers risks like fire, theft, vandalism, and natural disasters. Types of property insurance include homeowners insurance, renters insurance, flood insurance, earthquake insurance, and automobile insurance.

4. Workmen's Compensation Insurance:

In case of worker is injured or killed during the course of his work, the employer is supposed to provide compensation to him or his legal representatives. The resources of the employer are drained if more accidents take place. The employer can purchase insurance policy for workers under Workmen Compensation Act, 1924. The premium is payable according to the wages paid to the workers. In case of an accident, the insurance company pays the claim instead of the employer. The Workmen Compensation Act has made it compulsory for the employers to take such a policy.

5. Business Insurance:

Business insurance is designed to protect businesses from financial losses resulting from various risks and liabilities. It includes coverage for property damage, business interruption, liability claims, employee injuries, and other specific risks depending on the industry and operations of the business.

6. Travel Insurance:

Travel insurance offers coverage for unexpected incidents that may occur while traveling, such as trip cancellation or interruption, medical emergencies abroad, lost luggage, and travel delays. It offers peace of mind and financial protection for travelers, whether for business or leisure purposes.

7. Motor Insurance:

All public and private vehicles can be insured under motor insurance. These policies cover risk of theft, damage, floods etc. In case of damage of the vehicle the insurance company compensates such loss. Motor insurance policy covers loss to third party also. A third party is a person who or whose vehicle is involved in an accident and who lodges a claim for this loss.

8. Personal Accident Insurance:

The loss in this policy must be accident and not attentional.

The insurance policy covers a variety of subjects as mentioned above but commonly used insurance policies relate to the following subjects are:

1. Life Insurance
2. Marine Insurance
3. Fire Insurance

1. **Life Insurance**

It is "a contract in which the insurer, in exchange for a premium, promise to pay an annuity or a specified sum of money, either on the insured's death or at the end of a stipulated number of years." It is available in a variety of forms to its users which has their own features and benefits.

General Principles of Life Insurance:

There are two fundamental principles of life insurance: (1) Utmost good faith, and (2) Insurable interest. It means that the insured must be honest and truthful when presenting information to the insurance company and he/she must have an insurable interest in the life of the individual for whom the policy is issued.

Types of Life Insurance:

1. **Term Life Insurance**: This kind of insurance covers a specific number of years, i.e. 1ten, twenty, or thirty years. If the insured dies during the time, the beneficiaries will get the death benefit. As far as permanent life insurance is concerned, it is less expensive because it does not accumulate monetary value. Premiums remain unchanged during the duration of the term is another feature of this type of insurance.
2. **Whole Life Insurance**: In this type of life insurance one can avail the coverage for the insured's entire life as long as payments are made. One can also avail the benefit of tax-free as the cash value grows.
3. **Variable Life Insurance**: Variable life insurance provides both a death benefit and a cash value component that can be invested in a variety of sub-accounts, much like mutual funds. Cash value and death benefit can fluctuate based on the performance of the underlying investments. Policyholders bear investment risks but also have the potential for higher returns.
4. **Family Protection Assurance Policy:** This policy is beneficial to those who have responsibilities of their families and those who wish to provide for their relatives in the event of an early death. On the death of a person before the specified time period, the family receives a lump sum payment immediately.

Benefits of Life Insurance:

1. **Income Replacement**: There is a facility of financial security for dependents by replacing the insured's income in the event of early death. To meet their living expenses, debts, and future financial obligations, beneficiaries are given a lump sum payout (death benefit).
2. **Debt Repayment**: Its benefits can be used to pay off current debts, such as mortgages, loans, or credit card amounts, which ensuring that dependents are not saddled with financial commitments.

3. **Estate Planning**: It allows for the distribution of wealth and assets to its beneficiaries, which can help them to pay estate taxes and ensure that inheritances are distributed in accordance with the insured's wishes.

4. **Business Continuity**: In business contexts, life insurance can fund buy-sell agreements, key person insurance, or provide funds for business succession planning. It ensures that a business can continue operations and manage transitions smoothly in the event of the death of a key stakeholder.

5. **Tax Advantages**: Life insurance may offer tax benefits, such as tax-deferred growth of cash value and tax-free death benefits paid to beneficiaries. However, the tax treatment depends on the type of policy and individual circumstances.

6. **Peace of Mind**: Without worrying about the financial consequences of unforeseen events, people having life insurance can focus on their tasks and goals, which gives them peace of mind.

7. **Helpful in Education and Marriages**: An insurance policy can be helpful in providing funds for educational purposes and at marriages also. The policies are purchased for such time that they mature at a time when money is needed.

Life insurance is a crucial component of financial planning, providing protection and security to individuals, families, and businesses. Choosing the right type and amount of life insurance depends on factors such as financial goals, family needs, budget, and personal circumstances.

2. Marine Insurance

Marine insurance concerned with overseas trade. It is one of the oldest forms of insurance. International trade involves transportation of goods from one country to another country by ships. Insurance in the marine industry is a specific area of coverage that encompasses the potential loss or harm to ships, cargo, terminals, and any mode of transportation used for the transfer, acquisition, or storage of goods between the starting point and the end destination. It is essential for businesses involved in maritime activities, providing financial protection against various risks associated with sea travel and transport. Marine insurance has two branches i) Ocean Marine Insurance and ii) Inland Marine Insurance.

Principles of Marine Insurance:

Generally, all types of insurance have the same principles. Absolute good faith, insurable interest, indemnification, and causa proxima are some of the concepts which includes in marine insurance.

Types of Marine Insurance:

1. **Hull Insurance**: Covers physical damage to the ship or vessel.

2. **Cargo Insurance**: Protects the goods or merchandise being transported.

3. **Freight Insurance**: Ensures that the shipping company gets paid for the freight charges in case the goods are lost or damaged.

4. **Liability Insurance**: Covers legal liabilities arising from bodily injury or property damage to third parties.

Kinds of Martine Policies:

To cover a variety of risks, there are several maritime insurance policies. Following are the main policies:

1. **Voyage Policy:** In this policy the risk covers from the port of departure till the port of arrival. This type of policy is commonly purchased for freight and it expires when the ship reaches its designated port.
2. **Time Policy:** This policy is only applicable for a certain time period. All maritime risks are insured throughout the duration of the policy. Policy like this is suitable for full insurance. Under this policy, the ship is insured for a set period of time, regardless of the route.
3. **Valued Policy:** In this policy, the value of the policy is calculated at the time of contract and its value is displayed on the policy's face.
4. **Floating Policy:** One must obtain a marine policy each time, when a person ships goods on regularly basis in a specific geographical area. It requires a significant amount of time and formalities. To avoid this, he buys a policy for a lump sum without specifying the value of the goods or the name of the ship, etc.
5. **Block Policy:** Sometimes a policy is issued to cover both land and sea risks. One single policy can be issued to cover risks from the point of dispatch to the point of ultimate arrival. This policy is called a block policy.
6. **Wager Policy:** One who has no insurable interest in the topic insured, he prefer to owned wager policy. He is simply betting or gambling with the underwriter.
7. **Fleet Policy:** A policy may be taken up for one ship or for the whole fleet. If it is taken for each ship, it is called as single vessel policy. When a company purchases one policy for all its ships, it is called a fleet policy.

Coverage and Exclusions:

Coverage: The list of coverage are as follows:

- Perils of the sea (storms, waves, etc.)
- Fire, explosion
- Theft, piracy
- Jettison (throwing cargo overboard to save the ship)
- Collision

Exclusions: The list of exclusions are as follows:

- Acts of war
- Piracy in some cases
- Wear and tear
- Deliberate damage by the ship's owner

Clauses in Marine Insurance:

1. **Institute Cargo Clauses (ICC):** Standardized terms set by the International Underwriting Association. Types include ICC(A), ICC(B), and ICC(C), offering varying levels of coverage.

2. **Sue and Labor Clause**: Requires the insured to take reasonable measures to minimize the loss.

3. **General Average**: Losses and expenses are shared among all cargo owners in the event of a major sacrifice for the safety of the vessel.

Importance of Marine Insurance:

Risk Mitigation: It protects against financial loss due to maritime risks.

Legal Requirement: It is often required by law or contractual obligations.

Trade Facilitation: It enhances confidence in international trade by providing security against potential losses.

Claims Process: The claim process in Marine Insurance is as follows:

1. **Notification**: There is immediate notification to the insurer in case of an incident.
2. **Survey and Assessment**: A surveyor assesses the extent of the damage or loss.
3. **Documentation**: There is submission of required documents such as the insurance policy, bill of lading, and survey report.
4. **Settlement**: According to the provisions of the insurance, the insurer compensates for the loss or damage.

It is essential for businesses involved in maritime trade to have a good grasp of marine insurance in order to protect themselves from the natural risks of the sea.

3. Fire Insurance

Insurance against fire was established subsequent to insurance related to maritime activities. The utility of maritime insurance was limited to individuals involved in trade. The devastation caused by fire affected individuals from all different backgrounds. Under fire insurance, the property must have been damaged or destroyed by fire. To protect property owners from financial losses caused by fire-related incidents, there is need of fire insurance.

Kinds of Fire Insurance Policies:

Kinds of policies that generally issued for fire insurance are as follows:

1. **Specific Policy**: This policy provides insurance coverage for a particular amount of risk. If the property incurs a loss that is lower than the designated sum, the insurer will make the payment.
2. **Floating Policy**: A floating policy is taken up to covet the risk of goods lying at different places. The goods should belong to the same person and one policy will cover the risk of all these goods. This policy is useful to those businessmen who are engaged in import and export of goods and goods lie in warehouses at different places.
3. **Comprehensive Policy**: A policy may be taken up to cover up all types of risks, including fire. A policy may be issued to cover risk like fire, explosion, lightening, burglary, riots, labour disturbances etc.

Features: Following are the features of fire insurance:

1. **Basic Coverage**: Fire insurance typically covers damage to the insured property caused directly by fire, including flames, smoke, and soot. It may also cover damage caused by firefighting efforts, such as water damage.
2. **Additional Perils**: Some fire insurance policies may include coverage for additional perils related to fire, such as lightning strikes, explosions, riots, civil commotion, and vandalism. It's important to check the policy details for specific covered perils.
3. **Exclusions**: Fire insurance coverage often exclude damage caused by war, nuclear incidents, intentional acts, and natural disasters such as earthquakes or floods. These exclusions may differ based on the insurer and policy terms.
4. **Coverage Limits**: In fire insurance, the coverage limit of a fire insurance policy is the maximum amount that the insurer will pay for covered damages. It becomes the duty of the property owners to ensure that the coverage limit is sufficient for the value of their property and its contents.
5. **Deductibles**: A deductible is the amount of money that the insured must pay out of pocket before their insurance coverage begins. Higher deductibles can lead to reduced premiums, as a result the insured must bear a greater portion of the initial cost in the event of a claim.
6. **Cost of Rebuilding or Repairing**: Fire insurance generally includes the expenses for reconstructing or fixing the affected property within the limits specified in the policy. It may encompass repairing the structure, replacing possessions, and covering the costs for cleaning up after fire damage.

Importance and Benefits:

1. **Financial Protection**: Insurance for fire offers financial security to property owners in case they need to cover the expensive expenses of repairing or

reconstructing a property that has been damaged by fire. It helps mitigate the financial impact and allows property owners to recover more quickly.

2. **Legal and Lender Requirements**: Fire insurance is often mandated by either law or mortgage lenders as a prerequisite for securing a mortgage loan. Lenders want to ensure that their financial interest in the property is protected in case of fire damage.

3. **Peace of Mind**: Fire insurance provides property owners with piece of mind by ensuring that they have a safety net in place to deal with unforeseen fire-related losses. It enables individuals to concentrate on other elements of home ownership without concern for financial hazards.

4. **Business Continuity**: Fire insurance is critical for businesses to ensure their activities continue. It assures that the company can quickly recover from fire damage, restart normal operations, and reduce delays to revenue and customer service.

5. **Risk Management**: Property owners and businesses rely on fire insurance as an essential part of their risk management strategy. It helps them transfer the risk of fire-related losses to an insurance company, reducing their exposure to financial uncertainties.

In conclusion, fire insurance plays a vital role in protecting property owners from the financial consequences of fire damage. It offers essential coverage against fire-related risks, ensuring that property owners can recover and rebuild after such incidents.

23.7 DIFFERENCE BETWEEN LIFE INSURANCE, FIRE INSURANCE AND MARINE INSURANCE

Basis of Difference	Life Insurance	Fire Insurance	Marine Insurance
1. Nature of Risk	The risk is certain in life.	The risk is not certain.	There may be or may not be a chance of risk.
2. Object	To secure the future by making investments is the basic object of life insurance.	To provide security in the event of a loss is the object of fire insurance.	The object of marine insurance is to be compensated in the event of loss or damage.

3. Time	The policy is generally of a longer period, say 10, 15, 20 years or even for the whole life.	Fire insurance policy is not a short period. Generally, the period is one year after which it is rendered.	The policy is for a short period, generally a year.
4. Premium	The policy is determined based on the insured's age and the duration of the policy.	According to the level of risk, the premium is calculated.	According to the nature of the risk, the premium is calculated.
5. Insurable Interest	The insurable interest must be present at the time of policy purchase.	The insurable interest must be present both at the time of contract and when the loss occurs.	The insurable interest must exist when the loss happens.
6. Compensation	In this case loss is not compensated, instead a fixed amount of money is paid.	In this case actual loss is compensated.	The amount of compensation can be more than the loss. A profit of 10 to 15% is added to the actual loss.
7. Surrender of Policy	The policy can be surrendered before its maturity. Insurance company is relieved of the liability and it returns some money known as surrender value.	The policy cannot be returned.	Marine insurance policy cannot be surrendered.
8. Moral Obligation	The moral obligation of the insured is less because nobody commits suicide to get insurance money.	The insured is under moral obligation to protect0 the goods insured. A person may sets the goods on fire in order to get insurance money.	There is no moral obligation because goods insured are on the sea.

9. Payment of Premium	The premium is paid on instalments.	The payment of premium is in lump sum payment.	The premium is paid on lump sum payment.

23.8 BANCASSURANCE

Bancassurance is a partnership between a bank and an insurance company, allowing the insurance company to sell its products to the bank's customer base. This model leverages the extensive network and customer relationships of banks to distribute insurance products, providing benefits to both the bank and the insurance company, as well as convenience for customers.

Key Features of Bancassurance:

1. **Distribution Channels:**
    - Banks offer insurance products through their branches, online platforms, and other customer touchpoints.
    - Banks' employees are often trained to provide information and sell insurance products.
2. **Product Range:**
    - **Life Insurance:** Term life, whole life, endowment plans, unit-linked insurance plans (ULIPs), etc.
    - **General Insurance:** Health, home, auto, travel, and other non-life insurance products.
3. **Integrated Services:**
    - Banks and insurance companies integrate their services to offer seamless financial solutions.
    - Customers can manage their banking and insurance needs under one roof.

Benefits of Bancassurance:

1. **For Banks:**
    - **Additional Revenue**: Banks earn commissions from selling insurance products.
    - **Enhanced Customer Loyalty**: Offering a wider range of financial products can increase customer satisfaction and retention.
    - **Diversification**: It adds a new revenue stream, reducing reliance on traditional banking activities.

2. **For Insurance Companies:**

- **Extended Reach**: It helps in accessing a large and diverse customer base without the need to establish a separate distribution network.
- **Cost-Effective**: It reduces the costs associated with establishing branches and hiring agents.
- **Brand Trust**: Benefit from the credibility and trust that customers have in the bank.

3. **For Customers:**

- **Convenience**: It provides one-stop shop for banking and insurance needs.
- **Comprehensive Financial Planning**: It makes easier to manage finances and insurance under a single umbrella.
- **Trust:** Customers often trust their banks and feel more comfortable buying insurance products through them.

Models of Bancassurance:

1. **Full Integration Model**: Banks and insurance companies fully integrate their services, often co-developing products and sharing operational functions.
2. **Strategic Alliance Model**: Banks and insurance companies enter into a partnership where they remain separate entities but collaborate closely on product distribution and marketing.
3. **Referral Model**: Banks refer customers to the insurance company, which handles all aspects of the insurance transaction.
4. **Non-Exclusive Partnership Model**: Banks partner with multiple insurance companies to offer a variety of products to their customers.

Challenges and Considerations:

- **Regulatory Compliance**: Adhering to regulatory requirements in both the banking and insurance sectors.
- **Customer Education**: Ensuring that bank staff are adequately trained to advise on insurance products.
- **Integration**: The bank and insurance company's systems and processes are effectively integrated.
- **Conflicts of Interest**: Managing potential conflicts of interest so that customers obtain unbiased advice.

The bancassurance model has gained attraction worldwide, providing a mutually beneficial scenario for banks, insurance firms, and customers. It helps in expanding the reach of insurance services and provides customers with a convenient and integrated approach to managing their financial needs.

23.9 REINSURANCE

Reinsurance is a financial arrangement where an insurance company (the ceding company) transfers part of its risk portfolio to another insurance company (the reinsurer). This process helps insurance companies manage risk, stabilize their financial performance, and increase their capacity to underwrite more policies. Reinsurance is essential in the insurance industry as it provides a safety net for insurers, ensuring they can meet large claims without jeopardizing their financial stability.

Types of Reinsurance:

1. **Proportional (Pro Rata) Reinsurance:**
   - **Quota Share**: The ceding company and reinsurer share premiums and losses based on a fixed percentage.
   - **Surplus Share**: The ceding company maintains a set level of risk, while the reinsurer is responsible for the surplus. If a policy surpasses the retention limit, the extra part is transferred to the reinsurer.
2. **Non-Proportional (Excess of Loss) Reinsurance:**
   - **Per Risk Excess of Loss**: In this type of reinsurance, it Covers individual risks that exceed a predetermined limit.
   - **Aggregate Excess of Loss**: Covers losses that surpass a predetermined aggregate amount over a specific time period.

Benefits of Reinsurance:

1. **Risk Management**: It reduces the risk of large losses from significant claims or catastrophic events and helps to maintain financial stability and solvency.
2. **Capacity Expansion**: It allows insurance companies to underwrite more policies and larger risks than they could on their own and enhances the ability to enter new markets or lines of business.
3. **Capital Relief**: It frees up capital that would otherwise be held to cover potential large losses and enables insurers to use their capital more efficiently.
4. **Underwriting Support:** It provides expertise and support from reinsurers, helping insurers improve their underwriting practices and access to advanced risk assessment tools and analytics.

Reinsurance Contracts:

1. **Treaty Reinsurance:** A reinsurance agreement that covers a portfolio of risks automatically, without individual underwriting and commonly used for a specific line of business or geographic area.

2. **Facultative Reinsurance:** A reinsurance agreement for individual risks, negotiated separately and it is used for large or unusual risks that do not fit within the terms of a treaty reinsurance agreement.

Reinsurance Process:

1. **Negotiation and Agreement**: The ceding company and reinsurer negotiate terms, including coverage limits, premiums, and exclusions.
2. **Premium Payment:** The reinsurer receives a premium from the ceding company according to the agreed-upon terms.
3. **Claims Handling:** In the event of a claim, the ceding company handles the initial claim process and then seeks reimbursement from the reinsurer for the covered portion.
4. **Periodic Review:** Regular review and adjustment of reinsurance agreements to ensure they meet the changing needs and risk profiles of the ceding company.

23.10 TAX BENEFITS OF INSURANCE

Insurance products often come with various tax benefits, which can make them more attractive to consumers. These advantages may differ depending on the type of insurance and the jurisdiction. Below are some frequent tax benefits associated with various types of insurance:

Life Insurance:

1. **Premium Payments**: In many countries, life insurance premiums are tax deductible up to a certain amount. Premiums for life insurance policies in India can be deducted under Section 80C of the Income Tax Act.
2. **Maturity Benefits**: The maturity proceeds from a life insurance policy are frequently tax deductible, providing certain conditions are met.
3. **Death Benefits:** In the case of the death benefit received by beneficiaries, there is provision of exemption from income tax.

Health Insurance:

1. **Premium Payments:**

   Tax Deduction: Premiums paid for health insurance policies are often tax-deductible. For instance, in the U.S., premiums paid for qualified health plans can be deducted if they exceed a certain percentage of adjusted gross income (AGI).

   Health Savings Account (HSA): Contributions to an HSA are tax-deductible, and withdrawals for qualified medical expenses are tax-free.

2. **Medical Expenses:**

Tax Deduction: Unreimbursed medical expenses that exceed a certain percentage of AGI can be deducted from taxable income.

Business Insurance:

1. **Premium Payments**:

   Tax Deduction: Premiums paid for business-related insurance (such as liability, property, and workers' compensation insurance) are typically deductible as business expenses.

2. **Health Insurance for Employees**:

   Tax Deduction: Employers can deduct premiums paid for employees' health insurance. Additionally, there may be tax credits available for small businesses providing health insurance to employees.

Key Considerations:

1. **Policy Structure**: Tax benefits may vary depending on the insurance policy's structure. Therefore, it is essential to understand the policy's terms and conditions, as well as their influence on tax treatment.
2. **Jurisdictional Differences**: Tax laws vary significantly by country and sometimes by state or region within a country. It's crucial to consult with a tax advisor or financial planner familiar with local tax laws.
3. **Documentation**: Proper documentation and record-keeping are essential to claim tax benefits. Ensure all premium payments, claims, and related expenses are well-documented.
4. **Limits and Caps**: Be aware of the limits and caps on deductions and exemptions. Tax benefits often come with specific thresholds that must be met to qualify.

Insurance products not only provide financial protection but also offer valuable tax benefits that can enhance their overall value. Understanding these benefits and how to maximize them can lead to significant tax savings.

Check Your Progress-B

Q1. Explain the advantages of insurance.

Q2. What are the basic difference between life insurance, fire insurance and marine insurance?

Q3. What do you mean by the term 'Bancassurance' and 'Reinsurance'?

Q4. What are the various tax benefits of insurance?

Q5. Fill in the Blanks with appropriate word or words.

I. In Life insurance …………………… policy is useful for those persons who have large dependent families and want to make provisions for their families in case of early death.

II. In fire insurance ……………………………… policy is taken up to covet the risk of goods lying at different places.

III. In …………………… loss is not compensated, instead a fixed amount of money is paid.

IV. The premiums for life insurance policies are eligible for deduction according to Section ……… of the Income Tax Act.

23.11 SUMMARY

Insurance is a financial arrangement that provides protection against potential future losses or risks. The key components of insurance are policyholder, insurer, premium, coverage, claim, deductible and limit. Health insurance, fire insurance, marine insurance, life insurance, auto insurance, travel insurance, disability insurance, business insurance and homeowners insurance are the main types of insurance. It provides peace of mind by mitigating financial risks and helping individuals and businesses recover from unexpected events. Insurers assess the level of risk associated with providing coverage to an individual or entity. It operates on the principle of risk pooling, where premiums from many policyholders are collected to pay for the losses of a few. When a loss occurs, the policyholder files a claim with the insurer. The insurer evaluates the claim and, if valid, pays out according to the policy terms.

The future of insurance is expected to be shaped by technological advancements, changing consumer expectations, and evolving risks. It will also be characterized by increased reliance on technology, greater focus on customer needs, and the ability to adapt to emerging risks. Insurers that embrace innovation and proactively respond to these trends are likely to succeed in this evolving landscape.

23.12 GLOSSARY

Insurance: It is a financial arrangement that provides protection against financial loss or risk.

Assurance: A level of certainty and reliability in fulfilling promises or achieving specific outcomes.

Subrogation: It refers to an insurance company's right to seek a third party who caused an insurance loss for the insured.

Premium: The amount of money the insured pays to the insurer, usually on a regular basis.

Insurable Interest: The legal or financial interest that an individual or corporation has in the continued existence, preservation, or safety of the insured person or property.

Bancassurance*:* It describes a collaboration or agreement between a bank and an insurance company in which the bank vends the insurance company's products to its clients.

Reinsurance: A process where an insurance company (known as the "ceding company" or "primary insurer") transfers part of its risk portfolio to another insurance company (called the "reinsurer").

23.13 ANSWER TO CHECK YOUR PROGRESS

Check Your Progress –A

Q5.

i. Insurance ii. Policy iii. Indemnity iv. Gambling v. Assurance

Check Your Progress –B

Q5. i. Family Protection Assurance, ii. Floating, iii. Life Insurance iv. 80C

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23.15 SUGGESTED READINGS

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3. "Fundamentals of Risk and Insurance" by Emmett J. Vaughan and Therese Vaughan
4. "The Economics of Insurance" by Harold D. Skipper and W. Jean Kwon
5. "Risk Management and Insurance" by Scott Harrington and Gregory Niehaus
6. Risk Management and Insurance by Williams, Jr., Smith and Young (Published by McGraw Hill International Editions)

23.16 TERMINAL QUESTIONS

1. What are the advantages of insurance?
2. Explain the principles of insurance.
3. Define life insurance and discuss the main features of life insurance.
4. Explain the principle of utmost good faith in life insurance.
5. Explain various classification of life insurance.
6. Distinguish between insurance and gambling.
7. Distinguish between Re-insurance and Double-insurance.
8. What do you understand by insurance? Give the importance of insurance in the present context.
9. Who is meant by marine insurance? How is it useful for the trade? Explain various types of marine insurance policies.
10. Who do understand by fire insurance? What are its characteristics?
11. Explain the kinds of policies that are generally issued for life insurance contracts.
12. What is the importance of ‘insurable interest’ in a marine insurance policy? What can have an insurable interest in a marine insurance?
13. Explain the procedure followed for acquiring a life insurance policy.
14. Describe important types of miscellaneous insurance policies.
15. What are the various tax benefits of insurance?
16. “Life insurance involves protection as well as investment while fire insurance is a contract of indemnity”. Explain.
17. What are the benefits of Insurance?
18. Distinguish the differences between Life Insurance and General Insurance.

UNIT 24 SECURITIZATION AND ASSET RECONSTRUCTION COMPANIES

24.1 INTRODUCTION

Since they increase the safety and efficacy of the financial system, securitization and asset reconstruction companies, or SARCs, are essential to the financial services sector. The act of pooling different financial assets, such loans and receivables, and turning them into securities that can be sold to investors is known as securitization. Through the conversion of illiquid assets into marketable securities, this process helps financial institutions diversify their risk and offers liquidity.

Asset Reconstruction Companies (ARCs) manage and recover problematic assets. Their major role is to acquire non-performing assets (NPAs) from banks and other financial institutions, repair or restructure them, and then sell them to recover debt. By doing this, ARCs assist banks balance their accounts, which enhances their capacity to lend to other economic sectors.

SARCs and ARCs work together to significantly improve the overall health of the financial system. They facilitate the efficient deployment of capital, boost the liquidity of financial institutions, and assist in the recovery of distressed assets. Their operations are critical to maintaining financial stability and fostering economic prosperity.

24.2 OBJECTIVES

After finishing this unit, you will be able to:

- Explain the terms securitization and assets rebuilding.
- Describe how NPA securitization benefits you.
- Understand the role that companies that reconstruct assets play in the securitization process.
- Understand the intent and provisions of the SARFAESI Act of 2002.

24.3 SECURITIZATION

24.3.1 Definition of Securitization

Securitization is a financial process that transforms illiquid assets into marketable securities, thereby enhancing liquidity and dispersing risk. This strategy involves combining multiple financial assets, such as mortgages, auto loans, and credit card receivables, into a single organization called as a Special Purpose Vehicle (SPV). The SPV then produces securities backed by these assets and makes them available to investors.

24.3.2 Benefits of Securitization

Securitization has several benefits for investors and financial institutions, increasing the overall effectiveness and liquidity of the financial system. Listed below are a few key benefits:

1. Enhanced Liquidity: By converting illiquid assets like loans and receivables into tradable securities, securitization enables financial institutions to release capital. This liquidity enables banks and lenders to continue operating and extend credit, which fosters economic expansion.
2. Risk diversification: Securitization combines several asset classes into a single instrument, such as auto loans and mortgages. This diversification spreads the risk associated with specific assets over a number of securities, reducing the impact of defaults on any one asset and providing investors with a more stable investment.
3. Capital Relief: Financial institutions can remove the underlying assets from their balance sheets through the use of securitization. This asset dumping can improve their ability to lend and grow, as well as enable them more successfully satisfy regulatory obligations and increase their capital ratios.

4. Access to New Funding Sources: By issuing asset-backed securities, financial institutions can reach a larger range of investors, including individual and institutional investors. The capacity to access alternative funding sources can reduce borrowing costs and reduce reliance on traditional funding sources.
5. Customized Investment Opportunities: The securitization process makes it possible to issue securities, or tranches, with various risk and return attributes. Investors seeking consistent, low-risk returns as well as those willing to take on more risk in exchange for potentially larger rewards are both catered to by these tranches.
6. Enhanced Risk Management: Throughout the asset-backed securities structuring process, thorough credit research and risk assessment are required. The potential for this procedure to improve overall risk transparency and more effectively manage underlying asset risks may benefit issuers as well as investors.
7. Market Efficiency: Securitization can enhance market efficiency by providing transparent asset pricing mechanisms. On the secondary market, investors can buy and sell these securities based on their value, which promotes more accurate pricing and better capital allocation for the economy.

24.3.3 Securitization Types

Asset pools are converted into securities through the financial process of securitization. The many forms of securitization represent the diversity of the assets being securitized as well as the particular needs of investors. Here are a few common types:

1. Mortgage-Backed Securities (MBS): A pool of mortgages backs these securities. Residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS), which are backed by residential house loans and commercial real estate loans, respectively, are the two main categories into which MBS can be divided. Investors that want exposure to real estate markets often employ mortgage-backed securities (MBS).
2. Asset-backed securities, or ABS, are created from a pool of non-mortgage assets, such as leases, credit card receivables, auto loans, and student loans. Investors can purchase a range of consumer and business credit products with the use of these securities. To account for different levels of risk tolerance, ABS is commonly split into many tranches.
3. A type of structured credit product known as "collateralized debt obligations" (CDOs) blends bonds, loans, and other securities with additional financial instruments. The pooled assets are divided into multiple tranches, each offering a distinct rate of return, based on credit risk. CDOs can be complex, with varying degrees of reward and risk.
4. Collateralized loan obligations, also known as CLOs, are a specific type of CDO that revolve around a group of loans, typically corporate or leveraged loans. CLOs are set up in tranches to distribute risk across investors. Oftentimes, these loans

have large yields or severe risks. CLOs are often used by institutional investors seeking better returns.

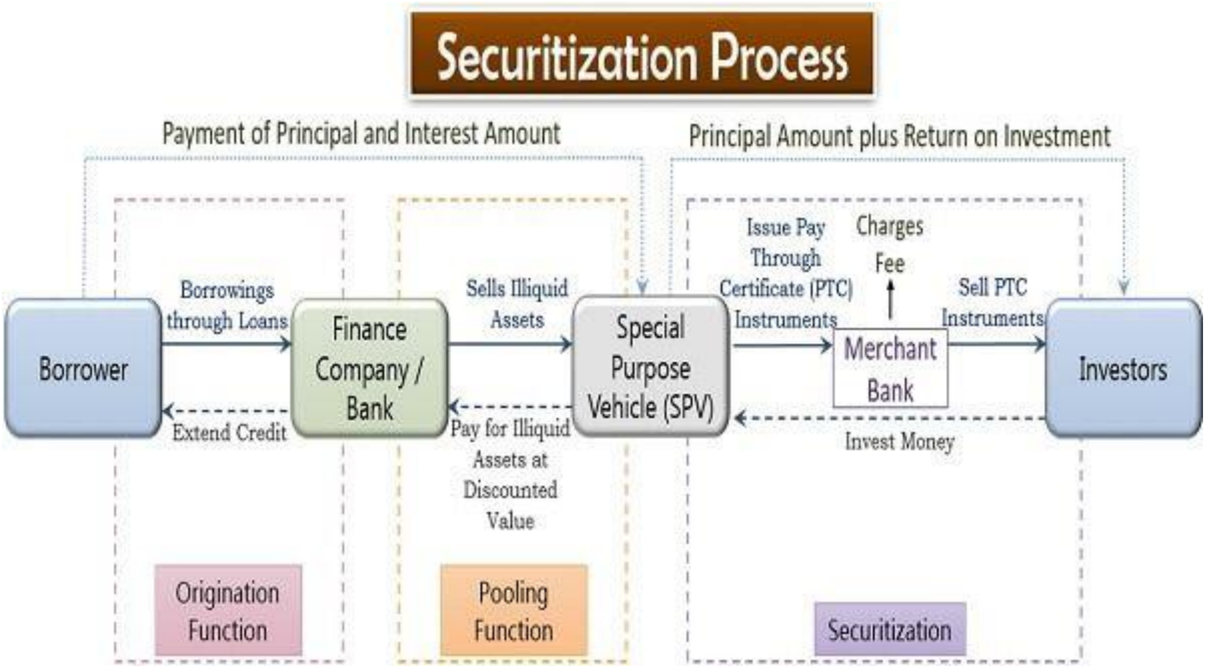
5. Residential Mortgage-secured Securities, or RMBS, are securities that are specifically guaranteed by residential mortgages. Subtypes such as agency RMBS, which are insured by government agencies like Freddie Mac or Fannie Mae, and non-agency RMBS, which are issued by private enterprises without government support, are among them.
6. Commercial real estate loans serve as the collateral for commercial mortgage-backed securities, or CMBS. Usually, real estate like office buildings, retail establishments, and apartment complexes is the purpose of these loans. Multiple tranches of CMBS can be created to represent varying degrees of credit risk.
7. A pool of student loans serves as collateral for securities referred to as Student Loan Asset-Backed Securities (SLABS). These loans are typically granted to cover college expenses, and SLABS provide investors with access to the world of student loan financing.
8. A group of vehicle loans serves as collateral for securities referred to as vehicle Loan-Backed Securities (ABS). Investors in securities backed by vehicle loans receive payments from the principal and interest of the underlying loans.

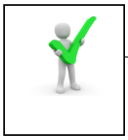
24.4 PROCESS OF SECURITIZATION

The multi-step process of securitization is necessary to convert illiquid assets into securities that can be sold. This rigorous process increases liquidity, reduces risk, and creates new investment opportunities. This is a thorough overview:

1. Asset Selection and Pooling: The initial stage of the process involves selecting the assets that will be securitized. These assets include things like credit card receivables, mortgages, auto loans, and other financial assets. The selected assets are combined to produce a diversified portfolio. This pooling increases the overall stability of the securities that will be generated by spreading the risk.
2. Establishing a Special Purpose Vehicle (SPV): A Special Purpose Entity (SPE) or Special Purpose Vehicle (SPV) is created to make the securitization process easier. Specifically designed to hold the pooled assets and issue the new securities, the SPV is a distinct legal organization. This arrangement creates a distinct division for financial and legal purposes because the assets are held outside from the originator's balance sheet.
3. Transfer of Assets: The originator, typically a financial institution, transfers the pooled assets to the SPV. An agreement for securitization or selling is used to facilitate this transfer. The originator's capital position and liquidity are improved when the assets are transferred into the SPV and are no longer included on the originator's balance sheet.

4. Securities Structuring: The Special Purpose Vehicle (SPV) divides the pooled assets into classes or tranches of securities, each with a distinct blend of reward and risk. These tranches are meant to appeal to various investment types. For instance, senior tranches have lower yields and better credit quality, whereas junior or mezzanine tranches carry greater risk but have larger potential returns.
5. Securities Issuance: The SPV provides investors with the structured securities. These instruments are backed by the cash flows from the underlying asset pool, which include loan principal and interest payments. Steps in the issuance process include underwriting and marketing the securities to potential purchasers, including hedge funds, institutional investors, and other financial institutions.
6. Credit Enhancement: To make securities more appealing to investors, credit enhancement techniques may be applied. This could mean subordinating particular tranches, obtaining assurances, or purchasing insurance. Because of credit enhancement, assets with higher credit ratings are more alluring to investors.
7. Asset Servicing: After the securities are issued, a servicer is in charge of the ongoing management of the underlying assets. The servicer is responsible for keeping an eye out for defaults, collecting payments, and ensuring that investors receive the appropriate allocation of the asset's cash flows in line with the terms stated in the instruments.
8. Distribution of Cash Flows: Investors receive a percentage of the cash flows that the Special Purpose Vehicle (SPV) obtains from the underlying assets, according to the terms of the securities. Payments are often made in a predetermined priority order, starting with investors in senior tranches and working down to those in junior tranches.
9. Monitoring and Reporting: Throughout the securities' life, the SPV's financial stability and the underlying asset pool's performance are monitored. Regular reports detailing performance, cash flows, and issues related to the assets or securities are sent to investors.




Check Your Progress-A

Q1. Describe the advantages of securitization.

Q2. What is the NPA securitization process?

24.5 INTRODUCTION TO ASSETS RECONSTRUCTION AND ASSETS RECONSTRUCTION COMPANIES (ARCS)

24.5.1 Definition of Asset Reconstruction

Reorganizing and fixing financial assets to increase their value or recoverability is known as asset reconstruction. When banks and other financial institutions come upon troublesome assets, including non-performing loans or poor investments, they frequently employ this procedure.
Restoring these assets' worth through a variety of tactics is the main goal of asset reconstruction. This may entail selling the assets to more seasoned management teams or investors, renegotiating the loan terms, or restructuring the underlying debt. In order to maintain financial stability, the objectives are to limit losses and maximize recoveries.

The involvement of specialized businesses known as Asset Rehabilitation Companies (ARCs) is a crucial part of asset rehabilitation. Usually, these companies are in charge of buying and overseeing troubled assets. To revitalize these assets, they use a variety of strategies, such as targeted sales, operational enhancements, and financial restructuring.

24.5.2 Asset Restoration Businesses (ARCs)

One of the most crucial responsibilities of the administration and resolution of financially distressed assets is the responsibility of Asset Reconstruction Companies (ARCs). The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 established ARCs, a specialized business. Its objective is to buy and repair banks' and financial institutions' non-performing assets (NPAs).

ARCs purchase distressed real estate with funds they receive from investors. They might securitize these assets to produce financial instruments that they can subsequently offer to other investors. In addition to providing banks with the funds they require to concentrate on new loan opportunities, this procedure aids in the recovery of value from non-performing assets (NPAs).

In the Indian financial sector, asset recovery companies (ARCs) are becoming indispensable, especially when it comes to managing the substantial volume of non-performing assets that banks manage. Through addressing and resolving these troublesome assets, ARCs allow banks to continue lending and foster economic growth while maintaining the overall soundness of the financial system.

The performance of ARCs in India depends on a number of factors, including market conditions, legislative frameworks, and their capacity to carry out asset recovery strategies. However, their importance in managing financial affairs and enhancing the efficiency of the banking sector endures.

24.5.3 The Need for ARCs

Establishing and running Asset Reconstruction Companies (ARCs) is essential to maintaining the stability and productivity of the financial sector, particularly in nations where non-performing assets (NPAs) are common. ARCs are essential to the banking sector for several key reasons:

1. Managing Non-Performing Assets: It is sometimes difficult for financial institutions to maintain a significant percentage of their loans in good standing, which negatively impacts their liquidity and balance sheets. To lessen the load on banks and increase their financial sustainability, ARCs must handle and resolve these distressed assets.

2. Better Asset Recovery: Banks and other financial institutions might not have the knowledge or resources necessary to salvage value from distressed assets. Because ARCs are experts in asset reconstruction, they utilize their knowledge to maximize asset value and increase recovery rates.

3. Improving Financial Stability: A systemic failure in the financial sector could be possible due to the high levels of non-performing assets (NPAs). ARCs improve economic stability and lessen the likelihood of widespread financial instability by resolving and restructuring these problematic assets.

4. Promoting Credit Flow: Banks free up funds for fresh lending when they sell troubled assets to ARCs. This contributes to maintaining the credit flow to businesses and consumers, which is essential for the economy to grow and prosper.

5. Regulatory Compliance: To maintain the stability of the banking industry, financial regulations frequently require the management and resolution of non-performing assets. Asset Recovery Certificates (ARCs) provide financial institutions with a formal tool for asset recovery and restructuring, making it easier for them to comply with specific regulatory requirements.

6. Specialist skills: Restructuring, asset management, and legal processes are a few of the specialized skills needed to handle distressed assets. By bringing this knowledge to the table, ARCs give banks and other financial institutions access to expert services that they might not otherwise have.

7. Economic Efficiency: ARCs help ensure that resources are allocated as efficiently as possible within the economy by expertly managing and resolving distressed assets. This might result in a more frugal use of resources and promote the financial system's general expansion and effectiveness.

24.5.4 The Role of the ARCs

Specialized financial firms known as Asset Reconstruction Companies (ARCs) were founded to handle and resolve troubled assets, mainly non-performing loans (NPLs) and other damaged financial assets. Their roles are essential to maintaining financial institutions' stability and raising the industry's general standard of living. A summary of their main duties is as follows:

1. Acquisition of Distressed Assets: Banks and other financial institutions sell non-performing assets to ARCs. By taking this action, banks are able to reduce the financial burden that bad loans place on them while also cleaning up their balance books.

2. Restructuring and Rehabilitation: After assuming control of troubled assets, Alternative Credit Syndicates (ARCs) endeavor to restructure loan or investment agreements. To help the borrower manage the debt more effectively, this may entail renegotiating repayment schedules, extending the loan length, or changing interest rates.

3. Asset Management and Improvement: To increase the value of the assets they have acquired, ARCs actively manage their assets. This can mean investing in the asset to make it more marketable or altering operational or strategic management procedures.

4. Sale and Securitization: By securitizing distressed assets, other investors can buy them as financial instruments. This approach helps with risk dispersion and asset value recovery.

5. Recovery and Collection: To get the most value out of distressed assets, ARCs use a variety of tactics. Ensuring that the assets are appropriately monetized involves a number of procedures, such as pursuing recovery strategies, speaking with stakeholders, and bringing legal action.

6. Financial advice: ARCs frequently offer advise services to banks and other financial institutions about how to handle and settle non-performing assets. This consulting job facilitates the creation of efficient programs for asset recovery and restructuring.

7. Compliance and Reporting: ARCs make certain that all of their activities abide by the relevant legal and regulatory specifications. To further promote transparency and accountability, they also offer comprehensive reports on the operation and condition of the assets under their care.

24.6 LEGAL FRAMEWORK OF ASSETS RECONSTRUCTION COMPANIES

Asset Reconstruction Companies (ARCs) cannot function or manage distressed assets effectively without the legal framework. The rules and regulations listed below essentially define India's regulatory framework:

1. The cornerstone of India's ARC legal framework is the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. The regulations governing the establishment, administration, and functioning of ARCs are outlined in the SARFAESI Act. It gives ARCs the authority to carry out asset reconstruction operations, such as debt recovery and loan restructuring, and to purchase non-performing assets from banks and other financial institutions. The Act also gives ARCs the authority to sell assets in order to enforce security interests and collect outstanding amounts.

2. The Reserve Bank of India's (RBI) regulations are significant since they set the guidelines for how ARCs are managed. It establishes standards and guidelines that ARCs must follow, encompassing requirements for capital, operations, and registration. Through adherence to industry best practices in asset recovery and management, these laws guarantee the financial stability of ARCs.
3. ARCs are subject to the regulations outlined in the Companies Act of 2013 because they are corporate organizations. To maintain accountability and transparency in their business operations, ARCs must adhere to the legal standards, corporate governance, and financial disclosures outlined in the Act.
4. The 2016 Insolvency and Bankruptcy Code (IBC) offers a framework for managing matters involving insolvency and bankruptcy; however, it is not limited to ARCs. The SARFAESI Act is improved and ARCs can handle distressed assets more skilfully with the help of additional channels for asset collection and settlement procedures.
5. The Securities and Exchange Board of India's (SEBI) laws: Asset-repair firms (ARCs) are required to abide by SEBI's requirements regarding securitization and reconstruction. The rules outlined in these regulations apply to the issuance of financial instruments related to asset reconstruction, such as security receipts.
6. Legal Precedents and Judicial Interpretations: By offering interpretations of the country's current laws and regulations, the Indian court also contributes to the advancement of the legal system. Court decisions may have an effect on the asset management tactics and procedures used by ARCs, as well as how they function and defend their legal rights.

Check Your Progress-A

Q1. Describe the importance of Asset Restoration Companies.

Q2. Talk about the various regulatory bodies that keep an eye on ARCs.

24.7 OVERVIEW OF SECURITIZATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST (SARFAESI) ACT, 2002

An important piece of Indian law, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, addresses the problem of non-performing assets (NPAs) and expedites the asset recovery process for financial institutions. The Act is summarized as follows:

24.7.1 Objectives and Meaning

The major aims of the SARFAESI Act are to simplify the enforcement of security interests and to establish a legal framework for the reconstruction and securitization of financial assets. The Act seeks to improve overall financial stability, increase the efficacy of asset recovery processes, and lessen the burden of non-performing assets (NPAs) on banks and other financial institutions.

24.7.2 Crucial Sections

1. Creation of Asset Reconstruction Companies (ARCs): The Act establishes the guidelines for ARC formation and administration. These specialized organizations are in charge of purchasing and overseeing bankruptcies and other financial institutions' distressed assets. ARCs can handle debt recovery and loan restructuring, among other asset reconstruction-related tasks.
2. Asset Securitization: Because SARFAESI permits asset securitization, banks and other financial institutions are permitted to bundle and sell their loans and receivables as securities. This approach reduces the quantity of non-performing loans and increases liquidity by converting non-performing assets into marketable securities.
3. Enforcement of Security Interests: One of the Act's primary features is its capacity to uphold security interests outside of the court system. In the event that the borrower is unable to make payments, this includes the power to seize and sell secured property. The Act expedites asset recovery by empowering banks and other financial institutions to promptly enforce their security interests.
4. SARFAESI facilitates the process of security receipt issuance for ARCs. These receipts represent the interests of investors in the assets that ARCs have acquired. They are essential to the securitization process and provide ARCs with a means of raising capital.
5. Legal Structure for Asset Recovery: The Act outlines the procedures and frameworks that are in place under the law for asset recovery. This covers protocols

for the attachment, seizure, and sale of assets in addition to designating managers to oversee the processing and disposition of distressed assets.

6. Regulatory Oversight: The regulatory body in charge of regulating the execution of SARFAESI is the Reserve Bank of India (RBI). To guarantee adherence to the Act and preserve the stability and integrity of the financial system, the RBI promulgates rules and regulations.

24.7.3 Significance of the SARFAESI Act of 2002

The Securitization and Reconstruction of banking Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 is a critical piece of legislation for the Indian banking sector. Its impacts are wide-ranging and include serious problems with financial stability, asset management, and institutional efficacy. This is a synopsis of its significance:

1. Increased Asset Recovery

The SARFAESI Act makes it feasible to recover non-performing assets (NPAs) from noncompliant borrowers in a more effective manner. By enabling banks and other financial institutions to exercise their security interests without having to go through drawn-out judicial actions, the Act speeds up the recovery process. This efficiency helps institutions holding distressed assets minimize losses and improve their financial stability.

2. Enhanced Financial Stability

The SARFAESI Act, which provides a methodical approach to the management and settlement of non-performing assets, improves the overall soundness of the banking sector. It helps lower systemic risk and strengthen the financial system by reducing the amount of distressed assets on bank balance sheets.

3. Promotion of Asset Reconstruction

The Act promotes the establishment and functioning of Asset Reconstruction Companies (ARCs). Because they provide value to troubled assets, these specialized companies are crucial to their purchase, restructuring, and eventual recovery. This process makes it easier for resources and capital to be used efficiently inside the financial system.

4. Promotion of Securitization

SARFAESI provides a legislative framework for financial asset securitization. By doing this, banks and other financial organizations can group and sell their loans and receivables as securities, converting non-performing assets into tradable instruments. This process improves liquidity while reducing the detrimental consequences of bad loans on financial institutions.

5. Simplified Enforcement of Security Interests

Financial institutions can now seize and sell secured assets without having to engage in protracted legal fights according to the Act. This accelerated enforcement procedure benefits both borrowers and lenders by accelerating asset recovery and reducing the length and cost of legal proceedings.

6. Increased Transparency and Accountability

SARFAESI establishes clear legal guidelines and procedures that increase openness when managing distressed assets. It creates reporting requirements and regulatory controls, which encourage accountability and ensure that asset reconstruction operations are conducted in an orderly and transparent manner.

7. Promotion of Economic Expansion

The SARFAESI Act facilitates the flow of credit across the economy by making distressed asset restructuring simpler and asset recovery more effective. Because of this, banks are better able to allocate resources and encourage economic growth by providing more financing options to consumers and businesses.

8. Improved Legal Framework

The Reserve Bank of India (RBI), which is in charge of the SARFAESI Act, integrates it with the broader regulatory framework to ensure sound financial practices. The RBI's regulations and oversight ensure that the Act's provisions are implemented as intended and contribute to maintaining the integrity of the financial system.

24.8 SUMMARY

Overview

Securitization and Asset Reconstruction Companies (SARCs) are vital to the financial sector because they boost efficiency and stability. Marketable securities are produced from illiquid assets, such loans, through the securitization process, providing both risk diversification and liquidity. When Asset Reconstruction Companies (ARCs) manage and recover distressed assets, bank balance sheets are strengthened and more lending is made available.

Objectives

Explaining the concepts underlying asset reconstruction and securitization, as well as the roles played by ARCs and the significance of the SARFAESI Act of 2002, is the aim of this unit.

Securities secured by mortgages

- Meaning: By converting illiquid assets into securities, securitization improves liquidity and diversifies risk.
- Benefits: These include enhanced risk mitigation, more capital relief, improved liquidity, risk diversification, additional funding sources, customized investment possibilities, and heightened market efficiency.

- Types: Among them are mortgage-backed securities (MBS) such as collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), auto loan-backed securities (ABS), student loan asset-backed securities (SLABS), and commercial mortgage-backed securities (CMBS).

The process of securitization

1. The act of selecting and putting together financial assets.
2. Creating an SPV: To hold and issue securities, a Special Purpose Vehicle (SPV) must be created.
3. Transfer of Assets: The originator's liquidity is enhanced by transferring assets to the SPV.
4. Putting money together in tranches with varying risk and return characteristics is known as securities structuring.
5. Offering investors asset-backed securities is known as securities issuance.
6. Credit enhancement: Techniques to make securities more appealing, such as guarantees.
7. Maintaining the assets and ensuring that cash flow is allocated are two aspects of asset servicing.
8. Distributing cash flows to investors is known as cash flow management.
9. Monitoring and Reporting: Provide investors with regular performance updates.

Restoring ARCs and Assets

- Meaning: Asset reconstruction is the process of reorganizing financially problematic assets to raise their value or recoverability.
- Asset Recovery and Rehab Companies (ARCs): Established under the SARFAESI Act of 2002, ARCs collaborate with banks to retrieve and revitalize non-performing assets (NPAs).

The goals of ARCs

1. Acquiring Bank Non-Performing Assets: Buying distressed assets.
2. Restructuring and rehabilitation include renegotiating agreements and managing assets more.
3. Asset management is the process of applying various strategies to increase the value of assets.
4. The process of converting problematic assets into financial instruments and then selling them is known as securitization and sale.
5. Recovering and collecting: Applying methods to restore the value of assets.

6. Restructuring and asset recovery guidance are included in financial advising services.
7. using reporting and compliance to guarantee transparency and adherence to rules.

Lawful Framework

Included in the legal purview of ARCs are:

The basis for Asset Reconstruction and Securitization (ARCs) is established by the SARFAESI Act of 2002.

- RBI Guidelines: The oversight of regulations is the responsibility of the Reserve Bank of India.
- Companies Act 2013: Manages company governance and legal requirements.
- The 2016 Insolvency and Bankruptcy Code (IBC) offers additional pathways for asset recovery.
- SEBI regulations oversee financial instruments related to securitization.

The 2002 SARFAESI Act

This legislation provides a framework for the reconstruction and securitization of financial assets and the enforcement of security interests. It aims to reduce non-performing assets, improve financial stability, and expedite asset recovery processes.

24.9 GLOSSARY

Financial instruments backed by a pool of non-mortgage assets, such as credit card receivables, student loans, or vehicle loans, are known as asset-backed securities (ABS). The purpose of these securities is to offer investors a variety of investment options.

Asset Reconstruction Companies (ARCs): These are specialized organizations that purchase banks' and financial institutions' non-performing assets (NPAs), with an emphasis on managing and recovering distressed assets.

Asset Reconstruction: Restructuring and rehabilitating financially troubled assets in order to increase their recoverability or value.

Collateralized Debt Obligations (CDOs) are credit products that are structured and consist of a variety of debt instruments, such as bonds and loans, grouped into tranches with varying degrees of risk and return.

Collateralized Loan Obligations (CLOs): A particular kind of CDO that is divided into various tranches and focuses on a pool of leveraged or corporate loans.

Commercial Mortgage-Backed Securities (CMBS): Securities, like those for office buildings, retail establishments, or apartment buildings, backed by loans secured by commercial real estate.

Credit Enhancement: Techniques such as tranche subordination, obtaining guarantees, or acquiring insurance are employed to enhance the credit rating of securities.

Mortgage-Backed Securities (MBS): Securities backed by a pool of mortgages, typically categorized as residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS).

Non-Performing Assets (NPAs): Loans or advances for which the borrower has defaulted or is delinquent on payments.

Residential Mortgage-Backed Securities (RMBS): Mortgage-backed securities specifically collateralized by residential mortgages. These securities include non-agency RMBS, which are issued by private companies, and agency RMBS, which are guaranteed by government agencies.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, known as the SARFAESI Act 2002, is a fundamental Indian statute governing the enforcement of security interests and the securitization and reconstruction of financial assets.

Securitization: The practice of pooling different kinds of financial assets to create tradable securities that increase liquidity and spread risk.

Special Purpose Vehicle (SPV): An independent legal body established to retain pooled assets and issue securities while the assets are being securitized, keeping the assets off the balance sheet of the originator.

Student Loan Asset-Backed Securities (SLABS): Securities that give investors exposure to the financing of education and are backed by a pool of student loans.

Tranches: During the securitization process, various classes of securities were established, each with a distinct amount of risk and return to appeal to various investor types.

24.10 REFERENCES

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24.11 SUGGESTED READINGS

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2. **"Asset Reconstruction and Securitization in India"** by Kothari, V. (2006).
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24.12 TERMINAL QUESTIONS

1. From the perspective of financial institutions and investors, what are the key advantages of securitization, and how does it contribute to the enhancement of market efficiency?
2. Provide a detailed explanation of the entire process of securitization, including the selection of the assets and the distribution of cash flows to investors.
3. In the context of the management of non-performing assets (NPAs), what part do Asset Reconstruction Companies (ARCs) play? To what extent do they utilize various methods for the purpose of asset recovery and rehabilitation?
4. In this section, you will address the legal structure that governs Asset Reconstruction Companies (ARCs) in India, with a particular emphasis on the SARFAESI Act 2002 and any other pertinent legislation.
5. Describe the ways in which the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002 has contributed to the enhancement of India's financial stability as well as the management of non-performing assets (NPAs).

UNIT 25 NON -BANKING FINANCIAL COMPANIES

25.1 INTRODUCTION

Financial organizations are known as Non-Banking Financial Companies (NBFCs) which function outside of the conventional banking system and offer a variety of financial services that are comparable to those provided by banks. In contrast to banks, non-bank financial companies (NBFCs) lack a banking license and are not allowed to provide savings accounts or take demand deposits.

Leasing, investment services, asset finance, advances and loans, and leasing are just a few of the financial services provided by NBFCs. They frequently concentrate on particular markets, such infrastructure, housing, or consumer finance. The financial system cannot run without nonbank financial businesses (NBFCs), that provide loans and financial services to groups and people traditional banks might ignore. Interacting with smaller businesses and individuals with specific financial needs helps to promote financial inclusion.

All things considered, NBFCs improve the banking sector and help the financial system to grow and flourish overall by offering specialized financial services and expanding credit availability.

25.2 OBJECTIVES

Upon completion of this unit, you will be capable of:

- Distinguish between NBFCs and banks.
- Describe the range of services that NBFCs provide.
- Recognize the contribution of NBFCs to India's economic expansion and financial inclusion.
- State laws governing different kinds of NBFCs.

25.3 NBFC: DEFINITION AND SCOPE

25.3.1 NBFC Definition

A non-banking financial corporation (NBFC) is a financial institution providing a range of financial goods and services but without a banking license. Unlike banks, NBFCs are not allowed to provide demand deposits or savings and checkbooks. Rather, their focus is on services including loan provisioning, asset financing, investment management, and other financial processes.

According to the Reserve Bank of India's (RBI) Frequently Asked Questions (FAQ) dated January 10, 2017, an NBFC is:

• is a business that is registered under the 2013 or 1956 Companies Act;

• engaged in the loan and advance sector; bought shares, stocks, bonds, debentures, securities issued by a local authority or government; leased; hire-purchase; company in insurance; chit-business;

• excludes, however, any company whose primary lines of business include sales, purchase, or building of immovable property; industrial activity; or the purchase or sale of any commodities (apart from securities).

Any firm whose main operation is accepting deposits under any scheme of arrangement either in one big payment or in installments via contributions or in any other manner is known as a non-banking financial firm, or residual non-banking company.

25.3.2 Important NBFC Facts in India:

1. Regulatory Framework: The Reserve Bank of India (RBI) oversees NBFCs in accordance with the Reserve Bank of India Act, 1934. The RBI regulates them,

establishes standards for capital sufficiency, and makes sure that financial standards are followed.

2. Services Provided: Nonbank financial institutions (NBFCs) provide a variety of financial services, such as wealth management, asset finance (for things like cars and equipment), personal and company loans, and investments in securities.
3. Operational Restrictions: NBFCs are not able to offer checking accounts or accept demand deposits, which are sums of money that can be taken out whenever needed, unlike banks. Additionally, they don't take part in systems for settlement and payments.
4. Types: Based on their operations, NBFCs in India are divided into a number of sorts, including Housing Finance Companies (HFCs), Investment Companies (ICs), Loan Companies (LCs), and Asset Finance Companies (AFCs).
5. Function in Financial Inclusion: By offering credit and financial services to a portion of the population that traditional banks might overlook, NBFCs significantly contribute to the improvement of financial inclusion.

25.3.3 NBFCs' Scope

Non-Banking Financial Companies (NBFCs) are essential to the financial ecosystem since they offer a variety of services that enhance what traditional banks have to offer. Their purview extends to a range of financial operations, with an emphasis on sectors in which banks may have limited expertise or access. Here is a detailed examination of the wide range of NBFCs:

1. Finance for Assets

When it comes to funding the purchase of tangible assets like machinery, cars, and equipment, NBFCs are essential. Asset finance firms (AFCs) in the non-bank financial companies (NBFC) sector help businesses and individuals buy these assets, helping industries that need large capital investments.

Important Domains:

- Commercial Vehicles: Trucks, buses, and other commercial vehicles can all be financed.
- Equipment and Machinery: Credit available for purchases of construction and industrial equipment.

2. Finance for Consumers

Personal loans, loans for consumer durables, and credit for home needs are among the consumer financial services provided by NBFCs. Individual borrowers who might require financial assistance for a range of personal reasons are served by this section.

Important Domains:

- Personal Loans: Unsecured loans for individual needs, such as emergency medical care, vacation, and education.
- Consumer Durables: Credit used to buy furniture, appliances, and electronics.

3. Small-scale lending

The primary goal of non-bank financial community microfinance institutions (NBFC-MFIs) is to give small-scale loans to underserved low-income individuals and small companies. By providing financial services to those in economically disadvantaged groups, they play a vital role in promoting financial inclusion.

Important Domains:

- Small Loans: Giving people tiny loans for individualized needs or small-scale business ventures.
- Group Lending: By using group lending methods, debts can be made more easily repaid.

4. Asset Allocation and Management

Investment firms that are part of the NBFC industry offer investment advising services in addition to managing portfolios. They help customers manage their holdings in a range of financial products, such as mutual funds, bonds, and stocks.

Important Domains:

- Portfolio Management: overseeing both individual and institutional investors' investment portfolios.
- Investment Advisory: Providing guidance on financial planning and investment tactics.

5. Finance for Infrastructure

Infrastructure Finance Companies, often known as NBFC-IFCs, are experts in financing major infrastructure projects. They encourage the construction of vital infrastructure, including energy facilities, bridges, and highways.

Important Domains:

- Project Financing: Money allocated to energy, transportation, and public utility infrastructure projects.
- Long-Term Loans: supplying huge infrastructure undertakings with long-term funding.

6. **Mortgage Financing**

   Loans are provided by Housing Finance Companies (NBFC-HFCs) for the acquisition, building, or remodeling of residential buildings. They serve the housing industry by serving real estate developers and purchasers.

Important Domains:

- Home loans: Funding for the purchase or construction of residential real estate.
- Home improvement loans: These are loans taken out to upgrade or renovate current residences.

7. Leasing and Purchase Agreements

Financing alternatives for purchasing goods and equipment through hire purchase agreements or leasing arrangements are offered by NBFCs engaged in hire purchase and leasing. Over time, these businesses enable asset ownership and use.

Important Domains:

- Hire Purchase: Making installment payments to finance the purchase of capital equipment and consumer products.
- Leasing: Providing possibilities for leasing machinery and other assets like cars.

8. Services for Factoring

Businesses sell their accounts receivable to factoring companies in the NBFC sector, which then uses the money to provide quick cash flow against unpaid invoices. This solution aids companies in better working capital management.

Important Domains:

- Receivables Financing: Getting money right now by buying invoices at a discount.
- Debt Collection: overseeing and obtaining receivables for companies.

25.4 NBFC TYPES

Non-Banking Financial Companies (NBFCs) constitute a substantial segment of the financial industry in India, providing a suite of financial services akin to those provided by banks, albeit without the requirement of a banking license. In India, NBFC types are classified according to their roles, pursuits, and legal environments. This is a thorough rundown of the many kinds of NBFCs that are present in the nation:

1. Assets Finance Company (AFCs)

AFCs mainly offer financing for the purchase of tangible goods, such as machinery, cars, and equipment. These businesses are essential to industries where capital investment is needed to acquire assets. AFCs assist people and companies in obtaining the equipment they need to run their operations by lending or leasing assets to them.

Important Roles:

- Funding for the acquisition of machinery, equipment, and commercial vehicles.
- Making loans secured by the financed assets.

2. Investment Companies (ICs)

Securities and other financial assets are managed and invested in by investment companies. Investing in stocks, bonds, and other financial instruments in order to generate returns is their main line of business.

Important Roles:

- Purchasing and overseeing securities portfolios.
- Offering investment-related advising services.

3. Financial Institutions (Banks)

Loan companies are experts at providing advances and loans to people and companies for a range of uses. They might not take deposits like banks do, but their main goal is to offer credit facilities.

Important Roles:

- Offering credit facilities such as personal and business loans.
- Granting credit for personal necessities and durable goods.

4. Companies that Hire Purchase Finance (HPFCs)

Hire purchase agreements are used by HPFCs to finance the purchase of goods. Under these contracts, ownership of the purchased products transfers only after the final payment, which is made by the borrower while they are still using the goods.

Important Roles:

- Using hire purchase agreements to finance the purchase of capital items and consumer products.
- Encouraging the gradual acquisition of assets through installment payments.

5. Housing Finance Companies (HFCs)

Financing for residential property purchases or construction is the area of expertise for HFCs. They are essential to the housing industry since they provide loans to people who want to build or purchase homes.

Important Roles:

- Providing house loans for residential property building or acquisition.
- Offering loans for remodeling and home improvement.

6. Infrastructure Finance Companies (IFCs)

Infrastructure finance companies (IFCs) specialize in funding projects related to building roads, bridges, and power plants. They are in favour of building extensive infrastructure, which is essential for the development of the country. Important characteristics of IFCs are listed below:

I. at least 75% of overall total assets go towards infrastructure loans.

II. Has at least Rs. 300 crore in net owned money.

III. has been given a minimum credit rating of RSARS or the equivalent rating from any other crediting agency recognized by RBI.

IV. has a minimum Tier I capital requirement of 10% and a Capital to Risk Asset Ratio (CRAR) of 15%.

Important Roles:

- Providing funds for significant infrastructure projects.
- Promoting growth in industries including public utilities, energy, and transportation.

7. CIC-ND-SI, a Core Investment Company with Systemic Importance

CIC, or Core Investment Company: CICs that raise or keep public funds and have total assets of at least Rs. 100 crore are considered to be Systemically Important Core Investment Companies (CICs-ND-SI). These CICs can operate alone or in conjunction with other capital investment companies (CICs) in the group.

According to the date of the most recent audited balance sheet, a CIC is a non-bank financial company (NBFC) that does a business that involves the acquisition of shares and securities and that satisfies the conditions listed below.

i. In addition to investments in bonds, debentures, equity shares, preference shares, debt, or loans to group companies, at least ninety percent of its net assets are comprised of these types of investments;

ii. According to the information provided in clause (i) above, the company's net assets consist of at least sixty percent of its investments in equity shares (including instruments that are compulsorily convertible into equity shares within a period of not more than ten years from the date of issue) in group companies and units of Infrastructure Investment Trust only as sponsor. In accordance with the SEBI (Infrastructure Investment Trusts) Regulations, 2014, which are subject to periodic amendments, the exposure of these CICs to Infrastructure Investment Trusts must be restricted to their sponsorship holdings and must not exceed the minimum unit and term holding restrictions.

iii. it does not sell its debt, loans, or shares in group companies unless it is conducting a block sale with the intention of diluting or disinvesting its holdings;

iv. It does not engage in any other financial activity, as that term is defined in sections 45-I(c) and 45-I(f) of the Reserve Bank of India Act, 1934, with the exception of the following:

   a. money market instruments, government securities, bank deposits, and bonds or debentures issued by group corporations are all examples of investments that fall into this category;

   b. giving financial assistance to companies that are part of the group; and

   c. c. offering guarantee on behalf of the businesses that are part of the group?

8. Microfinance Institutions/Non-Banking Financial Companies (NBFC-MFIs)

NBFC-MFIs concentrate on offering small enterprises and low income people that don't have access to standard banking services microfinance services. They are required in order to attain financial inclusion. To be eligible for MFIs, one needs to meet the requirements listed below:

1. A minimum of Rs. 5 crore in net owned funds. The minimum amount of NOF required for NBFC-MFIs registered in the country's North Eastern Region id Rs. 2 crore.

   85% or more of its net assets are "qualifying assets." "Qualifying assets" is a loan that meet the following requirements, "net assets" are all assets that meet the second requirements, minus cash, bank accounts and money market instruments:

   a. A loan from NBFC-MFI to a borrower whose family income is less than Rs. 125000 in rural areas and Rs. 2,00,000 in urban or semi-urban areas.

   b. In the first cycle the loan limit is Rs. 125000, in the second it is rs. 75000.

   c. The borrower allowable total debt is Rs. 125000.

   d. Early payment is free of cost and a loan over Rs. 30000 cannot have a shorter term than 24 months.

   e. Enabling a loan without calling for security.

   f. MFIs provide at least half of all the loans provided, solely with profit in mind.;

   g. The loan repayment options available to the borrower include weekly, fortnightly, or monthly installments.

Crucial Positions:

- Offering small enterprises and individuals modest loans.
- Offering specific financial products to low-income people.

9. Non-Banking Financial Companies (NBFCs) Related Factors

NBFC-Factors offers a discounted purchase of accounts receivable from businesses as part of its factoring services. Quick finance is provided, which helps firms improve their cash flow.

Crucial Positions:

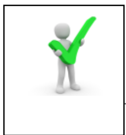
- Purchasing accounts receivable to make quick cash.T
- Taking care of and getting businesses' accounts receivable back.

10. Platforms for peer-to-peer lending provided by non-banking financial institutions (NBFC-P2P)

Instead of using traditional financial institutions, NBFC-P2P platforms allow for direct lending between people or businesses. These are online companies that provide a forum for communication between lenders and borrowers.

Crucial Positions:

- Providing an online peer-to-peer funding platform.
- Connecting direct loan applicants with certain lenders.



Check Your Progress-A

Q1. Describe the reach of NBFCs.

Q2. Address NBFCs that are Systematically Important.

25.5 DIFFERENCE BETWEEN NBFCS AND BANKS

S. No.	Point of Difference	NBFC	Bank
1	Regulatory Bodies	The Reserve Bank of India Act, 1934 as well as further rules unique to their type and activities control NBFCs. They follow rules even if they are not as strict as those controlling banks.	The Banking Regulation Act, 1949 which the Reserve Bank of India (RBI) upholds mostly controls banks. They have to abide by rigorous RBI set capital adequacy, liquidity, and other financial criteria.
2	Acceptance of Deposit	In general, public demand deposits (like savings or checking accounts) are not accepted by NBFCs. Certain NBFCs, namely Deposit-Taking NBFCs (NBFC-D), are allowed to accept fixed and recurring deposits but are not allowed to provide checking or savings accounts.	Banks provide public deposits, such as savings, fixed, and recurring accounts. This is a crucial aspect of a bank's main operations that maintains its viability.
3	Creation of Credit	NBFCs cannot generate loans in the same manner as banks. They can only provide loans and advances; they have no real influence on the quantity of money in circulation. Their primary responsibility is to offer specialized financial services rather than extending enormous credit amounts.	Banks can create credit through their lending activities. A bank loan adds to the quantity of money in circulation in the economy by creating a deposit in the borrower's account.
4	Usability	NBFCs typically focus on certain financial services such investment management,	Banks provide a wide range of financial services, including processing payments, issuing credit

		microfinance, asset financing, and factoring. They don't offer the same breadth of services as banks and are more specialized.	cards, accepting deposits, and making loans. They provide a number of financial functions and are vital to the financial system.
5	Regulatory Capital needs	Capital rules apply to non-bank financial institutions (NBFCs), however they are sometimes less stringent than those for banks. NBFC capital adequacy standards are set by the RBI based on the kind and size of the firm.	To ensure stability and solvency, banks are required to maintain a certain level of regulatory capital under the Basel standards (Basel I, II, III). These criteria are stringent in order to guarantee financial stability.
6	Payment and Settlement Access	NBFCs cannot immediately access these payment and settlement processes. Typically, they rely on banks to take care of the clearing and settlement of transactions. Their ability to take part in particular payment-related activities is thereby limited.	Banks have direct access to payment and settlement systems like RTGS (Real-Time Gross Settlement), NEFT (National Electronic Funds Transfer), and SWIFT. They can now help with interbank transactions and provide payment services to customers as a result.
7	Protection of Consumer	Though not as comprehensive as bank rules, NBFCs do have consumer protection policies in place. NBFC protection plans can vary based on the specific type and objective of the NBFC.	Strict consumer protection regulations that safeguard depositors' interests and mandate openness in business practices must be followed by banks. Customer service and complaint management procedures have certain criteria that must be followed.
8	Kinds of Services Provided	NBFCs also provide specialized services. While investment firms	Among the several services banks offer are corporate banking (trade finance,

		handle investment portfolios, asset finance companies—such as those that handle machinery and cars—manage small loans to low-income people.	business loans), retail banking (savings accounts, personal loans), and investment banking (mergers and acquisitions).

25.6 ROLE OF NBFCS IN INDIA'S DEVELOPMENT

Non-Banking Financial Companies (NBFCs) have grown to be an important component of India's financial system and have been essential to the nation's economic growth. They assist infrastructure development and encourage financial inclusion, among other things. This is a in-depth look of the contributions NBFCs have made to India's development:

1. Increasing Access to Finance

NBFCs are crucial for boosting financial inclusion, especially for underprivileged populations. As of March 2023, sizable fraction of Indian rural and low income population receives services from NBFCs, according to the projections made by the Reserve Bank of India (RBI). They have been successful in filling the gaps left by conventional banks, particularly in places with low banking penetration that rural or semi-rural.

- Impact on microfinance: In the direction of Financial Inclusion, NBFC-Micro Finance Institutions (MFIs) have achieved notable progress. The Microfinance Institutions Networks (MFIN) report that in financial year 2022-23 MFIs have sanctioned loans of Rs. 1.2 Lakh Crore approximately to low income individuals.

2. Providing assistance to small and medium business (SMEs)

The foundation of the Indian economy is the SMEs and the NBFCs are essential in supplying them with the capital they needed. The Small Industries Development Bank of India (SIDBI) asserts that NBFCs have played a critical role in assisting SMEs in obtaining the loans they needed to grow the economy and create job.

- Financing for SMEs: According to industry figures, NBFC financed more than Rs. 2.5 Lakh crore to SMEs in F.Y. 2022-23. This money can be used by SMEs fir number of things, such as working capital, equipments acquisitions and company growth.

3. Promoting Infrastructure Growth

The work of Infrastructure Finance Companies (NBFC-IFCs) has been extremely beneficial to India's infrastructure development. They provide large-scale infrastructure projects with long-term finance, which is crucial for the expansion and development of the economy.

• Infrastructure Investment: Over the course of the last five years, NBFC-IFCs have made contributions totaling more than ₹3 lakh crore to infrastructure projects, aiding in the building of energy plants, roads, bridges, and other essential infrastructure, according to the Infrastructure Development Finance Company (IDFC).

4. Expanding the Credit Options for Customers

Thanks largely to NBFCs, the expansion of consumer loans has raised purchasing power and boosted the economy. They offer a range of products, including financing for consumer durables, credit cards, and personal loans.

• Consumer Loans: According to the Credit Information Bureau (India) Limited (CIBIL), NBFCs accounted for roughly 30% of India's total personal loan market in 2023, with approximately ₹4 lakh crore in outstanding loans.

5. Promoting Ownership of Real Estate

NBFCs facilitate asset acquisition by providing financing alternatives such as hire buy and lease. This promotes asset ownership among people and companies, which fosters economic growth.

• Asset Financing: In FY 2022–2023, NBFCs loaned about ₹1.8 lakh crore for vehicles, machinery, and equipment. This financing supports both industry expansion and individual mobility.

6. Promoting Innovation in Financial Services

NBFCs are setting the standard for financial innovation when it comes to creating new financial products and leveraging digital technologies.

• Digital Transformation: As of 2023, more than 40% of NBFCs managed customer relationships and loan disbursements using digital channels, per a National Payments Corporation of India (NPCI) study. This implies that NBFCs have made significant use of digital lending platforms.

7. Providing Specialized Financial Services

Several kinds of non-bank financial firms (NBFCs) offer specialized services, including factoring, housing finance, and peer-to-peer lending.

• House Finance: According to industry sources, NBFC-Housing Finance Companies (HFCs) disbursed more than ₹2.2 lakh crore in home loans in FY 2022–2023. This money is advantageous to homeowners as well as real estate developers.

8. Encouraging Financial System Stability

Despite not being governed by the same laws as banks, NBFCs help to stabilize the financial system by diversifying it and reducing reliance on traditional banks.

• Diversification: Based on RBI data, as of March 2023, NBFCs possessed assets valued at ₹38 lakh crore, or a substantial portion of the assets in the financial system. This enhances system resilience and helps to spread financial risk.

Check Your Progress-B

Q1. Describe any two ways that banks and NBFCs vary from each other.

Q2. Talk about how NBFCs contribute to financial inclusion.

25.7 SUMMARY

Non-banking financial companies (NBFCs) are financial firms in India that resemble banks but lack a banking license and cannot accept demand deposits. They provide several financial services. Under the Reserve Bank of India (RBI), NBFCs—which focus on markets sometimes overlooked by conventional banks—offer loans, asset finance, leasing, and investment management. Based on their roles, they can be divided into a number of categories, such as Housing Finance Companies (HFCs), Investment Companies (ICs), Loan Companies (LCs), and Asset Finance Companies (AFCs).

By providing lending and financial services to small enterprises and individuals in rural and semi-urban regions, NBFCs are essential to the cause of financial inclusion. They provide support to a number of industries, including microfinance, housing, infrastructure, and consumer finance. NBFCs enhance the banking industry by offering specialized services and increasing financial access, even if they are not able to generate credit or take part in payment and settlement systems like banks can.

The range of services offered, regulatory requirements, and deposit acceptance capabilities set NBFCs apart from banks. NBFCs do not provide checking or savings accounts and are subject to laxer regulations. Nonetheless, by promoting financial inclusion and offering crucial services to underrepresented economic sectors, they make a substantial contribution to economic growth.

25.8 GLOSSARY

Non-Banking Financial Companies (NBFCs): Organizations that function outside of the conventional banking system yet offer a range of financial services akin to those provided by banks. They are not authorized to take demand deposits and do not possess a banking license.

Asset Finance Companies (AFCs): An NBFC type that supports industries requiring significant capital expenditure by offering financing for the purchase of tangible assets including machinery, cars, and equipment.

Consumer Finance: Credit for household costs, loans for consumer durables, and personal loans are among the financial services offered by NBFCs.

Microfinance Institutions (NBFC-MFIs): By providing small scale loans to low income individuals and small businesses, these specialist NBFCs help the economically disadvantaged and advance financial inclusion.

Investment Companies (ICs): These non banking financial institutions manage portfolios and provide investment consulting services to assist clients in managing their assets in a variety of financial instruments, such as equities, bonds and mutual funds.

Infrastructure Finance Companies (IFCs): NBFCs that specialize in providing funding for large scale infrastructure projects, such as construction of roads, bridges and energy facilities in order to encourage the development of essential infrastructure.

Housing Finance Companies (HFCs): NBFCs that offer loans for the purchase, construction or renovation of residential properties to home buyers and real estate developers.

Hire Purchase Finance Companies (HPFCs): NBFCs that provide financing for the acquisition of goods and machinery via hire purchase or lease agreements, enabling the gradual ownership and usage of assets.

Factoring Services: These are offered by NBFC whereby they purchase accounts receivables from businesses in return for quick cash flow against outstanding invoices, helping businesses to effectively manage their working capital.

Peer-to-peer lending platforms (P2P): These websites, which are managed by non banking financial companies (NBFCs) enable loans to be given to people or businesses without going through banks.

Systemically Important Core Investment Company (CIC-ND-SI): This type of NBFC is primarily involved in the purchase of shares and securities and is distinguished by its considerable assets. Significant investments in group firms are also held by it.

Requirements for Regulatory Capital: The minimal capital levels that Nonbank Financial Companies (NBFCs) must maintain to ensure their stability and solvency in compliance with Reserve Bank of India (RBI) regulations.

Deposit Acceptance: This feature sets NBFCs apart from banks; some are allowed to take fixed and recurring deposits, but the majority cannot accept demand deposits.

Credit Creation: The power of financial institutions to expand the amount of money in the economy by making loans; NBFCs lack the capacity to create credit, while banks do.

Financial Inclusion: The endeavors of Non-Bank Financial Companies (NBFCs), mostly via microfinance and additional specialized services, to furnish financial services to marginalized or unserved communities, hence promoting wider economic engagement.

SMEs (small and medium-sized enterprises): An important economic sector that NBFCs help by providing financial services, such as loans and credit facilities, which encourage the creation of jobs and economic expansion.

Capital to Risk Asset Ratio (CRAR): IFCs are required to maintain a CRAR of 15% with a minimum Tier I capital of 10%. This metric is used to make sure that NBFCs have adequate capital to cover their risks.

Compliance with Financial Norms: The NBFCs' observance of the rules and norms established by the RBI, which supervise their business practices, guarantee financial stability, and safeguard customers.

Operational Restrictions: To distinguish NBFCs apart from banks, these are restrictions on their ability to conduct business, such as not being able to take demand deposits or take part directly in payment and settlement systems.

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25.11 TERMINAL QUESTIONS

1. What distinguishes the fundamental products of Non-Banking Financial Companies (NBFCs) from those of traditional banking services?
2. Have a conversation about the laws that govern non-banking financial companies (NBFCs) in India, paying particular attention to the Monitoring Authority of the Reserve Bank of India (RBI).
3. Please explain the operation of asset financing as it is provided by NBFCs. NBFCs could be of assistance to people and businesses who are interested in purchasing real estate.
4. How may non-banking financial companies (NBFCs) contribute to India's attempts to broaden access to financial services? It would be helpful if you could provide some instances of specific NBFC industries that target low-income populations.
5. Please name the Microfinance Institutions (NBFC-MFIs) and explain why they are so important to the Non-Bank Financial Companies (NBFC) sector. What specifications are necessary for these businesses to be recognized as NBFC-MFIs?

UNIT 26 INDIAN AND GLOBAL PERSPECTIVE – MANAGING NEW CHALLENGES

26.1 INTRODUCTION

Overview of Challenges in the Modern Business Environment The global business landscape has undergone a rapid shift in recent years, driven by the rapid technological advancements, changing consumer behavior, and geopolitical tensions across the globe. Companies, whether operating in mature markets or emerging economies, are grappling with an array of challenges that demand innovative solutions and strategic foresight. These challenges include digital transformation, sustainability pressures, and the need to adapt to volatile market conditions.

The Role of Globalization in Shaping Business Dynamics Globalization has blurred the lines between local and international markets, creating opportunities and challenges alike. While businesses now have access to broader markets, they also face increased competition, cultural complexities, and the need for compliance with a diverse set of regulations. Understanding the dual impact of globalization is crucial for developing effective strategies in the modern business world.

26.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the Indian perspectives on managing new challenges
- Understand the Global perspectives on managing new challenges
- Analyse the difference between Indian and Global perspectives
- Devise strategies for managing new challenges
- Explore the Future outlook for challenges.

26.3 INDIAN PERSPECTIVE ON MANAGING NEW CHALLENGES

Economic and Political Landscape in India

India's economic environment has been marked by robust growth, though it remains susceptible to political and economic fluctuations. The government's policies, such as Make in India and Digital India, are aimed at fostering innovation and growth. However, businesses must navigate a complex regulatory environment, infrastructure challenges, and evolving consumer markets to thrive.

Challenges in the Indian Business Environment

Indian businesses face unique challenges such as infrastructural bottlenecks, regulatory hurdles, and the need for skilled labour. The informal economy, while large, poses challenges in terms of formalization and productivity. Additionally, businesses must adapt to rapid urbanization and changing consumer expectations in a diverse and price-sensitive market.

Innovation and Technology Adoption in India

India is emerging as a hub for innovation, with a thriving startup ecosystem and increasing investments in technology. However, the pace of technological adoption varies across sectors, with traditional industries lagging behind. Companies that can leverage technology for operational efficiency, customer engagement, and product development are likely to gain a competitive edge.

Human Resource Management in Indian Companies

Managing human resources in India involves dealing with a diverse and multicultural workforce. Issues such as labour laws, employee engagement, and talent retention are critical. Additionally, businesses must focus on upskilling their workforce to meet the demands of a rapidly changing technological landscape.

Regulatory Framework and Compliance in India

India's regulatory environment is complex and ever-evolving, with businesses required to comply with a wide range of laws and regulations. From environmental norms to tax regulations, companies must stay updated and ensure compliance to avoid legal and financial penalties. The recent introduction of GST and changes in labour laws are examples of significant regulatory shifts that businesses must navigate.

26.4 GLOBAL PERSPECTIVE ON MANAGING NEW CHALLENGES

Key Global Economic Trends and Their Impact on Businesses

Global businesses are deeply affected by economic trends, including changing trade policies, currency fluctuations, and broader economic shifts and slowdowns. To navigate these challenges effectively, companies need to craft strategies that address how these macroeconomic factors impact their operations, from supply chains to consumer demand.

Challenges faced by Multinational Companies

Operating across multiple countries presents its own set of challenges, including navigating cultural differences, adhering to various legal requirements, and addressing political instability. For multinational companies, crafting a strong global strategy while remaining adaptable to local conditions is essential. The increasing trend of protectionism and ongoing trade disputes have added another layer of complexity to the global landscape, making it crucial for businesses to stay agile and responsive.

Cross-Cultural Management and Global Workforce Diversity

Diversity is a key strength in today's interconnected world, but it also brings its own set of management challenges. Companies must navigate cultural differences in working styles, communication, and leadership to build cohesive and effective teams. Successfully managing these diverse elements can drive innovation and enhance performance on a global scale.

The COVID-19 pandemic has highlighted vulnerabilities in global supply chains, pushing companies to rethink their strategies for greater resilience. To prepare for future disruptions, businesses may need to diversify their suppliers, invest in new technologies, and explore options like offshoring or reshoring to lessen their dependence on distant markets.

Technology and Innovation in a Global Context

Technological breakthroughs like AI, blockchain, and the Internet of Things are revolutionizing industries across the globe. Businesses that embrace these innovations are better equipped to compete internationally. However, alongside these advancements, it's crucial to address concerns related to data privacy, cybersecurity, and ethical considerations to ensure that technology serves everyone responsibly and effectively.

Check Your Progress-A

Q1. What are the primary challenges faced by Indian businesses in the current economic environment, and how do they differ from those faced by global businesses?

Q2. How has globalization impacted Indian businesses, and what strategies can they adopt to remain competitive on the global stage?

Q3. What role does strategic leadership play in managing new challenges in both Indian and global contexts?

Q4. How can companies build resilience in their supply chains in response to global disruptions, such as the COVID-19 pandemic?

Q5. What is one of the key challenges specific to the Indian business environment?

A) High labour costs

B) Regulatory complexities

C) Lack of global competition

D) Uniform consumer behavior

Q6. What is a common challenge faced by multinational corporations (MNCs) operating in global markets?

A) Homogeneous cultural practices

B) Stable geopolitical environments

C) Uniform regulatory frameworks

D) Cross-cultural management

Q7. Which of the following is a benefit of adopting sustainable business practices?

A) Short-term profit maximization

B) Compliance with environmental regulations

C) Reducing operational transparency

D) Avoiding investments in new technologies

26.5 COMPARATIVE ANALYSIS: INDIA VS. GLOBAL

Aspect	**India**	**Global Perspective**
Management Style	Often hierarchical with a strong emphasis on authority and seniority.	Varies by region; more emphasis on participative and collaborative management in Western countries.
Cultural Norms	High power distance and collectivist culture; decisions often centralized.	Low power distance in many Western cultures; more individualistic and decentralized decision-making.
Communication	Formal communication with a tendency to avoid direct confrontation; indirect feedback.	Open and direct communication is often encouraged, with a focus on constructive feedback.
Decision-Making	Decisions may be slow and involve multiple levels of approval; can be influenced by relationships.	Faster decision-making processes in many regions; often based on data and efficiency.
Employee Engagement	Focus on job security and stability; lower emphasis on personal growth and development.	Higher emphasis on career development, work-life balance, and employee well-being.
Conflict Resolution	Conflicts may be handled discreetly and through informal channels; less direct.	Direct conflict resolution strategies are common, with formal processes for addressing disputes.

Aspect	India	Global Perspective
Technology Adoption	Rapidly growing, but there may be regional disparities in access and implementation.	Generally high adoption rate, though varied by region; often leading-edge in developed countries.
Training and Development	Training often focused on technical skills; less emphasis on soft skills and leadership.	Comprehensive training programs include both technical and soft skills; leadership development is prioritized.
Regulatory Environment	Complex and often bureaucratic with significant red tape; regulations can be region-specific.	Varies by country; generally more streamlined processes in developed countries, but regulatory compliance is still crucial.
Workplace Diversity	Growing awareness and initiatives, but still evolving; diversity may be more limited in practice.	Emphasis on diversity and inclusion is strong in many global organizations; diverse workplaces are often promoted and celebrated.
Economic Challenges	Emerging market with high growth potential but also significant economic disparities and instability.	Developed economies often have more stability but face challenges related to globalization and economic shifts.
Leadership Development	Increasing focus on developing leaders, but traditionally less structured compared to global standards.	Structured leadership development programs; emphasis on building global leadership competencies.
Employee Benefits	Benefits may vary widely; often include basic healthcare and retirement plans.	Comprehensive benefits packages are common, including health insurance, retirement plans, and various employee perks.

26.6 STRATEGIES FOR MANAGING NEW CHALLENGES

Strategic Leadership and Decision-Making

In an increasingly complex business environment, effective leadership is critical. Strategic leaders must be able to make informed decisions that balance short-term objectives with long-term goals. This section explores the qualities of successful leaders and decision-making frameworks that help navigate the challenges of the modern business landscape. Leadership strategies that focus on adaptability, resilience, and ethical considerations are particularly important in managing new challenges.

Innovation and Adaptation in a Changing World

In today's fast-paced world, innovation is a crucial factor for achieving success. Companies must foster a culture of innovation, encouraging creativity and risk-taking at all levels of the organization. This section discusses how businesses can embed innovation into their operations, from product development to customer engagement, and adapt their business models to meet evolving market demands. The ability to innovate and adapt is crucial for staying competitive in a dynamic environment.

Sustainable Business Practices

Sustainability is increasingly recognized as a critical component of business strategy. Companies are under pressure to adopt sustainable practices that address environmental, sustainability, and governance (ESG) standards. The ways in which companies might incorporate sustainability into their operations are examined in this section, from reducing carbon footprints to ensuring ethical supply chains. By adopting sustainable practices, companies can not only meet regulatory requirements but also enhance their brand reputation and long-term profitability.

Risk Management in Uncertain Environments

Risk management is essential in an era of uncertainty. Businesses need to identify potential risks, evaluate their impact, and create strategies to minimize them. This section covers risk management frameworks and tools that can help companies navigate economic, operational, and reputational risks. Effective risk management enables businesses to anticipate challenges and respond proactively, ensuring continuity and resilience in the face of disruptions.

26.7 FUTURE OUTLOOK

As the world transitions into an era defined by rapid technological advancements, environmental shifts, and socio-economic transformations, both India and the global community are confronted with an array of new challenges. These challenges span across diverse domains, including technology, health, environment, geopolitics, and economy. This chapter delves into the future outlook on managing these emerging challenges, focusing on strategies and perspectives from both an Indian and global standpoint.

1. Technological Disruption and Digital Transformation

Global Perspective

The pace of technological change is accelerating at an unprecedented rate, with breakthroughs in AI, machine learning, quantum computing, and biotechnology reshaping our world. These advancements are opening new doors and creating exciting opportunities across various fields. However, they also bring significant challenges, including increased risks to cybersecurity, potential job losses from automation, and important ethical questions about the use of AI.

Addressing these challenges requires a united global effort. International bodies like the United Nations and the World Economic Forum are at the forefront, working to promote responsible AI development, improve cybersecurity practices, and ensure that the benefits of technology are distributed equitably. By working together, we can harness the power of these innovations while mitigating their risks and ensuring a positive impact on society.

Indian Perspective

India is on the verge of making a significant impact in the global digital economy. The country's expanding IT sector and a pool of highly skilled professionals position it to excel in software development, AI, and fintech. However, there are hurdles to overcome, including improving digital infrastructure, ensuring data privacy, and boosting digital literacy.

To drive this digital revolution, the Indian government has introduced initiatives such as Digital India and the National AI Strategy. These efforts aim to upgrade digital infrastructure, foster innovation, and ensure that the benefits of digital advancements are widely shared, paving the way for inclusive growth and transformation.

2. Environmental Sustainability and Climate Change

Global Perspective

Climate change is one of the most urgent challenges facing our planet today. With rising temperatures, extreme weather events, and a decline in biodiversity already taking their toll on communities and economies worldwide, there's a pressing need for decisive action. To address these issues and transition to a sustainable, low-carbon future, global efforts are focused on initiatives like the Paris Agreement, which aims to limit global warming to well below 2 degrees Celsius above pre-industrial levels.

Countries around the world are increasingly turning to renewable energy sources, embracing circular economy practices, and investing in green technologies. These steps are crucial in mitigating the impacts of climate change and ensuring a more sustainable future for all.

Indian Perspective

India faces unique environmental challenges, including water scarcity, air pollution, and the vulnerability of its large agricultural sector to climate change. As one of the world's largest emitters of greenhouse gases, India's role in global climate action is critical.

India's commitment to achieving net-zero emissions by 2070, along with initiatives like the National Action Plan on Climate Change, reflects its dedication to addressing these challenges. India is also a leader in renewable energy, particularly solar power, and is working towards enhancing its capacity for climate resilience.

3. Public Health and Pandemic Preparedness

Global Perspective

The COVID-19 pandemic has underscored the importance of global health security and pandemic preparedness. Future pandemics, driven by factors such as urbanization, climate change, and global travel, are likely inevitable. Therefore, the international community must strengthen health systems, enhance surveillance, and promote vaccine equity.

Organizations like the World Health Organization (WHO) are crucial in coordinating global health responses. There is also a growing emphasis on One Health approaches, which recognize the interconnectedness of human, animal, and environmental health.

Indian Perspective

India's experience with COVID-19 highlighted both the strengths and weaknesses of its public health system. While the country demonstrated remarkable capacity in vaccine production and distribution, challenges such as healthcare infrastructure gaps and inequities in healthcare access were also evident.

Moving forward, India aims to strengthen its healthcare system by increasing investments in healthcare infrastructure, promoting digital health solutions, and ensuring universal health coverage. Initiatives like Ayushman Bharat, which aims to provide affordable healthcare to millions of Indians, are steps in this direction.

4. Geopolitical Shifts and Global Governance

Global Perspective

The global geopolitical landscape is becoming increasingly complex, characterized by shifting power dynamics, rising nationalism, and growing tensions between major powers. These changes are influencing global governance structures, trade relations, and international security.

To manage these challenges, there is a need for robust multilateral institutions that can adapt to new realities. The United Nations, the World Trade Organization, and other international bodies must evolve to address emerging issues such as cyber warfare, transnational terrorism, and the weaponization of trade.

Indian Perspective

India's geopolitical stance is evolving in response to the shifting global order. As a rising power, India is seeking to play a more prominent role on the global stage. This is reflected in its active participation in multilateral forums such as the G20, BRICS, and the Shanghai Cooperation Organization (SCO).

India's foreign policy is increasingly focused on balancing relations with major powers while strengthening ties with neighbouring countries and the Global South. Strategic partnerships, particularly in defence, trade, and technology, are central to India's approach to navigating the complex geopolitical environment.

5. Economic Resilience and Inclusive Growth

Global Perspective

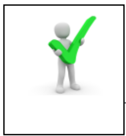
The global economy is facing a period of uncertainty, driven by factors such as technological disruption, climate change, and geopolitical tensions. Building economic resilience and promoting inclusive growth are key priorities for the future.

Countries are increasingly focusing on diversifying their economies, enhancing social safety nets, and promoting sustainable development. There is also a growing recognition of the need for global economic governance that can address issues like inequality, tax evasion, and the regulation of multinational corporations.

Indian Perspective

India's economic trajectory is marked by significant opportunities and challenges. As one of the fastest-growing major economies, India has the potential to lift millions out of poverty and become a global economic powerhouse. However, achieving this requires addressing structural issues such as unemployment, income inequality, and regional disparities.

The Indian government is implementing reforms to promote economic resilience, including initiatives to boost manufacturing, enhance infrastructure, and improve ease of doing business. The focus is also on ensuring that economic growth is inclusive, with policies aimed at supporting small and medium enterprises (SMEs), promoting financial inclusion, and expanding social welfare programs.



Check Your Progress-B

Q1. What are some of the key differences between India and global perspectives on managing new challenges in the business environment?

Q2. How do Indian companies typically respond to global challenges like supply chain disruptions compared to their global counterparts?

Q3. What is the future outlook for Indian businesses in comparison to global trends regarding the adoption of emerging technologies and business models?

Q4. Which of the following best describes the future outlook for global companies in terms of emerging technologies?

A) Slow adoption of new technologies due to high costs
B) Increasing reliance on traditional business models
C) Accelerated adoption of advanced technologies like AI and blockchain
D) Complete avoidance of technology-driven solutions

26.8 SUMMARY

1. **Economic and Political Landscape:** India's economic growth faces challenges from regulatory complexities and infrastructure issues, while global economies navigate diverse political and economic fluctuations.
2. Challenges in the Indian Business Environment: Indian businesses contend with infrastructural bottlenecks, regulatory hurdles, and a large informal economy.
3. **Innovation and Technology Adoption:** India's growing tech sector contrasts with varying tech adoption rates across traditional industries.
4. **Human Resource Management:** Managing a diverse workforce in India involves labour laws and upskilling, whereas global firms focus on employee engagement and development.
5. **Regulatory Framework:** Indian businesses must comply with complex regulations, while global companies face varied regulatory environments.
6. **Global Economic Trends:** Global businesses deal with trade policies and economic slowdowns, impacting supply chains and consumer demand.
7. **Multinational Challenges:** Multinational corporations face cultural, legal, and political complexities, requiring adaptable global strategies.
8. **Future Outlook:** Both India and global markets must address challenges in technology, sustainability, public health, and economic resilience to remain competitive.

26.9 GLOSSARY

Digital Transformation: The integration of digital technologies into all aspects of a business fundamentally transforms how companies operate and deliver value to their customers.

Sustainability: The practice of fulfilling present needs while ensuring that future generations can meet theirs, typically involves environmental, social, and economic considerations.

Frugal Innovation: A strategy that involves creating low-cost solutions and products, often by simplifying existing models, to meet the needs of cost-sensitive markets, particularly in developing countries like India.

Globalization: The process through which businesses or organizations expand their influence internationally or begin operating on a global scale, often resulting in greater interdependence among world economies.

Supply Chain Resilience: The ability of a supply chain to anticipate, prepare for, respond to, and recover from disruptions in a way that ensures continuity of operations and minimizes impact on customers.

Corporate Social Responsibility (CSR): A business model that helps a company be socially accountable to itself, its stakeholders, and the public by engaging in activities that benefit society and the environment.

Cross-Cultural Management: The practice of managing a workforce that includes individuals from different cultural backgrounds, taking into consideration cultural differences in business practices, communication, and management styles.

Talent Management: The systematic process of attracting, identifying, developing, engaging, retaining, and deploying high-potential individuals who hold significant value to an organization.

Intellectual Property Rights (IPR): Legal rights that protect the creations and inventions of individuals or organizations, including patents, trademarks, copyrights, and trade secrets.

Market Entry Strategy: A plan devised by a company to deliver its products or services to a new target market. This could involve direct exporting, joint ventures, franchising, or establishing new business operations.

Global Competitiveness: The ability of a country or company to compete successfully in the global market, often measured by the productivity and efficiency with which resources are used to produce goods and services.

Innovation Ecosystem: A network of organizations—including companies, universities, and government agencies—that interact as a system to foster innovation through collaboration, research, and the development of new technologies.

Risk Management: The process of identifying, evaluating, and managing threats to an organization's capital and earnings, which may arise from sources like financial uncertainties, legal liabilities, or strategic management errors.

Sustainability Reporting: The practice of publishing information about an organization’s environmental, social, and governance (ESG) performance, often in the form of annual reports or corporate sustainability reports.

Crisis Management: The process through which an organization manages disruptive and unforeseen events that pose a threat to the organization, its stakeholders, or the public.

E-Commerce: The buying and selling of goods or services online, involving the transfer of money and data to complete these transactions.

Corporate Governance: The system of rules, practices, and processes through which a company is directed and controlled, typically emphasizing the relationships between the company's management, board, shareholders, and other stakeholders.

Localization: The process of modifying a product or service to address the language, cultural, and other specific needs of a particular market or region.

Leadership Development: The process of enhancing the ability of individuals to perform leadership roles within an organization, often involving training, mentoring, and experiential learning.

Outsourcing: The practice of hiring external firms to handle certain business activities or functions, often to reduce costs or focus on core competencies.

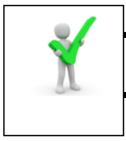
Offshoring: The transfer of a business process, such as manufacturing or support operations, from one country to another.

Regional Trade Agreement (RTA): A treaty between two or more governments that discusses the rules of trade for all signatories, often aimed at reducing or eliminating tariffs, import quotas, and preferences on traded goods and services.

Emerging Markets: Economies that are in the process of rapid growth and industrialization, often characterized by low to middle per capita income levels, such as India, China, and Brazil.

Megatrends: Large, transformative global forces that impact businesses, economies, industries, and societies, shaping the future and driving innovation and change.

Cultural Intelligence (CQ): The ability to relate to and work effectively across cultures, involving an understanding of cultural norms, practices, and context in business and social settings.



26.10 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

1. B) Regulatory complexities
2. D) Cross-cultural management
3. B) Compliance with environmental regulations

<u>Check Your Progress –B</u>

1. C) Accelerated adoption of advanced technologies like AI and blockchain

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10. "Digital India: Technology to Transform a Connection to Progress" by Deloitte

26.13 TERMINAL QUESTIONS

1. Choose a successful Indian company that has effectively managed a significant challenge (e.g., entering a global market, digital transformation, or sustainability). Analyze the strategies they used and compare them with the strategies of a similar global company. What factors contributed to their success?
2. Discuss the role of strategic partnerships and collaborations between Indian companies and global firms in managing new challenges. What are the benefits and risks associated with such collaborations, and how do they compare with partnerships in other regions?
3. Assess the current state of technology adoption in Indian businesses compared to global benchmarks. What are the barriers to technology adoption in India, and how can they be overcome to ensure that Indian businesses remain competitive globally?
4. Examine the role of government policies in shaping the business environment in India. How do these policies compare with those in other major economies, and what challenges do they present for Indian businesses in a globalized world?
5. Analyze how Indian businesses manage crises compared to global best practices. Use a recent example, such as the COVID-19 pandemic, to illustrate your points. What lessons can be learned from the differences in crisis management strategies?
6. Evaluate the challenges related to intellectual property rights that Indian companies face in the global market. How do these challenges differ from those faced by global corporations, and what strategies can Indian companies employ to protect their intellectual assets?

26.14 CASE LETS/CASES

Caselet 1: Digital Transformation in Indian Banking

Background: The Indian banking sector has been rapidly evolving with the advent of digital technologies. Traditional banks in India have been under pressure to adopt digital banking solutions to meet the changing demands of tech-savvy customers. However, the challenges of infrastructure, cybersecurity, and customer adoption have posed significant hurdles. Meanwhile, global banks with advanced digital ecosystems are setting high standards for digital services.

Scenario: A leading Indian bank, ABC Bank, has recently launched a mobile banking app aimed at providing a seamless digital experience for its customers. However, the app has faced issues such as server downtimes, security vulnerabilities, and low user adoption rates. In contrast, a global bank operating in India has successfully implemented its digital platform with high customer satisfaction.

Questions:

1. What are the key challenges faced by ABC Bank in implementing its digital transformation strategy?
2. Compare the digital strategies of ABC Bank with that of the global bank operating in India. What lessons can ABC Bank learn from its global counterpart?
3. What steps should ABC Bank take to address the issues of cybersecurity and customer adoption in the digital platform?
4. How can bank of India leverage local strengths while adopting global best practices in digital banking?

Caselet 2: Sustainable Manufacturing in India

Background: As the global focus on sustainability grows, Indian manufacturers are increasingly being asked to adopt environmentally friendly practices. While global companies have made great strides in sustainability through the use of advanced technology and resilient supply chains, many Indian companies struggle to balance sustainability with cost competitiveness. Scenario: XYZ Manufacturing, a mid-sized Indian automotive company, is facing criticism for its environmental impact, particularly in terms of high carbon emissions and waste management. The company's management is aware of global trends towards sustainable manufacturing and is exploring ways to integrate these practices into its operations. But the company is also concerned about potential increases in costs and the impact on profitability.

Questions:

1. What are the key barriers to sustainable manufacturing faced by Indian companies like XYZ Manufacturing?
2. How do the sustainability practices of global automotive companies differ from those of Indian companies? What are the drivers behind these differences?
3. What approaches can XYZ Manufacturing take to enhance its sustainability efforts while maintaining profitability?
4. How can Indian companies balance the need for sustainability with the pressures of maintaining cost competitiveness in the global market?

Caselet 3: Global Expansion of an Indian Tech Company

Background: India has emerged as a global hub for IT services, with many Indian tech companies expanding their operations internationally. However, entering foreign markets poses numerous challenges, including cultural differences, regulatory hurdles, and competition from well-established global players.

Scenario: TechSoft Solutions, an Indian IT services company, plans to expand its operations into Europe. The company has identified Germany as its entry point due to the country's strong demand for IT services and its strategic location within the EU. However, TechSoft faces challenges related to cultural integration, local competition, and compliance with EU data protection regulations.

Questions:

1. What are the primary challenges TechSoft Solutions might face in expanding its operations to Germany?
2. Compare the strategies that TechSoft Solutions could use to enter the German market with those typically employed by global IT companies. What are the potential advantages and disadvantages of each approach?
3. How should TechSoft Solutions address cultural differences and integrate into the local business environment in Germany?
4. What steps should the company take to ensure compliance with EU data protection regulations while maintaining its competitive edge?

Caselet 4: Supply Chain Resilience in the Indian Pharmaceutical Industry

Background: The COVID-19 pandemic exposed vulnerabilities in global supply chains, particularly in the pharmaceutical industry. Indian pharmaceutical companies, which are key suppliers of generic drugs globally, faced significant disruptions due to lockdowns, supply chain bottlenecks, and dependence on imported raw materials.

Scenario: PharmaCo, a leading Indian pharmaceutical company, experienced severe disruptions in its supply chain during the pandemic, leading to delays in production and distribution. The company is now looking to build a more resilient supply chain that can withstand future shocks. It is considering strategies such as diversifying suppliers, increasing local sourcing, and investing in digital supply chain technologies.

Questions:

1. What were the main factors contributing to the supply chain disruptions faced by PharmaCo during the COVID-19 pandemic?
2. Compare PharmaCo's supply chain challenges with those faced by global pharmaceutical companies. How did global companies mitigate these challenges, and what can PharmaCo learn from them?

3. What strategies should PharmaCo implement to enhance its supply chain resilience? Evaluate the potential risks and benefits of these strategies.
4. How can the Indian pharmaceutical industry as a whole improve its supply chain practices to better compete on a global scale?

Caselet 5: Leadership Challenges in Global Expansion

Background: Leadership styles can vary significantly across cultures, impacting how companies manage international teams and operations. Indian companies expanding globally often encounter leadership challenges related to managing diverse workforces and adapting to different business cultures.

Scenario: ABC Corp, an Indian conglomerate, has recently acquired a company in the United States as part of its global expansion strategy. The Indian leadership team, accustomed to a hierarchical management style, is finding it challenging to manage the American workforce, which values autonomy and flat organizational structures. This cultural disconnect is leading to communication issues, lower employee morale, and challenges in integrating the two companies.

Questions:

1. What are the key leadership challenges faced by ABC Corp in managing its newly acquired American company?
2. How do leadership styles in India differ from those in the United States, and how do these differences impact cross-cultural management?
3. What strategies can ABC Corp's leadership adopt to bridge the cultural gap and improve communication and morale in the American subsidiary?
4. How can Indian companies ensure effective leadership and management practices when expanding into culturally diverse markets?

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