UNIT-1 INTRODUCTION OF INDIAN FINANCIAL SYSTEM

Meaning of Indian financial system

The financial system enables lenders and borrowers to exchange funds. India has a financial system that is controlled by independent regulators in the sectors of insurance, banking, capital markets and various services sectors.

Thus, a financial system can be said to play a significant role in the economic growth of a country by mobilizing the surplus funds and utilizing them effectively for productive purposes.

FEATURES OF INDIAN FINANCIAL SYSTEM:

- It plays a vital role in economic development of a country.
- It encourages both savings and investment.
- It links savers and investors.
- It helps in capital formation.
- It helps in allocation of risk.
- It facilitates expansion of financial markets.

COMPONENTS/ CONSTITUENTS OF INDIAN FINANCIAL SYSTEM

The following are the four major components that comprise the Indian Financial System:

1. Financial Institutions

2. Financial Markets

3. Financial Instruments/ Assets/ Securities

4. Financial Services.

COMPONENT IS DISCUSSED BELOW:

FINANCIAL INSTITUTIONS

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions also provide services to entities (individual, business, government) seeking advice on various issue ranging from restructuring to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets or elsewhere.

Financial institutions are also termed as financial intermediaries because they act as middle between savers by accumulating Funds them and borrowers by lending these fund.

It is also act as intermediaries because they accept deposits from a set of customers (savers lend these funds to another set of customers (borrowers). Like - wise investing institutions such ICCIC, mutual funds also accumulate savings and lend these to borrowers, thus perform the role of financial intermediaries.

TYPES OF FINANCIAL INSTITUTIONS

Financial institutions can be classified into two categories:

A. Banking Institutions

B. Non - Banking Financial Institutions

A. BANKING INSTITUTIONS (Reserve Bank of India)

Indian banking industry is subject to the control of the Central Bank. The RBI as the apex institution organises, runs, supervises, regulates and develops the monetary system and the financial system of the country. The main legislation governing commercial banks in India is the Banking Regulation Act, 1949.

The Indian banking institutions can be broadly classified into two categories:

1. Organised Sector

2. Unorganised Sector.

1. Organised Sector

The organised banking sector consists of commercial banks, cooperative banks and the regional rural banks.

(a) Commercial Banks: The commercial banks may be scheduled banks or non – scheduled banks. At present only one bank is a non - scheduled hank. All other banks are schedule banks. The commercial banks consist of 27 public sector banks, private sector banks and foreign banks. Prior to 1969, all major banks with the exception of State Bank of India in the private sector. An important step towards public sector banking was taken in July 1969, when 14 major private banks with a deposit base of 50 crores or more were nationalised. Later in 1980 another 6 were nationalised bringing up the total number banks nationalised to twenty.

(b) Co-operative banks: An important segment of the organized sector of Indian banking is the co-operative banking. The segment is represented by a group of societies registered under the Acts of the states relating to co-operative societies. In fact, co-operative societies may be credit societies or non-credit societies.

Different types of co-operative credit societies are operating in Indian economy. These institutions can be classified into two broad categories: (a) Rural credit societies which are primary agriculture, (b) Urban credit societies which are primarily non-agriculture.

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For the purpose of agriculture credit there are different co-operative credit institutions to meet different kinds of needs.

(c) Regional Rural Banks (RRBs): Regional Rural Banks were set by the state government and sponsoring commercial banks with the objective of developing the rural economy. Regional rural banks provide banking services and credit to small farmers, small entrepreneurs in the rural areas. The regional rural banks were set up with a view to provide credit facilities to weaker sections. They constitute an important part of the rural financial architecture in India. There were 196 RRBs at the end of June 2002, as compares to 107 in 1981 and 6 in 1975.

(d) Foreign Banks: Foreign banks have been in India from British days. Foreign banks as banks that have branches in the other countries and main Head Quarter in the Home Country. With the deregulation (Elimination of Government Authority) in 1993, a number of foreign banks are entering India. Foreign Banks are: Citi Bank. Bank of Ceylon.

2. Unorganised Sector.

In the unorganised banking sector are the Indigenous Bankers, Money Lenders.

1. **Indigenous Bankers**

Indigenous Bankers are private firms or individual who operate as banks and as such both receive deposits and given loans. Like bankers, they also financial intermediaries. They should be distinguished professional money lenders whose primary business is not banking and money lending. The indigenous banks are trading with the Hundies, Commercial Paper.

2. **Money Lenders:**

Money lenders depend entirely to on their one funds. Money Lenders may be rural or urban, professional or non-professional. They include large number of farmer, merchants, traders. Their operations are entirely unregulated. They charge very high rate of interest.

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B. NON – BANKING INSTITUTIONS

The non – banking institutions may be categorized broadly into two groups:

(a) Organised Non – Banking Financial Institutions.

(b) Unorganised Non – Banking Financial Institutions.

(a) Organised Non – Banking Financial Institutions

The organised non - banking financial institutions include:

1. **Development Finance Institutions**.

These include: The institutions like IDBT, ICICI, IFCI, IIBI, IRDC at all India level.

The State Finance Corporations (SFCs), State Industrial Development Corporations (SIDCs) at the state level.

Agriculture Development Finance Institutions as NABARD,LDBS etc. Development banks provide medium and long term finance to the corporate and industrial sector and also take up promotional activities for economic development

2. Investment Institutions.

These include those financial institutions which mobilise savings at the public at large through various schemes and invest these funds in corporate and government securities. These include LIC, GIC, LTT, and mutual funds. The non - banking financial institutions in the organised sector) have been discussed at length in detail in separate chapters of this book.

(b) Unorganised Non - Banking Financial Institutions

The unorganised non - banking financial institutions include number of non - banking financial companies (NBFCs) providing whole range of financial services. These include hire - purchase 300 consumer finance companies, leasing companies, housing finance companies, factoring companies, Credit rating agencies, merchant banking companies etc. NBFCs mobilise public funds and provide loanable funds.

FINANCIAL MARKET

It is through financial markets and institutions that the financial system of an economic works. Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds etc.

Functions of financial markets are:

(i) To facilitate creation and allocation of credit and liquidity
(ii) To serve as intermediaries for mobilisaton of savings.
(iii) To assist the process of balanced economic growth.
(iv) To provide financial convenience.
(v) To cater to the various credit needs of the business houses.

These organised markets can be further classified into two they are

(i) Capital Market

(ii) Money Market

CAPITAL MARKET

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely:

(I) Industrial securities market

(II) Government securities market and

(III) Long term loans market

1. INDUSTRIAL SECURITIES MARKET:

As the very name implies, it is a market for industrial securities namely:
(i) Equity shares or ordinary shares,
(ii) Preference shares and
(iii) Debentures or bonds.

It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are:
(i) Primary market or New issue market
(ii) Secondary market or Stock exchange

PrimaryMarket
Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time.
In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market. They are:

(i) Public issue
(ii) Rights issue
(iii) Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called **public issue**. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called **rights issue. Private placement** is a way of selling securities privately to a small group of investors.

SecondaryMarket
Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted the Stock Exchange and it provides a continuous and regular market to buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

II. GOVERNMENT SECURITIES MARKET

It is otherwise called Gilt - Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities - short term and long term. Long term securities are traded in this market while short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi Government authorities like City Corporations, Port Trusts etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

III. LONG TERM LOANS MARKET

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers.

Long term loans market may further be classified into:

(1) Term loans market

(ii) Mortgages market

(iii) Financial Guarantees market.

Term Loans Market

In India, many industrial financing institutions have been created by the Government both at the national and regional levels to supply long term and medium term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IDBI, IFCI, ICICI, and other financial corporations come under this category.

Mortgages Market

A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one.

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MONEY MARKET

Money market is a market for dealing with financial assets and securities which have a maturity period of upto one year. In other words, it is a market for purely short term funds. The money market may be subdivided into four. They are:

(i) Call money market

(ii) Commercial bills market

(iii) Treasury bilis market

(iv) Short term loan market.

Call Money Market

The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Bombay, Calcutta, Madras, Delhi, Ahmedabad etc. The special feature of this market is that the interest rate varies from day to day and even from hour to hour and Centre to Centre. It is very sensitive to changes in demand and supply of call loans.

Commercial Bills Market

It is a market for Bills of Exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

Treasury Bills Market

It is a market for treasury bills which have ' short - term ' maturity. A treasury bill is a promissory note or a finance bill issued by the Government.

It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short term borrowing of the Government There are two types of treasury bills namely (i) ordinary or regular and (ii) ad hoc treasury bills popularly known as ' ad hocs’. **Ordinary treasury bills** are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short term financial needs. Ad hoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. **Ad hocs** are not marketable in India but holders of these bills can sell them back to RBI.

Short - Term Loan Market

It is a market where short - term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short term loans in the form of cash credit and overdraft Over draft facility is mainly given to business people whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But cash credit is for a period of one year and it is sanctioned in a separate account.

FINANCIAL INSREUMENTS

Financial instruments refer to those documents which represents financial claims on assets. As discussed earlier, financial asset refers to a claim to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples: Bill of exchange, Promissory Note, Treasury Bill.

Financial securities can be classified into:

(i) Primary or direct securities.

(ii) Secondary or indirect securities.

Primary Securities

These are securities directly issued by the ultimate investors to the ultimate savers. Eg. shares and debentures issued directly to the public.

Secondary Securities

These are securities issued by some intermediaries called financial intermediaries to the ultimate savers. Eg. Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows:

(i) Short - term securities

(ii) Medium term securities

(iii) Long - term securities.

Short - term securities are those which mature within a period of one year. Eg, Bill of Exchange, Treasury bill, etc. **Medium term securities** are those which have a maturity period ranging between one and five years. Eg. Debentures maturing within a period of 5 years, **Long - term securities** are those which have a maturity period of more than five years. Eg, Government Bonds maturing after 10 years.

FINANCIAL SERVICES

Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries. The term financial services can be defined as “activities, benefits, and satisfactions, connected with the sale of money, that offer to users and customers, financial related value. within the financial services industry the main sectors are banks, financial institutions, and non-banking financial companies.

KINDS OF FINANCIAL SERVICES

Financial services provided by various financial institutions, commercial banks and merchant bankers can be broadly classified into two categories.

1. Asset based/fund based services.
2. Fee based/advisory services.

Asset based/fund based services

The asset/ fund based services provided by banking and non - banking financial institutions as discussed below briefly.

1. Equipment Leasing/ Lease Financing

Leasing is a 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. However, in making an investment, the firm need not own the asset. It is basically interested in acquiring the use of the asset. Thus, the firm may consider leasing of the asset rather than buying it.

In comparing leasing with buying, the cost of leasing the asset should be compared with the cost of financing the asset through normal sources of financing, i. e. debt and equity. Since payment of lease rentals is similar to payment of interest on borrowings and lease financing is equivalent to debt.

2. Hire Purchase and Consumer Credit

Hire purchase means a transaction where goods are purchased and sold on the terms that (i) payment will be made it installments, (ii) the possession of the goods is given to the buyer immediately, (iii) the property ownership) in the goods remains with the vendor till the last installment is paid,(iv) the seller can repossess the goods in case of default in payment of any instalment, and (v) each instalment is treated as hire charges till the last instalment is paid.

Consumer credit includes all asset based financing plans offered to individuals to help them acquire durable consumer goods. In a consumer credit transaction the individual/ consumer/ buyer pays a part of the cash purchase price at the time of the delivery of the asset and pays the balance with interest over a specified period of time.

3.VENTURE CAPITAL

In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These **venture capital** companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters contribution as required by the financial institutions. In addition to providing capital, these VCFS (venture capital firms) take an active interest in guiding the assisted firms.

4. Insurance Services

Insurance is a contract where by the insurer e. insurance company agrees/ undertakes, in consideration of a sum of money (premium) to make good the loss suffered by the insured (policy holder) against a specified risk such as fire or compensate the beneficiaries (insured) on the happening of a specified event such as accident or death. The document containing the terms of contract, in black and white, between the insurer and the insured is called policy. The property which is insured is the subject matter of insurance. The interest which the insured has in the subject matter of insurance is known as insurable interest. Depending upon the subject matter, insurance services are divided into (i) life (ii) general.

5. Factoring

Factoring, as a fund based financial service provides resources to finance receivables as well as it facilitates the collection of receivables. It is another method of raising short - term finance through account receivable credit offered by commercial banks and factors.

A commercial bank may provide finance by discounting the bills or invoices of its customers. Thus, a firm gets immediate payment for sales made on credit. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales.

B. FEE BASED ADVISORY SERVICES

(i) Merchant Banking

Fee based advisory services includes all these financial services rendered by Merchant Bankers. Merchant bankers play an important role in the financial services Sector. The Industrial Credit and Investment Corporation of India (ICICI) was the first development finance institution to initiate such service in 1974. After mid - seventies, tremendous growth in the number of merchant banking organisations les taken place. These include banks financial institutions, **non - banking financial companies (**NBFCS), brokers and so on. financial Services provided by these organisations include loan syndication portfolio management, corporate counselling project counselling debenture trusteeship, mergers acquisitions.

(ii) Credit Rating

Credit rating is the opinion of the rating agency on the relative ability and willingness of the issuer of debt instrument to meet the debt service obligations as and when they arise. As a fee based financial advisory service, credit rating useful to investors, corporates (borrowers), banks and financial institutions. For the investors, it is an indicator expressing the underlying credit quality of a (debt) issue programme. The investor is fully formed about the company as any effect of changes in business/ economic conditions on the agency company is evaluated and published regularly by the rating agency.

(iii) Stock - Broking

Prior to the setting up of SEBI, stock exchanges were being supervised by the Ministry of Finance under the Securities Contracts Regulation Act (SCRA) and were operating more or less self-regulatory organisations.

The need to reform stock exchanges was felt, when malpractices crept into Trading and in order to protect investor's interests, SEBI was set up to ensure that stock exchange perform their self - regulatory role properly. Since then, stock broking has emerged as a professional advisory service Stockbroker is a member of a recognised stock exchange who buys, sells or deals in shares/ securities. It is mandatory for each stockbroker to get him/ herself registered with SEBI order to act as a broker. SEBI is empowered to impose conditions while granting the certificate of registration.

FINANCIAL MARKET

It is through financial markets and institutions that the financial system of an economic works. Financial markets refer to the institutional arrangements for dealing in financial assets and credit instruments of different types such as currency, cheques, bank deposits, bills, bonds etc.

Financial market classified into two they are:

(i) Money Market

(ii)Capital Market

(i) Money Market

Money market is a market for dealing with financial assets and securities which have a maturity period of upto one year. In other words, it is a market for purely short term funds.

The importance/functions of the money market is highlighted as under:

1. Economic development: The money market provides short term funds to both public and private institutions. These institutions need money to finance their capital needs.

In other words, the money market assures supply of funds; the financing is done through discounting of the trade bills, commercial banks, acceptance houses, discount houses and brokers. In this way, the money market helps in the economic development by providing financial help to trade, commerce and industry. The businessmen take advantage by investing their cash in

highly liquid assets to earn income and also to enjoy liquidity because these assets can be converted into cash without much difficulty.

2. Profitable investment: The commercial banks deal with the deposits of their customers. The banks are required to put their assets into cash form to meet the directions of the central bank on the one hand, while on the other, they have to put their excess reserves into productive channels to earn income on them. The aim of the commercial banks is to maximize profits. The excess reserves of the banks are invested in near money assets.

3. Borrowings by the government:

The money market helps the government in borrowing short term funds at very low interest rates. The borrowing is done on the basis of treasury bills. But in case the government resorts to deficit financing or to print more currency or to short term funds at the money supply over and above the borrow from the central bank, it will merely raise Thus it is clear that the needs of the economy and hence the price level will boost up. Money market is very useful for the government since it meets its financial needs.

4. Importance for central bank:

If the money market is well - developed, the central bank implements the monetary policy successfully. It is only through the money market that the central bank can control the banking system and thus contribute to the development of trade and commerce. The money market is very sensitive a change in one sub – market affects the other sub - markets immediately. It means the central bank can affect the whole money market by changing just one sub - market.

5. Mobilisation of funds:

The money market helps in transferring funds from one sector to another. The development of any economy depends on availability of finance. No country can develop its trade, commerce and industry until and unless the financial resources are mobilized.

6. Savings and investment

The money market is that it helps in promoting liquidity and safety of financial assets. By doing so it can help in encouraging savings and investment. The saving and investment equilibrium of demand and supply of loanable funds helps the allocation of resources.

CAPITAL MARKET

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

FUNCTIONS OF CAPITAL MARKET

' The major functions performed by a capital/ security market are:

1. Helps in capital formation.

The capital market plays an important role in mobilisation of savings and channel them into productive investments for the development of commerce and industry. As such, the capital market helps in capital formation and economic growth of the country.

2. Act as link between savers and investors.

The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called "Surplus units" and the borrowers are known as " deficit units. The capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus unity lend their surplus funds to deficit units.

3. Helps in increasing national income.

Funds come into the capital market from individuals and financial intermediaries and are used by commerce, industry and government. It thus facilitates the transfer of funds to be used more productively and profitability to increases the national income.

4. Facilitates buying and selling.

Surplus units buy securities with their surplus funds and deficit wits ells securities to raise the funds they need. Funds flow from lenders to borrowers either directly or indirectly through financial institutions such as banks, unit trusts, mutual funds, etc. The borrowers issue primary securities which are purchased by lenders either directly or indirectly through financial institutions.

5. Channelizes funds from unproductive to productive resources.

The capital market provides a market mechanism for those who have savings and to those who need funds for productive investments. It divers resources from wasteful and unproductive channels such as gold, jewellery, real estate, conspicuous consumption, etc, to productive investments

6. Minimises speculative activities.

It does so by providing capital to the needy al reasonable interest rates and helps in minimising speculative activities.

7. Brings stability in value of stocks.

A well - developed capital market comprising expert banking and non - banking intermediaries brings stability in the value of stocks and securities..

8. Promotes economic growth. The capital market encourages economic growth. The various institutions which operate in the capital market give quantities and qualitative direction to the flow of funds and bring rational allocation of resources. They do so by converting financial assets into productive physical assets. This leads to the development of commerce and industry through the private and public sector, thereby inducing economic growth.

Primary Market / New Issue Market

Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time.

In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market.

FEATURES OF PRIMARY MARKETS

(i) This is the market for new long term equity capital. The primary market is the market where the securities are sold for the first time. Therefore it is also called the new issue market (NIM).

(ii) in a primary issue, the securities are issued by the company directly to investors.

(iii) The company receives the money and issues new security certificates to the investors

(iv) Primary issues are used by companies for the purpose of setting up new business or for expanding or modernizing the existing business.

(v) The primary market performs the crucial function of facilitating capital formation in the economy.

(vi) The new issue market does not include certain other sources of new long term external

finance, such as loans from financial institutions. Borrowers in the new issue market may be raising capital for converting private capital into public capital, this is known as " going public. "

FUNCTIONS OF NEW ISSUE MARKET

A three service functions:

The main functions of a new issue sue market can divided into new project.

1. **Origination.**

It refers to the work of investigation analysis and processing of new project proposals.. It starts before an issue is actually floated in the market. This function is done by merchant bankers who may be commercial banks, all India financial institutions or private firms. At present, financial institutions and private firms also perform this service is highly important the success of the issue depends, to a large extent on the efficiency of the market.

2. **Underwriting.**

It is an agreement whereby the underwriter promises to subscribe to specified number of shares or debentures or a specified amount of stock in the event of public not subscribing to the issue. If the issue is fully subscribed, then there is no liability for the underwriter. If a part of share issues remains unsold, the underwriter will buy the shares. Thus, underwriting is a guarantee for marketability of shares. There are two types of underwriters in India - Institutional (LIC, UTI, IDBI, ICICI) and Non - institutional are brokers.

3. **Distribution.**

It is the function of sale of securities to ultimate investors. This service is performed by specialized agencies like brokers and agents who maintain a regular direct contact with the ultimate investors.

SECONDARY MARKET

Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted the Stock Exchange and it provides a continuous and regular market to buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

FUNCTIONS OF STOCK EXCHANGE

The stock exchanges play an important role in the economic development of a country.

The importance of stock exchange will be clear from the functions they perform and discussed:

as follows: provide a place where shares and stock

1. Ensure Liquidity of Capital.

The stock exchanges where buyers and sellers are converted into cash. The exchanges provide a ready market. Had are always available and those who are in need of hard cash can sell their holdings this not been possible then many persons would have feared for blocking their savings in Securities as they can not again convert them into cash.

2. Continuous Market for Securities.

The stock exchanges provide a ready market in securities. The securities once listed continue to be traded at the exchanges irrespective the fact that owners go on changing. The exchanges provide a regular market for trading in securities.

3. Mobilising Surplus Savings.

The stock exchanges provide a ready market for various securities. The investors do not have any difficulty in investing their savings by purchasing shares, bonds etc, from the exchanges. If this facility is not there then many persons who want to invest their savings will not find avenues to do so. In this way stock exchanges play an important role in mopping up surplus funds of investors.

4. Helpful in Raising New Capital.

The new and existing concerns need capital for their activities. The new concerns raise capital for the first time and existing units increase their capital for expansion and diversification purposes. The shares of new concerns are registered at stock exchanges and existing companies also sell their shares through brokers etc, at exchanges. The exchanges are helpful in raising capital both by nets old concerns.

5. Safety in Dealings.

The dealings at stock exchanges are governed by well - defined rules and regulations of Securities Contract (Regulation) Act, 1956. There is no scope manipulating transactions. Every contact is done according to the procedure laid down and there is no fear in the minds of contracting parties. The safety in dealings brings confidence in the minds of all concerned parties and helps in increasing various dealings.

6. Listing of Securities.

Only listed securities can be purchased at stock exchanges. Every company desirous of listing its securities will apply to the exchange authorities. The listing is allowed only after a critical examination of capital structure, management and prospects of the company. The listing of securities gives privilege to the company. The investors can form their own views about the securities because listing a security does not guarantee the financial stability of the company.

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.7. Smoothens the Price Movements.

A stock exchange smoothens the price movements of stocks in the market by ensuring a continuous flow of securities,

8. Investor Protection.

The stock exchange renders safeguarding activities for investors in securities. It provides a grievance redressal mechanism for investors. Stock exchanges also operate a compensation fund for the protection of investors.

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UNIT-3 FINANCIAL SERVICES

FINANCIAL SERVICES

Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries. The term financial services can be defined as "activities, benefits, and satisfactions, connected with the sale of money, that offer to users and customers, financial related value. within the financial services industry the main sectors are banks, financial institutions, and non-banking financial companies.

FACTORING

INTRODUCTION

Receivables constitute a significant portion of Current Assets of a firm. But for investment in receivables, a firm has to incur certain costs such as Lusts financing receivables and costs of collection from receivables. Further, there is a risk of had debts also, it is therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses to types of problems; the problem of raising funds to finance the receivables, and (ii) the problems relating to collection, delays and defaults of the receivables. A small firm may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. In such a casts, a firm nay avail the services of specialised institutions engaged in receivable management, called factoring firms.

MEANING & DEFINITION

Factoring may broadly be defined as the relationship, created by an agreement between the seller of goods/ services and a financial institution called the factor, whereby the later purchases the receivables of the former and also controls and administers the receivables of the former

Factoring may also be defined as a continuous relationship between Financial institution (the factor) and business concern selling goods and/ or providing

service (the client) to a trade customer on an open account basis, whereby the factor purchases the client's book debts(account receivables) with or without recourse to the client , thereby controlling the credit extended to the customer and also undertaking to administer the sales ledgers relevant to the transaction.

FUNCTIONS OF THE FACTOR

These are the functions of factor:

1. Administration of Sales Ledger.

The factor maintains sales ledger in respect of each client. When the sales transaction action takes place an invoice is prepared in duplicate by the client one copy is given to customer and second copy is sent to the factor. Entries are made in the ledger on open - item method.

Each receipt is matched against the specific invoice. Periodic reports are sent by factor to the client with respect to current status of receivables and amount received from customers. Depending upon the volume of transactions, the periodicity of report is decided. Thus, the entire sales ledger administration responsibility of the client gets transferred to the factor.

2. COLLECTION OF RECEIVABLES

The main functions is to collect the receivables on behalf of the client and to relieve him from all the botheration/ problems associated with the collection. This way the client can concentrate on other major areas of his business on one hand and reduce the cost of collection by way of savings in labour, time and efforts on the other hand.

3. PROVISION OF FINANCE

Finance, which id the life blood of a business, is made available easily by the factor to the client. A factor purchases the book debts of his client and debts are assigned in favour of the factor. 75 % to 80 percent of assigned debts is given as an advance to the client by the factor.

(i) Where an agreement is entered into between the client (seller) and the factor for the purchase of receivables without recourse, the factor becomes responsible to the seller on the date of the invoice whether ether or not the buyer makes the payment to the factor.

4. PROTECTION AGAINST RISK

This service is provided where the debts are factored without recourse. The factor fixes the credit limits (i.e. the limit up to which the client can sell goods to customers) in respect of approved customers and factor collect that fixed trade debt.

The factor not only relieves the client from the collection work And also advises the client on the creditworthiness of potential customers.

The credit standing of the customer is assessed by the factors on the basis of information collected from credit rating reports, bank reports, trade reference, financial statement.

5. Advisory Services

These services arise out of the close relationship between a factor and a client. Since the factors are better knowledge and wide experience in field of finance, and possess extensive credit Information about customer's standing, they provide various advisory services on the matters relating to:

(i) Customer ' s preferences regarding the clients products,

(ii) Changes in marketing policies/ strategies of the competitors.

(iii) Suggest improvements in the procedures adopted for invoicing, delivery and sales return.

(iv) Helping the client for raising finance from banks/ financial institutions, etc.

TYPES OF FACTORING

A number of factoring arrangements are possible depending upon the agreement reached between the selling firm and the factor. The most common feature of practically all the factoring transactions is collection of receivables and administration of sale ledger. However, following are some of the important types of factoring arrangements.

(i). Recourse and Non - recourse Factoring

In a **recourse factoring** arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, i.e. the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables. Thus the factor acts as an agent for collection of bills and does not cover the risk of customer 's failure to pay debt or interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by client (selling firm) for the period.

Whereas, in case of **non - recourse factoring**, the risk or loss on account of non - payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non - payment, commission or fees charged for the services in case of non - recourse factoring is higher than under the recourse factoring. The additional fee charged by the factor for bearing the risk of bad debts/ non - payment on maturity is called **Del credere commission**.

(ii) Maturity Factoring

Under this type, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire amount collected less factoring fees is paid to the client immediately. Hence it is also called

collection Factoring '. In fact, under this type, no financing is involved. But all other services are available.

(iii) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc., has to be done by the client himself. Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as " Disclosed Factoring " or " Notified Factoring "

(iv) Agency Factoring

The word agency has no meaning as far as factoring is concerned, Under this type, the factor and the client share the work between themselves as follows:

(i) The client has to look after the sales ledger administration and collection work and

(ii) The factor has to provide finance and assume the credit risk.

(v) International Factoring

Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely the basis of the invoice prepared by the exporter. Thus, the exporter able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

(vi) Suppliers Guarantee Factoring

This type of factoring is suitable for business establishments which sell goods through middlemen Generally goods are sold through wholesalers, retailers or through middlemen. In such cases, the factor guarantees the supplier of goods against invoices raised by the supplier upon another supplier. The bills are

assigned in favour of the factor who guarantees payment of those bills. This enables the supplier to earn profits without much financial involvement.

(vii) Limited Factoring

Under this type, the factor does not take up all the invoices of a client. He discounts only selected invoices on merit basis and converts credit bills into cash in respect of those bills only.

(ix) Buyer Based Factoring

In most cases, the factor is acting as an agent of the seller. But under this type, the buyer approaches a factor to discount his bills. Thus, the initiative for factoring comes from the buyers ' end. The approved buyers of a company approach a factor for discounting their bills to the company in question. In such cases, the claims on such buyers are paid by discounting the bills without recourse to the seller and the seller also gets ready cash. This facility is available only to reputed credit worthy buyers and hence it is also called selected Buyer Based Factoring,

(x) Seller Based Factoring

Under this type, the seller, instead of discounting his bills, sells all his accounts receivables to the factor, after invoicing the customers. The seller ' s job is over as soon as he prepares the invoices. Thereafter, all the documents connected with the sale are handed over to the factor who takes over the remaining functions. This facility is extended to reputed and credit worthy sellers and hence it is also called Selected Seller Based Factoring!

LEASING

INTRODUCTION

The main objective of a business is to maximise the owner ' s economic welfare. The firm makes investments to maximise stockholder's wealth. After identifying attractive projects, the firm considers various methods of financing them. 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. c. land and buildings. But today, almost 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. Since then, a number of medium to large - sized companies, financial institutions like ICICI, IRCI, SICOM and CIC have also entered the field of leasing.

MEANING

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. Lease is a contract between the owner of the asset (lessor) and the user of the asset called the lesser, whereby the lessor gives the right to use the asset to the lessee over an agreed period of time for a consideration called the lease rental. The lease contract is regulated by the terms and conditions of the agreement. The lessee pays the lease Tent periodically to the lessor as regular fixed payments over a period of time. The rentals may be payable at the beginning or end of a monthly, quarter, half - year or year. The lease rentals can also be agreed both in terms of amount and timing as per the profits and cash flow position of the lessee. At the expiry of the lease period, the asset reverts back to the lessor who is the legal owner of the asset.

ESSENTIAL ELEMENTS OF LEASING

1. No. of Parties to the Contract. There are always two parties to a contract of lease financing

(a) The user or the lessee (b) The owner or the lessor

2. Asset. The subject matter of a lease financing contract may be an asset, property equipment e.g. plant and machinery, land and building etc.

3. Consideration. The right to use an asset is given to lessee for a consideration called lease rental. Lease rent is determined by the lessor taking into consideration the capital invested in the asset, depreciation, interest on capital, repairs etc.

4. Lease Period. A contract of leasing is usually undertaken for a fixed period (no. of years). It may sometimes spread over the entire economic/ useful life of the asset. At the expiry of the lease period, the asset reverts back to the lesser who is the legal owner of the asset.

5. Use VIS. Ownership. During the term of lease, ownership of the asset remains with the lessor where as the possession of asset lies with the lessee. He is allowed to use the asset during the tenure of lease agreement.

Types of Leasing

1. Operating Leasing

2. Financial Leasing

OPERATING OR SERVICE LEASE

An operating lease is usually characterised by the following features:

(i) It is a 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 has to 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 lease period.

(v) The lessor is generally responsible for maintenance, insurance and taxes of the asset. He may also provide other services to the lessee.

As it is a short - term cancellable lease, it implies higher risk to the lessor but higher lease rentals to the lessee Operating or service leasing is common to the equipment which require expert technical stat for maintenance and are exposed to technological developments, e.g. computers, vehicles

II. FINANCIAL LEASE

A lease is classified as financial lease if it ensures the term of the lessor for amortisation of the entire cost of investment plus the expected return on capital outlay during the term of the lease. Such a lease is usually for a longer period and non - cancellable. As a source of funds, the financial leases is an alternative similar to debt financing. Most of the leases in India are financial leases that are commonly used for leasing land, building, machinery and fixed equipment.

A financial lease is usually characterised by the following features:

(1) The present value of the total lease rentals payable during the period of the 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 recovery his investment in the asset along with an acceptable rate of return.

(2) As compared to operating lease, a financial lease is for a longer period of time.

(3) It is usually non - cancellable by the lessee prior to its expiration date.

(4) The lessee is generally responsible for the maintenance, insurance and service of the asset. However, the terms of lease agreement, in some cases. may require the lessor to maintain and service the asset. Such an arrangement is called **' Maintenance or gross lease'**.

(5) A financial lease usually provides the lessee an option of renewing the lease for further period at a nominal rent.

Forms of Financial Lease arrangements:

The following are the important forms of financial lease arrangements:

(i) 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. A sale and leaseback arrangement is generally preferred by firms facing shortage of working capital funds. The lessors engaged in sale and lease back include insurance companies, pension funds, private finance companies and financial institutions.

(ii) Direct Leasing. In contrast with sale and leaseback, under direct leasing a firm acquires the use of an asset that it does not already man. A direct lease may be arranged either the manufacturer supplier directly or through the leasing company.

In the first case, the manufacturer/ supplier himself acts as the lessor while in the second case the lessee firm arranges the purchase of the asset for the

leasing company (lessor) from the manufacturer or the supplier and also enters into an agreement with the lessor for the lease of on the asset.

(iii) Leveraged Lease. A leveraged lease is an arrangement under which the lessor borrows funds for purchasing the asset, from a third party called lender which is usually a bank, finance company. The loan is usually secured by the mortgage of the asset and the 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 only the excess amounts to the lessor. The lessor acts as the owner as well as the borrower and the lender is usually a bank insurance company financial institution or a private financing company.

(iv)Straight Lease and Modified Lease. Straight lease requires the lessee firm to pay lease rentals over the expected service life of the asset and does not provide for any modifications to the terms and conditions of the basic lease.

Modified lease, on the other hand, provides several options to the lessee during the lease period. For example, the option of terminating the lease may be provided by either purchasing the asset or returning the same.

(v) Primary and Secondary Lease (Front - ended and Back - ended Lease). Under primary and secondary lease, the lease rentals are charged in such a manner that the lesser recovers the cost of the asset and acceptable profit during the initial period of the lease and then a secondary lease is provided at nominal rentals. In simple words, the rentals charged in the primary period are much more than that of the secondary period. This form of lease arrangement is also known as front - ended and back - ended lease.

OTHER TYPES OF LEASES

(1) Floating Rental Rate Lease Contracts. Frequent changes in the interest rates in the last few years have led to this type of lease contract. Under this type of lease, lease rentals are reduced or increased according to the borrowing rates by the lessor. This type of lease contract permits the lessee to undertake the risk and enjoy the benefits of interest rate variations

(2) Domestic Lease and International Lease. When the lessor, lessee and the equipment supplier involved in the lease contract are resident in the same country, the lease transaction is said to be domestic lease. When the parties to the lease contract are residing in different countries it is known as international lease.

It is of two types:

(a) Import Lease. In this type of lease, both the lessor and lessee are residing in the same country but the equipment supplier belongs to different country. The lessor first imports the equipment and leases it to the lessee.

(b) Cross Border Lease. When a lessor - leases an equipment to a lessee who is not falling in the jurisdiction of the lessor ' s country then the lease is known as cross Border leasing, the domicile of the supplier is immaterial.

(3) Sale - Aid Leasing. Under this type of leasing, a manufacturer directly extends facility of leasing either by one of his own subsidiaries of through a third party. The leasing enables a manufacturer to have direct liaison with the customer, ensure regular updating or replacement of equipment and improve sales position. The lessee is also at great advantage because he gels asset on monthly payment basis spread out on a very long period. He gets the asset installed and operational without incurring capital expenditure.

CONSUMER FINANCE

Consumer Finance/ Consumer Credit includes all asset based financing plans offered to individuals to help them acquire durable consumer goods. In a consumer credit transaction the individual/ consumer/ buyer pays a part of the cash purchase price at the time of the delivery of the asset and pays the balance with interest over a specified period of time.

IMPORTANCE/ADVANTAGES OF CONSUMER FINANCE

Consumer finance plays an important role in the mass production and distribution of consumer durables such as motorcars, refrigerators, TV sets. radios, typewriters, sewing machines, electrical Appliances and many other

goods. Offering credit is a great convenience to consumers. Further, credit has come to occupy an important place in the modern competitive market. It is used as a selling device and also as an ideal method of sale promotion.

Following arguments can be given in favour of consumer of consumer finance:

(i) Enjoying Possession of Goods. An important benefit of consumer credit is that it allows people the possession of goods without having to pay for them immediately. The user does not have to wait and save money for purchasing a dream product.

(ii) Compulsory Saving. Consumer credit allows for a mechanism of compulsory saving. This has the effect of inducing people into using their income more wisely. It promotes thrift among people and enables people with limited means to acquire goods.

(iii) Easy Mode of Purchase. Consumer credit through the open account system, offers a convenient mode of acquiring consumer durables.

(iv) To Meet Emergency Needs. Consumer credit is useful in meeting emergencies, such as illness, accident and death, which involve expected expenses. This also helps save the esteem of the consumer in dire circumstances.

(v) Maximization of Revenue. Consumer credit facilitates speedy disposal of goods, which would have remained unsold in the absence of a credit facility to customers. Credit induces more business. This is quite true with regard to non - essential or luxury goods, such as motorcars, trucks, refrigerators, typewriters, all kinds of electrical appliances, TV sets, sewing machines, etc. It is therefore possible for the manufacturers and dealers to secure ever - increasing sales and profits through credit sales.

(vi) Realization of Dreams. Consumer credit is a boon for a consumer who can enjoy the possession of goods without paying for them immediately. The installments can be conveniently paid, spread over a fixed future period.

Consumers are in a position to budget for the purchase of even expensive capital items out of their regular, fixed and limited income .

1. AUTOMOBILE FINANCE (VEHICLE FINANCE)

The changing paradigm of society and further in this era of fast life every one wants to own a vehicle of his own. Thus, auto loans have become a need of the hour because the people who do ne have sufficient funds prefer to buy today and pay tomorrow Under the banks auto loan scheme the is a vehicle loan for every classic 2 wheeler ' s loan, 2nd hand car loans, new car loan. The market auto loans is large and lot of opportunity exists there for the banks and other finance companies who by adopting customer friendly policies and mass advertising can surely make auto loan schemes a success.

Eligibility. Auto loan facility is extended to

(i)Permanent employees of government, public/ private sector with minimum of 3 years' service.

(ii)Professionals and self-employed such as doctors, CAs, Company Secretaries, engineers architects and MBAs etc.

(iii) Persons engaged in agricultural and allied activities.

Purpose. Auto loans are extended for the purchase of vehicle both for personal and professional.

Type of loan. Finance is provided in form of term loans extending for a period from 1 to 5 years.

Rate of Interest. The rate of interest varies from bank to bank.

Security. All the banks ask for hypothecation of the financed automobile.

Insurance. All vehicles are insured. A comprehensive insurance policy is taken for market value or 10 % above the loan amount whichever is higher. Bank ' s interest is noted in policy.

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Processing Charges. Most of the banks do not charge any processing fee, or 250 to 500 may be collected as one time fee from the customers.

Price Discounts. Some banks offer various discounts to its customers in the form of any of the

following:

(a) Volume discount of 0. 5 % is offered to customers taking a loan for more than one car or an existing auto loan customer availing another loan subject loan. to satisfactory conduct of earlier

(b) Relationship discount of 1. 0 % may be offered to applicant maintaining current account or saving bank account satisfactory for atleast 3 months, customer having an equivalent amount of FD with lien marked to bank and applicant maintaining satisfactory working capital or term loan account.

(c) Good Credit Discount of 1. 0 % may be offered to credit card holders maintaining satisfactory account for a minimum period of 12 months with no adverse credit card history, and customers repaying previous car loans/ 2 wheelers loans in time

(d) Income discount of 1. 0 % is offered to those applicants whose income exceeds certain limit

For example, Bank of Punjab has limits:

Rs 1, 00, 000 for a standard segment car loan

Rs 1, 20, 000 for a middle segment car loan

Rs 140, 000 for a premium segment car loan

(e) Professional discount of 10 % is offered to doctors. CAs and lecturers

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UNIT-4 REGULATORY INSTITUTIONS

Reserve Bank of India

Establishment:

The Reserve Bank of India was established in ***1935*** under the provisions of the Reserve Bank of India Act, 1934 in Calcutta, eventually moved permanently to ***Mumbai***. Though originally privately owned, was nationalized in 1949.

Organisation and Management:

The Reserve Bank's affairs are governed by a *central board of directors*. The board is appointed by the Government of India for a period of **four years,** under the Reserve Bank of India Act.

(i) Full-time officials : **Governor** and *not more than four Deputy Governors.* The current Governor of RBI is *Mr. Urjit Pattel*. There are 3 **Deputy Governors** presently – *B P Kanungo, N S Vishwanathan and Viral V Acharya*.

- Nominated by Government: ten Directors from various fields and two government Officials
- Others: four Directors – one each from four local boards.

Let us make in-depth study of the functions and promotional roles of Reserve Bank of India (RBI).

Functions:

The Reserve Bank of India is performing various functions related to monetary management, banking operations, foreign exchange, developmental works and research on problems of economy.

The following are some of the major functions normally performed by the Reserve Bank of India:

1. Note Issue:

Being the Central Bank of the country, the RBI is entrusted with the sole authority to issue currency notes after keeping certain minimum reserve consisting of gold reserve worth Rs. 115 crore and foreign exchange worth Rs. 85 crore. This provision was later amended and simplified.

2. Banker to the Government:

The RBI is working as banker of the government and therefore all funds of both Central and State Governments are kept with it. It acts as an agent of the government and manages its public debt. RBI also offering "ways and means advance" to the government for short periods.

3. Banker's Bank:

The RBI is also working as the banker of other banks working in the country. It regulates the whole banking system of the country, keep certain percentage of their deposits as minimum reserve, works as the lender of the last resort to its scheduled banks and operates clearing houses for all other banks.

4. Credit Control:

The RBI is entrusted with the sole authority to control credit created by the commercial banks by applying both quantitative and qualitative credit control measures like variation in bank rate, open market operation, selective credit controls etc.

5. Custodian of Foreign Exchange Reserves:

The RBI is entrusted with sole authority to determine the exchange rate between rupee and other foreign currencies and also to maintain the reserve of foreign exchange earned by the Government. The RBI also maintains its relation with International Monetary Fund (IMF).

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6. Developmental Functions:

The RBI is also working as a development agency by developing various sister organisations like Agricultural Refinance Development Corporation. Industrial Development Bank of India etc. for rendering agricultural credit and industrial credit in the country.

On July 12, 1986, NABARD was established and has taken over the entire responsibility of ARDC. Half of the share capital of NABARD (Rs. 100 crore) has been provided by the Reserve Bank of India. Thus, the Reserve Bank is performing a useful function for controlling and managing the entire banking, monetary and financial system of the country.

Regulatory and Promotional Roles of Reserve Bank of India:

The Reserve Bank of India (RBI) has been playing an important role in the economy of the country both in its regulatory and promotional aspects. Since the inception of planning in 1951, the developmental activities are gaining momentum in the country. Accordingly, more and more responsibilities have been entrusted with the RBI both in the regulatory and promotional area. Now-a-days, the RBI has been performing a wide range of regulatory and promotional functions in the country.

The following are some of the regulatory and promotional functions performed by the RBI:

1. Regulating the Volume of Currency:

The RBI is performing the regulatory role in issuing and controlling the entire volume of currency in the country through its Issue Department. While regulating the volume of currency the RBI is giving priority on the demand for currency and the stability of the economy equally.

2. Regulating Credit:

The RBI is also performing the role to control the credit money created by the commercial banks through its qualitative and quantitative methods of credit control and thereby maintains a balance in the money supply of the country.

3. Control over Commercial Banks:

Another regulatory role performed by the RBI is to have control over the functioning of the commercial banks. It also enforces certain prudential norms and rational banking principles to be followed by the commercial banks.

4. Determining the Monetary and Credit Policy:

The RBI has been formulating the monetary and credit policy of the country every year and thereby it controls the Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR), bank rate, interest rate, credit to priority sectors etc.

5. Mobilizing Savings:

The RBI is playing a vital promotional role to mobilize savings through its member commercial banks and other financial institutions. RBI is also guiding the commercial banks to extend their banking network in the unbanked rural and semi-urban areas and also to develop banking habits among the people. All these have led to the attainment of greater degree of monetization of the economy and has been able to reduce the activities of indigenous bankers and private moneylenders.

6. Institutional Credit to Agriculture:

The RBI has been trying to increase the flow of institutional credit to agriculture from the very beginning. Keeping this objective in mind, the RBI set up ARDC in 1963 for meeting the long term credit requirement of rural areas. Later on in July 1982, the RBI set up NABARD and merged ARDC with it to look after its agricultural credit functions.

7. Specialized Financial Institutions:

The RBI has also been playing an important promotional role for setting specialized financial institutions for meeting the long term credit needs of large and small scale industries and other sectors. Accordingly, the RBI has promoted the development of various financial institutions like, WCI, 1DBI, ICICI, SIDBI, SFCs, Exim Bank etc. which are making a significant contribution to industry and trade of the country.

8. Security to Depositors:

In order to remove the major hindrance to the deposit mobilization arising out of frequent bank failures, the RBI took major initiative to set up the Deposit Insurance Corporation of India in 1962. The most important objective of this corporation is to provide security to the depositors against such failures.

9. Advisory Functions:

The RBI is also providing advisory functions to both the Central and State Governments on both financial matters and also on general economic problems.

10. Policy Support:

The RBI is also providing active policy support to the government through its investigation research on serious economic problems and issues of the country and thereby helps the Government to formulate its economic policies in a most rational manner. Thus, it is observed that the RBI has been playing a dynamic role in the economic development process of the country through its regulatory and promotional framework.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

Under these circumstances, the government felt the need for setting up of an apex body to develop and regulate the stock market in India Eventually, the Securities and Exchange Board of India (SEBI) Was set on April 12, 1998. To start with, SEBI was set up as a non - statutory body.

It took almost four years for the government to bring about a separate legislation in the name of Securities and Exchange Board of India Act 1992 conferring statutory powers. The Act, charged to SEBI with comprehensive powers over practically all aspects of capital market operations.

Objectives of SEBI

According to the preamble of the SEBI Act, the primary objective of the SEBI is to promote healthy and orderly growth of the securities market and secure investor protection. For this purpose, the SEBI monitor the activities of not only stock exchanges but also merchant bankers etc. The objectives of SEBI are as follows:

1. To protect the interest of investors so that there is a steady flow of savings into the capital market.

2. To regulate the securities market and ensure fair practices by the issuers of securities so that they can raise resources at minimum cost.

3. To promote efficient services by brokers, merchant bankers and other intermediaries so that they become competitive and professional.

Functions of SEBI

Section 11 of the SEBI Act specifies the functions as follows:

1. Regulatory Functions:

(a) Regulation of stock exchange and self regulatory organisations.

(b) Registration and regulation of stock brokers, sub - brokers, registrar to all issue, merchant bankers, underwriters, portfolio managers and such other intermediaries who are associated with securities market.

(c) Registration and regulation of the working of collective investment schemes including mutual funds.

(e) Prohibit insider trading in securities.

(f) Regulating substantial acquisitions of shares and take over of companies

2. Developmental Functions:

(a) Promote investor ' s education.

(b) Training of intermediaries

(c) Conducting research and published information useful to all market participants.

(d) Promotion of fair practices. Code of conduct for self regulatory organisations.

(e) Promoting self regulatory organisations.

Powers of SEBI

SEBI has been vested with the following powers:

1. Power to call periodical returns from recognised stock exchanges.

2. Power to call any information or explanation from recognised stock exchanges or their members.

3. Power to direct enquiries to be made in relation to affairs of stock exchanges or their members.

4. Power to grant approval to bye - laws of recognised stock exchanges.

5. Power to make or amend bye - laws of recognised stock exchanges.

6. Power to compel listing of securities by public companies.

7. Power to control and regulate stock exchanges.

8. Power to grant registration to market intermediaries.

9. Power to levy fees or other charges for carrying out the purpose of regulation

10. Power to declare applicability of Section 17 of the Securities Contract (Regulation) Act is any state or area to grant licences to dealers in securities.

UNIT-5 MUTUAL FUNDS AND VENTURE CAPITAL

MUTUAL FUND

Mutual funds have become a hot favourite of millions of people all over the world. The driving force of mutual funds is the 'safety of the principal' guaranteed, plus the added advantage of capital appreciation together with the income earned in the form of interest or dividend. People prefer mutual funds to bank deposits, life insurance and even bonds because with a little money, they can get into the investment game.

What is Mutual Fund

To state in simple words, a mutual fund collects the savings from small investors, invest them in Government and other corporate securities and earn income through interest and dividends, besides capital gain.

IMPORTENCE OF MUTUAL FUNDS

(i) DIVERSIFICATION:

A large number of investors have small savings with them. They can at the most buy shares of one or two companies. When small savings are pooled and entrusted to mutual funds then these can be used to buy shares of many different companies. Thus, investors can participate in a large basket of shares of different companies.

(ii) Liquidity

A peculiar advantage of a mutual fund is that investment made in its schemes Can be converted back into cash promptly without heavy expenditure on brokerage, delays, etc. According to the regulations of SEBI, a mutual fund in India is required to ensure liquidity. For open ended schemes, the investor can always approach the Mutual Fund to repurchase units at declared het assets value ' (NAV). In case of close can easily be sold in the stock market. ended schemes, units

(iii) Reduced Risk.

As mutual funds invest in large number of companies and are managed professionally, the risk factor of the investor is reduced. A small investor, on the other hand, may not be in a position to minimise such risks.

(iv) Tax advantage. There are certain schemes of mutual funds which provide lax advantage under the Income Tax Act. Thus, the tax liability of an investor is also reduced when he invests in these schemes of the mutual funds.

(v) Low Operating costs.

Mutual funds have large investible funds at their disposal and thus can avail economics of large scale. This reduces their operating costs by way of brokerage, fees, commission etc. Thus, a small investor also gets the benefit of large scale economies and low operating costs.

(vi) Flexibility.

Mutual funds provide flexible investment plans to its subscribers such as, regular investment plans, regular withdrawal plans and dividend reinvestment plans, etc. Thus, an investor can invest or withdraw funds according to his own requirements,

(vii) Higher Returns.

Mutual funds are expected to provide higher return to the investors as compared to direct investment because of professional management, economies of scale, reduced risk, etc.

(viii) Investor Protection.

Mutual funds are regulated and monitored by the Securities and Exchange Board of India (SEBI). The SEBI Mutual Funds) Regulations, 1996 which have replaced the regulations of 1993, provide better protection to the investors, impart a greater degree of flexibility and facilitate competition

TYPES OF MUTUAL FUNDS

(A) Close - ended Funds

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre - determined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus, the fund ceases to be a fund, after the final distribution.

Features: The main features of the close - ended funds are:

(i) The period and/ or the target amount of the fund is definite and fixed beforehand.

(ii) Once the period is over and/ or the target is reached, the door is closed for the investors. They cannot purchase any more units.

(iii) These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.

(iv) The main objective of this fund is capital appreciation.

(B) Open - ended Funds

It is just the opposite of close - ended funds. Under this scheme, the size of the fund and/ or the period of the fund is not pre - determined. The investors are free to buy and sell any number of units at any point of time. Anybody can buy this unit at any time and sell it also at any time at his discretion.

The Main Features of the Open - Ended Funds are:

(i) There is complete flexibility with regard to one's investment or disinvestment. In other words, there is free entry and exit of investors in an open - ended fund. There is no time limit. The investor can join in and come out from the Fund as and when he desires.

(ii) These units are not publicly traded but, the Fund is ready to repurchase them and resell them at any time.

(iii) The investor is offered instant liquidity in the sense that the units can be sold on any working day to the Fund.

(iv) The main objective of this fund is income generation. The investors get dividend, rights or bonuses as rewards for their investment.

(v) Since the units are not listed on the stock market, their prices are linked to the Net Asset Value (NAV) of the units. The NAV is determined by the Fund and it varies from time to time.

On the Basis of Income

A) Income Funds: As the very name suggests, this Fund aims at Generating and distributing regular income to the members on a return is higher than periodical basis. It concentrates more on the distribution that of income and it also sees that the average the income from bank deposits.

The main features of the Income Funds are

(i) The investor is assured of regular income at periodic intervals. say half - yearly or yearly and so on.

(ii) The main objective of this type of Fund is to declare regular dividends and not capital appreciation.

(iii) The pattern of investment is oriented towards high and fixed income yielding securities like debentures, bonds etc.

(iv) This is best suited to the old and retired people who may not have any regular income.

(v) Il concerns itself with short run gains only.

(B) Pure Growth Funds (Growth Oriented Funds). Unlike the Income

Funds, Growth Funds concentrate mainly on long run gains i.e. capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. Hence, they have been described as " Nest Eggs " investments.

The Main features of the Growth Funds are.

(i) The growth oriented Fund aims at meeting the investors ' need for capital appreciation.

(ii) The investment strategy therefore, conforms to the Fund objective by investing the funds predominantly on equities with high growth potential.

(iii) The Fund tries to get capital appreciation by taking much risks and investing on risk bearing equities and high growth equity shares.

(iv) The fund may declare dividend, but its principal objective is only capital appreciation.

(v) This is best suited to salaried and business people who have high risk bearing capacity and ability to defer liquidity. They can accumulate wealth for future needs.

(C) Balanced Funds: This is otherwise called " income - cum - growth " fund/. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

(D) Specialised Funds: These funds invest in a particular type of securities, these funds may specialise in securities of companies dealing in a particular product, firms in a particular industry or of certain income producing securities. Ant investor wanting to invest in a particular security will prefer a fund dealing in such securities.

(E) Money - Market Mutual Funds (MMMFs): These funds are basically open ended mutual Funds and as such they have all the features of the Open ended Fund. But, they invest in highly liquid and safe securities like commercial paper, banker ' s acceptances, certificates of deposits, Treasury bills etc. These instruments are called money market instruments. They take the place of shares, debentures and bonds in a capital market. They pay money market rates of interest.

(F) Taxation Funds: A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March In India, at present the law relating to tax rebates is covered under Sec. 88 of the Income Tax Act, 1961. An investor is entitled to get 20 % rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs. 10, 000/ - per annum.

OTHER CLASSIFICATION

(**G) Leveraged Funds:** These funds are also called borrowed funds since they are used primarily to increase the size of the value of portfolio of a mutual fund. When the value increases, the earning capacity of the fund also increases. The gains are distributed to the unit holders, This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds.

(H) Dual Funds: This is a special kind of closed end fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investment stocks viz., income shares and capital shares. Those investors who seek current investment income can purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type. In this respect, the dual fund is different from a balanced fund.

(I) Index Funds: Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of some broad based market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.

(J) Bond Funds: These funds have portfolios consisting mainly of fixed income securities like bonds. The main thrust of these funds is mostly on income rather than capital gains. They differ from income funds in the sense income funds offer an average returns higher than that from bank deposits and also capital gains lesser than in equity shares.

VENTURE CAPITAL

CONCEPT OF VENTURE CAPITAL

The term ' Venture Capital ' is understood in many ways. In a narrow sense, if refers to investment in new and tried enterprises that that are lacking a stable record of growth.

In a broader sense, venture capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firm specialising in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. It is an association with successive stages of firm ' s development with distinctive types of financing appropriate to each stage of development.

Meaning of Venture Capital

Venture capital is long term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the Early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

Definition of a Venture Capital Company

A venture capital company is defined as " a financing institution which joins an entrepreneur as a co - promoter in a project and shares the risks and rewards of the enterprise. "

Features of Venture Capital

Some of the features of venture capital financing are as under:

1. Venture capital is usually in the form of an **equity participation**. It may also take the form of convertible debt or long term loan.

2. Investment is made not only in **high risk** but also in high growth potential projects.

3. Venture capital is available only for **commercialisation of new ideas** or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.

4. **Venture capitalist** joins the entrepreneur as a co - promoter in projects and share the risks and rewards of the enterprise.

5. There is **continuous involvement** in business after making an investment by the investor.

6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but **capital appreciation** at the time of disinvestment.

SCOPE OF VENTURE CAPITAL/ STAGES/TYPES OF VENTURE CAPITAL

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project viz.

Development of a project idea, Implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second and third stage but rarely

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from the first stage. But venture capitalist provide finance even from the first stage of idea formulation.

The various stages in the financing of Venture Capital are described below:

1. Development Of An Idea- Seed Finance

In the initial stage venture capitalist provide seed capital for translating an idea into business proposition. At this stage investigation is made indepth which normally takes a year or more.

2. Implementation Stage - Start up Finance:

When the firm is set up to manufacture a product or provide a service, start up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

3. Fledging Stage - Additional Finance:

In the third stage firm has made some headway and entered the stage of manufacturing product but faces teething problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

4. Establishment Stage. Establishment Finance:

At this stage the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that is can reap economics of scale and attain stability. At the end of the establishment stage, the firm is listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exist routes.

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