

UNIT-I**INDIAN FINANCIAL SYSTEM**

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1. Introduction to Financial System

The economic scene in the post independence period has seen a sea change; the end result being that the economy has made enormous progress in diverse fields. There has been a quantitative expansion as well as diversification of economic activities. The experiences of the

1980s have led to the conclusion that to obtain all the benefits of greater reliance on voluntary, market-based decision-making, India needs efficient financial systems.

The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it be the mobilisation of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

1.1 Significance and Definition

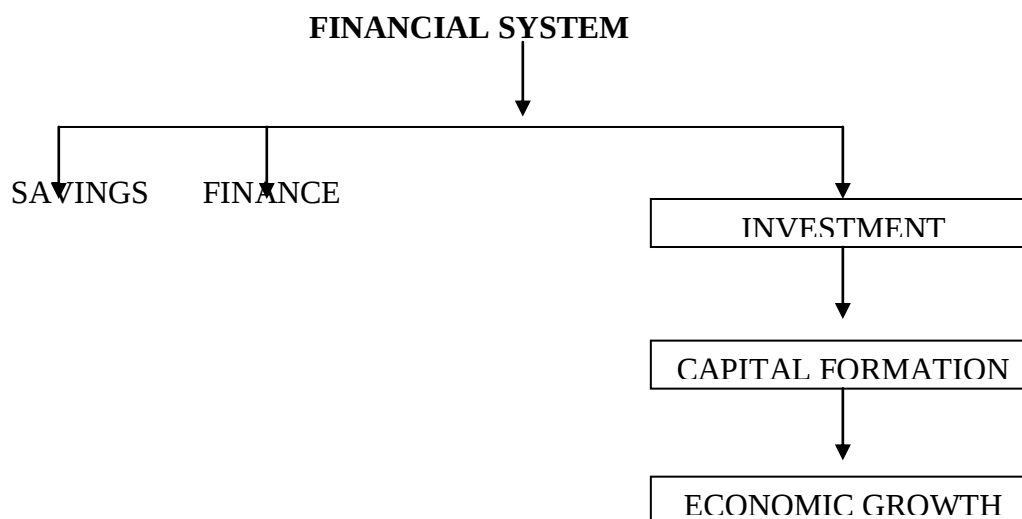
The term financial system is a set of inter-related activities/services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment capital formation and growth.

Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy has opined that the objective of the financial system is to *"supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires."*

According to Robinson, the primary function of the system is "to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth."

From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for

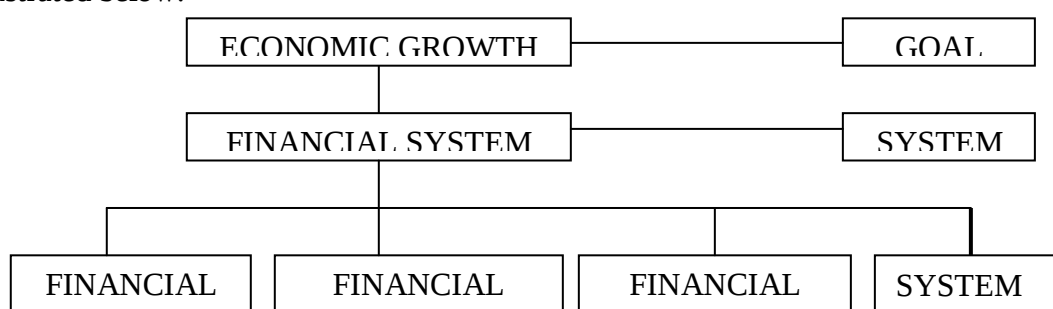
industrial investment and stimulating capital formation to accelerate the process of economic growth.



The Concept of the Financial System

The process of savings, finance and investment involves financial institutions, markets, instruments and services. Above all, supervision control and regulation are equally significant. Thus, financial management is an integral part of the financial system. On the basis of the empirical evidence, Goldsmith said that "... a case for the hypothesis that the separation of the functions of savings and investment which is made possible by the introduction of financial instruments as well as enlargement of the range of financial assets which follows from the creation of financial institutions increase the efficiency of investments and raise the ratio of capital formation to national production and financial activities and through these two channels increase the rate of growth....."

The inter-relationship between varied segments of the economy are illustrated below:-



Inter-relationship in the Financial System

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. In fact, the country could make this feasible with the active support of the financial system. The financial system has been identified as the most catalyzing agent for growth of the economy, making it one of the key inputs of development

1.2 The Organisation of the Financial System in India

The Indian financial system is broadly classified into two broad groups:

- i) Organised sector and (ii) unorganised sector.

"The financial system is also divided into users of financial services and providers.

Financial institutions sell their services to households, businesses and government. They are the users of the financial services. The boundaries between these sectors are not always clear cut.

In the case of providers of financial services, although financial systems differ from country to country, there are many similarities.

- (i) Central bank
- (ii) Banks

- (iii) Financial institutions
- (iv) Money and capital markets and
- (v) Informal financial enterprises.

i) Organised Indian Financial System

The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. Short-term funds are mainly provided by the commercial and cooperative banking structure. Nine-tenth of such banking business is managed by twenty-eight leading banks which are in the public sector. In addition to commercial banks, there is the network of cooperative banks and land development banks at state, district and block levels. With around two-third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas such as merchant banking, mutual funds, leasing and factoring.

The organised financial system comprises the following sub-systems:

1. Banking system
2. Cooperative system
3. Development Banking system
 - (i) Public sector
 - (ii) Private sector
4. Money markets and
5. Financial companies/institutions.

Over the years, the structure of financial institutions in India has developed and become broad based. The system has developed in three areas - state, cooperative and private. Rural and urban areas are well served by the cooperative sector as well as by corporate bodies with national status. There are more than 4,58,782 institutions channelling credit into the various areas of the economy.

ii) Unorganised Financial System

On the other hand, the unorganised financial system comprises of relatively less controlled moneylenders, indigenous bankers, lending pawn brokers, landlords, traders etc. This part of the financial system is not directly amenable to control by the Reserve Bank of India (RBI). There are a host of financial companies, investment companies, chit funds etc., which are also not regulated by the RBI or the government in a systematic manner.

However, they are also governed by rules and regulations and are, therefore within the orbit of the monetary authorities.

Indigenous Banking in India

At independence, India had an indigenous banking system with a centuries-old tradition. This system had developed the hundi, a financial instrument still in use that is similar to the commercial bill of Western Europe. Hundi were used to finance local trade as well as trade between port towns and inland centers of production. They were often discounted by banks, especially if they were endorsed by indigenous bankers.

Indigenous bankers combined banking with other activities, much as the goldsmiths, merchants, and shippers of eighteenth and nineteenth-century Europe had done. They usually belonged to certain castes or communities, such as the Multanis, Marwaris and Chettiars, and they differed in the extent to which they relied on their own resources, rather than deposits and other funds for their lending. Indigenous bankers often endorsed hundis issued by traders and sometimes provided personal guarantees for loans from commercial banks. Such bankers were collectively known as Shroffs, a term that probably originally referred to money changers but over time came to refer to the more sophisticated and influential indigenous bankers. The main moneylenders were the Sowkars (who lent to farmers from their own

resources or funds borrowed from the Chettiers and other indigenous bankers) and the Pathans (who lent mainly to poor people and often resorted to intimidation to ensure repayment).

Indigenous banking was based on an elaborate and extensive network of personal relations that overcame the problems of dealing with a large number of customers. Brokers were used for making introductions and vouching for the creditworthiness of individual borrowers but did not offer personal guarantees. Some brokers specialized in introducing indigenous bankers to commercial banks, while others brought together traders and indigenous bankers.

Rural Financial System.

Rural financial system has been evolved over a period of time from the year 1904, when the first Primary Agricultural Credit Society was organized, by accepting and implementing important recommendations of expert committees appointed by the Government of India/RBI from time to time. During the pre-reform period, more particularly, after the advent of the scientific and technological revolution in the sphere of agriculture, the Government of India and the RBI have evolved several new concepts, innovations and novel approaches, which, the Rural Financial Institutions (RFIs) have responded very favorably by implementing them.

The Banking System

The structure of the banking system is determined by two basic factors – economic and legal. The Development of the economy and the spread of banking habit calls for increasing banking services. The demand for these banking services affects the banks' structure and organisation. National objectives and aspirations result in government regulations, which have a profound influence on the banking structure. These regulations are basically of two types. First, regulations which result in the formation of new banks to meet the specific needs of a group of

economic activities. Secondly, legislation that affects the structure by means of nationalisation, mergers or liquidation.

RBI

The Reserve Bank of India as the central bank of the country, is at the head of this group. Commercial banks themselves may be divided into two groups, the scheduled and the non scheduled.

The commercial banking system may be distinguished into:

A. Public Sector Banks

- | | | | |
|------|------------------------------|---|------------------|
| i) | State Bank of India | } | State Bank Group |
| ii) | Associate Bank | | |
| iii) | 14 Nationalized Banks (1969) | } | Nationalized |
| | Banks | | |
| iv) | 6 Nationalized Banks (1980) | | |
| v) | Regional Rural Banks | } | Mainly sponsored |
| | by Public | | |
| | | | Sector Banks |

B. Private Sector Banks

- i) Other Private Banks;
- ii) New sophisticated Private Banks;
- iii) Cooperative Banks included in the second schedule;
- iv) Foreign banks in India, representative offices, and
- v) One non-scheduled banks

Cooperative Sector

The cooperative banking sector has been developed in the country to supplant the village moneylender, the predominant source of rural finance, as the terms on which he made finance available have generally been usurious and detrimental to the development of Indian agriculture. Although the sector receives concessional finance from the Reserve Bank, it is governed by the state legislation. From the point of view of the money market, it may be said to lie between the organized

and the unorganised markets.

Primary cooperative Credit Societies

The primary cooperative credit society is an association of borrowers and non-borrowers residing in a particular locality. The funds of the society are derived from the share capital and deposits of members and loans from Central Co-operative banks. The borrowing power of the members as well as of the society is fixed. The loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, implements etc.

Central Co-operative Banks

These are the federations of primary credit societies in a district. These banks finance member societies within the limits of the borrowing capacity of societies. They also conduct all the business of a joint-stock bank.

State Co-operative Banks

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

Land Development Banks

The Land Development Banks, which are organized in three tiers, namely, State, Central and Primary level, meet the long term credit requirements of farmers for developmental purposes, viz, purchase of equipment like pump sets, tractors and other machineries, reclamation of land, fencing, digging up new wells and repairs of old wells etc. Land Development Banks are cooperative institutions and they grant loans on the security of mortgage of immovable property of the farmers.

Money Market

Money market is concerned with the supply and the demand for investible funds. Essentially, it is a reservoir of short-term funds. Money market provides a mechanism by which short-term funds are lent out and borrowed; it is through this market that a large part of the financial transactions of a country are cleared. It is place where a bid is made for short-term investible funds at the disposal of financial and other institutions by borrowers comprising institutions, individuals and the Government itself.

Thus, money market covers money, and financial assets which are close substitutes for money. The money market is generally expected to perform following three broad functions:

- (i) To provide an equilibrating mechanism to even out demand for and supply of short term funds.
- (ii) To provide a focal point for Central bank intervention for influencing liquidity and general level of interest rates in the economy.
- (iii) To provide reasonable access to providers and users of short-term funds to fulfill their borrowing and investment requirements at an efficient market clearing price.

Capital Market

The capital market is the place where the medium-term and long-term financial needs of business and other undertakings are met by financial institutions which supply medium and long-term resources to borrowers. These institutions may further be classified into investing institutions and development banks on the basis of the nature of their activities and the financial mechanism adopted by them. Investing institutions comprise those financial institutions which garner the savings of the people by offering their own shares and stocks, and which provide long-term funds, especially in the form of direct investment in securities and underwriting capital issues of business enterprises. These institutions include investment banks, merchant

banks, investment companies and the mutual funds and insurance companies. Development banks include those financial institutions which provide the sinews of development, i.e. capital, enterprise and know-how, to business enterprises so as to foster industrial growth.

1.3 Liberalisation Of The Financial System

A radical restructuring of the economic system consisting of industrial deregulation, liberalisation of policies relating to foreign direct investment, public enterprise reforms, reforms of taxation system, trade liberalisation and financial sector reforms have been initiated in 1992-93. Financial sector reforms in the area of commercial banking, capital markets and non-banking finance companies have also been undertaken.

The focus of reforms in the financial markets has been on removing the structural weaknesses and developing the markets on sound lines. The money and foreign exchange market reforms have attempted to broaden and deepen them. Reforms in the government securities market sought to smoothen the maturity structure of debt, raising of debt at close-to-market rates and improving the liquidity of government securities by developing an active secondary market. In the capital market the focus of reforms has been on strengthening the disclosure standards, developing the market infrastructure and strengthening the risk management systems at stock exchanges to protect the integrity and safety of the market. Elements of the structural reforms in various market segments are introduction of free pricing of financial assets such as interest rate on government securities, pricing of capital issues and exchange rate, the enlargement of the number of participants and introduction of new instruments.

Improving financial soundness and credibility of banks is a part of banking reforms under. Taken by the RBI, a regulatory and supervisory agency over commercial banks under the Banking Companies

Regulation Act 1949. The improvement of financial health of banks is sought to be achieved by capital adequacy norms in relation to the risks to which banks are exposed, prudential norms for income recognition and provision of bad debts. The removal of external constraints in norms of pre-emption of funds, benefits and prudential regulation and recapitalisation and writing down of capital base are reflected in the relatively clean and healthy balance sheets of banks. The reform process has, however, accentuated the inherent weaknesses of public sector dominated banking systems. There is a need to further improve financial soundness and to measure up to the increasing competition that a fast liberalising and globalising economy would bring to the Indian banking system.

In the area of capital market, the Securities and Exchange Board of India (SEBI) was set up in 1992 to protect the interests of investors in securities and to promote development and regulation of the securities market. SEBI has issued guidelines for primary markets, stipulating access to capital market to improve the quality of public issues, allotment of shares, private placement, book building, takeover of companies and venture capital. In the area of secondary markets, measures to control volatility and transparency in dealings by modifying the badla system, laying down insider regulations to protect integrity of markets, uniform settlement, introduction of screen-based online trading, dematerialising shares by setting up depositories and trading in derivative securities (stock index futures). There is a sea change in the institutional and regulatory environment in the capital market area.

In regard to Non-Bank Finance Companies (NBFCs), the Reserve Bank of India has issued several measures aimed at encouraging disciplined NBFCs which run on sound business principles. The measures seek to protect the interests of depositors and provide more

effective supervision, particularly over those which accept public deposits. The regulations stipulate an upper limit for public deposits which NBFCs can accept. This limit is linked to credit rating by an approved rating agency. An upper limit is also placed on the rate of interest on deposits in order to restrain NBFCs from offering incentives and mobilising excessive deposits which they may not be able to service. The heterogeneous nature, number, size, functions (deployment of funds) and level of managerial competence of the NBFCs affect their effective regulation.

Since the liberalisation of the economy in 1992-93 and the initiation of reform measures, the financial system is getting market-oriented. Market efficiency would be reflected in the wide dissemination of information, reduction of transaction costs and allocation of capital to the most productive users. Further, freeing the financial system from government interference has been an important element of economic reforms. The economic reforms also aim at improved financial viability and institutional strengthening. To improve the effective implementation of the monetary policy, linkages among money and foreign exchange markets have been forged.

2. Saving and Financial Intermediation

2.1 Saving

The term *saving* refers to the activity by which claims to resources, which might be put to current consumption, are set aside and so become available for other purposes. It represents the excess of income over current consumption. The total volume of savings in an economy, therefore, depends mainly upon the size of its material income and its average propensity to consume, which, in its turn, is determined by the level and distribution of the incomes, tastes and habits of the people, their expectations about the future, etc. As the size of the national income increases, the volume and ratio of savings may generally be

expected to rise, unless the marginal propensity to consume is either equal to, or higher than the average propensity. This is very likely to be the case in countries where the standards of living are very low, and where the development policy places a heavy emphasis on the social objectives of raising the living standards of the poorer sections of the community, or where the spending habits of the people are strongly influenced by the "demonstration effect)

2.2 Composition of Savings

Total savings are composed of public savings and private saving. Public savings constitute the savings of the government through normal budgetary channels and the retained earnings of public enterprises.

Private savings includes household savings and business savings.

The house hold sector makes the largest contribution 77% in 94-95, the public sector – 6.8% and the business sector 16.2% of the savings of household sector, savings (gross) in the form of physical assets accounted for 36.1% in 1998-99.

2.3 Factors determining saving

The volume of public savings depends largely upon the functions assumed by the state, the general state of the economy, the tax structure, the fiscal policy of the government, its pricing and investment policies.

Private savings include household savings and business savings. They occupy, by far, the most important position in democratic countries. The size of household savings depends on the capacity and ability and willingness of the people to save, which are influenced by a multitude of social, psychological and political factors, in addition to the economic factors, the most important of which are the level and distribution of income and the general fiscal, monetary and economic policies of the state.

Business savings, in the form of retained savings and depreciations and other provisions, claim relatively large proportions of the total savings in developed countries. Such savings are identified generally with corporate savings because the savings of other forms of business enterprises are not only relatively small but are not easily distinguishable from household savings. Corporate savings depend chiefly on the profitability of the enterprises and their policies of the distribution of dividends, provision for depreciation, etc., and the retention of current earnings for financial expansion programmes. These, in their turn, are largely influenced by the general state of the economy (and of industry in particular), the fiscal policies of the state and expectations about the future).

Gross Domestic Savings

The savings on a gross basis include:

- Depreciation at book value in the case of the private corporate sector.
- In the case of the household sector, savings in the form of financial assets without allowing for increase in household liabilities which largely consist of loans and advances from banks, and
- In the case of physical assets of the household sector, the difference in value of physical assets in terms of gross saving and net saving which was as much as 43.2 per cent in 1994-95 (41.9 per cent in 1980-81). This may be largely on account of depreciation and changes in stocks of unincorporated enterprises which account for 80 per cent of the savings of the household sector. The gross domestic savings ratio was 23.4% in 1998-99).

Saving of Household Sector In the form of Gold

For long, gold has been kept out of the financial system. It has been left out of our savings estimates and purchase of gold is treated as consumption. This is really going against entrenched custom.

Gold hoards which are estimated at \$100 billion have to be brought into the mainstream of the financial system. Further, out of our annual import of \$6 billion (400 to 500 tones), 90 per cent goes towards investment in the form of jewellery. Gold should be treated as a 'hybrid asset' as the Committee on Capital Account Convertibility (CAC) has termed it. In the words of the Committee, "Gold is a surrogate for foreign exchange and because of its special features it is a hybrid between a commodity and a financial asset". The Committee on CAC recommended that asset." banks should be permitted to operate freely both in the domestic and international gold markets, sale of gold by banks and financial institutions (FIs) should be freely allowed to all residents, banks should be allowed to offer gold denominated deposits and loans and banks should be allowed to offer deposit schemes akin to gold accumulation plans.

The liberalization of the overall policy regime of gold as recommended by the Committee is the most far reaching and has a vital impact on our savings and investment. Its implementation would have enormous impact in terms of growth as gold can be mobilised for financing investment. Once we accept it as an instrument for saving, estimates of household savings in the national income statistics would go up by 10-12 per cent and overall gross saving and net saving ratios by 1.5 to 1.2 per cent.

The inclusion of gold in national income statistics is not suggested just to raise the savings rate. It is in the national interest to put it to productive use.

Savings of the Household Sector In Financial Assets

The financial assets in the order of their importance in 1998-99 are

bank deposits, provident and pension funds, non-bank deposits, currency, life insurance fund, claims on government and shares and debentures. The composition of household sector's savings has been generally in favour of financial assets as compared to physical assets on account of the higher rates of return on financial saving, growing financial intermediation and preference of households for less risky assets like bank deposits, contractual savings and small savings instruments.

2.4 Saving Rate In Ninth Plan

The savings rate in 1998-99 of 22.3% fell short of the Ninth Plan target of 25.2 per cent. The reliance on foreign capital and adoption of a deliberate policy to attract foreign savings into portfolio and direct investments have become a part of the liberalisation policy since 1991-92. Inflow of foreign savings was to finance an investment rate of 23.4 per cent in 1998-99. While the high domestic savings of the Asian Tigers provided powerful evidence of a link between thrift and growth, relying too much on foreign capital is a danger that could give rise to an economic crisis. Mexico experienced such a crisis in 1994 where domestic savings fell on account of the substantial inflow of foreign capital in the two or three years prior to 1994, giving rise to the liquidity effect. The Asian crisis of 1997 also confirms that foreign capital especially portfolio and debt are not only undependable but also aggravate financial stress into a full blown crisis. All this points to the importance of strengthening thrift. The recent developments in credit financing of automobiles and white goods and the impulsive expenditure-inducing effect of credit cards-are likely to make a dent in savings.

The savings rate in India is bound to rise as a result of the financial sector reforms. Financial sector reforms in many developing countries in Latin America and Asia were introduced as a part of an overall

programme of economic liberalisation. While they were initiated in the mid-70's in Latin America countries, they gained prominence by the mid-80's.

According to Jeffrey Sachs and Nirupam Rajpal of the Harvard Institute for International Development, the possible reasons for higher growth rate in India are the degree of market efficiency (a weighted average of degree of openness, size of government and labour market flexibility) and the savings rate. Market efficiency and savings rate account for 40 per cent variation in growth rates. If India improved its competitiveness (World Economic Forum's Global Competitiveness Report) to the level of other countries in East Asia, Sachs and Rajpal estimate that India's rate of growth of income will rise to 7.2 per cent per year. If the savings rate is also stepped up to the levels achieved in East Asia, the rate of growth will rise to 8.37 per cent. Tariff reduction in the 1997-98 budget to an average of 25 per cent is closure to a rate of less than 10 per cent in the case of East Asia helping 'openness' of the economy.

2.5 Financial Liabilities

Household financial liabilities largely consist of loans and advances from banks. The total financial liabilities were estimated at Rs. 26,722 crores or 1.3% of GDP in 1998-99.

2.6 Financial intermediation

The Institutions in the financial market such as Banks & other non banking financial intermediary undertakes the task of accepting deposits of money from the public at large and employing them deposits so pooled in the forms of loans and investment to meet the financial needs of the business and other class of society i.e. they collect the funds from surplus sector through various schemes and channelised then to the deficit sector.

These financial intermediaries act as mobilisers of public saving for

their productive utilization.

Funds are transferred through creation of financial liabilities such as bonds and equity shares.

Among the financial institutions commercial banks accounts for more than 64% of the total financial sector assets. Thus financial intermediation can enhance the growth of economy by pooling funds of small and scattered savers and allocating them for investment in an efficient manner by using their informational advantage in the loan market. They are the principal mobilisers of surplus funds to productive activity and utilize these funds for capital formation hence promote the growth.

3. Commercial banking

3.1 Evolution

Enhancement of the RBI Act 1935 gave birth to scheduled banks in India, and some of these banks had already been established around 1881. The prominent among the scheduled banks is the Allahabad Bank, which was set up in 1865 with European management. The first bank which was established with Indian ownership and management was the Oudh Commercial Bank, formed in 1881, followed by the Ayodhya Bank in 1884, the Punjab National Bank in 1894 and Nedungadi Bank in 1899. Thus, there were five Banks in existence in the 19th century. During the period 1901-1914, twelve more banks were established, prominent among which were the Bank of Baroda (1906), the Canara Bank (1906), the Indian Bank (1907), the Bank of India (1908) and the Central Bank of India (1911).

Thus, the five big banks of today had come into being prior to the commencement of the First World War. In 1913, and also in 1929, the Indian Banks faced serious crises. Several banks succumbed to these crises. Public confidence in banks received a jolt. There was a heavy rush on banks. An important point to be noted here is that no

commercial bank was established during the First World War, while as many as twenty scheduled banks came into existence after independence - two in the public sector and one in the private sector. The United Bank of India was formed in 1950 by the merger of four existing commercial banks. Certain non-scheduled banks were included in the second schedule of the Reserve Bank. In view of these facts, the number of scheduled banks rose to 81. Out of 81 Indian scheduled banks, as many as 23 were either liquidated or merged into or amalgamated with other scheduled banks in 1968, leaving 58 Indian schedule banks.

It may be emphasized at this stage that banking system in India came to be recognized in the beginning of 20th century as powerful instrument to influence the pace and pattern of economic development of the country. In 1921 need was felt to have a State Bank endowed with all support and resources of the Government with a view to helping industries and banking facilities to grow in all parts of the country. It is towards the accomplishment of this objective that the three Presidency Banks were amalgamated to form the Imperial Bank of India. The role of the Imperial Bank was envisaged as "to extend banking facilities, and to render the money resources of India more accessible to the trade and industry of this country, thereby promoting financial system which is an indisputable condition of the social and economic advancement of India."

Until 1935 when RBI came into existence to play the role of Central Bank of the country and regulatory authority for the banks, Imperial Bank of India played the role of a quasi-central bank. It functioned as a commercial bank but at times the Government used it for regulating the money supply by influencing its policies.

Thus, the role of commercial banks in India remained confined to providing vehicle for the community's savings and attending to the

credit needs of only certain selected and limited segments of the economy.

3.2 Financial services

Commercial banks are the heart of our financial system. They hold the deposits of millions of persons, governments and business units. They make funds available through their lending and investing activities to borrowers - individuals, business firms, and governments. In doing so, they facilitate both the flow of goods and services from producers to consumers and the financial activities of governments. They provide a large portion of our medium of exchange and they are the media through which monetary policy is effected. These facts obviously add up to the conclusion that the commercial banking system of the nation is important to the functioning of its economy.

Commercial banks play a very important role in our economy; in fact, it is difficult to imagine how our economic system could function efficiently without many of their services. They are the heart of our financial structure, since they have the ability, in cooperation with the Reserve Bank of India, to add to the money supply of the nation and create additional purchasing power. Banks' lending, investments and related activities facilitate the economic processes of production, distribution and consumption.

The major task of banks and other financial institutions is to act as intermediaries, channelling savings into investment and consumption: through them, the investment requirements of savers are reconciled with the credit needs of investors and consumers.

If this process of transference is to be carried out efficiently, it is absolutely essential that the banks are involved. Indeed, in performing their tasks, they realise important economies of scale: the savings placed at their disposal are employed in numerous and large transactions adapted to the specific needs of borrowers. In this way,

they are able to make substantial cost savings for both savers and borrowers, who would otherwise have to make individual transactions with each other. However, there is more to these economies of scale than just the cost aspect.

Commercial banks have been referred to as '*department stores of finance*' as they provide a wide variety of financial services. In addition to the acceptance of deposits, lending and investing, they provide a multitude of services, including transfer of funds, collection, foreign exchange, safe custody, safe deposit locker, traveller's cheque, merchant banking services, credit cards, gift cheques, etc.

Commercial Banks provide various securities related services. Commercial banks in India have set up subsidiaries to provide capital market related services, recruitment banking merchant banking etc.

Merchant banking services are activities i.e. counseling corporate clients who are in need of capital on capital structure, form of capital to be raised, the terms and conditions of issue underwriting of the issue, timing of the issue & preparation of prospectus and publicity for grooming the issue for the market. While providing these services they act as sponsor of issue, render expert advice on matters pertaining to investment decision, render the services as corporate counseling and advice on mergers acquisition and reorganization.

3.3 Fiduciary Services

Fiduciary Services are those services which banks perform on behalf of their client but do not show up on bank balance sheet. For Eg. employees pension fund, provident fund, profit sharing programmes managed by banks on the behalf of Cos which are their client.

In US, banks operate separate trust departments which manage the funds of other for a fee under the guidance of a trust agreement. The assets held in trust do not show up on bank balance sheet because they do not own by banks.

3.4 Off-Balance Sheet Activities

Banks assume contingent liabilities such as a guarantee of payment of another party, for a fee. Stand by letter of credit is another example whereby a bank agrees to pay specified amount on presentation of evidence of default or non-performance of the party whose obligation is guaranteed.

In India the off-balance sheet activities of commercial banks include forward exchange contracts, guarantees and acceptances and endorsement. The off-balance sheet exposure of commercial banks was Rs. 5,84,441 crores in 1999-2000. The off-balance sheet exposure as a proportion of total liabilities was 52.6% in 1999-2000

3.5 Analysis Of Assets And Liabilities Of Commercial Banks

The balance sheet is a statement of banks' liabilities and assets at particular time. Banks in India have to prepare their balance sheet and profit and loss account in form set out in the III Schedule of the Banking Regulation Act, 1949.'

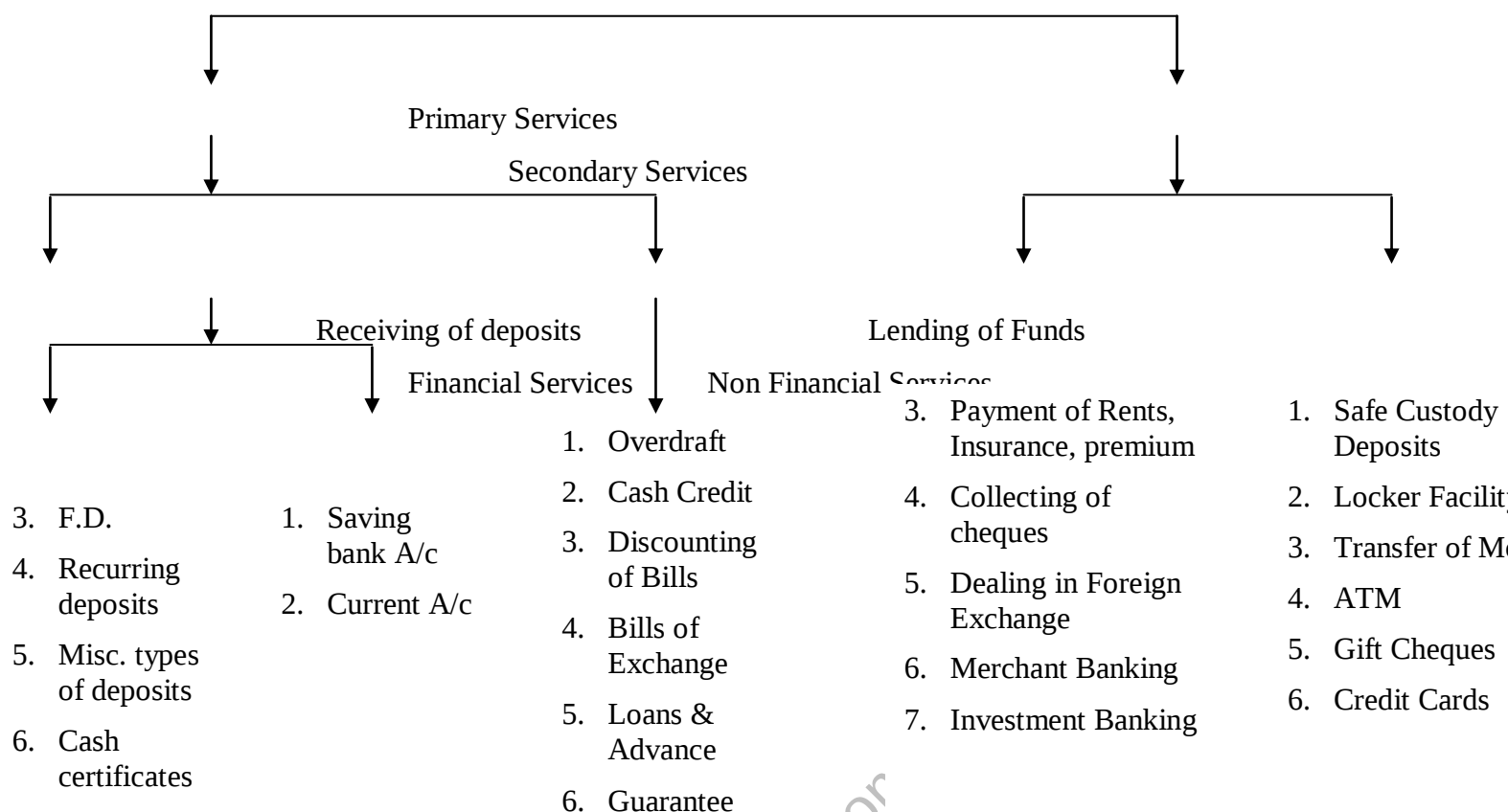
The Banking Regulation Act and the Companies Act requires that the balance sheet of a bank should give a true and fair view of its state of affairs and should be drawn within the prescribed form.

3.5.1 Liabilities of a Commercial Bank

Of the total liabilities, 3-7 per cent are internal to the system, i.e., liabilities to the banking system and borrowings from the Reserve Bank. The rest of total liabilities, i.e., 93-97% constitute the net: or external liabilities to others.

Liabilities to the banking system consist mainly of demand and time deposits from banks-60-80%. Borrowings from banks - 20-40%. There is a residual term generally below 4% but. in the interval 1992-96, it was high at 12.4 - 18.5%.)

Services provided by Commercial Bank



.Deposits

In the Liabilities to Others component, aggregate deposits constitute 92-94%, borrowings are negligible being less than half a percent, and the remainder is a residual term. Within aggregate deposits, 80-82% are time deposits and 18-20% are demand deposits. Since aggregate deposits account for close to 90% of the total liabilities of the banking system, and this 90% is uniformly following the 80:20 rule, it appears that 70% of the liabilities of the banking system are contracted with time covenants and only 20% without time covenants.

The liabilities of a bank are grouped under the following heads:

1. Capital.
2. Reserve fund and other reserves.
3. Deposits
(i) from the public

- (ii) from other banks.
- 4. Borrowings from other Banking Companies, Agents etc.
- 5. Bills payable.
- 6. Other liabilities.
- 7. Profit & Loss.
- 8. Contingent liabilities.

Bills for collection being bills receivable and acceptances, endorsements and other obligations are shown on both sides. Hence, they are not generally considered as liabilities.

Capital - All banks need capital to cover and extend fixed assets and business investments, to enable trading to continue and increase, to maintain the confidence of depositors and to ensure viability in the face of loss arising from inevitable business and political fluctuation and uncertainty, particularly in an inflationary climate.

Reserves: Reserves of a bank also indicate the health of the institution. It is obligatory on the part of banks to transfer 20 per cent of profit to reserves to strengthen the capital base of the bank. Capital and reserves together constitute the network of a bank.

The reserve fund is built to meet unforeseen and unexpected contingencies. It is a source of strength for the bank as it can withstand heavy losses. The reserve fund is invested in first class securities.

This apart, banks are also permitted to build secret reserves too.

Deposits from Banks

Deposits from banks and from the public are the life blood of commercial banks. They are the chief sources of bank and account for approximately 83 per cent of bank liabilities. Banks deposits are classified into (a) Fixed deposits (b) Savings bank deposits and (c) Current deposits, contingency accounts etc. Contingency accounts include head office funds and other inter-bank and inter-branch adjustments classified as deposit.

Borrowing from other Banking Companies, Agents

With a view to replenish their funds, banks borrow from the Reserve

Bank of India (presently refinance is given for food credit and export credit), bills rediscounted with the Reserve Bank. -In addition, banks borrow from other refinance bodies like IDBI, SIDBI, NABARD, EXIMBANK, IFC, IRBI and other financial institutions. **Bills Payable:** Outstanding bills constitute the liability of a bank.

Other Liabilities: Generally include provision of dividend, unclaimed dividends, interest provision accounts and inter-office adjustments.

3.5.2 Assets of a Commercial Bank: The assets of the commercial bank are given on the right hand side of the balance sheet. These are grouped under following heads:

1. Cash - in hand and with Reserve Bank of India (including foreign currency notes.)
2. Balances with other banks - on current account and on deposit accounts.
3. Money at call and short notice.
4. Investments - (a) Central and State Government securities and Treasury Bills (b) other Trustee securities (including shares which are Trustee securities).
5. Advances
 - (i) Loans, cash credits, overdrafts etc.
 - (ii) Bills discounted and purchased.
6. Premises less depreciation.
7. Furniture & Fixtures less depreciation.
8. Other assets

Cash and Balances

Among assets, the cash and balances with Reserve Bank component is theoretically a function of the Cash Reserve Ratio (CRR) prescribed by the Reserve Bank in line with monetary and credit policy.

Investments

The Investments component is ostensibly a function of the Statutory Liquidity Ratio prescribed by the RBI in line with monetary and credit policy.

Credit

Credit is the broadest and most important component of the assets of the banking system. It is also the most complex because in developing

economies, it is not merely an outcome of credit policy but also a tool of agricultural and industrial policy.

Within Bank credit, loans, cash credits and overdrafts constitute '90% and the rest are inland and foreign bills. Interestingly, the ratio of inland to foreign bills has changed from 3:1 to 1:1 which is probably due to the liberalisation of foreign trade as well as export finance coming under the scheme of priority sector advances

There are off balance sheet liabilities also, known as contingent liabilities like claims against the bank, guarantees and letters of credit issued on behalf of the customers, liabilities on account of outstanding forward exchange contracts, etc.

Size

The assets and liabilities of all scheduled commercial banks (SCBs) as at of march 2000 are presented in table 3.1 Assets of Rs. 11,10,368 crores consist of cash in hand balances with RBI of Rs.85,371 cores (7.69% of total assets) assets with banking system of Rs.81.019 crores (7.30%) investments of Rs.4,13,871 crores (37.27%) bank credit of Rs.4,43,469 crores (39.94%).

liabilities of all scheduled commercial banks, Rs.11,10,368 crores consists of capital of Rs,18,447 crores (1.66%) reserves and surplus of Rs. 43.834 crores (3.95%) and deposits from public of Rs. 9,00,307 crores (81.1%).

Assets and Liabilities of Scheduled Commercial Banks, March 31,2000

4. Central Banking

4.1 Introduction

The pattern of central banking in India was based on the Bank of England. England had a highly developed banking system in which the functioning of the central bank as a banker's bank and their regulation of money supply set the pattern. The central bank's, function as 'a: lender of last resort' was on the condition that the banks maintain stable

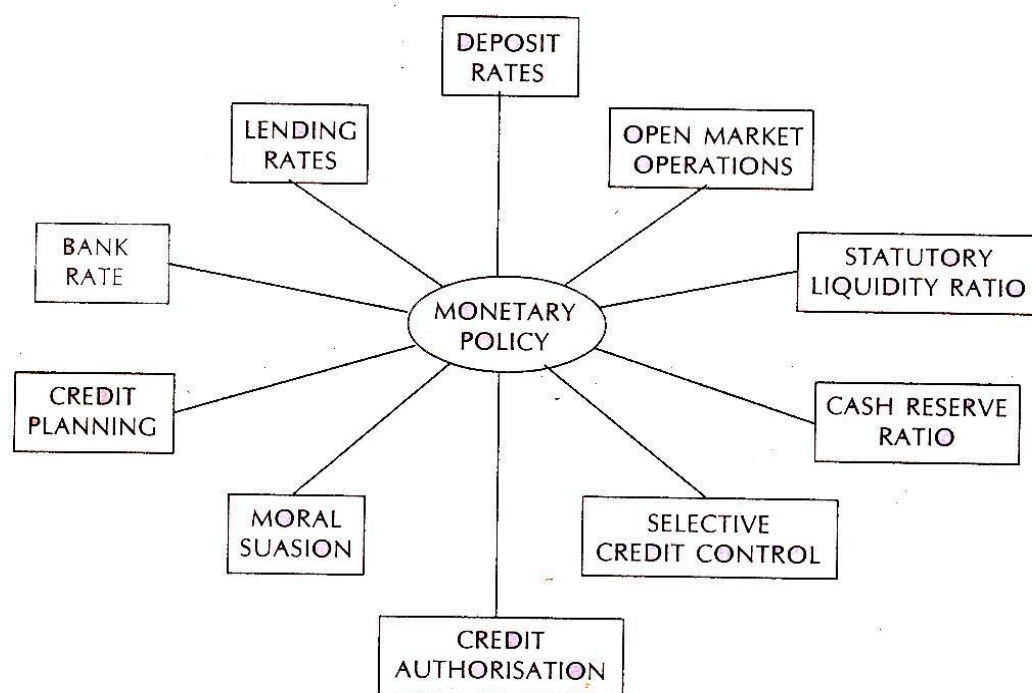
cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate. The effectiveness of open market operations however depends on the member banks' dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

Liabilities	Rs. Crores	%	Assets	Rs. Crores	%
1. Capital	18,447	1.66	Cash and Balance with RBI	85,371	7.69%
2. Reserves & Surplus	43,834	3.95	Balances with banks and money at call and short notice	81,019	7.30
3. Deposits	900,307	81.08	Investments	4,13,871	37.27
Demand	1,29,339	11.65	Government securities	2,88,178	25.95
Savings	1,88,483	16.97	Other approved	25,243	2.27
Term	5,82,485	52.46	Non approved	1,00,450	9.05
4. Borrowings	43,350	4.09	Loans and Advances	4,43,469	39.94
5. Other	1,02,420	9.22	Bills purchased and discount	43,051	3.88
Liabilities and Provisions			Cash Credit and over drafts	2,41,596	21.76

(Unclassified liabilities to banking system and participation certificates issued by SCBS			Terms deposit	1,58,822	14.30
			Fixed Assets	15,480	1.39
			Other assets	71,158	6.41
Total Liabilities	11,10,368	100.0	Total assets	11,10,368	100.0

4.2 Instruments Of Monetary Control

One of the most important functions of a central bank is monetary management-regulation of the quantity of money and the supply and availability of credit for industry, business and trade. The monetary or credit management activities of the bank are of two types: general monetary' and credit management functions-total supply of money and credit and the general level of interest rates. The central bank relies on two types of instruments, the direct and the indirect. The direct instruments of monetary control are reserve requirements, administered interest rates and credit controls; and the indirect instrument of control is open market operation.



Bank rate policy

Bank rate is the rate charged by the central bank for rediscounting first class bills of exchange and government securities held by Commercial Banks.

The Bank rate policy affects the cost and availability of credit to the Commercial Banks.

When there is inflation the central bank raises the bank rate. This will raise the cost of borrowing of the Commercial Banks, so they will charge a higher rate of interest on their loans and advances to the customer. This would lead to following effects:

- i) Rise in market rate of interest
- ii) Rise in the cost of borrowing money from the banks
- iii) Decline in demand for credit leading, to contraction of credit.

When there is deflation in the economy, the central bank will lower the bank rate. Opposite trend takes place leading to expansion of credit to the economy.

In short, an increase in the bank rate leads to rise in the rate of interest and contraction of credit, which in turn adversely affects investment activities and the economy as a whole.

Similarly, a lowering of bank rate will have a reverse effect. When the bank rate is lowered money market rate falls. Credit becomes cheaper. People borrow, these leads to expansion of credit. This increases investment, which leads to employment and increase in production. Economy gradually progresses.

In India, the bank rate has been of little significance except as an indicator of changes in the direction of credit policy. The bank rate was changed nine times during the period 1951-74, but only thrice during 1975-96. In 1997, it was changed thrice; in 1998 four times, twice in 1999 and once in 2000. It should become effective in the near future

since interest rates have been deregulated and market determined through the adoption of auction procedure for treasury bills and government securities. Variations in bank rate have little significance in a scenario where hardly any rates are linked to it and the amount of refinance extended to banks at this rate is minimal.

Open Market Operations

The technique of open market operations as an instrument of credit control is superior to bank rate policy. The need for open market operation was felt only when the bank rate policy turned out to be a rather weak, instrument of monetary control. According to some experts, bank rate policy and open market operations are complementary measures in the area of monetary management.

Open market operation is mainly related to the sale of government securities and during the busy season, they sell the securities. When commercial banks sell the securities and when RBI purchases them, The reserve position of the banks is improved and they can expand their credit to meet growing demands.

Cash Reserve Ratio

The commercial banks have to keep with the central bank a certain percentage of their deposits in the form of cash reserves. In India initially CRR was 5 percent. In 1962 RBI was empowered to vary it between 3 to 15 percent since then it has been increased or decreased a number of times.

Increasing the CRR leads to credit contraction and reducing it will lead to credit expansion.

The CRR is applicable to all scheduled banks including scheduled cooperative banks and the Regional Rural Banks (RRBs) and non scheduled banks. However, cooperative banks, RRBs, the non scheduled banks have to maintain the CRR of only 3 percent and so far it has not been changed the RBI. The CRR for both the types of

Non-Resident Indians (NRI) the RBI. The CRR for both the types of Non-Resident Indians (NRI) accounts Non-Resident (External) Rupee Account (NR(E)RA) and Foreign Currency (Non-Resident Accounts (FCNRA) - was the same as for other types of deposits till 9th April 1982, the CRR for these accounts was fixed at 3 percent. Subsequently, it was raised from time to time. For example in July 1988, it was raised from 9.5 percent to 10 percent.

The RBI has powers to impose penal interest rates on banks in respect of their shortfall in the prescribed CRR). CRR has been reduced to 10 percent in January 1997 and further to 8 percent (in stages of 0.25 percent per quarter over a two year period) and inter bank deposits have been exempted from April 1997.

Statutory Liquidity Ratio

Under the Banking Regulation Act (sec 24(2A) as amended in 1962, banks have to maintain a minimum liquid assets of 25 per cent of their demand and time liabilities in India. The Reserve Bank has, since 1970, imposed a much higher percentage of liquid assets to restrain the pace of expansion of bank credit. SLR was fixed at 31.5 percent of the net domestic and time liabilities (NDTL) on the base date 30-9-1994; and for any increase in NDTL over the level as on September 30, 1994, the SLR was fixed at 25 per cent. Inter bank deposits have been taken out of NDTL in April 1997. The overall effective SLR was estimated at 28.2 per cent at the end of March 1995 and reduced to 25 per cent in October 1997. The average investments in Government securities to deposits (IGS-D ratio) actually increased from 25.3% in 1980s to 30.4% in 1990 on account of introduction of prudential norms which imparted discipline in extending credit and auctions of government securities at market related rates.

Selective Credit Controls

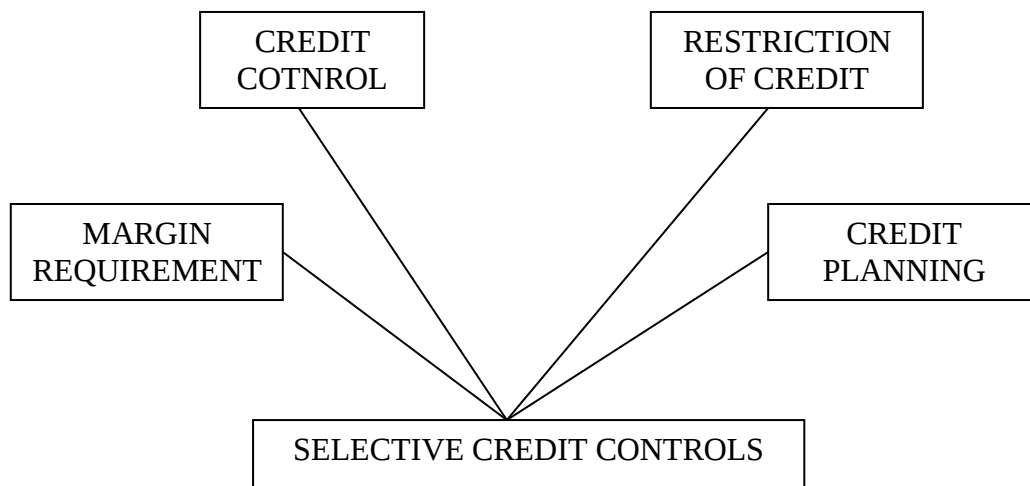
Selective credit controls have been used by the bank mainly with a

view to restraining excessive speculative stock-building of commodities in short supply either as a result of a crop shortage or as a result of a fall in the production of manufactured articles following raw materials shortages, etc. The commodities in respect of which these articles of consumption or items important for exports are food grains, oilseeds, jute, cotton textiles and sugar. These controls have taken the form of objectives to increase the margin requirements, to regulate the size of credit limit per borrower with a view to ensure maintenance of an aggregate level of credit against a particular commodity at a certain level which may have reference to the level of credit maintained in the corresponding period in the past, etc. Adjustments to suit the needs of the economy in a particular region have also been incorporated in these controls. Besides exercising control on bank credit against the security of particular commodities in short supply, the Reserve Bank has also endeavoured to control excessive borrowing from the banking system by way of clean advances or against the security of other assets, such as share and stocks.

The main instruments of selective controls in India are:

- (a) Minimum margins (in a secured advance, the "margin" represents a portion of the value of the security charged to the bank, which is expected to have been paid for by the borrower out of his own resources) for lending against selected commodities;
- (b) Ceilings on the levels. of credit; and
- (c) Charging minimum rate of interest on advances against specified commodities. While the two instruments control the quantum of credit, the third instrument works as leverage on the cost of credit. On the whole, the banking system in India has shown a good appreciation of the needs of such controls and has co-operated quite well. As regards their overall efficiency, the experience in India has been the same as that of most other countries, namely, that their effectiveness in general

is comparatively limited. Generally, they are successful if employed in combination with measures of general credit control.



Moral Suas

Fig. : Forms of Selective Credit Control

Moral suasion refers to the advice or indication given by the central bank, generally to banks and sometimes to other financial institutions also, in the matter of their lending and other operations with the objective that they might implement or follow it. Moral suasion may be quantitative in content, such as fixation of the aggregate amount of credit to be granted by banks during a period, or caution to be exercised in granting advances against commodities whose prices are subject to speculative tendencies. Periodically, letters are issued to banks urging them to exercise control over credit in general or advances against specified commodities or unsecured advances in particular. Discussions are also held from time to time with banks with the same objective. Wherever the use of moral suasion is possible, it makes it easier for the central bank to secure the willing and active co-operation of commercial banks in complying with the regulatory measures, both in letter and in spirit; it also enables the central bank to exert influence not only on the borrowing banks (which is possible by direct action) but also on the non-borrowing banks, and other credit

and financial institutions, whose operations are significant enough to affect the credit policy of the central bank.

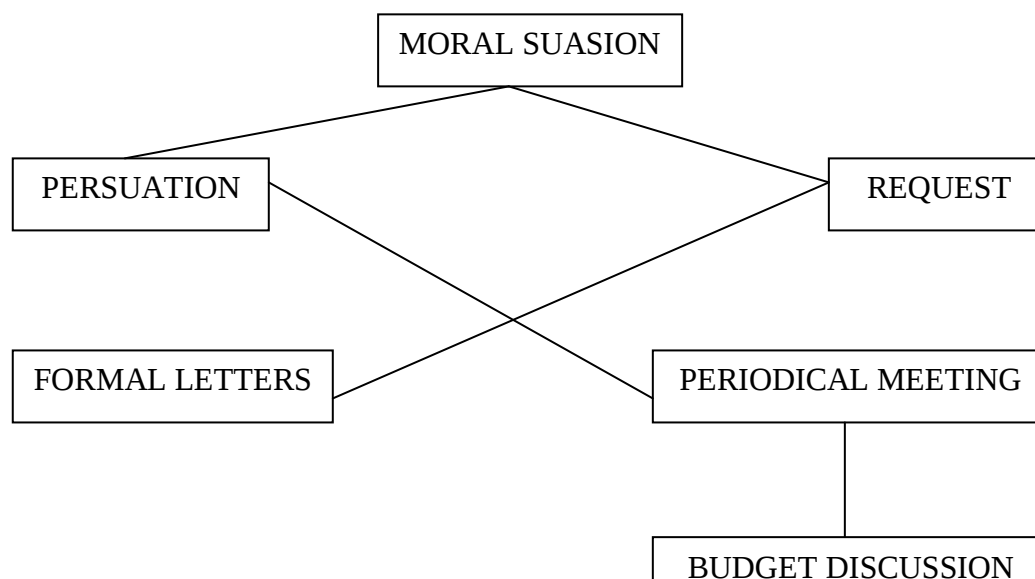


Fig.: Indicates Ways and Means of Moral Suasion

Credit Authorisation Scheme

The Credit Authorization Scheme was introduced by the Reserve Bank in November 1965 as an additional measure of credit regulation in the context of the Bank's policy of keeping inflationary pressures under check. The other main objectives of the scheme were to enforce financial discipline on the larger borrowers and ensure that they did not pre-empt scarce bank resources. Under the scheme, the Reserve Bank regulates not only the quantum but also the terms on which credit flows to the different large borrowers, in order that credit is directed to genuine productive purposes, that it is in accord with the needs of the borrowers, and that there is no undue channelling of credit to any single borrower or group of borrowers.

Originally, the scheduled commercial banks were required to obtain the Reserve Bank's prior authorisation for sanctioning any fresh working capital limit (including commercial bill discounts) of Rs.1 crore or

more to any single party or any limit that would take the total limits enjoyed by such a party from the entire banking system to Rs.1 crore or more on secured and/or unsecured basis. The scheme has been modified from time to time in the light of the prevailing economic situation. Thus, in exceeding Rs.25 lakhs and repayable over a period of more than 3 years sanctioned (singly or jointly with other banks or financial institutions) to any single party, irrespective of the totality of the credit limits available to it from the banking system as a whole. This modification was made in order that borrowers might not avoid the discipline sought to be enforced by the specialised term-lending institutions. Further, borrowings by the public sector undertakings, including State Electricity Boards, advances against the guarantees of Central" and State Governments, which were exempted from the requirement of and Reserve Bank's prior authorisation was required for sanctioning any credit limit (including commercial bill discounts) of Rs.3 crores or more to any single borrower, or any limit that would take the total limits enjoyed by such a borrower from the entire banking system to Rs. 3 crores or more on secured and/or unsecured basis.

4.3 Reserve bank of India

The Reserve Bank of India (RBI) is the apex financial institution of the country's financial system entrusted with the task of control, supervision, promotion, development and planning. RBI is the queen bee of the Indian financial system which influences the commercial banks' management in more than one way. The RBI influences the management of commercial banks through its various policies, directions and regulations. Its role in bank management is quite unique. In fact, the RBI performs the four basic functions of management, viz., planning, organising, directing and controlling in laying a strong foundation for the functioning of commercial bank

From Private Ownership to State Ownership

Originally, the Reserve Bank was constituted as a shareholders' bank, based on the model of leading foreign central banks of those days. The bank's fully-paid share capital was Rs.5 crores divided into shares of Rs.100 each. Of this, Rs.4,97,80,000 were subscribed by the private shareholders and Rs.2,20,000 were subscribed by the Central Government for disposal of 2,200 shares at par to the Directors of Bank (including members of the Local Boards) seeking the minimum share qualification. The share capital of the bank has remained unchanged until today .

Objectives of the Reserve Bank of India

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as: "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

Prior to the establishment of the Reserve Bank, the Indian financial system was totally inadequate on account of the inherent weakness of the dual control of currency by the Central Government and of credit by the Imperial Bank of India. The Hilton-Young Commission, therefore, recommended that the dichotomy of functions and division of responsibility for control of currency and credit and the divergent policies in this respect must be ended by setting-up of a central bank - called the Reserve Bank of India - which would regulate the financial policy and develop banking facilities throughout the country. Hence, the Bank was established with this primary object in view.

Another objective of the Reserve Bank has been to remain free from political influence and be in successful operation for maintaining financial stability and credit.

The fundamental object of the Reserve Bank of India is to discharge purely central banking functions in the Indian money market, i.e., to act as the note-issuing authority, bankers' bank and banker to government, and to promote the growth of the economy within the framework of the general economic policy of the Government, consistent with the need of maintenance of price stability.

A significant object of the Reserve Bank of India has also been to assist the planned process of development of the Indian economy. Besides the traditional central banking functions, with the launching of the five-year plans in the country, the Reserve Bank of India has been moving ahead in performing a host of developmental and promotional functions, which are normally beyond the purview of a traditional Central Bank.

Functions

The Reserve Bank of India performs all the typical functions of a good Central Bank. In addition, it carries out a variety of developmental and promotional functions attuned to the course of economic planning in the country:

- (1) Issuing currency notes, i.e., to act as a currency authority.
- (2) Serving as banker to the Government.
- (3) Acting as bankers' bank and supervisor.
- (4) Monetary regulation and management
- (5) Exchange management and control.
- (6) Collection of data and their publication.
- (7) Miscellaneous developmental and promotional functions and activities.
- (8) Agricultural Finance.
- (9) Industrial Finance
- (10) Export Finance.
- (11) Institutional promotion

Bank Issue:

Under Section 22 of the Reserve Bank of India Act, the bank has the sole right to issue bank notes of all denominations. The notice issued

by the Reserve bank has the following advantages:

- (i) It brings uniformity to note issue;
- (ii) It is easier to control credit when there is a single agency of note issue.
- (iii) It keeps the public faith in the paper currency alive;
- (iv) It helps in the stabilization of the internal and external value of the currency and
- (v) Credit can be regulated according to the needs of the business.

Since 1957 the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs.200 Crores, of which atleast Rs.15 crores should be in gold. The system of note issue as it exists today is known as the minimum reserve system. The currency notes issued by the Bank are legal tender every Where in India without any limit. At present, the Bank issues notes in the following denominations: Rs. 2, 5, 10, 20, 50 100, and 500. The responsibility of the Bank is not only to put currency into, or withdraw it from, the circulation but also to exchange notes and coins of one denomination into those of other denominations as demanded by the public. All affairs of the Bank relating to note issue are conducted through its Issue Department.

Banker, Agent and Financial Advisor to the State

As a banker agent and financial advisor to the State, the Reserve Bank performs the following functions:

- (i) It keeps the banking accounts of the government.
- (ii) It advances short-term loans to the government and raises loans from the public
- (iii) It purchases and sells through bills and currencies on behalf to the government.
- (iv) It receives and makes payment on behalf of the government:
- (v) It manages public debt and
- (vi) It advises the government on economic matters like deficit financing price stability, management of public debts. etc.

Banker to the Banks:

It acts as a guardian for the commercial banks. Commercial banks are required to keep a certain proportion of cash reserves with the Reserve bank. In lieu of this, the Reserve bank offers them various facilities like advancing loans, underwriting securities etc.,

The RBI controls the volume of reserves of commercial banks and thereby determines the deposits/credit creating ability of the banks. The banks hold a part or all of their reserves with the RBI. Similarly, in times of their needs, the banks borrow funds from the RBI. It is, therefore, called the bank of last resort or the lender of last resort.

Custodian of Foreign Exchange Reserves

It is the responsibility of the Reserve bank to stabilize the external value of the national currency. The Reserve Bank keeps golds and foreign currencies as reserves against note issue and also meets adverse balance of payments with other countries. It also manages foreign currency in accordance with the controls imposed by the government.

As far as the external sector is concerned, the task of the RBI has the following dimensions: (a) to administer the foreign Exchange Control; (b) to choose the exchange rate system and fix or manage the exchange rate between the rupee and other currencies; (c) to manage exchange reserves; (d) to interact or negotiate with the monetary authorities of the Sterling Area, Asian Clearing Union, and other countries, and with International financial institutions such as the IMF, World Bank, and Asian Development Bank.

The RBI is the custodian of the country's foreign exchange reserves, and it is vested with the responsibility of managing the investment and utilization of the reserves in the most advantageous manner. The RBI achieves this through buying and selling of foreign exchange market, from and to scheduled banks, which are the authorized dealers in the Indian, foreign exchange market. The Bank manages the investment of

reserves in gold counts abroad' and the shares and securities issued by foreign governments and international banks or financial institutions.

Lender of the Last Resort

At one time, it was supposed to be the most important function of the Reserve Bank. When Commercial banks fail to meet obligations of their depositors the Reserve Bank comes [b their rescue As the lender of the last resort, the Reserve Bank assumes the responsibility of meeting directly or indirectly all legitimate demands for accommodation by the Commercial Banks under emergency conditions.

Banks of Central Clearance, Settlement and Transfer

The commercial banks are not required to settle the payments of their mutual transactions in cash, It is easier to effect clearance and settlement of claims among them by making entries in their accounts maintained with the Reserve Bank, The Reserve Bank also provides the facility for transfer to money free of charge to member banks.

Controller of Credit

In modern times credit control is considered as the most crucial and important functional of a Reserve Bank. The Reserve Bank regulates and controls the volume and direction of credit by using quantitative and qualitative controls. Quantitative controls include the bank rate policy, the open market operations, and the variable reserve ratio. Qualitative or selective credit control, on the other hand includes rationing of credit, margin requirements, direct action, moral suasion publicity, etc. Besides the above mentioned traditional functions, the Reserve Bank also performs some promotional and supervisory functions. The Reserve Bank promotes the development of agriculture and industry promotes rural credit, etc. The Reserve Bank also acts as an agent for the international institutions as I.M.F., I.B.R.D., etc.

Supervisory Functions

In addition to its traditional central banking functions, the Reserve Bank has certain non- monetary functions of the nature of supervision of banks and promotion of sound banking in India. The supervisory functions of the RBI have helped a great deal in improving the methods of their operation. The Reserve Bank Act, 1934, and I Banking Regulation Act, 1949 have given the RBI wide powers of:

- (i) Supervision and control over commercial and cooperative banks, relating to licensing and establishments.
- (ii) Branch expansion.
- (iii) Liquidity of their assets.
- (iv) Management and methods of working, amalgamation reconstruction and liquidations;
- (v) The RBI is authorized to carry out periodical inspections off the banks and to call for returns and necessary information from them.

Promotional Role

A striking feature of the Reserve Bank of India Act was that it made agricultural credit the Bank's special responsibility. This reflected the realisation that the country's central bank should make special efforts to develop, under its direction and guidance, a system of institutional credit for a major sector of the economy, namely, agriculture, which then accounted for more than 50 per cent of the national income. However, major advances in agricultural finance materialised only after India's independence. Over the years, the Reserve Bank has helped to evolve a suitable institutional infrastructure for providing credit in rural areas.

Another important function of the Bank is the regulation of banking. All the scheduled banks are required to keep with the Reserve Bank a consolidated 3 per cent of their total deposits, and the Reserve Bank

has power to increase this percentage up to 15. These banks must have capital and reserves of not less than Rs.5 lakhs. The accumulation of these balances with the Reserve Bank places it in a position to use them freely in emergencies to support the scheduled banks themselves in times of need as the lender of last resort. To a certain extent, it is also possible for the Reserve Bank to influence the credit policy of scheduled banks by means of an open market operations policy, that is, by the purchase and sale of securities or bills in the market. The Reserve bank has another instrument of control in the form of the bank rate, which it publishes from time to time.

Further, the Bank has been given the following special powers to control banking companies under the Banking Companies Act, 1949:

- (a) The power to issue licenses to banks operating in India.
- (b) The power to have supervision and inspection of banks.
- (c) The power to control the opening of new branches.
- (d) The power to examine and sanction schemes of arrangement and amalgamation.
- (e) The power to recommend the liquidation of weak banking companies.
- (f) The power to receive and scrutinize prescribed returns, and to call for any other information relating to the banking business.
- (g) The power to caution or prohibit banking companies generally or any banking company in particular from entering into any particular transaction or transactions.
- (h) The power to control the lending policy of, and advances by banking companies or any particular bank in the public interest and to give directions as to the purpose for which advances may or may not be made, the margins to be maintained in respect of secured advances and the interest to be charged on advances.

5. PUBLIC DEBT

Public debt is raised by governments to meet the gap between budgeted receipts and payments. Public debt has far reaching consequences upon production and distribution of a country. Public debt is thus government or state debt. The state generally borrows to:

- (i) to meet budget deficits;
- (ii) to cover other expenses; and
- (iii) to finance development activities.

5.1 Classification of Public Debt

Public debts have been classified into two broad groups - internal and external debt. Internal debts are loans raised within the country.

External debts are cumulative amount raised outside the country by the government and others.

Internal Debt

Internal debt of the Government of India comprises of market loans, treasury bills, special securities issued to the Reserve Bank, and International financial institution and others.

Other liabilities (rupee debt under the public account) comprises of small savings, provident funds (State Provident Funds and Public Provident Funds), other accounts (mainly postal insurance and Life Annuity Fund, Special Deposits etc.) reserve funds.

The Indian debt market includes the money market and the bond market. While the money market is fairly well developed with a wide range of instruments and a fairly large turnover, the secondary market for bonds has been primitive and stunted. The instruments traded in the debt market include Government of India Securities, Treasury Bills, State Government Securities, Government guaranteed bonds, PSU bonds, corporate debentures, commercial papers and certificates of deposit.

The principal regulatory authorities of the debt market are Ministry of Finance and the Department of Company Affairs, Government of India, the Reserve Bank of India and the Securities and Exchange Board of India (SEBI). In addition, there are a few associations of intermediaries such as brokers, merchant bankers and fund managers in the securities industry, some of whom are planning to evolve into self-

regulatory organizations.

DEBT MARKET ISSUERS, INSTRUMENTS AND INVESTORS			
Issuer	Instruments	Issuance Maturity	Major Investors
Government of India	Govt. Securities	2 to 10 years	Banks, LIC, UTI, RBI
Government of India	T- Bills	91 days and 364 days	Banks, LIC, UTI, RBI
Government of India	Zero Coupon Bonds	5 to 10 years	Banks, LIC, UTI, RBI, MFs.
State Government	State Government Securities	5 to 10 years	Banks, LIC, PFs.
Development Financial Institutions (DFIs), State Electricity Boards	Government Guaranteed Bonds	5 to 10 years	Banks, LIC, PFs
Public Sector Undertakings	PSU Bonds	5 to 10 years	Banks, UTI, Corporates, MFs
Private Sector Corporates	Corporate Debentures	10 to 12 years	UTI, Other MFs, LIC, GIC, Fls
Public and Private Sector Corporates	Commercial Papers	3 months to 1 year	Banks, MFs, Fls
Banks and Financial Institutions	Certificates of Deposit	3 months to 1 year (Banks) 1-3 years (fls)	Banks, Corporates, MFs

External Debt

Under the Constitution, the Central Government but not State Governments, has access to external debt. However, Government of India has not been borrowing externally on commercial terms so far and its borrowings have been limited to external assistance mainly from other Governments and multilateral sources such as IBRD, IDA, etc. Public enterprises could, however, resort to external borrowings on

concessional terms also through on-lending arrangements with Government, though more recently, in intermediation of government has been dispensed with.

At the end of March 1996, total external liabilities of the Central Government represented only about 8 per cent of total liabilities of the Central Government (21 per cent, if external liabilities are valued at current exchange rates) signifying that only a modest proportion of the gross fiscal deficit has been financed over the years through external debt. Earlier, when Government of India borrowed under external assistance to finance State Government projects, it would pass on a portion to State Governments as additionality to central plan assistance for concerned state on terms as applicable to such central assistance. Now, it passes on the entire amount of external assistance as additionality. Further, States are now permitted to enter into dialogue with multilateral agencies like World Bank.

At present, India's external debt is presented on the basis of original maturity. In conventional analysis, the stock of debt by original maturity expressed as a ratio of GDP has been regarded as a measure of the long-term sustainability of debt and the overall solvency of the country. However, the recent experience of the Asian crisis has shown that another wise solvent economy, as reflected in its debt by original maturity, may suffer a serious liquidity problem when its debt servicing burden exceeds its stock of foreign exchange reserves and its ability to contract new debt or extend the old debt. In the event of a shift in market sentiment, the country might experience a debt crisis which may not be signaled in the standard measures of debt sustainability. This is especially true in the context of short-term debt; inability to capture roll-overs, and the cross-border bank liabilities imposes a downward bias on debt measured by original maturity. As against this, debt by residual maturity provides a true picture of the

impact of maturing debt on the foreign exchange market. It also enables authorities to prospectively fine tune debt management instruments, such as ceilings and interest rates, to ensure sustainability of external payments and brings about an integration of external debt statistics with the balance of payments.

The external debt stock of India stood at Rs. 4,93,502 crore at end September 2002 as against Rs. 4,78,782 crore a year ago. Despite increasing trend of external debt in the recent years, the key debt indicators has considerably improved over time. The external debt to GDP ratio, signifying the extent of external debt vis-a-vis domestic output, declined from 24.3 per cent at end-March 1998 to 20.9 per cent as at end-March 2002 and further down to 20.1 per cent at end-September 2002. Debt service to current receipts ratio that signifies capacity of the country to meet its debt service obligations, improved from 19.5 per cent in 1997-98 to 13.8 per cent in 2001-02. Short-term debt (debt with original maturity of up to one year) has also declined steadily from US \$ 5.05 billion at end-March 1998 to US \$ 2.75 billion at end March 2002, but has moved up to US \$ 3.04 billion at end-September 2002 revealing a decline in share of short-term debt to total external debt from 5.4 per cent at end-March 1998 to 3.0 per cent at end-September 2002. Similarly, short-term debt to foreign currency assets ratio has also declined consistently from 19.4 per cent at end-March 1998 to 5.4 per cent at end-March 2002 and further to 5.1 per cent at end-September 2002.

Of the total public liabilities of the Government, external debt is about 10 per cent and internal debt is about 90 per cent. External debt relates to all loans raised outside India and repayable to the foreign governments, foreign nationals and international bodies. The increase in external debt was on account of the revaluation of the non-US dollar components of the debt stock. The increase in foreign currency assets

pushed up the foreign exchange reserves to Rs. 79,780 crore at the end of March 1995.

According to the RBI, external debt as percentage of GDP at current market prices stood at 32.9 per cent in March 1995. The debt service ratio, however, was higher at 27.1 per cent.

A unique feature of our external debt lies in its structure. That is, probably, the reason why the IMF isn't terribly worried. Thirty-four per cent of our external debt is owed to multilateral financial institutions, like the World Bank and the IMF, and another 18 per cent is owed to bilateral aid agencies. Another feature is that over a third of our external debt is concessional debt.

EXTERNAL DEBT BURDEN

End-March	1991	1996	2000	2001 (R)	2002 (R)
1.Multilateral Borrowings	40,386	98,173	1,37,132	1,45,105	1,55,662
A-Government Borrowings	38,429	89,428	1,20,321	1,27,886	1,38,025
B.Non-Government Borrowings		8,745	16,811	17,219	17,607
II. Bilateral	1,957		79,278	74,519	74,878
A.Government Borrowings	27,378	65,740			
B.Non Government borrowings	23,065	53,119	60,920	56,802	56,299
III.International Monetary Fund	4,315	12,621	18,358	17,717	18,579
IV.Export Credit	5,132	8,152	113	0	0
A. Buyers Credit	8,374	18,432	29,564	27,625	24,423
B. Suppliers Credit	8,374	18,432	29,564	27,625	24,423
C. Export credit component of bilateral credit	933	5,382	5,582	5,401	5,042

D. Export credit for defence purpose	1,390	4,529	5,165	4,828	4,819
V. Commercial Borrowings	3,821	1,305	83	60	1,13,890
VI. NRI & FC (B&O) deposits	19,727	47,642	86,963	1,12,938	1,13,890
VII. Rupee Debt	20,030	37,802	59,137	77,273	83,712
VIII.Total Long Term Debt	20,030	37,802	59,137	77,273	83,712
IX. Short Term Debt	1,46,226	3,04,091	4,11,388	4,54,805	4,67,187
X. Gross Total (VIII+IX)	16,775	16,637	17,162	16,919	13,396
Debt Indicators	1,63,001	3,20,728	4,28,550	4,71,724	4,80,583
Debt service ratio (%) (for fiscal years)					
(Including debt servicing on non-civilian credit)	27.2	24.1	16.1	15.4	13.8

OWNERSHIP OF DEBT

A Survey of the ownership pattern of government securities, conducted by the RBI's research department some years ago, revealed that more than 92 per cent of government securities were held by governmental and quasi-governmental institutions, while individuals accounted for the rest. A recent estimate by the same source has now pegged the former group's holding at 99 per cent. Thus, the assumption that an increase in interest rates on treasury bills and government securities will attract large amounts of savings from the household sector does not appear to be justified. On the contrary, it was feared that such a measure would increase the debt burden on the government rather than reduce the level of deficit financing.

The four parameters on which the internal debt trap concept could rest are as follows:

First, it is generally argued that the government borrowings facilitate asset creation, which in turn and time take care of debt repayment. However, experience points the other way. By and large, government borrowings have been used for non-plan, non-development expenditure rather than for asset creation.

Second, even if it is assumed that a significant proportion of public borrowings is invested in productive enterprises, there are inordinate delays in the fructification of investment. As a result, the growth rate in the debt burden continues to rise unabated as interest charges pile up.

Third, as stated earlier, government securities and treasury bills have a captive market and the household sector savings account for an insignificant proportion of the government's total public borrowings. The situation would not undergo any drastic change when interest rates are increase.

Lastly, with the acceptance of monetary targeting by the government, it would not be possible for the RBI to absorb the residuary portion of the government's loan tranches any longer.

Maturity Pattern Of The Debt

Maturity-wise, there are three classes of loans which are floated by the Central and State Governments - short-term, medium-term and long-term. Short-term loans are for periods varying from 1 to 5 years, medium-term loans from 5 to 10 years and long-term loans above 10 years. The maturity pattern of the debt is arranged in such a way to suit the demands of the institutions. About 17% of the Central Government debt is of short-term nature, 22% of medium-term nature and 61 % of long-term nature. The Government would prefer a larger amount of long term debt as it would be suitable for developmental outlays. The maturities are now well distributed as between the various years. There are no double dated loans and none of the market loans are kept on tap and none are repaid before the maturity date.

There are about 40 Central Government loans outstanding in which the Reserve Bank does open market operations and which are held by the Reserve Bank in its investment account. Of these, 9 are of short-term maturity with coupon rates varying from $2\frac{3}{4}\%$ to $4\frac{3}{4}\%$ medium dated loans with coupon rates varying from $4\frac{1}{2}\%$ to $5\frac{1}{2}\%$, and the rest are the long dated loans with coupon rates varying from $4\frac{1}{2}\%$ to $6\frac{1}{2}\%$. As against these coupon rates on the Central Government loans, the State Government loans have a rate slightly higher by $\frac{1}{2}\%$ to $\frac{3}{4}\%$. Most of the State Government loans are of short and medium dated nature:

5.2 Secondary Debt Market

Debt management policy can be effective if there is a secondary market with depth. The move to market –related rates of interest is likely to strengthen the development of the secondary market. This enables the primary and secondary markets to give effective signals to each other.

Secondly, the system of primary dealers would enable the development of an orderly market. Primary dealers act as market makers for securities by giving two way quotes. They are not final investors but should have the financial capacity and skills to bid in the primary auctions and hold the securities till they are able to access them in the secondary market. Primary dealers are approved by the RBI and help in the placement of government securities in Primary issues by committed participation in auctions. The primary dealers act as a conduit for open market operations by the Reserve Bank and provide signals for market intervention. The Reserve Bank announced on March 29, 1995, guidelines and procedures for enlistment of primary dealers in government securities. These guidelines relate to commitment to bid minimum amount, underwrite a predetermined part, achieve a minimum turnover, maintain minimum capital standards on

risk-weighted assets and be subject to Reserve Bank regulation. The Bank in turn would extend facilities like current account/ subsidiary ledger account (SGL), liquidity support linked to bidding commitments, freedom to deal in money market instruments and I favoured access to open market operations. PDs are paid commission on primary purchases (including underwriting).

The development of the debt segment in the National Stock Exchange and duplication of transactions recorded by the Reserve Bank under the SGL Account has imparted a greater element of transparency. Finally, the system of delivery versus payment (DVP) in government securities introduced in Mumbai in July 1995, to synchronise the transfer of securities with the cash payment would reduce the settlement risk in transactions and prevent diversion of funds in the case of transactions through SGL. Liquidity of securities should improve with the setting up of the Securities Trading Corporation of India (STCI) along with the existing Discount and Finance House of India (DFHI) and the holding of government securities would become, attractive.

5.3 REPOs

REPO and reverse REPO operated by RBI in dated government securities and Treasury 'bills' (except 14 days) help banks to manage their liquidity as well as undertake switch to maximize [the return. REPOs are also used to signal changes in interest rates. REPOs bridge securities and banking business.

A REPO is the purchase of one loan against the sale of another. They involve the sale of securities against cash with a future buy back agreement. There are no restrictions on the tenor of REPOs. They are well established in US and spread to Euro market in the second half of 1980s to meet the trading demand from dealers and smaller commercial banks with limited access to international inter bank funding. REPOs are a substitute for traditional inter bank credit.

REPOs are part of open market operations undertaken to influence short-term liquidity. With a view to maintain an orderly pattern of yields and to cater to the varying requirements of investors with respect to maturity distribution policy or to enable them to improve the yields on their investment in securities, RBI engages extensively in switch operations. In a triangular switch, one institution's sale/purchase of security is matched against the purchase/sale transaction of another institution by the approved brokers. In a triangular switch operation, the selling Banks quota (fixed on the basis of time and demand deposit liabilities) is debited (the Reserve Bank being the purchaser). The objective behind fixing a quota for switch deals is to prevent the excessive unloading of low yielding securities on to the Reserve Bank. The Bank maintains separate lists for purchase and sale transactions with reference to its stock of securities and the dates of maturity of the different loan.

5.4 Reverse Repo

In order to activate the REPOs market so that it serves as an equilibrating force between the money market and the securities market, REPOs and reverse REPO transactions among select institutions have been allowed since April 1997 in respect of all dated Central Government securities besides Treasury Bills of all maturities. Reverse REPOs ease undue pressure on overnight call money rates. PDs are allowed liquidity support in the form of reverse, REPO facility.

Reverse REPO transactions can be entered into by non-bank entities who are holders of SGL accounts with the Reserve Bank (from April 1997) with banks, primary dealers in Treasury Bills of all maturities and all dated central government securities.

6. Advances To Priority Sector

Social control over banks initiated in 1969 introduced reforms to correct the functioning of the banking system and to promote purposeful distribution of bank credit. It was found that for various historical reasons, the bulk of bank advances was directed to the large and medium scale industries and big and established houses while agriculture, small scale industries and exports which were emerging priority sectors did not receive adequate attention. The nationalization of 14 major commercial banks in July 1969, led to considerable reorientation of bank lending towards the priority sectors. Priority sector lending was stipulated at one-third of the outstanding credit by March 1979, and 40 per cent by 1985. Since 1977-78, export credit has been excluded from computation of total priority sector advances, but refinance was provided.

Table:- Advances to the Priority Sectors by Public Sector Banks (Select Years)

Sector	June 1969	June 1976	June 1986	June 1990	March 1996	March 2000
I. Agriculture	162	590	9231	16434	26351	46190
i) Direct	40	NA	7918	15283	22892	34432
ii) Indirect	122	NA	1313	1151	3459	11758
II. Small scale industrial Unit	257	870	7836	14127	29482	45788
III. Other Priority Sector Advances	22	230	4719	8088	13751	32079
IV. Total Priority Sector advances	441	1690	21786	38649	69609	127807
V. Net Bank Credit	3016	6690	50820	91302	184391	292943
(IV as % of V)	14.6%	25%	42.9%	42.3%	37.8%	43.6%

Forty per cent of the priority sector advances were earmarked in 1985 for agriculture and allied activities; advances to weaker sections in agriculture and allied activities should be 50 percent of lending for agriculture; and advances to rural artisans, craftsmen and cottage industries should be 12.5 per cent of the total advances to small scale industries. Effective from April 1993, foreign banks were advised to bring their priority sector advances from 15 per cent hitherto fixed to 32 per cent by March 1994.

Table presents the advances to the priority sector in select years. Advances to priority sector have gone up from 14.6% of bank credit in 1969 to 25% in 1976, 42.9% in 1986, 42.3% in 1990, 37.8% in 1996 and 43.6% in 2000. The major portion of advances to the priority sector was to agriculture followed by small scale industrial units.

7. Supervision System

The Board for Financial Supervision (BFS) under the chairmanship of the Governor of the Reserve Bank became functional on November 16, 1994, with a Deputy Governor as Vice-Chairman and six other members. An advisory council was also constituted. The BFS was set up to ensure implementation of regulations in the areas of credit management, asset classification, income recognition, capital adequacy and treasury operations of commercial banks. Effective from April 1995, the BFS started supervising all-India financial institutions and from July 1995, non-banking financial companies. Operational support to BFS is rendered by the Department of Supervision within the Reserve Bank.

Under the direction of BFS, the time span for inspection of banks and discussions with the management has been substantially reduced so that the necessary rectification measures under a monitorable action plan (MAP) are promptly initiated by banks. The system of supervisory

visits to newly licensed private banks which were initiated in 1995 with the object of monitoring a proper build-up of portfolios, system and controls and compliance were extended to licensed foreign banks in 1996. Based on the visits, necessary corrections in specified policy and operational areas were suggested.

The BFS reviewed and approved the recommendations of the Working Group on the Review of the System of On-site Supervision set up in 1995 (Chairman S. Padmanabhan). The major recommendations of the group include adoption of a discriminative approach to supervision as between sound banks and problem banks, bestowing greater supervisory attention and resources on the latter, introduction of a supervisory rating system facilitating such classification and conducting targeted appraisals of major portfolios and control systems in between statutory full scope inspection

8. Regional Rural Banks (RRBs)

So as to liquidate rural indebtedness by stages and to dispense institutional credit facilities to farmers and artisans in rural areas, the Government of India promulgated on September 26, 1975, the Regional Rural Banks ordinance, 1975, to set-up regional rural banks throughout the country.

Accordingly 6 RRBs were opened in 1975 to cover 12 districts. Number of these banks went upto to 196 as on June end, 2000.

8.1 Objectives

RRBs were primarily set up with the objectives that they should form an integral part of the rural credit structure (along with co-operatives and commercial banks), under the multi-agency approach to rural lending. Accordingly, they were authorised to undertake the following activities:

- (i) Grant loans and advances to small and marginal farmers and agricultural labourers, whether individually or in

groups, and to co-operative societies, including agricultural marketing societies, agricultural processing societies and farmers' services societies. for agricultural purposes or agricultural operations or for other related purposes, and

- (ii) Grant loans and advances to artisans, small entrepreneurs and persons of small . means engaged in trade or other productive activities within its area of operation.

Each RRB is sponsored by a public sector bank which provides assistance in. several ways, viz., subscription to the share capital, provision of such managerial and financial assistance as may be mutually agreed upon, and help in the recruitment and training of personnel during the initial period of its functioning.

8.2 RBI Assistance

With a view to facilitate their operations, the RBI gave regional rural banks direct access to refinance assistance at a concessional rate of 3 per cent below the bank rate. They have been allowed to maintain a lower level of statutory liquidity than the scheduled commercial banks. They have been allowed to pay 1/2 per cent more interest on all deposits except those of three years and above. The sponsor banks IDBI, NABARD, SIDBI and other financial institutions are statutorily required under the Regional Rural Bank Act to provide managerial and financial assistance to them.

8.3 Evaluation Of RRBs

The Committee constituted by the RBI in June 1977 to evaluate the performance of RRBs concluded that with some modifications in their organisation and structure, they could become a useful component in the totality of the rural credit structure. The Committee also suggested the setting up of RRBs where the cooperative organisation was not able to adequately serve the credit needs and even in other areas in order to

fill the large gap. This formed the basis for the branch licensing policy during 1979-81.

Number, Deposits and Advances

The number of branches has gone up from 13,353 in 1987 to 14,497 in 1996, the number of districts covered from 363 to 427. In March 1999, 196 RRBs catered to the credit requirement of 451 districts. The total outstanding deposits at the end of March 2000 were Rs. 30,051 crores and advances Rs. 12,663 crores. Loan recovery to demand ratio was 60.54% during 1997-98. Recovery rate was high in Kerala (88.1%), Tamil Nadu (79.37%), Gujarat (72.33%) and Puni (72.11%). Tripura showed the lowest recovery rate (11.61%). When RRBs were set up, they could lend only to the target group, weaker sections. From 1992, RRBs were advised to lend only up to 60 per cent of their incremental credit to the target group. The percentage was next brought down to 40 per cent and now they are at par with public sector banks. RRBs are required from April, 1997 to restrict their lending to weaker sections to 10 per cent of their total credit. According to the RBI, the weaker sections comprise small and marginal farmers, SC/STs and beneficiaries of DRI and IRDD schemes which is only a portion of poor below the poverty line.

Restructuring of RRB

As part of the financial sector reforms, Government of India, RBI and NABARD initiated various measures for improving the viability of RRBs. For instance, in the first phase, 49 RRBs were taken up for restructuring and revival in the year 1994-95 and the Government of India provided Rs. 150 crores for cleaning their balance sheets. They were also asked to prepare Development Action Plans (DAPs) to attain current and sustainable viability. Sponsor Banks and RRBs entered into a Memorandum of Understanding (MoU) to ensure implementation of DAP. In the phase II of comprehensive restructuring, 53 RRBs were

taken up for revamping in 1995-96 and the Government provided a sum of Rs. 223.57 crore for the purpose. A further provision of Rs. 200 crores was made in the Union Budget for 1996-97. Thus, by the end of March 1997, as many as 138 RRBs were selected for comprehensive restructuring. These RRBs were sanctioned financial support in the form of additional equity to the extent of Rs. 1,147 crores.

Interest rates on deposits and loans and advances were changed from time to time to help the RRBs. Changes were also made in loan composition and bank services. In September, 1992, they were allowed to finance non-target group borrowers upto a ceiling of 40% of fresh advances which was subsequently raised to 60% from January, 1994. Finally, from 1st April, 1997, RRBs have been brought on par with the Commercial banks with regard to priority sector lending. They are also allowed to purchase/discount and issue DD/Cheques guarantee, provide remittance and locker facilities.

For better risk management, exposure norms were introduced in 1994-95 under which individual exposure and group exposure are restricted to 25 per cent and 50 per cent of the capital funds respectively. In case of companies, the exposure (credit and investment) is restricted to 25 per cent of the capital fund of RRB or 25 per cent of the paid-up share capital of the company, whichever is less. Regarding investments, in 1994-95, they were allowed to deploy part of their surplus from non-SLR funds in shares and debentures of companies and units of mutual funds, bonds of PSUs and All-India financial institutions, subject to exposure norms, they were also permitted to invest surplus non-SLR funds in risk-sharing participation certificates of their sponsor banks.

Norms of income recognition and asset classification and provisioning were made applicable to them on par with commercial banks to maintain healthy credit portfolio.

Finally, in 1993-94 RRBs were freed from the Service Area obligations

whereby they can relocate their loss making branches preferably within the same block or convert them into satellite/mobile offices. Later, in 1995-96 and 1996-97, the branch licensing policy was modified enabling the RRBs to merge two loss making branches functioning within 5 kms.

The implementation of the above measures brought about steep improvement in the financial health of the RRBs in as much as 126 RRBs (out of 196) earned profits to the extent of Rs. 291 crores as against 45 RRBs having profit of Rs. 7 crores in 1987.

Most of the RRBs took the advantage of the freedom to rationalise their branches, and relocated some of the branches to better locations and converted some other branches into satellite branches. This led to better utilisation of manpower and rise in deposit growth rate of 23% in 1997-98 as against 13% prior to 1994. The diversification of lending portfolio through housing loans, loan for consumer durables, non-target group loans, etc. and the various non-fund based activities like issuing guarantees, purchase and discounting of cheques and demand drafts, providing safe deposit lockers facility etc., have improved the income and avoided concentration of risk. However, the impact of revamping initiatives on profitability of RRBs has been blunted due to introduction of prudential norms of income recognition and provisioning, which helped to maintain healthy loan portfolio management.

So as to ensure successful survival in competitive environment it would be in fitness of things to allow those RRBs which have not been able to turn-around on account of limited potential to operate in adjoining one or two districts, provided there is no such organisation, functioning in such districts. They may also be allowed to relocate their loss branches to more potential centres outside their service areas. The capital base of such RRBs may: further be strengthened by

enhancing to Rs. 5 crores. I

Regarding recovery of dues of RRBs, arrangements should be made by the concerned state governments to put them on equal footing with cooperatives.

RRB may also be permitted to mobilise and accept NRI deposits as there are ample opportunities of such business in the states like Kerala, Gujarat, Andhra Pradesh and Uttar Pradesh

9. Practice Questions

1. What is the importance of financial system in promoting economic growth?
2. What is a financial system? Discuss the constituents of Indian Financial System.
3. Define savings ratio? What are the factors that determine savings?
4. Explain the concept of financial intermediation.
5. Analyse the monetary policy of Reserve Bank of India. How do repos & reverse repo affect liquidity?
6. Critically analyse the role of RBI in Indian Economy.
7. What do you understand by priority sector advances and state their impact on non-performing assets?
8. What do you understand by liberalisation and discuss its various aspects?
9. What do you mean by commercial banking? Discuss the various services offered by commercial banks.
10. Evaluate the role of regional rural banks in poverty alleviation.

Unit-II

Cooperative Credit**Objectives**

At the end of the study of this unit, the students will be able to understand the nature, feature and functions of Cooperative Systems and Credit opportunities available in India; cooperative sector reforms; relevant regulations and guidelines from the Govt. of India, RBI, and NABARD.

Structure of Unit

The unit is divided into 3 Lessons which will give overall idea of Cooperative movement in India; NABARD and their Financing Activities; and Reforms in Cooperatives. Each lesson and chapters are structured and explained to understand easily as below:

Lesson-1: Cooperative Movement and Development in India

Lesson-2: NABARD and

Lesson-3: Reforms in Cooperative Sector

Review Questions**Important Glossary****References & Further to Study****Lesson-1****Cooperative Movement and Development in India****Objectives**

This lesson will focus on Cooperative movement in India and their structure and activities in detail. Students will be able to understand the ideas of cooperatives and developments in India.

This lesson will be covered the following for better understanding in detail:

- 1.1 Introduction
- 1.2 Co-operative Societies Act
- 1.3 Organisational Structure
- 1.4 Development in Cooperative Sector
- 1.5 Role of Reserve Bank of India
- 1.5.1 Cooperative Banks
- 1.6 Role of Cooperatives in Providing Agricultural Credit
 - 1.6.1 Salient features of the Cooperative Credit Structure (CCS)
 - 1.6.2 Financial Performance of CCS
 - 1.6.3 Outstanding, Recovery rates and NPAs
- 1.7 Summary

1.1 Introduction

Co-operatives are autonomous associations of persons united voluntarily to meet their common, economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise. The Cooperative movement is rooted in people's organisation based on 7(seven) basic principles:

1. Voluntary and open membership
2. Democratic members control
3. Members economic participation
4. Autonomy and Independence
5. Education, Training and Information
6. Cooperation among cooperatives and
7. Concern for the community.

The Cooperative Values are include Self – help, Self – responsibility, Democracy, Equity, Solidarity , Honesty, Openness, Social responsibility and Care for others.

There were great concern and revolt by farmers in some parts of India during British Rule in India against misuse and abuse of agency system for rural credit by landlords, money lenders, zamindars. This led to search for some reform models. The first Cooperative Society Act of 1904 was enacted to enable formation of "agricultural credit

cooperatives". The 1904 Cooperative Societies Act was later repealed by 1912 Cooperative Societies Act which provided for formation of Cooperative societies other than credit. In 1919 there was Administrative Reforms and Cooperatives were made a provincial subject making each province responsible for Cooperative movement and development.

1.2 Cooperative Societies Act

Cooperative Societies Act is a Central Act. However, 'Cooperative Societies' is a State Subject (Entry 32 of List II of Seventh Schedule to Constitution, i.e. State List). Though the Act is still in force, it has been specifically repealed in almost all the States and those States have their own Cooperative Societies Act. Thus, practically, the Central Act is mainly of academic interest. As per preamble to the Act, the Act is to facilitate formation of cooperative societies for the promotion of thrift and self-help among agriculturists, artisans and persons of limited means.

The Statement of Objects and reasons states as follows : (a) Cooperative Society can be established for purpose of credit, production or distribution. (b) Agricultural credit societies must be with unlimited liability. (c) Unlimited society is not best form of cooperation for agricultural commodities. However, the provision is continued as in several provinces (now States) such societies do exist and are working. It is not intended to give them undue encouragement, but to legalise their existence. (d) Unlimited society can distribute profits with permission of State Government.

1.2.1 Registration of Society

State Government will appoint Registrar of Cooperative Societies. State Government can appoint persons to assist Registrar and confer on such persons all or any of powers of Registrar. Function of Registrar starts with registration of a society. He has powers of general

supervision over society. Returns of Society are to be filed with Registrar. He can order inquiry or inspection against society. He can order dissolution of society.

1.2.2 Societies which can be registered

A society which has as its object the promotion of economic interests of its members in accordance with cooperative principles can be registered as a Society. Similarly, a society established with the object of facilitating operation of such a society can also be registered under the Act. The society can be registered with limited or unlimited liability. However, unless State Government otherwise directs, (1) Liability of a society of which a member is a registered society shall be limited. (2) Liability of a society of which object is to creation of funds to be lent to members, and of which majority of members are agriculturists and of which no member is a registered society shall be unlimited. Thus, a registered society can be member of another society, but liability of such other society must be limited, unless State Government otherwise directs.

1.2.3 Members of a society

A society can be formed with at least 10 members of age above 18 years. If object of society is creation of funds to be lent to its members, all the members must be residing in same town, village or group of villages *or* all members should be of same tribe, class, caste or occupation, unless Registrar otherwise directs. The provision of minimum 10 members or residing in same town/village etc. is not applicable if a registered society is member of another society. The last word in name of society should be 'Limited'. If the Society is registered with limited liability. Registrar is empowered to decide whether a person is agriculturist or non-agriculturist or whether he is

resident of same town/village or whether the members belong to same caste/tribe etc. and his decision will be final.

1.2.4 Society with limited liability

If a society has limited liability, any individual member of such society cannot have share capital more than one-fifth of total capital. An individual member cannot have interest in shares exceeding Rs 1,000. This restriction of 20% shares or Rs1,000 shares value is not applicable to a registered society which is member of another society. Thus, if a registered society is member of another society, it can hold shares exceeding 20% or exceeding Rs 1,000 in value.

1.2.5 Rights and liabilities of members

If liability of members is not limited by shares, each member shall have one vote irrespective of amount of his interest in the capital. If liability of members of a registered society is limited by shares, each member will have as many votes as may be prescribed in bye-laws. If a registered society has invested in shares of other registered society, it can vote by appointing a proxy. A member of registered society shall not exercise his rights as member, unless he has made payment to society in respect of membership or has acquired interest in society, as may be prescribed by rules or bye-laws. Thus, if there is any default in payment to society, the member cannot exercise his rights.

1.2.6 Management of society

Each society will be managed by Committee. Committee means the governing body of a registered society to whom the management of its affairs is entrusted. Officer of society includes a Chairman, Secretary, treasurer, member of Committee or other person empowered under rules or bye-laws to give directions in regard to business of society.

1.2.7 Registered Society is body corporate

A registered cooperative society is a body corporate with perpetual succession and common seal. It can hold property, enter into contracts,

institute and defend suit and other legal proceedings and to do all things necessary for the purposes of its constitution.

1.2.8 Amendment of bye-laws

Any Amendment to bye-laws shall be registered with Registrar. If Registrar is satisfied that the amendment is not contrary to Act or rules, he will register the amendment. He will issue a certificate of registration along with copy of amendment certified by him, which is conclusive evidence that the amendment has been duly registered.

1.2.9 Priority claim of society dues from member

A registered society is entitled to priority to other creditors and enforce outstanding demand due to society from any member. However, the priority is subject to prior claims of (a) Government dues in respect of land revenue or (b) Dues of landlord in respect of rent receivable by the landlord. The priority of society is in respect of following : (a) Supply of seed or manure or loan for purchase of seed or manure. The priority is upon the crops or other agricultural produce upto 18 months from date of supply of seed/manure or loan. (b) Supply of cattle or fodder of cattle, agricultural implements or machinery or raw materials or loan for these. The priority is upon the cattle/fodder/ machinery / raw materials supplied or any articles manufactured from raw materials supplied or purchased from loan given by society.

1.2.10 Restrictions on loans

A registered society can give loans only to its members. However, it can give loan to another registered society with permission of Registrar. A society with unlimited liability cannot lend money on security of movable property without sanction of registrar. State Government, by issuing a general or special order, can prohibit or restrict lending of money on mortgage of immovable property by any registered society or class of registered society.

1.2.11 Inspection of affairs of society

Registrar can hold an enquiry or direct some person authorised by him to hold enquiry in following circumstances: (a) Of his own motion, (b) Request of Collector, (c) Application by majority of committee members of society, or (d) At least one-third of members of society. All officers and members of society shall furnish necessary information to registrar or person authorised by him.

1.2.12 Dissolution of society

Registrar, after inspection or inquiry, or on application received from 75% of members of society, may cancel the registration of society, if in his opinion, the Society should be dissolved. Any member can appeal against the order of Registrar within two months to State Government or other Revenue Authority authorised by State Government. If no appeal is filed within two months, the order of dissolution shall become effective. If appeal is filed, the order will become effective only after it is confirmed by appellate authority.

1.3 Organizational Structure

The Indian cooperative sectors are consisting various segments based on the needs and requirements of the individuals as follows:

- Agricultural Credit Cooperatives (Production)
- Agricultural Credit Cooperatives (Investment)
- Non-Agricultural. Credit Cooperatives (Urban Banks)
- Cooperative Marketing
- Tribal Cooperatives
- Fertiliser Cooperatives Consumer Cooperatives
- Weavers Cooperatives
- Sugar Cooperatives
- Cooperative Spinning Mills
- Industrial Cooperatives (Non-Weavers)
- Dairy Cooperatives

- Fisheries Cooperatives
- Housing Cooperatives
- Labour Cooperatives
- Poultry Cooperatives

Further these societies are grouped into:

- a) **National Level Cooperative Federations** like National Agricultural. Coop.Marketing Federation of India Ltd. (NAFED), Krishak Bharati Cooperative Ltd. (KRIBHCO), Indian Farmers Fertilizer Cooperative Ltd. (IFFCO), National Federation of Urban Coop.Banks & Credit Societies, National Federation of State Coop. Bank Ltd., etc.
- b) **Member of Parastatal Institutions** are National Dairy Development Board and M.P.State Cooperative Union Ltd
- c) **State Cooperative Union**
- d) **Cooperative Unions of Union Territories**
- e) **State Cooperative Marketing Societies**
- f) **State Cooperative Banks**
- g) **State Cooperative Agricultural & Rural Development Bank**
- h) **State Cooperative Consumers Federations**
- i) **State Urban Coop Banks & Credit Associations**
- j) **State Tribal Development Cooperative Corporations**
- k) **Other State Cooperative Federations**
- l) **Multi state Cooperative Societies**

State Co-operative Unions and Societies are incorporated at all level of states to satisfy the needs of Agriculture and Rural credit.

1.4 Development in Cooperative Sector

In 1942, the Multi-Unit Cooperative Societies Act, 1942 was enacted by the Government of India with an object to cover societies whose operations are extended to more than one state. The Hazari Committee recommended integration of short term and long term structures in the

Cooperative Credit System. The Bawa Committee (1971) recommended setting up Large Multi-purpose Cooperatives in tribal areas. The National Commission on Agriculture (1976) recommended setting up Farmers Service Cooperative Societies with the active collaboration of the nationalised banks.

NABARD was created on the recommendation of the CRAFICARD (Sivaraman Committee 1981). The State's heightened interest in and concern for the performance of cooperatives in the country was obvious. The focus, however, was on expanding and reorganising the State supported structures, without addressing the tasks of restoring and strengthening autonomy, mutual help and self-governance, that are the cornerstones of genuine cooperatives. In 1984, the Government of India enacted a comprehensive Act known as Multi State Cooperative Societies Act, 1984, which also repealed the Act of 1942.

After 1990, several committees (notably those headed by Chaudhry Brahm Perkash, Jagdish Capoor, Vikhe Patil and V S Vyas) were set up to suggest cooperative sector reforms during this period. The Brahm Perkash Committee emphasised the need to make cooperatives self-reliant, autonomous and fully democratic institutions and proposed a Model Law. On the recommendation of the Mirdha Committee and the "Model Cooperative Societies Act" the Government of India enacted the Multi State Cooperative Societies Act, 2002 which provided for democratic and autonomous working of the Cooperatives. The Multi State Cooperative Societies Act, 2002 came into force with effect from August 19, 2002 . They have also recommended revamping and streamlining the regulation and supervision mechanism, introducing prudential norms and bringing cooperative banks fully under the ambit of the Banking Regulation Act, 1949. To facilitate the implementation of these reforms, they proposed that

governments provide viable cooperative credit institutions with financial assistance for re-capitalisation.

The National Cooperative Union of India is the apex organisation promoting the cooperative movement in the country. Cooperatives have extended across the entire country and there are currently an estimated 230 million members nationwide. The cooperative credit system has the largest network in the world and cooperatives have advanced more credit in the Indian agricultural sector than commercial banks. In fertiliser production and distribution the Indian Farmers Fertiliser Cooperative (IFFCO) commands over 35 percent of the market. In the production of sugar the cooperative share of the market is over 58 percent and in the marketing and distribution of cotton they have a share of around 60 percent. The cooperative sector accounts for 55 percent of the looms in the hand-weaving sector. Cooperatives process, market and distribute 50 percent of edible oils. Dairy cooperatives operating under the leadership of the National Dairy Development Board and through 15 state cooperative milk marketing federations has now become the largest producer of milk in the world. The groundwork for this was laid in the early 1970's when the largest dairy development programme in the world - *Operation Flood* - was launched. *Operation Flood* was a national marketing strategy linked to a dairy infrastructure development programme that created a chain of dairy processing plants, collection stations and a national milk transportation grid.

The cooperatives in India have made remarkable progress in the various segments of Indian Economy. There are 5.03 lakh cooperative societies with a membership of more than 20.9 crores and working capital of more than Rs.227111.8 crores. In many segment of Indian economy, cooperatives are contributing predominant role in the credit sector despite of keen competition from nationalised and private sector

banks. Cooperatives are disbursing nearly 46% of total agricultural credit. They are distributing 36% of total fertilisers in the country. The share of cooperatives in sugar production is nearly 55%, in spindle 10%, in yarn production 22.1% and in coverage of handlooms 55%. The cooperatives are playing a very important role in the public distribution system to serve the weaker sections of the community. Nearly 28% of the rural fair price shops are within the cooperative fold. Cooperatives have also played an effective role in exports. The economic reforms which have been introduced since 1991 have given new dimensions to precepts and practices of economic development. However, cooperatives have not been able to take the fullest advantage of the economic reforms, as they have not been provided level playing field. Recently, the Government of India have initiated various measures under the process of Second Phase of Economic Reforms.

1.5 Role of RBI

The Reserve Bank's concern and involvement in the sphere of rural credit stemmed from its very statute of incorporation. Specific provisions were made in the Reserve Bank of India Act, 1934 both for the establishment of an Agricultural Credit Department (ACD) in the bank and for extending refinance facilities to the cooperative credit system. Emphasis was laid on setting up, strengthening and promoting financially viable provincial cooperative banks, central cooperative banks, marketing societies and primary agricultural credit societies in each province. The RBI, since 1942, also started extending credit facilities to provincial cooperative banks for seasonal agricultural operations and marketing of crops.

Generally the co-operative societies (other than those operating in more than one State) is a State subject like incorporation, regulation and winding up and is governed by the State laws on co-operative societies. In the case of co-operatives established in more than one

state are governed by the Multi-State Co-operative Societies Act, 2002. Majority of the co-operative societies are operating only in one State and the State Government appoints Registrar of Co-operative Societies as regulatory authorities.

1.5.1 Cooperative Banks

Any co-operative society engaging in banking business, the central laws governing banking are attracted, in addition to the regulatory laws applicable to co-operative societies. The Banking Regulation Act, 1949 has been made applicable to co-operative banks, provided limiting the extent of regulation under Section 56 by the Reserve Bank of India. According to this the duality of regulation is followed under State laws for incorporation, regulation and winding up of cooperative societies and under banking regulation laws for regulation of banking business. However, all co-operative societies engaged in the business of banking are not regulated by the Banking Regulation Act, 1949 as the Act does not apply to Primary Agricultural Credit Societies and Land Development Banks and the regulatory provisions including that on licencing are not applicable to primary credit societies, thus leaving them under the regulatory purview of the State.

The High Power Committee on Urban Co-operative Banks (Madhav Rao Committee) has made an attempt to list the banking-related functions and co-operative functions as under :

Banking Related Functions which should be under the domain of Reserve Bank of India

1. Issues relating to interest rates, loan policies, investments, prudential exposure norms, forms of financial statements, reserve requirements, appropriation of profits etc.
2. Branch licensing, area of operation.
3. Acquisition of assets incidental to carrying on banking functions.

4. Policy regarding remission of debts.
5. Audit.
6. Change of Management and appointment of CEO.
7. Appointment of Administration.
8. Any other banking related function to be notified by RBI from time to time.

Co-operative Functions which should be under the domain of the Registrar of Co-operative Societies for concerned State

1. Registration of co-op. societies.
2. Approval and amendment to by-laws.
3. Elections to Managing Committees.
4. Protection of members' rights.
5. Supersession of Managing Committee for violation on items 1 to 4 above.

Section 7 of the Banking Regulation Act prohibits the use of the term "bank, banker or banking" by a co-operative society other than a co-operative bank in its name or in connection with business and no co-operative society shall carry on the business of banking without using any of such words as part of its name. A co-operative bank as defined in sec 5(cci) of B R Act (AACS) is a primary co-operative bank or Central Co-operative bank or a State co-operative bank. However, a primary credit society, a co-operative society formed for the protection of mutual interest of cooperative banks, a co-operative land mortgage bank and co-operative societies formed by employees of banks are exempted.

Section 49A of the Banking Regulation Act restricts acceptance of deposits by any person other than a banking company, Reserve Bank, State Bank or any other banking institution, firm or other person notified by the Central Government. However, a primary credit society is exempted from these provisions.

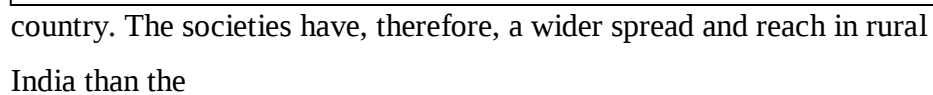
1.6 Role of Cooperatives in Providing Agricultural Credit

The main players in the field of agricultural credit in the formal sector include the commercial banks, the regional rural banks (RRBs), and the rural cooperatives (Fig.1). Rural cooperative credit institutions have played a large role in providing institutional credit to the agricultural and rural sectors in the past. Typically, these credit institutions have been part of two distinct structures, commonly known as the short term cooperative credit structure (ST CCS) and the long term cooperative credit structure (LT CCS). The ST CCS, comprising primary agricultural credit societies (PACS) at the village level, district central cooperative banks (DCCBs) at the intermediate level, and the state cooperative bank (SCB) at the apex level, primarily provides short term crop loans and other working capital loans to farmers and rural artisans, although over the last few years, it has also been providing longer duration loans for investments in the rural sector. The LT CCS, comprising state cooperative agriculture and rural development bank (SCARDB) at the state level and primary (P) CARDs or branches of SCARDB at the decentralised district or block level, has been providing typically medium and long term loans for making investments in agriculture, rural industries, and lately housing.

1.6.1 Salient features of the CCS

The short term Cooperative Credit Structure (CCS) has a federal three-tier structure with PACS being the grass root level institutions, the Central Banks at the District level (DCCBs) and the apex Bank at the State level (SCB). In the North-Eastern States and smaller States, there are no DCCBs and the SCB purveys credit through its affiliated PACS (and so the CCS is a two-tier system).

According to the NAFSCOB compilation, there are 1,12,309 PACS, which works out to roughly one PAC for every six villages in the



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commercial banks (CBs) and Regional Rural Banks (RRBs). The CCS, moreover, has more than twice the rural outlets and 50 per cent more clients than commercial banks and RRBs put together.

The total membership of the PACS is reported to be around 12 crore. Scheduled Castes and Scheduled Tribes and small farmers each, are reported to account for about 36 per cent to 37 per cent of the PAC membership as per NAFSCOB. Only half the members are borrowers - this proportion being less than average among small and marginal farmers and least among Scheduled Castes.

In some regions there are a few pure thrift and credit societies that generate resources only from members and do not have financial transactions with non-members. In Maharashtra, apart from the regular PACS, there are around 22,000 thrift and credit societies. In States like Kerala, PACS collect deposits from members, as well as non-members, in a significant way.

There are also differences in the structure of the CCS. Most States, for instance, have different structures for purveying long term (LT) and short term (ST) credit, but Andhra Pradesh has a single unified structure for providing both long term and short term loans. Most States have a three-tier structure, comprising PACS, DCCBs, and SCBs. While in Gujarat, the SCB conducts most of its transactions with lower tier organisations and does not have any branches outside of its Head Office, in Maharashtra the SCB undertakes full-fledged banking activities through multiple branches, that operate like branches of any other commercial bank.

The shares of different institutional sectors in providing credit to the rural areas are shown in the table below.

Table-1:

Flow of ground level credit to agriculture (both ST and LT)

through various agencies and their relative shares

Rs.

in crores

Agency	1992-93	1997-98	2000-01	2001-02	2002-03
Coop Banks	9,378	13975	20,718	23,524	23,636
Percentage share	62%	44%	39%	38%	34%
Regional Rural Banks	831	2040	4,219	4,854	6,070
Percentage share	5%	6%	8%	8%	9%
Commercial Banks	4,960	15831	27,807	33,587	39,774
Percentage share	33%	50%	53%	54%	57%

Source: NABARD

Two trends emerge from the overall flow of credit to agriculture from the commercial banking sector. The number of rural branches of commercial banks has gone down marginally as part of the branch rationalisation programme. The second trend is that even though the commercial banks almost meet their targets for lending to the priority sector, they have moved more towards larger customers.

1.6.2 Financial Performance

Data on the proportion of societies in different tiers that reported making profits during 2000-2001 and 2002-2003, the numbers that reported zero or negative net worth and the magnitude of reported accumulated losses are shown in the following table :

Table-2: Financial Results of the CCS

Tier		2000-01	2001-02	2002-03
No of SCBs		29	30	30
	No. in Profits	24	24	25
	No. in Losses	5	6	5
	No. that have eroded net worth	6	9	8
	Total Accumulated losses (Rs. Crore)	492	567	281
No of DCCBS		367	368	367
	No. in Profits	247	243	237
	No. in Losses	120	125	130

	No. that have eroded net worth	139	139	144
	Total Accumulated losses (Rs. Crore)	3,177	3,770	4,401
PACS (Total number approximately one lakh)	No. in Profits	46,807	45,292	58,683
	No. in Losses	41,991	43,511	53,626
	Total Accumulated losses (Rs. Crore)	2,112	NA	4,595

Source: For SCB and DCCB: NABARD, For PACS: NAFSCOB

Based on available data, while the large majority of SCBs were reporting profits during this period, more than 35 per cent of DCCBs and more than half the PACS were reporting losses. About one in five SCBs and almost 38 per cent of the DCCBs have eroded their net worth. Accumulated losses of DCCBs amounted to around Rs 3,200 crore in 2000-2001 and increased to Rs 4,400 crore two years later. Accumulated losses of PACS exceed that of DCCBs.

1.6.3 Outstanding, Recovery rates and NPAs

The recovery percentages for the system as a whole have been low continuously, making the system unsustainable without external injection of resources.

Table-3 : Recovery and NPA Percentages of the co-operative system

Tier		2000-01	2001-02	2002-03
SCBs	Recovery %	82	82	79
	NPA %	13	13	18
DCCBs	Recovery %	67	66	61
	NPA %	28	22	20
PACS	Recovery %	65	67	62
	NPA	No NPA Norms have been specified for PACS		

Source: SCB and DCCBs-NABARD, PACS –NAFSCOB

Diversification of portfolio is also reflected in the exposure to agriculture and other sectors as given in the table below. While diversifying the portfolio has its own advantages in risk management,

it also has the potential danger of the institutions suffering a strategic drift.

Table-4 Break up of loan outstandings as on 31 March 2003

(Rs. in Crore)

Tier	Agriculture loans	Non-Agri. loans	Other Loans	Total	Agri as a % of total
SCBs	12,488	16,366	6,198	35,052	36
DCCBs	30,951	21,931	9,516	62,398	49
PACS	23,153	7,668	11,591	42,412	55

Source: NAFSCOB

1.7 Summary

Cooperatives are autonomous associations of persons united voluntarily to meet their common, economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise. The Cooperative Values are include Self – help, Self – responsibility, Democracy, Equity, Solidarity , Honesty, Openness, Social responsibility and Care for others. The first Cooperative Society Act of 1904 was enacted to enable formation of "agricultural credit cooperatives". The 1904 Cooperative Societies Act was later repealed by 1912 Cooperative Societies Act which provided for formation of Cooperative societies other than credit. The Indian cooperative sectors are consisting various segments based on the needs and requirements of the individuals such as Agricultural Credit Cooperatives, Cooperative Marketing, Tribal Cooperatives etc. NABARD was created on the recommendation of the CRAFICARD (Sivaraman Committee 1981). After 1990, several committees (notably those headed by Chaudhry Brahm Perakash, Jagdish Capoor, Vikhe Patil and V S Vyas) were set up to suggest cooperative sector reforms during this period. Any co-operative society engaging in banking business, the central laws governing banking are attracted, in addition to the regulatory laws applicable to co-operative societies. The Banking

Regulation Act, 1949 has been made applicable to co-operative banks. Typically, these credit institutions have been part of two distinct structures, commonly known as the short term cooperative credit structure (ST CCS) and the long term cooperative credit structure (LT CCS). The economic reforms which have been introduced since 1991 have given new dimensions to principles and practices of economic development. However, cooperatives have not been able to take the fullest advantage of the economic reforms, as they have not been provided level playing field. Recently, the Government of India have initiated various measures under the process of Second Phase of Economic Reforms.

Lesson-2

National Bank for Agriculture and Rural Development (NABARD)

Objectives

This lesson is dealing with NABARD and its structures , activities and achievements as a part of cooperative development in India in detail. After completing this lesson, aspirants can be identify financing facilities available for cooperative sector from NABARD.

This lesson will be covered the following for easy understanding in detail:

- 2.1 Introduction
- 2.2 Types of Refinance Facilities
- 2.3 Production Credit
 - 2.3.1 Short-Term Refinance
 - 2.3.2 Medium Term Finance
 - 2.3.3 Long Term Finance
 - 2.3.4 Liquidity Support
 - 2.3.5 Investment Credit (Medium & Long Term) Refinance
 - 2.3.6 Important Investment Credit activities
 - 2.3.7 NABARD's Performance Highlights for the year 2004-05
- 2.4 Summary

2.1 Introduction

NABARD is established as a development Bank, in terms of the Preamble of the Act, "for providing and regulating Credit and other facilities for the promotion and development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto."

The Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), set up by the Reserve Bank of India (RBI) under the Chairmanship of Shri B. Sivaraman, conceived and recommended the establishment of the National Bank for Agriculture and Rural Development (NABARD). The Indian Parliament through the Act 61 of 1981, approved the setting up of NABARD. The Bank which came into existence on 12 July, 1982.

NABARD took over the functions of the erstwhile Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of RBI and Agricultural Refinance and Development Corporation (ARDC). Its subscribed and paid-up Capital was Rs.100 crore which was enhanced to Rs. 500 crore, contributed by the Government Of India (GOI) and RBI in equal proportions. Currently it is Rs. 2000 crore, contributed by GoI (Rs.550 crore) and RBI (Rs.1450 crore).

NABARD:

- (i) serves as an apex financing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas;
- (ii) takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc. ;

- (iii) co-ordinates the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with Government of India, State Governments, Reserve Bank of India (RBI) and other national level institutions concerned with policy formulation; and
- (iv) Undertakes monitoring and evaluation of projects refinanced by it.

NABARD operates throughout the country through its 28 Regional Offices and one Sub-office, located in the capitals of all the states/union territories. It has 336 District Offices across the country, one Sub-office at Port Blair and one special Cell at Srinagar. It also has 6 training establishments.

NABARD's refinance is available to State Co-operative Agriculture and Rural Development Banks (SCARDBs), State Co-operative Banks (SCBs), Regional Rural Banks (RRBs), Commercial Banks (CBs) and other financial institutions approved by RBI. While the ultimate beneficiaries of investment credit can be individuals, partnership concerns, companies, State-owned corporations or co-operative societies, production credit is generally given to individuals.

2.2 Types of Refinance Facilities

Agency	Credit Facilities
Commercial Banks	- Long-term credit for investment purposes - Financing the working capital requirements of Weavers' Co-operative Societies (WCS) & State Handloom Development Corporations
Short-term Co-operative Structure (State Co-operative Banks, District Central Co-operative Banks, Primary	- Short-term (crop and other loans) - Medium-term (conversion) loans

Agricultural Credit Societies)	• Term loans for investment purposes • Financing WCS for production and marketing purposes • Financing State Handloom Development Corporations for working capital by State Co-operative Banks
Long-term Co-operative Structure (State Co-operative Agriculture and Rural Development Banks, Primary Co-operative Agriculture and Rural Development Banks)	• Term loans for investment purposes
Regional Rural Banks (RRBs)	• Short-term (crop and other loans) • Term loans for investment purposes
State Governments	• Long-term loans for equity participation in co-operatives • Rural Infrastructure Development Fund (RIDF) loans for infrastructure projects
Non-Governmental Organisations (NGOs) - Informal Credit Delivery System	• Revolving Fund Assistance for various micro-credit delivery innovations and promotional projects under 'Credit and Financial Services Fund' (CFSF) and 'Rural Promotion Corpus Fund' (RPCF) respectively

2.3 Production Credit

NABARD provides refinance for various types of production/marketing/ procurement activities.

2.3.1 Short-Term Refinance

Agency: SCBs on behalf of all eligible DCCBs/DICBs/RRBs

Purpose	Conditions of Finance / Rate of Interest
Financing for Seasonal Agricultural Operations (SAO) which covers such activities as are undertaken in the process of raising various crops and are seasonal in nature. The activities include among others, ploughing and preparing land for sowing, weeding, transplantation where necessary, acquiring and applying inputs such as seeds, fertilizers, etc., and labour for all operations in the fields for raising and harvesting the crops.	Rate of Interest on NABARD refinance will be linked to NPA levels as under: Level of NPAs upto 20%--> 5.25% p.a. Level of NPAs > 20% --> 5.25% p.a. SCBs in North Eastern Region, Jammu and Kashmir and Sikkim will be charged at the rate of 5.25% p.a. irrespective of the level of their NPAs.
Financing for approved short-term agricultural / allied and marketing activities which are not covered under normal credit covering secured advances.	ROI 6.50% p.a.
Financing for the working capital requirements of the Primary Weavers' Cooperative Societies (PWCS) for production and marketing of cloth. Refinance will also be extended to the SCBs for Financing for the individuals directly by DCCBs for meeting the working capital requirements of those engaged in the field of handloom weaving.	ROI 6.00% p.a.
Financing for working capital requirements of cottage, village, small scale primary and Apex Industrial Cooperative Societies (Other than Weavers) for production and marketing activities.	ROI: Apex Societies 6.25% p.a. Primary Societies 6.00% p.a.
Financing for working capital requirements of Labour Contract and Forest Labour Cooperative Societies for activities such as marketing, manufacturing or processing of goods and/or collection and marketing of minor forest produce and engaged in any one or more of the 22 approved broad groups of cottage and small scale industries.	ROI: Apex Societies 6.25% p.a. Primary Societies 6.00% p.a.
Financing for working capital requirements of Rural Artisans (including Weaver members of PACS/LAMPS/FSS) for	ROI 6.00% p.a.

production and marketing or servicing activities of such rural artisans including weaver members of PACS/FSS/LAMPS engaged in any of the 22 broad groups of approved cottage and small scale industries or handloom weaving industry and working on a viable basis	
Financing for collection and marketing of minor forest produce by adivasis and persons belonging to the Scheduled Tribes covering all types of minor forest produce which are fast moving and where operations are conducted on a commercial basis. .	ROI: Apex Societies 6.25% p.a. Primary Societies 6.00% p.a.
Financing for procurement, stocking and distribution of chemical fertilizers and other agricultural inputs.	ROI: For Wholesale Procurement by SCBs : 6.50% p.a. For Retail Distribution on Cash and Carry basis : 6.25% p.a.
Financing for Marketing of crops for affording reasonable opportunities for remunerative price to growers for their produce by enabling them to hold on to the produce for time being. Such advances are permitted against pledge of agricultural produce kept in own godowns also.	Ceiling of Rs. 5 lakh per borrower and Maximum period of credit upto 12 months. ROI 6.00% p.a.
Financing for working capital requirements of Fisheries Societies /fishermen of PACS (for SCBs) and in case of RRBs for individuals also.	ROI 5.75% p.a.

Agency: State Cooperative Banks / Scheduled Commercial Banks

Purpose	Conditions of Finance / Rate of Interest
Financing for procurement and marketing of cloth and Trading in yarn by Apex/Regional Weavers' Cooperative Societies.	ROI 6.25% p.a.
Financing for working Capital requirements of Primary Handloom Weavers' Cooperative Societies(PHWCS).	ROI 6.25% p.a.

Financing for working capital requirements of State Handloom Development Corporations (SHDCs) for production / procurement and marketing of Handloom goods and State Handicrafts Development Corporations (SHnDCs) for production / procurement and marketing of Handicrafts goods .	ROI 6.25% p.a.
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Agency: State Cooperative Banks against pledge of Government Securities

Purpose	Conditions of Finance / Rate of Interest
For (i) Financing for Seasonal Agriculture Operations (ii) meeting share of SCBs in conversion of ST loans into MT loans against pledge of securities representing investment of Agricultural Credit Stabilization fund (ACSF) and (iii) General banking business.	ROI 6.00% p.a.

Agency: Regional Rural Banks (RRBs)

Purpose	Conditions of Finance / Rate of Interest
Financing for Seasonal Agricultural Operations (SAO) for meeting the production credit needs of farmers and Other than SAO such as production and marketing activities of artisans (including handloom weavers) and village/cottage/tiny sector industries as also for Financing for persons belonging to weaker sections and engaged in trade/business/service.	ROI: NPAs up to 20%: For ST-SAO→5.75% p.a. For ST-OSAO→6.00% p.a. NPAs above 20%: For ST-SAO→6.00% p.a. For ST-OSAO→6.25% p.a.

2.3.2 Medium Term finance

Agency: SCBs/DCCBs and RRBs

Purpose	Conditions of Finance / Rate of Interest
Providing Medium-term (Non-schematic) loans for 22 approved agricultural investment purposes.	ROI 5.75% p.a.

Agency: SCBs on behalf of DCCBs / RRBs

Purpose	Conditions of Finance / Rate of Interest
Financing for purchase of shares in cooperative processing societies by agriculturist members	ROI 5.75% p.a.
Against the loans converted/ rescheduled / rephased of farmers affected by natural calamities under Medium term stabilization arrangement.	Period of refinance: Initially 3 years, subject to a maximum of 7 years. Share in ground level conversion : <u>Cooperative Banks</u> :NABARD(60%), State Government(15%), SCB(10%), DCCB(15%) <u>RRBs</u> : NABARD (70%), Sponsor Bank (25%) and RRBs(5%). ROI : Same as applicable to the ST(SAO) loans converted.

2.3.3 Long Term Finance

Agency: State Governments

Purpose	Conditions of Finance / Rate of Interest
For Contribution of share capital to cooperative credit institutions (SCBs/ DCCBs/ SCARDBs/ PCARDBs/PACS/FSS/ LAMPS) for periods upto 12 years in order to strengthen the share capital base of these institutions and thereby increase their maximum borrowing power and enable them to undertake larger lending programmes; subject to certain conditions.	ROI 8.00% p.a.

2.3.4 Liquidity Support

In order to enable the cooperative banks to tide over the liquidity gap due to various relief measures and extension of the conversion/re-schedulement of loans to farmers in distress and farmers in arrears,

NABARD is extending liquidity support to State Cooperative Banks by way of Short Term refinance on behalf of DCCBs for supporting conversion/reschedulement of farmers dues at ground level under the Schemes of Farmers in Distress and Arrears.

NABARD will sanction credit limits to SCBs on behalf of each of the eligible DCCBs and the limit shall cover conversion/reschedulement of crop loans outstanding as on 31st March.... in respect of farmers covered under the scheme for providing relief on account of successive drought/flood/other calamities as also the scheme for providing relief to farmers in arrears.

Liquidity refinance support would be up to 50% of crop loans covered under the above schemes outstanding as on 31st March.... together with interest thereon which have been converted/rescheduled. The rate of interest payable at each half year will be 6.50% p.a.

2.3.5 Investment Credit (Medium And Long Term) Refinance

The scheme of finance is to accelerate Private Capital Formation to Promote Sustainable and Equitable Agriculture and Rural Prosperity with Refinance. Eligible Agencies are State Co-operative Agriculture & Rural Development Banks (SCARDBs), Regional Rural Banks (RRBs), State Co-operative Banks (SCBs), Commercial Banks (CBs), State Agricultural Development Finance Companies (ADFCs) and Primary Urban Co-operative Banks. However, the ultimate beneficiaries of investment finance will be individuals, proprietary/partnership concerns, companies, state-owned corporations or co-operative societies.

Under Farm Sector, the purposes is to invest in agriculture and allied activities such as minor irrigation, farm mechanisation, land development, soil conservation, dairy, sheep rearing, poultry, piggery, plantation/horticulture, forestry, fishery, storage and market yards, bio-gas and other alternate sources of energy, sericulture, apiculture,

animals and animal driven carts, agro-processing, agro-service centres, etc.

Under Non-Farm Sector , the purposes is to invest in activities of artisans, small-scale industries, tiny sector, village and cottage industries, handicrafts, handlooms, powerlooms, etc.

The Loan Period will be up to a maximum of 15 years and the Criteria for Refinance are Technical Feasibility of the project, Financial viability and bankability and Organisational arrangements for credit supervision

Quantum of Refinance varies from 90% to 100% of bank loan depends upon the Region, Financial Institutions and Sectors @ prescribed interest rates, fixed from time to time.

2.3.6 Important investment credit activities

Under Farm Sector,

- 1) Refinance Assistance for financing farm mechanization like purchase of Tractors and Power Tillers,
- 2) Swarnajayanti Gram Swarozgar Yojana (SGSY) is a restructured self-employment programmes of IRDP, TRYSEM, DWCRA, etc. Individuals as also SGSY group members, below poverty line are assisted under the programme.
- 3) Scheme for setting up of Agriclinc and Agribusiness centers to finance agriculture Graduates for setting up Agriclinics and Agribusiness Centres The scheme aims at supplementing the existing Extension Network to accelerate the process of technology transfer to agriculture and supplement the efforts of State Agencies in providing inputs and other services to the farmers.

The salient features of the scheme are as under:

- The scheme is open to agriculture graduates/graduates in subjects allied to agriculture.
- The outer ceiling of the project cost would be Rs.10 lakh for individuals and Rs.50 lakh for groups.

- RBI has waived margin money requirements for loans upto Rs. 5 lakhs.
- Margin money assistance from NABARD's Soft Loan Assistance Fund upto 50% of the margin prescribed by banks to meet any shortfall in borrower's contribution when the loan amount exceeds Rs. 5 Lakhs.
- Mode of refinance will be under ARF as also under prior sanction procedure of NABARD.

4) Scheme for financing farmers for purchase of land for Agricultural purposes is formulated by the Working Group of Indian Banks Association in consultation with the Government of India, RBI and NABARD. Important features of the scheme are :

1. **Eligibility** (i) Small and marginal farmers i.e., those who would own maximum of 5 acres of non- irrigated land or 2.5 acres of irrigated land including purchase of land under the scheme and (ii) Share croppers / Tenant farmers are eligible.
2. **Margin** : Minimum of 20% or as may be prescribed by RBI from time to time.
3. **Security** : The land purchased out of the bank finance will be mortgaged to the bank as security for the loan from borrowers.
4. **Interest Rate**: As per the RBI norms issued from time to time.
5. **Valuation** : Valuation of the land for fixing the quantum of finance, banks to decide based on the price indicated by the farmer vis-à-vis the last 5 years' average registration value available with the Registrar / Sub-Registrar of the area.
6. **Quantum of loan** : Based on the land to be purchased, its valuation and also development cost.
7. **Repayment period**: 7-10 years in half yearly / yearly installments including a maximum moratorium period of 24 months based on the gestation period of the project and cash flow.
8. **Repaying Capacity** : Based on the income surpluses from the production activities on the land being purchased and income from other sources may be considered to repay the bank loan with interest.
9. **NABARD Refinance**: Refinance will be extended under both Automatic Refinance Facility (ARF) and pre-sanction procedure of NABARD depending upon the project cost and the amount of refinance involved.

5) SEMFEX II is a scheme to assist Ex-Servicemen and as a part of measures to increase the flow of credit under the scheme, NABARD is

extending, on a selective basis, Margin Money Assistance under SWRTOs upto 10% of the cost of the vehicle.

2.3.7 NABARD's Performance Highlights for the year 2004-2005

Credit Operations

- Short-term credit limits sanctioned during 2004 - 05
 - For SCBs, RRBs - seasonal agricultural operations - Rs.10185.06 crore
 - For RRBs - other than seasonal agricultural operations - Rs.216.83 crore.
 - For SCBs - financing Weavers' Cooperative Societies- Rs.349.89 crore.
- Long term loans sanctioned to 7 State Governments for contribution to the share capital of co-operative credit institutions aggregated Rs.32.98 crore.
- Liquidity support to SCBs - Rs.1914.24 crore
- Liquidity support to RRBs - 158.78 crore
- Investment Credit to CBs, SCARDBs, SCBs, RRBs and other eligible institutions - Rs. 7605.29 crore.

Kisan Credit Card Scheme

- During the year (upto Feb' 2005), 70.43 lakh cards issued by co-operative banks, RRBs and commercial banks.
- Since inception in 1998-99, 4.84 crore cards issued.

Rural Infrastructure Development Fund

- GoI announced Rs. **8000** Crore for RIDF XI (2005-06)

As at the end of March 2005, RIDF sanctions under all the tranches of RIDF amounted to Rs. **42948.51** crore against which the disbursements were Rs. **25384.02** crore.

2.4 Summary

The Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), set up by the Reserve Bank of India (RBI). NABARD is established as a development Bank, in terms of the Preamble of the Act, "for providing and regulating Credit and other facilities for the promotion and

development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto." NABARD took over the functions of the erstwhile Agricultural Credit Department (ACD) and Rural Planning and Credit Cell (RPCC) of RBI and Agricultural Refinance and Development Corporation (ARDC). NABARD's refinance is available to State Co-operative Agriculture and Rural Development Banks (SCARDBs), State Co-operative Banks (SCBs), Regional Rural Banks (RRBs), Commercial Banks (CBs) and other financial institutions approved by RBI. While the ultimate beneficiaries of investment credit can be individuals, partnership concerns, companies, State-owned corporations or co-operative societies, production credit is generally given to individuals. Type of Refinance include Short-Term, Long-Term, Liquidity Support, Investment Credit etc. Rural Infrastructure Development Fund has been created by the Govt. of India and other schemes to develop rural cooperative credits. NABARD's performance are impressing one by way of disbursing loans to cooperatives and development of the sector.

Lesson-3

Reforms in Cooperative Credit

Objectives

This lesson will highlight the Reforms in Cooperative Credit in India and specifying the relevant structures and measures adopted. This will update the present status and developments of cooperatives in India.

This lesson will be covered the following in detail:

- 3.1** Introduction
- 3.2** Institutional, Legal and Regulatory Reforms
- 3.3** Department for Cooperative Revival and

- Reforms (DCRR)
- 3.4 Cooperative Development Fund (CDF)
- 3.5 Role of National Cooperative Data Bank
- 3.5.1 Services of NCDB
- 3.6 Summary

3.1 Introduction

Over the last 100 years, the cooperatives can look back at their achievements with pride. There are however several pitfalls like Poor infrastructure, lack of quality management, over-dependence on government, dormant membership, non-conduct of elections, lack of strong human resources policy, neglect of professionalism, etc. Cooperatives are also unable to evolve strong communication and public relations strategies which can promote the concept of cooperation among the masses. They should push forward by developing effective strategies for overcome existing weaknesses and for continuing growth of the sector.

In the new economic environment, cooperatives at all levels are making efforts to reorient their functions according to the market demands. The government is committed to cooperative development and it wants cooperatives to succeed. The government knows that cooperatives have inherent advantages in tackling the problems of poverty alleviation, food security and employment generation. Cooperatives are also considered to have immense potential to deliver goods and services in areas where both the state and the private sector have failed. Financial assistance alone cannot revive cooperatives and empower them to realise their full potential to reach adequate credit to villages and the rural population there. Cooperatives can only be revived if they become democratic, self-governing, self-reliant organisations for mutual thrift and credit.

With the rapid growth of the cooperative sector, a supportive climate has been created for the development of cooperatives as democratic

and autonomous businesses providing them with the opportunities for diversification. the Central Government recently passed the *Multi-State Cooperatives Societies Act* and also formulated a national cooperative policy that provides greater autonomy to cooperatives.

3.2 Institutional, Legal and Regulatory Reforms

Rural cooperative credit institutions have played a large role in providing institutional credit to the agricultural and rural sectors in the past. Typically, these credit institutions have been part of two distinct structures, commonly known as the short term cooperative credit structure (ST CCS) and the long term cooperative credit structure (LT CCS). The ST CCS, comprising primary agricultural credit societies (PACS) at the village level, district central cooperative banks (DCCBs) at the intermediate level, and the state cooperative bank (SCB) at the apex level, primarily provides short term crop loans and other working capital loans to farmers and rural artisans, although over the last few years, it has also been providing longer duration loans for investments in the rural sector. The LT CCS, comprising state cooperative agriculture and rural development bank (SCARDB) at the state level and primary (P) CARDBs or branches of SCARDB at the decentralised district or block level, has been providing typically medium and long term loans for making investments in agriculture, rural industries, and lately housing.

Over the past 10 years, however, not only has the share of the CCS in agricultural credit fallen from 62% in 1992-93 to 34% in 2002-03, its financial health has also seen a downturn. Accumulated losses in the ST CCS have been estimated at almost Rs. 10,000 crore, and those in the LT CCS at about Rs. 4,000 crore.

Various committees had been set up in the past to enquire into the problems faced by the CCS institutions, and to make recommendations for their revival. No concrete action was however taken on these

recommendations due to various reasons. The Government of India (GoI) appointed a Task Force under the Chairmanship of Prof. A Vaidyanathan in 2004 to analyse the problems faced by the CCS institutions and to suggest an action plan for their revival. The draft report of the Task Force was put in the public domain for comments in January 2005, and after considering the responses on the draft report, the finalised Report of Task Force on Revival of Rural Cooperative Credit Institutions (in the ST CCS) was submitted to the GoI in February 2005. During 2005, the GoI had extensive discussions with the state governments on the recommendations of the Task Force on ST CCS, and a consensus was achieved on the Revival Package that could be implemented across the country. This Revival Package was communicated to the state governments in January 2006.

The Revival Package focuses on introducing legal and institutional reforms which will enable the cooperatives to function as autonomous member centric and member governed institutions. These reforms will enable wider access to financial resources and investment opportunities, remove geographical restrictions in operations as well as mandated affiliations to federal structures, and provide administrative autonomy to cooperatives at all levels. Suitable amendments in the BR Act and certain provisions in the NABARD Act are also contemplated. In addition to providing resources for covering the accumulated losses in the ST CCS, the Package also provides for taking cooperatives to a minimum level of CRAR of 7%, and meet the costs of computerisation and human resource development at all the levels of the ST CCS. The sharing of the accumulated losses between GoI, state govt., and the CCS is based on the concept of origin of losses rather than any arbitrary proportions.

3.3 Department for Cooperative Revival and Reforms (DCRR)

NABARD has been designated the Implementing Agency for implementing the Revival Package in all the states. The Department for Cooperative Revival and Reforms (DCRR) has been constituted in NABARD for this purpose. NABARD is providing dedicated manpower at the national, state and district levels for implementing the Package.

The implementation of the Revival Package is guided and monitored by the National Implementing and Monitoring Committee (NIMC) chaired by Dr. Y V Reddy, Governor, RBI. Similar state and district level committees are also constituted for the purpose. Five States, viz., Maharashtra, Madhya Pradesh, Gujarat, Rajasthan, and Orissa have communicated their in principle acceptance of the Revival Package to the GoI. Steps have been initiated in these states for the implementation of the Revival Package.

The process of implementing the Revival Package in any state begins with the signing of the MoU between the GoI, the participating State government and NABARD. The next step is conduct of special audit to determine the correct amount of accumulated losses in PACS, DCCBs and SCB of a state. Special formats and a manual have been designed by NABARD to facilitate this exercise. These special audits would be conducted either by the personnel from the cooperative audit department of the state or by selected outsourced auditors. In either case, the exercise will be test checked by a set of independent Chartered Accountants who will report to the district level implementation and monitoring committee (DLIC) constituted for guiding and overseeing the implementation in each district. NABARD has however decided to create a pool of trainers for special audits in all the states which have conveyed at least an in principle acceptance of the Revival Package to the GoI even if the state is yet to sign the MoU with the GoI and NABARD.

The participating State is also required to sign an MoU with the RBI to give interim effect to the proposed amendments in the BR Act which will ensure that the RBI will have direct regulatory authority over all cooperative banks in the state.

The State would also promulgate an Ordinance to amend the State Cooperative Societies Act to give effect to the institutional and legal reforms envisaged in the Revival Package and would enact the necessary legislation in due course. Certain provisions are also being made within the NABARD Act to enable availability of NABARD refinance to the cooperatives at any of the levels either directly or through a federal cooperative or any regulated FI.

The RBI is prescribing fit and proper criteria for election to the Boards of the cooperative banks along with criterion for professionalisation of the boards of these banks. RBI is also prescribing the minimum qualifications for the CEOs of DCCBs and SCBs. A common accounting system is being designed for the ST CCS which will ensure transparency and prudent accounting methods. The system would be computerised as part of the Revival Package and would generate necessary MIS for internal control and management decisions as well as meeting the needs of other associated agencies.

3.4 Cooperative Development Fund (CDF)

In pursuance with the recommendations of the Parliamentary Committee on Agriculture, NABARD had created Co-operative Development Fund for providing assistance to Co-operative Credit Institutions for improving their infrastructural facilities for growth. The Objectives and Purposes of the fund are Supporting the efforts of grass root level institutions (PACS) to mobilize resources etc., Human Resource Development aimed at achieving better working results and improvements in viability and also for improvement in systems in cooperative credit institutions,

Building of better MIS and Conduct of special studies for improving functional efficiency and on subjects referred to above.

The Fund, which started with an initial corpus of Rs.10.00 crore from the surplus contributed by NABARD, has a balance of Rs.115.68 crore as on 31 March, 2003. The assistance sanctioned to various cooperative institutions from the Fund till 31 March, 2004 aggregated to Rs.62.18 crore against which an amount of Rs.50.87 crore has been disbursed.

The eligible purposes for assistance are Provision of infrastructural facilities to PACS for deposit mobilization, Staff training and faculty support, Computerisation support for building of MIS in cooperative banks, Conduct of special studies, Creation of a conducive recovery climate through meeting the cost of publicity, media, etc., Providing mobility to the field staff for improving recovery, Reimbursement of training expenditure to ACSTIs and JLTCs, Best Performance Awards to Cooperative Banks, Establishment of Business Development Department (BDD) in Cooperative Banks, and Publicity of Kisan Credit Cards (KCC). Assistance is provided by way of grant, soft loan or grant-cum-soft loan.

3.5 Role of National Cooperative Data Bank

In the era of e-commerce and highly competitive market driven economy, the cooperatives must improve their management capabilities to withstand challenges and they have to devise timely and effective measures. There is a need for an effective information system with a sound communication network to help the management in their decision making process. Considering the importance of information system in the decision making process of cooperative management as well as in the absence of centralised information system, the NCUI some time in 1989 took a decision and set up a National Cooperative Data Bank with the objectives to:

- Create awareness among the member organisations about importance of effective data base.
- Identify areas of training of cooperative managerial personnel in the use of technology and computers for efficient management.
- Evolve an effective management information system within the NCUI and promote the management information system in cooperatives and usages of modern technology.
- Evolve effective monitoring system for implementation of various activities of NCUI including cooperative projects.
- Develop suitable software programmes for the use of cooperative training set up consisting of one National Institute of Cooperative Management and 18 Institutes of Cooperative Management for Sr. and Middle level Executives.
- Assist and help the policy makers and planners in formulating cooperative development policies
- Assist and guide the research scholars in promoting cooperative research in the universities
- Develop educational modules and promote the concept of data banks with member organisations
- Act as resource centre for collection and dissemination of cooperative information
- Develop a sound network of cooperative information system and establish the linkages with other national and international network.

3.5.1 Services of NCDB

The NCDB has been rendering the services as mentioned below:

1. Establishing the state level Cooperative data banks and developing a network.
2. Establishing a sound data bases of Cooperatives and Publishing a regular profile of Indian Cooperative Movement – an Analytical study.

3. Developing the Training Modules and application software of Credit and Non-Credit segments of Cooperative.
4. Studying the trend analysis of important sectors of cooperatives and published many studies of credit and non-credit cooperatives.

With the passage of the Insurance Act, cooperatives have been allowed to entry into the insurance business. Insurance is a field where the immense potential of cooperatives still remains untapped. The Indian Farmers Fertiliser Cooperative has recently teamed up with a Japanese company and formed a joint venture for undertaking general insurance business in India. This signifies that Indian cooperatives have come of age in formulating strategic alliances.

3.6 Summary

Over the last 100 years, the cooperatives can look back at their achievements with pride. There are however several pitfalls like Poor infrastructure, lack of quality management, over-dependence on government, dormant membership, non-conduct of elections, lack of strong human resources policy, neglect of professionalism, etc. In the new economic environment, cooperatives at all levels are making efforts to reorient their functions according to the market demands. The government is committed to cooperative development and it wants cooperatives to succeed. The Government of India (GoI) appointed a Task Force under the Chairmanship of Prof. A Vaidyanathan in 2004 to analyse the problems faced by the CCS institutions and to suggest an action plan for their revival. The Revival Package focuses on introducing legal and institutional reforms which will enable the cooperatives to function as autonomous member centric and member governed institutions. The Department for Cooperative Revival and Reforms (DCRR) has been constituted in NABARD for this purpose. NABARD is providing dedicated manpower at the national, state and

district levels for implementing the Package. In pursuance with the recommendations of the Parliamentary Committee on Agriculture, NABARD had created Co-operative Development Fund for providing assistance to Co-operative Credit Institutions for improving their infrastructural facilities for growth. The Objectives and Purposes of the fund are Supporting the efforts of grass root level institutions (PACS) to mobilize resources etc. With the passage of the Insurance Act, cooperatives have been allowed to entry into the insurance business. Insurance is a field where the immense potential of cooperatives still remains untapped.

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Important Glossary

- (a) **Cooperative Society** means a society registered or deemed to be registered under any law relating to cooperative societies for the time being in force in any State.
- (b) **Member** means a person joining in the application for the registration of a multi-State cooperative Society and includes a person admitted to membership after such registration in accordance with the provisions of Cooperative Societies Act, the rules and the bye-laws.
- (c) **Bye-Laws** means the bye-laws for the time being in force which have been duly registered under this Act and includes amendments thereto which have been duly registered under the Cooperative Societies Act.
- (d) **Registrar of Cooperatives** Official appointed to oversee regulation and carry out regulatory duties

set out in the Cooperative Societies Act. Maintains register of cooperatives. Collects, approves, issues and files legal documents related to the registration, incorporation and operation of cooperatives.

- (e) **Cooperative Bank** means a cooperative society which undertakes banking business.
- (f) **Cooperative Year** in relation to any cooperative society, means the year ending on the 30th day of June and where the accounts of such society with the previous sanction of the Central Registrar, balanced on any other day, the year ending on such day.
- (g) **Multi-State Cooperative Society** means a society registered or deemed to be registered to establish in more than one state under Multi-State Cooperative Societies Act and includes a national cooperative society.
- (h) **Consumer cooperatives** buy goods in bulk and sell them at competitive prices; examples are retail co-ops, direct charge co-ops, and buyers' clubs.
- (i) **Employment cooperatives** provide employment to the worker-members who produce and/or market their goods or services through the cooperative; examples include bakeries, janitorial services, and printing/publishing plants. Also called **Worker cooperatives**.
- (j) **Financial cooperatives** provide a variety of financial services such as savings, investments and

loans; examples include credit unions, insurance and trust cooperatives.

- (k) **Marketing cooperatives** established to support members' efforts to sell their products; examples include agricultural cooperatives.
- (l) **Producer cooperatives** owned by producers for their mutual benefit; examples include dairy, feeder, film, fishery, handcraft and worker (employment) cooperatives.
- (m) **Service cooperatives** provide needed services, generally at improved quality, price and availability; examples include health care, child care, cablevision, farm machinery, housing and transportation cooperatives.

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Review Questions:

- 1) Discuss briefly major principles and values of cooperation.
- 2) Discuss the major provisions and features of Cooperative Societies Act.
- 3) Describe briefly the role of RBI in Cooperative Banking Systems in India.
- 4) Examine the evolution of Cooperatives and Credit situation in India.
- 5) Explain the main features of Cooperative Credit Structure (CCS).
- 6) State objectives of NABARD and type of finances available for cooperatives.
- 7) Critically examine the issues of cooperative credit system in India.

- 8) Discuss in detail about reforms in cooperative credit and give your views and suggestions briefly.

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References & Further to study:

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- 4) Mukki. H.R : “Cooperation in India”
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- 7) Mahesh Chand Garg and N.N. Joshi: “Cooperative Credit and Banking: Strategies for Development”
- 8) National Cooperative Union of India (www.ncui.nic.in)
- 9) National Federation of State Co-operative Banks Ltd. (www.nafscob.org)
- 10) Publications of Reserve Bank of India (www.rbi.org.in)
- 11) Publications of NABARD (www.nabard.org)
- 12) www.indiacode.nic.in

Unit-III

Non-Banking Financial Companies

Objectives

After reading and having discussion of this unit, the aspirants will be able to understand the nature, feature and functions of Non-Banking Financial Companies (NBFCs) in India; financial sector reforms and additional measures; relevant regulations and guidelines from RBI, SEBI and other Statutory bodies; and able to understand and apply the norms and directions existing in the financial sector.

Structure of Unit

The unit is divided into 3 Lessons which will give overall idea of NBFCs and their activities; Regulations for NBFCs and for accepting public deposits; and Prudential Norms , other guidelines for NBFCs and Sources and Deployment of Funds. Each every lesson and chapters are structured and explained to understand easily as below:

Lesson-1: Non-Banking Financial Companies in India

Lesson-2: Regulations for Non-Banking Financial Companies
and

Lesson-3: Sources and Deployment of Funds of NBFCs

Review Questions

Appendix-1: Forms used by NBFCs

Appendix-2: Important Glossary

References & Further to Study

Lesson-1**Non-Banking Finance Companies in India****Objectives**

This lesson will focus on Non-Banking Financial Companies in India their activities in detail. Students will be able to understand present scenario of NBFCs and operating activities.

This lesson will be covered the following for better understanding in detail:

- 1.1 Introduction
- 1.2 Definition of Non-Banking Financial Companies
 - 1.2.1 Difference between banks & NBFCs
- 1.3 Different type of NBFCs
- 1.4 Type of Services provided by NBFCs
 - 1.4.1 Hire Purchase Services
 - 1.4.2 Leasing Services
 - 1.4.3 Housing Finance Services
 - 1.4.4 Asset Management Company
 - 1.4.5 Venture Capital Companies
 - 1.4.6 Mutual Benefit Finance Companies
- 1.5 Financial Sector Reforms & Liberalization measures for NBFCs
- 1.6 Recent Trends in NBFC Sector
- 1.7 Summary

1.1 Introduction

Non-Banking Financial Companies play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. There are different types of institutions involved in financial services in India. These include commercial banks, financial institutions (FIs) and non-banking finance companies (NBFCs) (Fig.1). Due to the financial sector reforms, NBFCs have been emerged as an integral part of the Indian financial system. Non-banking finance companies frequently act as suppliers of loans & credit facilities and accept deposits, operating mutual funds and similar other functions. They are competitive and complimentary to banks and financial institutions. There are 13261 registered NBFCs in India as of June 2005 engaged in the financial services.

Table-1: Number of Non-Banking Financial Companies		
<i>End-June</i>	<i>All NBFCs</i>	<i>NBFCs Accepting Public Deposits</i>
1999	7,855	624
2000	8,451	679
2001	13,815	776
2002	14,077	784
2003	13,849	710
2004	13,764	604
2005*	13,261	507
* : net of cancellation.		

Source: RBI

NBFCs have registered significant growth in recent years both in terms of number and volume of business transactions (Table-2). The equipment leasing and hire purchase finance companies finance productive assets. NBFCs role in financing consumer durables and automobiles are very aggressive. The rapid growth in the business of NBFCs urged for effective regulatory action to protect the interests of investors. The Reserve Bank has started regulating the activities of NBFCs with the twin objectives of ensuring that they subserve the financial system efficiently and do not jeopardise the interest of depositors.

RBI has identified as many as 12 categories of NBFCs. Five of them are regulated by the RBI, Chit funds jointly by the RBI and the Registrar of Chits and two (mutual benefit funds including nidhis and micro finance companies) by the Department of Company Affairs, Government of India. The National Housing Bank (NHB) regulates housing finance companies. Stock Broking and Merchant Banking Companies are regulated by the Securities and Exchange Board of India and insurance companies come under the Insurance Regulatory and Development Authority.

Table-2: Profile of Non-Banking Financial Companies

Item	(Amount in Rs. crore)					
	As at End-March					
	2003		2004		2005	
	NBFCs	of which: RNBCs	NBFCs	of which: RNBCs	NBFCs	of which: RNBCs
Number of companies reporting	875	5	777	3	573	3
Total Assets	58,071	20,362 (35.1%)	50,709	17,955 (35.4%)	52,900	19,056 (36.0%)
Public Deposits	20,100	15,065 (75.0%)	19,644	15,327 (78.1%)	20,246	16,600 (82.0%)
Net Owned Funds	4,950	809	5,098	1,002	5,510	1,065

Fig.1: The Indian Financial system and Non-Banking Financial Companies

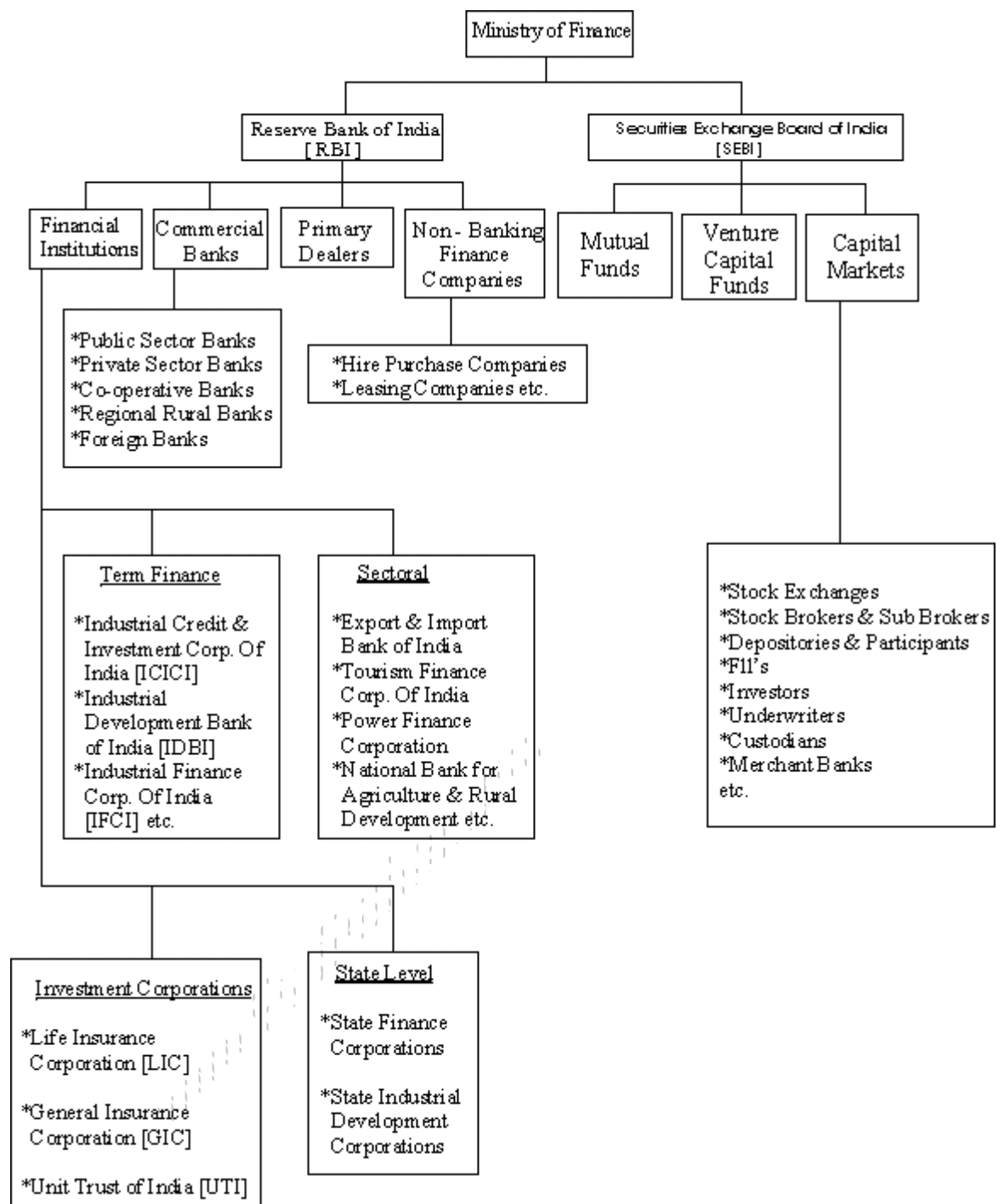
1.2 Definition of Non-banking Finance Company,

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, securities, leasing, hire-purchase, insurance business, and chit business.

1.2.1 Difference between banks & NBFCs

NBFCs are doing functions similar to that of banks, however there are a few differences:

- 1) a NBFC cannot accept demand deposits,
- 2) it is not a part of the payment and settlement system and as such cannot issue cheques to its customers, and
- 3) deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.



1.3 Different types of NBFCs

There are different categories of NBFC's operating in India under the supervisory control of RBI. They are:

1. Non-Banking Financial Companies (NBFCs)
2. Residuary Non-banking Finance companies(RNBCs).
3. Miscellaneous Non-Banking Finance Companies (MNBCs) and

Residuary Non-Banking Company is a class of NBFC, which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

Miscellaneous Non-Banking Financial Companies are another type of NBFCs and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above.

1.4 Type of Services provided by NBFCs

NBFCs provide range of financial services to their clients. Types of services under non-banking finance services include the following:

1. Hire Purchase Services
2. Leasing Services
3. Housing Finance Services
4. Asset Management Services
5. Venture Capital Services
6. Mutual Benefit Finance Services (Nidhi)

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.

Now we take a look at each type of service that an NBFC could undertake.

1.4.1 Hire Purchase Services

Hire purchase the legal term for a conditional sale contract with an intention to finance consumers towards vehicles, white goods etc. If a buyer cannot afford to pay the price as a lump sum but can afford to pay a percentage as a deposit, the contract allows the buyer to hire the goods for a monthly rent. If the buyer defaults in paying the installments, the owner can repossess the goods. HP is a different form of credit system among other unsecured consumer credit systems and benefits. Hero Honda Motor Finance Co., Bajaj Auto Finance Company is some of the HP financing companies.

1.4.2 Leasing Services

A lease or tenancy is a contract that transfers the right to possess specific property. Leasing service includes the leasing of assets to other companies either on operating lease or finance lease. An NBFC may obtain license to commence leasing services subject to , they shall not hold, deal or trade in real estate business and shall not fix the period of lease for less than 3 years in the case of any finance lease agreement except in case of computers and other IT accessories. First Century Leasing Company Ltd., Sundaram Finance Ltd. is some of the Leasing companies in India.

1.4.3 Housing Finance Services

Housing Finance Services means financial services related to development and construction of residential and commercial properties. An Housing Finance Company approved by the National Housing Bank may undertake the services /activities such as Providing long term finance for the purpose of constructing, purchasing or

renovating any property, Managing public or private sector projects in the housing and urban development sector and Financing against existing property by way of mortgage. ICICI Home Finance Ltd., LIC Housing Finance Co. Ltd., HDFC is some of the housing finance companies in our country.

1.4.4 Asset Management Company

Asset Management Company is managing and investing the pooled funds of retail investors in securities in line with the stated investment objectives and provides more diversification, liquidity, and professional management service to the individual investors. Mutual Funds are comes under this category. Most of the financial institutions having their subsidiaries as Asset Management Company like SBI, BOB, UTI and many others.

1.4.5 Venture Capital Companies

Venture capital Finance is a unique form of financing activity that is undertaken on the belief of high-risk-high-return. Venture capitalists invest in those risky projects or companies (ventures) that have success potential and could promise sufficient return to justify such gamble. Venture capitalist not only provides finance but also often provides managerial or technical expertise to venture projects. In India, venture capital concentrate on seed capital finance for high technology and for research & development. ICICI ventures and Gujarat Venture are one of the first venture capital organizations in India and SIDBI, IDBI and others also promoting venture capital finance activities.

1.4.6 Mutual Benefit Finance Companies (MBFC's),

A mutual fund is a financial intermediary that allows a group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the pooled money into specific securities/bonds. Mutual funds are one of the best investments ever

created because they are very cost efficient and very easy to invest in. By pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual funds is diversification.

There are two main types of such funds, open-ended fund and close-ended mutual funds. In case of open-ended fund, the fund manager continuously allows investors to join or leave the fund. The fund is set up as a trust, with an independent trustee, who keeps custody over the assets of the trust. Each share of the trust is called a Unit and the fund itself is called a Mutual Fund. The portfolio of investments of the Mutual Fund is normally evaluated daily by the fund manager on the basis of prevailing market prices of the securities in the portfolio and this will be divided by the number of units issued to determine the Net Asset Value (NAV) per unit. An investor can join or leave the fund on the basis of the NAV per unit.

In contrast, a close-end fund is similar to a listed company with respect to its share capital. These shares are not redeemable and are traded in the stock exchange like any other listed securities. Value of units of close-end funds is determined by market forces and is available at 20-30% discount to their NAV.

1.5 Financial Sector Reforms & Liberalization measures for NBFCs

During the period from 1992-93 to 1995-96 Indian Government took many steps to reform the financial sector like liberalized bank norms, higher ceiling on term loans, allowed to set their own interest rates, freed to fix their own foreign exchange open position subject of RBI approval and guidelines issued to ensure qualitative improvement in their customer service.

Foreign equity investments in NBFCs are permitted in more than 17 categories of NBFC activities approved for foreign equity investments such as merchant banking, stock broking, venture capital, housing finance, forex broking, leasing and finance, financial consultancy etc. Guidelines for foreign investment in NBFC sector have been amended so as to provide for a minimum capitalization norm for the activities, which are not fund based and only advisory, or consultancy in nature, irrespective of the foreign equity participation level.

The objectives behind the reforms in the financial sector are to improve the efficiency and competitiveness in the systems.

1.6 Recent trends in Non-Banking Financial Companies Sector

NBFCs initially cater to the needs of individual and small savings investors and later developed into financial institutions, providing services similar to those of banks. NBFCs have many tailor made services for their clients with lesser degree of regulation. They have offered high rate of interest to their investors and attracted many small size investors. In 1998, Reserve Bank of India implemented unprecedented regulatory measures to safeguard the public deposits.

The Bank has issued detailed directions on prudential norms, vide Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998. The directions inter alia, prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares.

The RBI has issued guidelines for entry of NBFCs into insurance sector in June 2000. Accordingly no NBFC registered with RBI having owned fund of Rs.2 Crore as per the last audited Balance Sheet would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation.

The focus of regulatory initiatives in respect of financial institutions (FIs) during 2004-05 was to strengthen the prudential guidelines relating to asset classification, provisioning, exposure to a single/group borrower and governance norms. Business operations of FIs expanded during 2004-05. Their financial performance also improved, resulting from an increase in net interest income. Significant improvement was also observed in the asset quality of FIs, in general. The capital adequacy ratio of FIs continued to remain at a high level, notwithstanding some decline during the year.

Regulatory initiatives in respect of NBFCs during the year related to issuance of guidelines on credit/debit cards, reporting arrangements for large sized NBFCs not accepting/holding public deposits, norms for premature withdrawal of deposits, cover for public deposits and know your customer (KYC) guidelines. Profitability of NBFCs improved in 2003-04 and 2004-05 mainly on account of containment of expenditure. While gross NPAs of NBFCs, as a group, declined during 2003-04 and 2004-05, net NPAs after declining marginally during 2003-04, increased significantly during 2004-05.

1.7 Summary

Non-Banking Financial Companies play an important and crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. There are different types of institutions involved in financial services in India. These include commercial banks, financial institutions (FIs) and non-banking finance companies (NBFCs). Due to the financial sector reforms, NBFCs have been emerged as an integral part of the Indian financial system. Non-banking finance companies frequently act as suppliers of loans & credit facilities and accept deposits, operating mutual funds and similar other functions. They are competitive and complimentary to banks and financial institutions. Many steps were taken in 1995-96 to reduce

controls and remove operational constraints in the banking system. These include interest rate decontrol, liberalization and selective removal of Cash Reserve Ratio (CRR) stipulation, enhanced refinance facilities against government and other approved securities.

Lesson-2

Regulations for NBFCs

Objectives

After going through this lesson , students will be able to understand and apply the regulations and guidelines prescribed for NBFCs in India.

In this lesson relevant norms and regulations will be discussed , which are currently existing in India, as follows:

- 2.1 Introduction
- 2.2 Requirements for registration with RBI
- 2.3 NBFCs exempted from registration
- 2.4 Regulations for NBFCs
- 2.5 Regulations for Residuary Non-Banking Financial Companies –RNBC
 - 2.5.1 Minimum Rate of Return
- 2.6 Prudential Norms for NBFCs
 - 2.6.1 Income Recognition
 - 2.6.2 Income from Investments
 - 2.6.3 Accounting for Investments
 - 2.6.4 Requirement as to Capital Adequacy
 - 2.6.5 Asset Classification
 - 2.6.5.1 Standard Assets
 - 2.6.5.2 Sub-Standard Assets
 - 2.6.5.3 Doubtful Assets
 - 2.6.5.4 Loss Assets
 - 2.6.6 Provisioning Requirements
 - 2.6.6.1 Provision on Loans, Advances and Other Credit Facilities including bills purchased and discounted
 - 2.6.6.2 Provision on Lease and Hire Purchase Assets
 - 2.6.7 Regulation through Auditors Report
 - 2.6.7.1 Matters to be included in the Auditors Report
- 2.6.8 Summary

2.1 Introduction

The Reserve Bank of India is entrusted with the responsibility of regulating and supervising the Non-Banking Financial Companies by virtue of powers vested in Chapter III B of the Reserve Bank of India Act, 1934. The regulatory and supervisory objective is to:

- a. ensure healthy growth of the financial companies;
- b. ensure that these companies function as a part of the financial system within the policy framework, in such a manner that their existence and functioning do not lead to systemic aberrations; and that
- c. the quality of surveillance and supervision exercised by the Bank over the NBFCs is sustained by keeping pace with the developments that take place in this sector of the financial system.

Department of Non-Banking Supervision (DNBS) has been created by RBI in January 1977 and the following Regulatory and Supervisory Framework has been established:

- 1 Entry norms for Non-Banking Financial Companies (NBFCs) and prohibition of deposit acceptance by unincorporated bodies with some exceptions
- 2 Powers of the Bank to issue asset side regulations
- 3 Compulsory registration, maintenance of liquid assets and reserve fund
- 4 Directions on acceptance of deposits and prudential regulation
- 5 Comprehensive regulation of deposit taking NBFCs

Punitive action like cancellation of Certificate of Registration, prohibition from acceptance of deposits and alienation of assets, filing criminal complaints and winding up petitions in extreme cases, appointment of RBI observers in certain cases.

The RBI has evolved a supervisory framework for NBFCs comprising (a) on-site inspection (CAMELS pattern) (b) off-site monitoring through returns (c) market intelligence, (d) auditors' exception reports.

2.2 Requirements for registration with RBI

A company incorporated under the Companies Act, 1956 and desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should have a minimum net owned fund of Rs 25 lakh (raised to Rs 200 lakh w.e.f April 21, 1999). The company is required to submit its application for registration in the prescribed format along with necessary documents for Bank's consideration. The Bank issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

2.3 NBFCs exempted from registration

The following NBFCs have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions :-

Housing Finance Companies as defined in Section 2(d) of the National Housing Bank Act, 1987;

Merchant Banking Companies registered with the Securities and Exchange Board of India as a Merchant Banker under Section 12 of the Securities and Exchange Board of India Act, 1992 and is carrying on the business of merchant Banker in accordance with the Securities and Exchange Board of India Merchant Banking (Rules) 1992 and Securities and Exchange Board of India Merchant Banking (Regulations) 1992 and does not carry any financial activity and does not accept or hold public deposits;

Micro Finance Companies which are engaged in micro financing activities, providing credit not exceeding Rs. 50,000 for a business enterprise and Rs. 1,25,000 for meeting the cost of a dwelling unit to

any poor person for enabling him to raise his level of income and standard of living and licensed under Section 25 of the Companies Act, 1956 and not accepting public deposits.

Mutual Benefit Companies as defined in paragraph 2(1) (ixa) of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 and not notified under section 620A of the Companies Act, 1956, which are carrying on the business of a non-banking financial institution and having the aggregate of net owned funds and preferential share capital of not less than Rs.10 Lakhs and is complying with the requirements contained in the relevant provisions of the Directions issued under Section 637A of the Companies Act, 1956 to Nidhi Companies by the Central Government.

Government Companies as defined in section 617 of the Companies Act, 1956, which not less than 51% of the paid up capital is held by the Central Government, or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is subsidiary of a Government Company.

Venture Capital Fund Companies holding a certificate of registration obtained under Section 12 of the Securities and Exchange Board of India Act, 1992 and not holding or accepting public deposits.

Insurance Companies which are not holding or accepting public deposits and doing the business of insurance' holding a valid certificate of registration issued under Section 3 of the Insurance Act, 1938 (IV of 1938);

Stock Exchanges recognized under Section 4 of the Securities Contracts

(Regulation) Act, 1956 (42 of 1956) ;

Stock-brokers or **Sub-brokers** holding a valid certificate of registration obtained under Section 12 of the Securities and Exchange Board of India Act, 1992.

Nidhi Companies which are notified under Section 620A of the Companies Act, 1956;

Chit Companies doing the business of chits, as defined in clause (b) of Section 2 of the Chit Funds Act, 1982.

2.4 Regulations for NBFCs

With the purview of controlling NBFCs and to protect interest of investor, Reserve Bank of India has been taken many controlling measures and issued many norms and guidelines such as:

- Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998
- Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998
- Residuary Non-Banking Companies (Reserve Bank) Directions, 1987
- Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998

All the regulations and norms for NBFCs to protect the investors interest and based on their Owned and Net Owned funds.

‘Owned Fund’ means aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the company after deducting there from accumulated balance of loss, deferred revenue expenditure and other intangible assets.

The amount of investments of such company in shares of its subsidiaries, companies in the same group and all other NBFCs and the book value of debentures, bonds, outstanding loans and advances made to and deposits with subsidiaries and companies in the same group is arrived at. The amount thus calculated, to the extent it exceeds 10% of the owned fund, is reduced from the amount of owned fund to arrive at ‘Net Owned Fund’.

Net owned fund means :-

Aggregate of the paid up equity capital and free reserves as disclosed in the latest balance sheet of the company **xxxx**

Less: -Accumulated balance of loss	xxxx	
-Deferred revenue expenditure	xxxx	
-Other intangible assets	<u>xxxx</u>	<u>xxxx</u>
Owned Funds		xxxx

Less: -Investments in subsidiaries/group cos./NBFCs	xxxx	
-Book value of debentures, bonds, outstanding loans and advances (including hire purchase and lease finance) made to, and deposits with Subsidiaries/Group Cos.	<u>xxxx</u>	<u>xxxx</u>

xxxx

Net Owned Funds

2.5 Regulations for Residuary Non-Banking Financial Companies

Residuary Non-Banking Companies (RNBCs) are another type of NBFCs, which receives any deposit under any scheme or arrangement in one lump sum or in installments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any other manner and is not an equipment leasing company, a hire purchase finance company, a housing finance company, an insurance company, an investment company, a loan company, a mutual benefit financial company, a miscellaneous non-banking company and a mutual benefit company.

RNBCs should not receive any deposit repayable on demand or on notice or for a period of less than 12 months or more than 84 months from the date of receipt of such deposit or renew any deposit. No residuary non-banking company shall open its branch / office or appoint agents to collect deposits if its NOF is up to Rs. 50 crore, within the State where its registered office is situated and if NOF is more than Rs. 50 crore, Anywhere in India.

If Residuary Non-Banking Company intended to close its branch / office, they have to publish such intention in any one national level newspaper

and in one vernacular newspaper in circulation in the relevant place before ninety days of the proposed closure.

2.5.1 Minimum Rate of Return

The amount payable by the RNBCs towards interest, premium, bonus or other payouts in respect of deposits received from that date, shall not be less than at the rate of 5% per annum on the amount deposited in lump sum or at monthly or longer intervals and at the rate of 3.5% per annum on the amount deposited under daily deposit schemes, provided that pre maturity repayments shall be reduced by one percent. Residuary Non-Banking Company shall not make premature repayment of deposit within a period of 12 months (**lock – in period**) from the date of its acceptance except in case of death of a depositor.

Under Non-Resident (External) Account Scheme the rate interest shall not exceeding the rate specified by the Reserve Bank of India for such deposits with scheduled commercial banks. The period of deposits shall be not less than one year and not more than three years

2.6 Prudential Norms for Non-Banking Financial Companies

The Prudential Norms for Non-Banking Financial Companies issued by the Reserve Bank of India in the interest of public and to regulate the NBFCs, applicable to all NBFCs, except a mutual benefit financial company and a mutual benefit company as defined in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 which is having net owned fund of Rs.25 Lakhs and above and accepting/holding public deposit; a residuary non-banking company and some of the provisions of Prudential Norms shall not apply to Government Company and a loan company, an investment company, a hire purchase finance company & an equipment leasing company, which is having NOF of Rs.25 lakhs and above but not accepting/holding public deposit.

2.6.1 Income recognition

The income recognition will be based on recognized accounting principles existing in India. Income including interest/discount or any other charges on Non Performing Assets shall be recognized only when it is actually realised.

In respect of hire purchase assets, where installments are overdue for more than 12 months, income shall be recognized only when hire charges are actually received. In respect of lease assets, where lease rentals are overdue for more than 12 months, the income shall be recognised only when lease rentals are actually received.

2.6.2 Income from investments

Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis. However, if the dividend is declared by the corporate body in its annual general meeting, it may be taken into account, where the right to receive payment is established.

Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis where interest rate is pre-determined.

Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

2.6.3 Accounting of investments

NBFCs shall frame investment policy for the company and implement the same such as classification of the investments into current and long term investments. Current Investments are grouped into Equity shares, Preference shares, Debentures and bonds, Government securities including treasury bills, Units of mutual fund, and others. Current investments for each category shall be valued at cost or market value

whichever is lower. A Long term investment shall be valued in accordance with the Accounting Standard issued by ICAI.

2.6.4 Requirement as to capital adequacy

Capital Adequacy Ratio of NBFCs is based on Tier-I and Tier-II Capitals. Tier-I Capital means owned fund as reduced by investment in shares of other NBFCs and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund.

Tier-II Capital includes preference shares other than those which are compulsorily convertible into equity, revaluation reserves at discounted rate of fifty five percent, general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets, hybrid debt capital instruments, and subordinated debt.

NBFC shall maintain a minimum capital ratio, consisting of Tier I and Tier II capital, not less than 12% of its aggregate risk weighted assets and of risk adjusted value of off-balance sheet items.

Degrees of credit risk exposure attached to off-balance sheet items have been expressed as percentage of credit conversion factor. The relevant conversion factor has to be used to arrive risk adjusted value of off-balance sheet item.

The risk adjusted value of the off-balance sheet items will be calculated as detailed below:

The total of Tier II capital, at any point of time, shall not exceed one hundred per cent of Tier I capital.

Nature of item	Credit conversion factor-percentage
i) Financial & other guarantees	100
ii) Share/debenture underwriting obligations	50
iii) Partly-paid shares/debentures	100
iv) Bills discounted/rediscouted	100
v) Lease contracts entered into but yet to be executed	100
vi) Other contingent liabilities (To be specified)	50

2.6.5 Asset Classification

NBFCs shall classify its lease/hire purchase assets, loans and advances and any other forms of credit into Standard assets, Sub-standard assets, Doubtful assets, and Loss assets.

2.6.5.1 Standard Assets

Standard asset means the asset in respect of which, there is no default in payments of principal or interest and which does not disclose any problem and carry normal risk attached to the business. For example, if a person bought a Motor cycle on Hire Purchase and pay his installments regularly is a Standard Asset to the H.P. Companies.

2.6.5.2 Sub-standard Assets

Those assets , which are overdue more than 12 months but less than 24 months and don't have adequate securities for the repayment are termed as sub-standard as sets.

2.6.5.3 Doubtful Assets

Those assets , which are overdue more than 24 months but less than 48 months and don't have adequate security for the repayment are termed as doubtful assets. The possibility of loss is extremely high.

2.6.5.4 Loss Assets

Assets classified as Loss, which are over due for more than 48 months and are considered unrecoverable. This classification does not mean the asset has absolutely no recovery or salvage value. But its better to write-off instead of keeping asset in the records, though there may be partial recovery in future

The class of assets mentioned above may be upgraded if it satisfies the conditions and possibility of recovery, but shall not be upgraded merely as a result of rescheduling.

2.6.6 Provisioning requirements

NBFCs shall make provision against sub-standard assets, doubtful assets and loss assets after taking into account of the delay in realization of the loans and advances and value of security charged as follows:

2.6.6.1 Provision on Loans, advances and other credit facilities including bills purchased and discounted

Assets Classification	Provision Requirement
Loss Assets	The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, the provision should be made @ 100% on outstanding.
Doubtful Assets	100% provision to be made for unrealizable value of the security and the realizable value should be estimated on realistic basis. Provision should be made on estimated realizable value of the out standings, if the assets remained doubtful up to one year @ 20%, one to three years @ 30% and more than three years @50%.
Sub-standard Assets	10% of total out standings shall be made generally.

2.6.6.2 Provision on Lease and hire purchase assets

In respect of hire purchase assets, the total dues including future installments after deduction of un-matured finance charges, security deposits, if any and depreciated value of underlying asset shall be provided for.

In respect of hire purchase and leased assets, additional provision shall be made as:

-where any amounts of hire charges or lease rentals are overdue up to 12 months	Nil
-where any amounts of hire charges or lease rentals are overdue for more than 12 months but up to 24 months	10% of the net book value
-where any amounts of hire charges or lease rentals are overdue for more than 24 months but up to 36 months	40% of the net book value
-where any amounts of hire charges or lease rentals are overdue for more than 36 months but up to 48 months	70% of the net book value
-where any amounts of hire charges or lease rentals are overdue for more than 48 months	100% of the net book value
-on expiry of a period of 12 months after the due date of the last installment of hire purchase/leased asset	The entire net book value

2.6.7 Regulation through Auditors Report

Reserve Bank of India has issued a Direction as “Non-Banking Financial Companies Auditor’s Report (Reserve Bank) Directions, 1998” and its applied to all Auditors of Non-Banking Financial Companies.

2.6.7.1 Matters to be included in the auditor’s report

The auditor’s report on the accounts of a non-banking financial company must

include a statement on company's registration status under RBI Act, 1934.

In case of those NBFCs accepting/holding public deposits, in addition to above, auditors have to give the information that:-

- whether the public deposits accepted by the company together with other borrowing like unsecured non-convertible debentures/bonds;
- whether credit rating for Fixed Deposits has been assigned by the Credit Rating Agency and is in force and aggregate deposits are within the limit specified by the rating agency;
- whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;
- whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the directions issued by the Reserve Bank of India in terms of the Non-Banking Financial Companies Prudential Norms(Reserve Bank) Directions, 1998;
- whether the capital adequacy ratio as disclosed in the return submitted to the Reserve Bank of India in terms of the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 has been correctly determined and whether such ratio is in compliance with the minimum Capital to Risk Asset Ratio prescribed by Reserve Bank of India;
- Whether the company has complied with the prescribed liquidity requirement and kept the approved securities with a designated bank.
- whether the company has furnished to the Reserve Bank of India within the stipulated period the half-yearly return on prudential norms as specified in the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998; and
- whether the company has furnished to the Reserve Bank of India within the stipulated period the return on deposits as specified in the First Schedule to the Non-Banking Financial Companies (Reserve Bank) Directions, 1998.

In the case of a non-banking financial company not accepting public deposits, auditors shall include the statement on:-

- whether the Board of Directors has passed a resolution for the non- acceptance of any public deposits.
- whether the company has accepted any public deposits during the relevant period/year; and
- whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it.

In the case of a non-banking financial company which is an investment company not accepting public deposits and which has invested not less than 90 percent of its assets in the securities of its group/holding/subsidiary companies as long term investments, the auditors should include a statement on:-

- whether the Board of Directors has passed a resolution for the non- acceptance of public deposits;
- whether the company has accepted any public deposits during the relevant period/year;
- whether the company has through a Board resolution identified the group/holding/subsidiary companies;
- whether the cost of investments made in group or holding or subsidiary companies is not less than 90 percent of the cost of the total assets of the company at any point of time throughout the accounting period/year;
- whether the company has continued to hold securities of group or holding or subsidiary companies as long term investments and has not traded in those investments during the accounting year/period.

If any of the statement regarding above items are unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the

auditor is unable to express any opinion on any of the items referred above his report shall indicate such fact together with reasons there for.

2.6.8 Summary

The Reserve Bank of India is entrusted with the responsibility of regulating and supervising the Non-Banking Financial Companies. The regulatory and supervisory objective, is to ensure healthy growth of the financial companies; ensure that these companies function as a part of the financial system within the policy framework, and that the quality of surveillance. Department of Non-Banking Supervision (DNBS) has been created by RBI and Regulatory and Supervisory Framework has been established. The RBI has evolved a supervisory framework for NBFCs comprising on-site inspection (CAMELS pattern), off-site monitoring through returns, market intelligence, and auditors' exception reports. Some of NBFCs are exempted from registration of RBI like Housing Finance Companies, Merchant Banking Companies, Venture Finance Companies etc. With the purview of controlling NBFCs and to protect interest of investor, Reserve Bank of India has been taken many controlling measures and issued many norms and guidelines such as Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998, Residuary Non-Banking Companies (Reserve Bank) Directions, 1987, Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998 etc. The Bank has issued detailed directions on prudential norms, vide Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998. The directions inter alia, prescribe guidelines on income recognition, asset classification and provisioning requirements applicable to NBFCs, exposure norms, constitution of audit committee, disclosures in the balance sheet, requirement of capital adequacy, restrictions on investments in land and building and unquoted shares. Auditors are also directed to mention relevant

information/qualifications in their report, which will be submitted to RBI.

Lesson-3

Objectives

After this lesson students will have overall picture of NBFCs and able to handle NBFCs activities independently, able to manage & advise on practical issues .

The chapters in this lesson will focus on important issues of NBFCs and will have the following structure:

- 3.1 Introduction
- 3.2 Public Deposits
 - 3.2.1 Regulations for NBFCs Accepting Public Deposits
 - 3.2.2 Period of Deposits
 - 3.2.3 Minimum Credit Rating
 - 3.2.4 Ceiling on quantum of deposit
 - 3.2.4.1 Equipment Leasing/Hire Purchase Company
 - 3.2.4.2 Loan Company / Investment Company
 - 3.2.5 Downgrading of Credit Rating
 - 3.2.6 Ceiling on the rate of interest
 - 3.2.7 Payment of brokerage
 - 3.2.8 Lock-in Period and Repayment
 - 3.2.9 Branches and appointment of agents
 - 3.2.10 Exempted NBFCs from Public Deposit Regulations
 - 3.2.11 FCNR Deposits for NBFCs
- 3.3 Regulations for MNBCs Accepting Public Deposits
 - 3.3.1 Ceiling on the rate of interest and brokerage
 - 3.3.2 Minimum Lock-in Period
- 3.4 Regulations for RNBCs Accepting Public Deposits
- 3.5 Role of Company Law Board
- 3.6 Fund Raising / Capital Issues
 - 3.6.1 Public Deposits
 - 3.6.2 Borrowings
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- 3.8 Maintenance of Liquid Assets by NBFCs
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3.1 Introduction

All NBFCs are not entitled to accept public deposits and only those NBFCs holding a valid Certificate of Registration with authorisation to accept Public Deposits can accept/hold public deposits. The NBFCs accepting public deposits should have minimum stipulated Net Owned Fund and comply with the Directions issued by the Reserve Bank of India. According RBI, Public Deposits held by all NBFCs declined significantly during the year ended March 2004 (14.2 per cent) as well as March 2005 (15.6 per cent). Significantly, public deposits by all NBFC groups declined in both the years, except loan companies, which increased marginally during 2003-04 and 'other' companies, which increased during 2003-04 and 2004-05. Hire purchase companies held the largest share of public deposits (63.5 per cent), followed remotely by equipment leasing companies, loan companies and investment companies.

3.2 Deposit and Public Deposit

Deposit is defined under Section 45 I(bb) of the RBI Act, 1934 that included any receipt of money by way of deposit or loan or in any other form but does not include any amount raised by way of share capital, any amount received from banks or any other financial institution specified by RBI, any amount received in course of business by way of security deposits, any amount received by way of subscriptions in respect of a 'Chit'.

Public Deposit is defined under Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 as a

Deposit, unsecured deposits received from the public, defined under RBI Act, 1934 and further excludes any amount received from the Central/State Government/local authority/foreign government, any amount received from other company as inter-corporate deposit, any amount received from directors or relative of the director of a NBFC, any amount raised by issue of bonds or debentures secured by mortgage of any immovable property or other asset of the company, any amount received from a mutual fund and any amount received by issuance of Commercial Paper.

3.2.1 Regulations for NBFC's Accepting Public Deposits,

RBI closely supervises those NBFCs, which accept public deposits, through a comprehensive mechanism comprising on-site examination, off-site surveillance, a sensitive market intelligence system and initiation of necessary supervisory action whenever necessary. The statutory auditors of NBFCs have been directed to report exceptions to compliance with RBI regulations to the Reserve Bank directly for punitive action. RBI has undertaken publicity campaign through print media all over the country to create awareness among the public about do's and don'ts in regard to making deposits with NBFCs. RBI has also been coordinating its efforts with State Government authorities and other enforcement bodies for checking unscrupulous activities of NBFCs and unincorporated bodies accessing public deposits illegally. At the same time, the well-run and managerially sound NBFCs are being encouraged to continue their genuine business operations. Bank credit to the NBFCs for their advances against commercial vehicles has recently been brought under the ambit of priority sector advances. The earlier ceilings on bank credit to NBFCs as a multiple of their NOF have been abolished for NBFCs registered with RBI.

3.2.2 Period of Deposit

Non-banking financial companies shall not accept or renew any public deposit, which is repayable on demand. The period of deposit shall be minimum of 12 months and maximum of 60 months.

3.2.3 Minimum Credit Rating

Non-banking financial companies having Net Owned Fund (NOF) of rupees twenty five lakhs and above are allowed to accept public deposit subject to the minimum investment grade or other specified credit rating for fixed deposits from any one of the approved credit rating agencies at least once a year and a copy of the rating to be sent to the Reserve Bank of India along with return on prudential norms. And this clause shall not apply to an Equipment Leasing or Hire Purchase Finance Company.

The following are the approved credit rating agencies and the minimum credit rating required for the fixed deposits:

Name of the agency	Minimum investment Grade Rating
The Credit Rating Information Service India Ltd.(CRISIL)	FA- (FA Minus)
ICRA Ltd.	MA- (MA Minus)
Credit Analysis & Research Ltd. (CARE)	CARE BBB (FD)
Fitch Ratings India Pvt. Ltd.	tA- (ind)(FD)

In the event of upgrading or downgrading of credit rating of any NBFC to any level from the level previously held by the non-banking financial company, they shall inform the new rating to Reserve Bank of India.

3.2.4 Ceiling on quantum of deposit

3.2.4.1 Equipment Leasing/Hire Purchase Company

An equipment leasing company or a hire purchase finance company having NOF of Rs.25 lakhs or more and complying with all the

prudential norms with capital adequacy ratio of not less than 15% as per last audited balance-sheet may, accept or renew public deposit not exceeding 1.5 times of its NOF or public deposit up to ten crore of rupees, whichever is lower.

An equipment leasing company or a hire purchase finance company having NOF of Rs.25 lakhs or more and complying with all the prudential norms and having minimum investment grade rating may, accept or renew public deposit not exceeding 4 times of its NOF.

3.2.4.2 Loan Company/Investment Company

A loan company or an investment company having NOF of Rs.25 lakhs or more and having minimum investment grade credit rating and complying with all the prudential norms with capital adequacy ratio of not less than 15% as per last audited balance-sheet may, accept or renew public deposit not exceeding 1.5 times of its NOF.

A loan company or an investment company which complies with all the prudential norms and having NOF of Rs.25 lakhs or more and having AA (double A) or A (single A) grade credit rating but not having capital adequacy ratio of 15% was allowed to accept or renew the public deposit not exceeding an amount equivalent to its NOF or half of its NOF, respectively, until it attains the capital adequacy ratio of 15% but not later than March 31, 2000 with other stipulations remaining the same.

3.2.5 Downgrading of Credit Rating

In the event of downgrading of credit rating below the minimum specified investment grade as provided above, the NBFCs shall regularise the excess deposit with immediate effect by stop accepting public deposit, reporting to RBI within fifteen working days and by reducing the amount of excess public deposit to nil by repayment as and when such deposit falls due or otherwise within three years from the date of such downgrading of credit rating.

3.2.6 Ceiling on the rate of interest

With effect from March 4, 2003 NBFCs may invite or accept or renew public deposit at a rate of interest, maximum of 11% per annum. Interest may be paid or compounded at rests which shall not be shorter than monthly rests.

With effect from September 18, 2003, NBFCs may invite or accept or renew repatriable deposits from Non-Resident Indians under Non-Resident (External) Account Scheme at a rate maximum of the rate specified by the Reserve Bank of India for such deposits with scheduled commercial banks.

3.2.7 Payment of brokerage

Non-Banking Financial Companies shall not pay to any broker in excess of 2% of the public deposit collected by them as brokerage, commission, incentive or any other benefit by whatever name called and the expenses by way of reimbursement on the basis of relative vouchers/bills produced by him shall not be in excess of 0.5 % of the deposit so collected.

3.2.8 Minimum lock- in period and Repayment in the event of death of the depositor

NBFCs shall not grant any loan against a public deposit or make premature repayment of a public deposit within a period of 3 months **(lock-in period)** from the date of its acceptance.

In the event of death of a depositor, NBFCs may repay the public deposit prematurely, even within the lock – in period, to the surviving depositor/s in the case of joint holding with survivor clause or to the nominee or the legal heir/s of the deceased depositor, on the request of the surviving depositor/s/nominee/legal heir, and only against submission of proof of death, to the satisfaction of the company.

3.2.9 Branches and appointment of agents to collect deposits

NBFCs may open its branch or appoint agents within the State where its registered office is situated, if its NOF is up to Rs. 50 crore and anywhere in India, if its NOF is more than Rs. 50 crore and its credit rating is AA or above. For the purpose of opening a branch, NBFCs shall notify to the RBI.

If NBFC intended to close its branch/office, they shall publish their intention in any one national level newspaper and in one vernacular newspaper in circulation in the relevant place and to notify to the RBI, before 90 days of the proposed closure.

3.2.10 Exempted NBFCs from Public Deposit Regulations

The directions of Accepting Public Deposits of RBI will not be applicable to the following NBFCs:

- 1 an insurance company holding a valid certificate of registration issued under section 3 of the Insurance Act, 1938,
- 2 a stock exchange notified under section 4 of the Securities Contracts (Regulation) Act, 1956,
- 3 a stock broking company defined in section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992),
- 4 a loan company, an investment company, a hire purchase finance company or an equipment leasing company **not accepting / holding** any public deposit,
- 5 a Government company as defined under section 617 of the Companies Act, 1956.

3.2.11 FCNR Deposits for NBFC's,

From April 24, 2004, NBFCs cannot accept deposits from NRI except deposits by debit to NRO account of NRI provided such amount do not represent inward remittance or transfer from NRE/FCNR (B) account.

3.3 Regulations for MNBC's Accepting Public Deposits

Miscellaneous Non- Banking Companies (MNBCs) not allowed to receive/renew any deposit repayable on demand or on notice, or for a period of less than six months and more than thirty six months

from the date of receipt of such deposit; any deposit against an unsecured debenture or any deposit from a shareholder exceeding 15% of its net owned funds; any other deposit exceeding 25% per cent of its net owned funds.

3.3.1 Ceiling on the rate of interest and brokerage

Miscellaneous Non- Banking Company shall pay interest not more than 11% on deposits and the interest may be paid or compounded at half-yearly/quarterly/monthly rests.

In case of Non-Resident (External) Account Scheme, the same rate specified by the Reserve Bank of India for such deposits with scheduled commercial banks.

Brokerage shall not be paid in excess of the following rates for deposits collected by or through them: 1% for deposits not exceeding one year, 1.25% for deposits between more than one year but less than two years and 1.5% for deposits exceeding two years.

3.3.2 Minimum lock- in period

Miscellaneous Non-Banking Companies shall not grant any loan against deposits or make premature repayment of deposit within a period of three months (**lock-in period**) from the date of its acceptance. Provided that in the event of death of a depositor, may repay the deposit prematurely, even within the lock – in period.

3.4 Regulations for RNBC's Accepting Public Deposits

There is no ceiling on raising of deposits by RNBCs but every RNBC has to ensure that the amounts deposited and investments made by the company are not less than the aggregate amount of liabilities to the depositors.

To secure the interest of depositor, such companies are required to invest in a portfolio comprising of highly liquid and secured instruments viz. Central/State Government securities, fixed deposit of

scheduled commercial banks (SCB), Certificate of deposits of SCB/FIs, units of Mutual Funds, etc.

3.5 The role of Company Law Board in protecting the interest of depositors.

If a NBFC defaults in repayment of deposit, the depositor can approach Company Law Board or Consumer Forum or file a civil suit to recover the deposits. The Company Law Board (CLB), on receipt of any complaint may order the non-banking financial company to make repayment of such deposit and subject to such conditions. The depositors can approach CLB by mailing an application in prescribed form to the appropriate bench of the Company Law Board according to its territorial jurisdiction with the prescribed fee.

Full time special officers have been appointed to ensure compliance with RBI directions to protect the interest of deposits. the bank has initiated adverse action against errant NBFCs for various defaults and contravention of the provisions of the RBI Act and directions issued there under.

3.6 Fund Raising/Capital Issues

NBFCs need vast funds and they raise funds primarily through deposit mobilisation, borrowings from banks and others and capital issues. Let us discuss one by one.

3.6.1 Public Deposits

NBFCs holding a valid Certificate of Registration with authorisation to accept Public Deposits can accept/hold public deposits. The NBFCs accepting public deposits should have minimum stipulated Net Owned Fund and comply with the Directions issued by the Reserve Bank of India. Regulations and other terms are explained separately in this unit.

3.6.2 Borrowings

NBFCs borrow from banks and financial institutions and also they raise loan fund by issue of debentures. Loan funds constitute a big

chunk of all sources of funds. Loan from scheduled commercial banks, co-op banks and financial institutions, security deposits, dealership deposit, earnest money, inter corporate deposit, advance against order for goods, funds raised through issue of bonds and debentures come under this category.

3.6.2.1 Borrowing limits of finance companies

The borrowing finance by all-India financial institutions are subject to regulation by the RBI. Initially, RBI had prescribed instrument-wise limits for the select FIs up to which the FIs could mobilise resources through the specified instruments. The instrument-wise ceilings were replaced in May 1997 by “umbrella limit” which was linked to the ‘net owned funds’ of the FI concerned and constituted the overall ceiling for borrowing by the FI through the specified instruments. The system of umbrella limit continues to be in force even now though a few additional instruments have been included under the limit, over the years.

The resource raising capabilities of Financial Institutions has been strengthened by recent changes include progressive deregulation, introduction of hedging instruments such as interest rate swaps and forward rate agreements (IRS/ FRA), introduction of Asset Liability Management (ALM) system, etc.

The ‘umbrella limit’ at present consists of five instruments viz., term deposits, term money borrowings, certificates of deposits (CDs), commercial papers (CPs) and inter-corporate deposits (ICDs). The aggregate borrowings through these instruments should not exceed the net owned funds of the FIs concerned at any time, as per its latest audited balance sheet.

Term Deposits can be issued for 1 to 5 years with minimum deposit of Rs.10000/-. Rating from Rating Agencies approved by SEBI is compulsory and they should provide any advance against deposits.

Term Money Borrowings may be accepted for not less than 3 months and not exceeding 6 months and eligible to borrow from Scheduled Commercial Banks and Co-operative Banks.

Certificates of Deposits denomination should be minimum of Rs. 1 lakh and will be in multiples of Rs 1 lakh. It can be resourced from individual, corporations, companies, trusts, funds, associations etc. including NRIs for a period of not less than 1 year and not more than 3 years. From June 2002, CDs should be issued in the dematerialized form only.

Commercial Papers can be issued in denomination of Rs. 5 lakh or multiples thereof for a period of minimum of 15 days and maximum up to one year from the date of issue. The total amount of CPs proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. The minimum credit rating shall be P-2 of CRISIL or equivalent rating by other agencies.

Inter Corporate Deposits can be resourced by the Financial Institutions as registered under the Companies Act 1956 .

3.6.3 Capital issues

NBFCs are greatly depending on capital market to raise funds. In 1994-95 lots of capital issues were from NBFCs with a varied size of issues from Rs. 75 Lakhs to Rs.600 Crores. Companies which do not want to come out with frequent public issues find private placement of debentures and equity as a viable avenue in raising finance/ Privately placed debentures especially for short durations like eighteen months are gaining popularity as no credit rating is required.

3.7 Investment Norms for NBFCs

To secure the public monies deposited into the NBFCs, RBI has issued directions to follow by the Non-Banking Financial companies as below:

3.7.1 Investment Norms and Security for Deposits

Non-Banking Companies are required to invest and continue to invest an amount including the amount invested in assets under Section 45-IB of the Reserve Bank of India Act, 1934 in securities or in other types of investments which are unencumbered and valued at a price not exceeding the current market price:-

- not less than 10% of the aggregate amount of liabilities to depositors in fixed deposits/ certificates of deposit of scheduled commercial banks; or in certificates of deposit (Credit Rating not less than AA+) of specified financial institutions or partly in any of these Fixed Deposits/Certificates of Deposit so rated;
- not less than 70% of the aggregate amount of liabilities to depositors in securities of any State Government or Central Government or in bonds or debentures (rated not less than AA+) of any other company incorporated under the Companies Act, 1956;
- from April 1, 2005 not more than 10% of the aggregate amount of liabilities to the depositors or one time the net owned fund of the company, whichever is less, may be invested in any manner which in the opinion of the company is safe as per the approval of the board of directors of the company;

To keep the unencumbered approved securities, NBFCs are required open a Constituent's Subsidiary General Ledger (CSGL) account with a scheduled commercial bank, or the Stock Holding Corporation of India Ltd. (SHCIL) or a dematerialized account with a depository through a depository participant registered with Securities and Exchange Board of India. Government Securities held in the said CSGL account or dematerialized account will not be allowed to trade either by entering into ready forward contracts, including reverse ready forward

contracts, or otherwise except for repayment to the depositors with the prior approval of RBI

Non-Banking Companies shall furnish a certificate from its statutory auditors to the Reserve Bank within 15 days from the close of business after the end of each quarter, to the effect that the amounts deposited and investments made by the company are not less than the aggregate amount of liabilities to the depositors outstanding at the close of business on the last working day of the second preceding quarter.

3.7.2 Restrictions on investments in land and building and Unquoted shares

As per Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998, if any Equipment leasing company or hire purchase finance company or Loan company or investment company is accepting public deposit, they shall not invest in land or building, except for its own use, more than 10% of its owned fund and shall not invest in unquoted shares of another company, which is not a subsidiary company/Group company, more than 10% of its owned fund. If any one having more than these limits shall dispose off to maintain the level.

3.7.3 Concentration of credit/investment

NBFC should not lend to any single borrower more than 15% of its owned fund and to any single group of borrowers more than 25% of its owned fund. They shall not invest in the shares of another company more than 15% of its owned fund and the shares of a single group of companies more than 25% of its owned fund. NBFCs shall not lend and invest together more than 25% of its owned fund to a single party and more than 40% of its owned fund to a single group of parties.

The above ceilings on credit/investment concentration shall not be applicable to a RNBC in respect of investments in approved securities, bonds, debentures and other securities issued by a Government company or a public financial institution or a scheduled commercial bank; and an investment in any Insurance company by NBFCs.

3.8 Maintenance of Liquid Assets by NBFCs

Non-banking financial companies other than residuary non-banking companies required to maintain the investment not less than 5 per cent of deposits outstanding at the close of business on the last working day of the second preceding quarter and subject to the conditions that they shall invest and continue to invest in India in unencumbered approved securities valued at the price not exceeding the current market price. Such investments at the close of business on any day shall not be less than 10% in approved securities and the remaining in unencumbered term deposits in any scheduled commercial bank. The aggregate of such investments shall not be less than 15 percent of the public deposit, outstanding at the close of business on the last working day of second preceding quarter.

3.9 Maintenance of Liquid Assets by RNBCs

RBI specified that the percentage of assets to be maintained by the Residuary Non-Banking Companies (RNBCs) shall be 10% of the deposits outstanding at the close of business on the last working day of the second preceding quarter, i.e. for the third quarter starting from 1st

October shall be maintained at 10% of the deposits outstanding as at 30th June.

3.10 Deployment of Funds

NBFC's mobilise funds from depositors just as commercial banks do. NBFC's disperse these funds through:

Hire Purchase: NBFCs are financing for acquisition of commercial and private vehicles (generally trucks and cars), as well as plant and machinery. The loans are secured by the purchased asset.

Equipment Leasing: In this financing mode, NBFCs leases of industrial equipment generally high price plant and machinery.

Investment Schemes: The funds mobilised are used to purchase corporate and government securities and other money market instruments.

Loan Schemes: Loans will be disbursed for industrial projects and real estate acquisitions, personal expenses, travel expenses etc.

Nidhis and Chit Funds: In this mode the mobilised funds are loaned or distributed among the depositors themselves in a variety of ways.

3.9 Summary

Only those NBFCs holding a valid Certificate of Registration with authorisation to accept Public Deposits can accept/hold public deposits. The NBFCs accepting public deposits should have minimum stipulated Net Owned Fund and comply with the Directions issued by the Reserve Bank of India. RBI closely supervises those NBFCs, which accept public deposits, through a comprehensive mechanism comprising on-site examination, off-site surveillance, a sensitive market intelligence system and initiation of necessary supervisory action whenever necessary. Some of the companies are exempted from the directions of accepting public deposits such as an insurance company, a stock broking company, a loan company, an investment company, a hire purchase finance company or an equipment leasing company not accepting / holding any public deposit, and a Government company. NBFCs need vast funds and they raise funds primarily through deposit mobilisation, borrowings from banks and others and capital issues. Non-Banking Financial Companies are required to invest and continue to invest an amount including the

amount invested in securities or in other types of investments which are unencumbered and valued at a price not exceeding the current market price. NBFCs are deploying their funds by way of Hire purchase financing, Leasing finance, Investment schemes, Loan schemes and Chit Fund / Nidhis.

Review Questions:

- 1) Define 'NBFC'. Discuss various services provided by NBFC.
- 2) Analyse the structure and growth of NBFCs.
- 3) Enumerate the features of the RBI Regulations governing NBFCs.
- 4) Discuss the requirements of registration with RBI and exemptions.
- 5) Briefly discuss the features of Prudential Norms for NBFCs.
- 6) What are the features of regulations for Accepting Public Deposits by NBFCs?
- 7) Explain the Asset Classifications and provision norms.
- 8) Discuss the matters to be included in the Auditors Report of NBFCs.
- 9) Credit Rating Agencies and NBFCs: Explain the relationship and why?
- 10) What are methods of fund raising adopted by NBFCs in India?
- 11) Discuss briefly the Investment Norms of Non-Banking Financial Companies.
- 12) What are the recent trend and changes in NBFCs?
- 13) What are the problems faced by the NBFCs today?
- 14) What are the suggestions you can make to the government for promotion of NBFC sector?

Appendix-1

Forms used by NBFCs

* **Form - NBS 1:** Annual Return on Deposits as on 31, March 20. .

(To be submitted by all Non-Banking Financial Companies accepting / holding public deposits, and MNBCs - except Residuary Non-Banking Companies)

* **Form - NBS 1A:** (Annual Return on Deposits as on 31, March 20. .)

* **Form - NBS 2:** (Half yearly Statement of capital funds, risk assets/exposures and risk asset ratio etc.,)

* **Form - NBS 3:** (Quarterly Return on Statutory Liquid Assets for the Quarter ended March/June/September/December, 20...)

* **Form - NBS 3A:** (Quarterly Return on Statutory Liquid Assets for the quarter ended March/June/September/December, 20. .)

* **Form - NBS - 4** (Monthly Return on Repayment of Deposits)

* **Form - NBS - 5** (Monetary and Supervisory Return)

* **First Schedule** (Non-Banking Financial Companies)

* **Annexure - Reporting Format** (Non-Banking Financial Companies)

* **Form - Schedule 'A'**

* **Form of Quarterly Return I**

(To be submitted by a residuary non-banking company)

* **Form of Quarterly Return II**

(To be submitted by equipment leasing or hire purchase finance or loan or investment company)

* **Form of Quarterly Return I**

(Reserve Bank of India (NBFC) Returns Specification, 1997. To be submitted by a residuary non-banking company)

* **Form of Quarterly Return II**

(Reserve Bank of India (NBFC) Returns Specification, 1997. To be submitted by Equipment leasing or hire purchase finance or loan or investment company)

* **Format of Special Return**

(To be submitted by all NBFCs whether holding public deposits or not)

Appendix-2

Important Glossary

- 1) "depositor" means any person who has made a deposit with a company; or a heir, legal representative, administrator or assignee of the depositor.
- 2) "equipment leasing company" means any company which is a

financial institution carrying on as its principal business, the activity of leasing of equipment.

- 3) "free reserves" means the aggregate of the balance in the share premium account, capital and debenture redemption reserves and any other reserve shown or published in the balance sheet of a company and created through an allocation of profits not being a reserve created for repayment of any future liability or for depreciation in assets or for bad debts or a reserve created by revaluation of the assets of the company.
- 4) "hire purchase finance company" means any company, which is a financial institution carrying on as its principal business, the activity of hire purchase transactions.
- 5) "insurance company" means any company registered under section 3 of the Insurance Act, 1938 (4 of 1938).
- 6) "investment company" means any company which is a financial institution carrying on as its principal business the acquisition of securities.
- 7) "loan company" means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an equipment leasing company or a hire-purchase finance company.
- 8) "mutual benefit financial company" means any company which is a financial institution notified by the Central Government under section 620A of the Companies Act, 1956 (1 of 1956).
- 9) "mutual benefit company" means a company not notified under section 620A of the Companies Act, 1956 (1 of 1956) and carrying on the business of a non-banking financial institution.
- 10) "net owned fund" means net owned fund as defined under section 45-IA of the Reserve Bank of India Act, 1934 (2 of 1934) including the paid up preference shares which are compulsorily convertible into equity.
- 11) "non-banking financial company" means only the non-banking institution which is a loan company or an investment company or a hire purchase finance company or an equipment leasing company or a mutual benefit financial company.
- 12) "current investment" means an investment which is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.
- 13) "doubtful asset" means a term loan, or a lease asset, or a hire purchase asset, or any other asset, which remains a sub-standard asset for a period exceeding 24 months.
- 14) "loss asset" means an asset which has been identified as loss

asset by the NBFC or its internal or external auditor or by the Reserve Bank of India during the inspection of the NBFC, to the extent it is not written off by the NBFC.

- 15) "long term investment" means an investment other than a current investment.
- 16) "net asset value" means the latest declared net asset value by the concerned mutual fund in respect of that particular scheme.
- 17) "non-performing asset" (referred as "NPA") means an asset, in respect of which, interest has remained overdue for a period of six months or more of a term loan, demand loan, debt, advances, lease rental, installment of hire purchase.
- 18) "owned fund" means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any.
- 19) "standard asset" means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business.
- 20) "sub-standard asset" means an asset which has been classified as non-performing asset for a period not exceeding 24 months.
- 21) "subordinated debt" means a fully paid up capital instrument, which is unsecured and is subordinated to the claims of other creditors and is free from restrictive clauses and is not redeemable at the instance of the holder or without the consent of the supervisory authority of the NBFC.
- 22) "Tier-I Capital" means owned fund as reduced by investment in shares of other NBFCs and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund.
- 23) "Tier-II capital" includes preference shares other than those which are compulsorily convertible into equity; revaluation reserves at discounted rate of fifty five percent; general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets; hybrid debt capital instruments; and subordinated debt, to the extent the aggregate does not exceed Tier-I capital.

- 24) "aggregate amounts of liabilities" shall mean total amount of deposits received together with interest, premium, bonus or other advantage by whatever name called, accrued on the amount of deposits according to the terms of contract.

References and Further to Study:

- 1) 'Indian Financial System', by H. R. Machiraju
- 2) 'The Indian Financial System', by Vasant Desai
- 3) 'The Indian Financial System', by P.N. Varshney & Mittal
- 4) 'Manual of Non-banking Financial Companies,' by Bharat's
- 5) Publications of Reserve Bank of India
- 6) Publications of SEBI.
- 7) Publications of Ministry of Company Affairs, Govt. of India

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UNIT-IV

MERCHANT BANKING.

Introduction:

Generally merchant banking refers the entire range of financial services such as organizing and extending finance for investment in projects, assistance in financial Management, acceptance of house business, raising Eurodollar loans and issues of foreign currency bonds, financing local authorities, financing export of capital goods, ships, hydropower installation, valuation of assets etc. In India the merchant banking services were recognised due to the increase in the volume of financial services

Merchant bankers (Category I) however are mandated by SEBI to manage public issues (as lead managers). Issue management activity has a big fall out on the integrity of the market. It affects investors interest and hence transparency has to be ensured.. There are also areas where compliance can be monitored and enforced.

BANKING COMMISSION REPORT,1972:

The Banking Commission in its report in 1972 has indicated the necessity of merchant banking service in view of the wide industrial base of the Indian Economy. The Commission was in favour of a

separate institution (different from commercial banks and term lending institutions) to provide merchant banking services. The commission suggested that they should offer investment management and advisory services particularly to the medium and small savers. The commission also suggested that they should be able to manage provident funds, pension funds and trusts of various types.

MERCHANT BANKING IN INDIA:

In India Grindlays Bank was authorized to carry merchant banking services and obtained a license from Reserve Bank of India in 1967. Grindlays which started with management of capital issues, recognised the needs of an emerging class of entrepreneurs for diverse financial services ranging from production planning and systems design to market research.. Apart from meeting specially the needs of small-scale units, it provided management consultancy, services to large and medium sized companies.

Following Grindlays Bank, Citibank set up its merchant banking division in 1970. The division took up the task of assisting new entrepreneurs and existing units in the evaluation of new projects and raising funds through borrowing and equity issues. Management consultancy services were also offered. Merchant bankers are permitted to carry-on activities of primary dealers in government securities.

Consequent to the recommendations of Banking Commission in 1972, that Indian banks should offer merchant banking services as part of the multiple services they could provide their clients, State Bank of India started the Merchant Banking Division in 1972. In the initial years the SBI's objective was to render corporate advice and assistance to small and medium entrepreneurs.

The commercial banks that followed State Bank of India were Central Banks of India, Bank of India and Syndicate Bank in 1977: Bank of

Baroda, Standard Chartered Bank and Mercantile Bank in 1978, and United bank of India. United Commercial Bank, Punjab National Bank, Canara bank and Indian overseas Bank in late '70s and early '80s. Among the development banks, ICICI started merchant banking activities in 1973, followed by IFCI (1986) and IDBI (! 991).

ORIGION OF MERCHANT BANKING –ABROAD:

The origin of merchant banking is to be traced to Italy in late medieval times. And France during the seventeenth and eighteenth centuries. The Italian merchant bankers introduced in England not only the bill of exchange but also all the institutions and techniques connected with an organized money market. In France, during 17th and 18th centuries a merchant banker (le Merchant Banquer) was not merely a trader but an entrepreneur par excellence. He invested his accumulated profits in all kinds of promising activities. He added banking business to his merchant activities and became a merchant banker.

REGULATIONS OF MERCHANT BANKING:

Notifications of the Ministry of Finance and SEBI

Merchant bankers have to be organized as body corporates. They are governed by the Merchant Bankers Rules (MB Rules) issued by the Ministry of Finance and Merchant Bankers Regulations (MB Regulations) issued by SEBI (22.12.1992)

Rationale of Notifications:

Investors confidence is a prerequisite for an orderly growth and development of the securities market. In the primary market, investors confidence dependence in a large measure on the efficiency of the issue management functions which covers drafting and issue of prospectus or letter of offer after submitting it to SEBI and timely dispatch of share certificates or refund orders. To ensure proper disclosure and to bring about transparency in the primary market with a view to protect investors interest. SEBI has issued MB Regulations

Objectives of the Merchant Bankers Regulations:

M B regulations which seek to regulate the raising of funds in the primary market would assure the issuer a market for raising resources effectively and easily, at a low cost, to ensure a high degree of protection of the interests of investors and provide for the merchant banker a dynamic and competitive market with high standard of professional competence, honesty, integrity and solvency. The regulations would promote a primary market which is fair, efficient flexible and inspires confidence.

The regulations stipulates that any person or body proposing to engage in the business of merchant banking or presently engaged as managers, consultants or advisors to issue would need authorisation by Securities and Exchange Board of India.

DEFINITION OF MERCHANT BANKER:

The notification of the Ministry of finance defines a merchant banker as “any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management”.

PROSPECTUS (FILING & REGISTRATION)

The Registrar of Companies has also been advised that prospectus for public issue can only be filed by merchant bankers who are authorized by SEBI and given a code number. Further the Registrar of Companies is required not to register a prospectus where he has been informed by SEBI that the contents of the prospectus are in contravention of the provisions of any law or statutory rules and regulations.

REGISTRATION OF MERCHANT BANKERS

SEBI abolished on 5-09-1997 all categories of merchant bankers below category I. Merchant bankers operating in the categories below I have

to apply for category I status or take up some other activity. Portfolio management requires separate registration. Underwriting could be done without any additional registration. Merchant bankers can carry on any activity of issue management, which will *inter alia* consist of preparation of prospectus and other information relating to the issue, determining the financial structure, tie up of financiers and final allotment and refund of subscription and act in the capacity of managers, adviser or consultant to an issue, portfolio manager and underwriter.

NETWORK

Minimum net worth is Rs.5 Crores. Registration fee is Rs.2.5 lakhs annually in the first two years and Rs.1 lakh in the third year and Rs.1 lakh to be paid annually.

Number of Lead Managers: Number of lead managers depends on the size of the issue. The guidelines stipulate that for an issue of Rs.50 crores, the no of lead managers should not exceed 2, for issues between Rs.50-100 crores maximum of 3, for issues between 100-200 crores 4 etc.

CODE OF CONDUCT

The code of conduct stipulates that in the performance of duties, merchant bankers should act in an ethical manner, inform the client that he is obliged to comply with the code of conduct, render high standard of service and exercise due diligence, not to indulge in unfair practices, not to make misrepresentations, give best advise, not to divulge confidential information about the clients, endeavor to ensure that true and adequate information is provided to investors and to abide by all rules, regulations, guidelines, resolutions issued by the Government of India and SEBI from time to time.

GENERAL OBLIGATIONS AND RESPONSIBILITIES

Maintenance of books of accounts, records and documents is required. Merchant bankers have to keep and maintain a copy of the balance sheet, a copy of the auditor's report and a statement of financial position. Merchant bankers should inform SEBI where the accounts, records and documents are maintained. .

Merchant bankers have to furnish annually to SEBI copies of balance sheet, profit and loss account and such other documents for preceding 5 accounting years as required.

Merchant bankers are required to submit to SEBI half-yearly working results with a view to monitor the capital adequacy. Books, records and documents should be preserved for 5 years. Auditor's report should be acted upon within 2 months. Merchant bankers should execute an agreement with the issuing company setting out their mutual rights, liabilities and obligations relating to the issue, and in particular to disclosures, allotment and refund.

RESPONSIBILITIES OF LEAD MANAGER

Lead manager should not agree to manage any issue unless his responsibilities relating to the issue mainly disclosures, allotment and refund are clearly defined. A statement specifying such responsibilities should be furnished to SEBI.

Underwriting Obligation: Lead merchant banker should accept a minimum underwriting obligation of 5% of total underwriting commitment or Rs.25 lakhs whichever is less. However, underwriting is now optional.

Submission of due diligence certificate: A due diligence certificate about the verification of contents of prospectus or the letter of a offer in respect of an issue and the reasonableness of the views expressed

therein should be submitted to SEBI at least 2 weeks prior to the opening of an issue by the lead merchant banker.

Documents to be submitted to SEBI by the lead manager: The lead manager should submit to SEBI,

- (a) particulars of the issue, draft prospectus or letter of offer,
- (b) any other literature intended to be circulated to the investors including the shareholders and
- (c) such other documents relating to prospectus or letter of offer as the case may be

These documents should be furnished at least 2 weeks before filing the draft prospectus or letter of offer with ROC or with Regional Stock Exchange. The lead manager has to ensure that modifications suggested by SEBI are incorporated. The lead manager undertaking the responsibility for refunds or allotment of securities in respect of any issue should continue to be associated with the issue till the subscribers have received the share certificate or refund of excess application money.

INSIDER TRADING

Merchant bankers either directly or indirectly are prohibited from entering in to any transaction in securities on the basis of unpublished price sensitive information.

Acquisition of shares: Merchant bankers should submit to SEBI particulars of any transaction for acquisition of securities of a company whose issue is managed by them within 15 days from the date of entering in to such a transaction. Lead managers have been permitted by SEBI in September 1995 to take a stake of upto 5% of the company's post issue equity in the issues. This stake would be from the reserved category shares for the institutional investors and other corporate bodies.

Disclosures: As and when required by SEBI, merchant bankers have to disclose their (a) responsibilities with regard to the management to the issue, (b) any change in information furnished which has a bearing on the certificate granted, (c) the name of the companies whose issues they have managed, (d) breach of capital adequacy and (e) their activities as managers, underwriters, consultants or advisors to an issue.

PROCEDURES FOR INSPECTION

SEBI may inspect books of accounts, records and documents of merchant bankers to ensure that the books of accounts are maintained in the required manner, that the provisions of the Act, rules, regulations are complied with. To investigate complaints against the merchant banker and to investigate *suo moto* in the interest of securities business or investors interest in to the affairs of the merchant bankers. SEBI may either give reasonable notice or undertake inspection without notice in the interest of the investor. The findings of the inspection report are communicated to the merchant banker. SEBI may appoint a qualified auditor to investigate in to the books of accounts or the affairs of the merchant banker.

Penalties for noncompliance of conditions; for registration and contravention of the provisions of the MB regulations include suspension or cancellation of registration. SEBI categorized defaults and the penalty points they attract.

The details regarding defaults of merchant bankers and penalty points are as follows:

Defaults	Penalty Points
1. general default	1
2. Minor default	2
3. Major default	3
4. Serious default	4

General Defaults:

For the purpose of penalty point, the following activities fall under general default and attract one penalty point.

- a) Non-receipt of draft prospectus/letter of offer form the lead manager by SEBI before filing with Registrar of Companies/ Stock Exchange.
- b) Non-receipt of inter se allocation of responsibilities of lead managers in an issue by SEBI prior to the opening of issue.
- c) Non-receipt of due diligence certificate in the prescribed manner by SEBI, before opening of the issue.
- d) Failure to ensure submission of certificate of minimum 90% subscription to the issue as required under Government of India, press note No.F2/14/cci\$90 dated 6th April,1990.
- e) Failure to ensure publicising of dispatch of refund orders, shares /debentures, certificates, filing of listing application by the issuer by the issuer as required under Government of India press notification No.2/6/cci/89 dated.10-1-1990.

Minor Defaults:

The following activities are categorized under minor defaults and attract two penalty points

- a. Advertisement circular brochure , press release and other issue related materials not being in conformity with contents of the prospectus.
- b. Exaggerated information or information extraneous to the prospectus is given by the issuer or associated merchant banker in any press conference, investor conference, brokers conference or other such conference/meet prior to the issue for marketing of the issue arranged/generated by the merchant banker.

- c. Failure to substantiate matters contained in highlights to the issue in the prospectus.
- d. Violation of the Government of India letter number F1/2/SE/86 dated 24th March 1986 and/or Government of India letter number F1/23/SE/86 dated 24th June 1987 regarding advertisement on new capital issue.
- e. Failure to provide adequate and fair disclosure to investors and objective information about risk factors in the prospectus and other issue literature.
- f. Failure to exercise due diligence in verifying contents of prospectus/letter of offer.
- g. Delay in refund/allotment of securities.
- h. Non handling of investor grievances promptly.

Major Defaults:

The following activities are categorized under major defaults and attract three penalty points:

- a. Mandatory underwriting not taken by lead managers.
- b. Excess number of lead managers than permissible under SEBI press release of 28th February 1981.
- c. Association of unauthorized merchant banker in an issue.

Serious Defaults:

The following activities are categorized under serious defaults and attract four penalty points.

- a. Unethical practice by merchant banker and/or violation of code of conduct.
- b. Non cooperation with SEBI in furnishing desired information, documents, evidence as may be called for.

A merchant banker on reaching cumulative penalty points of eight(8) attracts action from SEBI in terms of suspension /cancellation of authorisation.

To enable a merchant banker to take corrective action, maximum penalty points awarded in a single issue managed by a merchant banker are restricted to four.

In the event of joint responsibility, same penalty point is awarded to all lead managers jointly responsible for the activity. In the absence of receipt of inter se allocation of responsibilities, all lead managers to the issue are awarded the penalty points.

Defaults in Prospectus:

If highlights are provided, the following deficiencies will attract negative points:

- a. Absence of risk factors in highlights.
- b. Absence of listing in highlights.
- c. Extraneous contents to prospectus, if stated in highlights.

The maximum grading points of prospectus will be 10 and prospectuses scoring greater than or equal to 8 points are categorized as A+ those with 6 or less than 8 points as A, with 4 or less than 6 points as B and with score of less than 4 points, the prospectus falls in to category C.

General Negative Marks:

If at all "Highlights" are provided in the same:

- a. Risk factors should form part of "Highlights" otherwise it will attract negative point. Of -1.
 - b. Listing details, should form a part of "Highlights" otherwise it will attract negative point of -0.5
 - c. Any matter extraneous to the contents of the prospectus, if stated in highlights, will attract negative point of -0.5.
-

Mutual Funds

Introduction:

Mutual funds are financial intermediaries which collect the savings of investors and invest them in a large and well diversified portfolio of securities such as money market instruments, corporate and Government bonds and equity shares of joint stock companies. A mutual fund is a pool of commingle funds invested by different investors, who have not contract with each other. Mutual funds are conceived as institutions for providing small investors with avenues of investments in the capital market.. Since small investors generally do not have adequate time, knowledge, experience and resources for directly accessing the capital market, they have to rely on an intermediary which undertakes informed investment decisions and provides the consequential benefits of professional expertise. The raison d'être of mutual funds is their ability to bring down transaction costs. The advantages for the investors are reduction in risk, expert professional management ,diversified portfolios, liquidity of investment and tax benefits . By pooling their assets through mutual funds, investors achieve economies of scale. The interests of the investors are protected by the SEBI which acts as a watch dog. Mutual funds are governed by the SEBI (Mutual Funds) Regulations,1993.

MUTUAL FUNDS IN INDIA:

The first mutual fund to be set up was the Unit Trust of India in 1964 under an act of Parliament . During the years 1987-1992,even new mutual funds were established in the public sector. In 1993, the government changed the policy to allow the entry of private corporations and foreign institutional investors in to the mutual fund segment. By the end of march 2000, apart from UTI there were 36 mutual funds, 9 in the public sector and 27 in the private sector.

The UTI dominated the mutual fund sector till 1994-95, accounting for 76.5% of the total mobilization. But there were large repurchases by UTI in 1995-97, which resulted in reverse flow funds. Meanwhile the number of mutual funds especially in the private sector have grown along the number of schemes matching the preferences of the investors. The year 1999-2000 was a watershed year in which mutual funds emerged as an important investment conduit for investors at large. Net resource mobilization by all mutual funds amounted to 21,972 crores. Growth was led mainly by private sector mutual funds, which witnessed an inflow of the order of Rs. 17,171.0 crores.

Fiscal incentives provided in the union funds 1999-2000 exempted all income received by the investors from UTI and other mutual funds from income-tax. All open-ended equity oriented schemes along with the US 64 scheme were exempted from dividend tax for 3 years. Buoyant stock markets were also a contributory factor.

The outstanding net assets of all domestic schemes of mutual funds stood at Rs 1,07,946 crores at the end of March 2000. the share of UTI in the outstanding assets was 67%, public sector funds 10%, and private sector mutual funds 23%.

Types if Mutual Funds::

There are tow major categories of mutual funds They are:

1. Closed-end mutual funds.
2. Open-end mutual funds.

Closed –end mutual funds: These are the mutual funds where investment company cannot sell share units after its initial offering.

Characterizes of closed-end mutual funds:

1. Closed –end mutual fund investment company cannot sell share after its initial offering.
2. It growth in terms of the number of share is limited.

3. The shares are issued like the new issues of any other company, listed and quoted on a stock exchange.
4. The shares of closed –end funds are not redeemable at their NAV as in the case of open-end funds.
5. These share are traded in the secondary market on a stock exchange.
6. The minimum amount of the fund is Rs.20 crores or 60% of targeted amount.

Open-end mutual funds: Open –end mutual funds are commonly referred to as the mutual funds..

Characteristics of open-end mutual funds:

1. . Mutual funds do not have a fixed capitalisation.
2. It sells its shares to the investing public, whenever it can at their Net Asset Value per share (NAV) and stands ready to repurchase the same directly from the investing public at the net asset value per share
3. Minimum amount of the fund is Rs.50 crores or 60% of targeted amount. Examples are UTIs Unit 64, Kothari Pioneer, Prima and Lic Schemes

Apart from the above classification the mutual funds are also classified as under:

1. .Equity funds..
2. Growth funds.
3. Income funds.
4. Real estate funds.
5. Offshore funds,
6. Leveraged funds
7. Hedge funds.

The above all the schemes are listed on the stock exchange for dealings in the secondary market.

Return form mutual funds: Investors on mutual funds can obtain the following returns . They are:

- 1.Dividends.
- 2.Capital gains.
- 3.Increase or decrease in NAV

1.Dividends:The dividend income of a mutual fund company form its investments in share , both equity and preference, are phased on to the unit holders. All income received by investors form mutual funds is exempt form tax.

2.Capital Gains: Mutual fund unit holders or owners also got benefits of capital gains which are realized and described to them in cash or kind.

3.Increase or Decrease in NAV: The increase or decrease in the NAV are the result of unrealized gains or losses on the portfolio holdings of the mutual fund. Although mutual funds do not earn high rates of return, they are able to reduce risk to the systematic level of market fluctuations. Most mutual funds earn in long run, an average rate of return that exceeds the return on bank tern deposits.

Mutual Fund Holders Account:

There are three types of accounts offered by most of the mutual funds. The investors select the type that matches their objectives. The various accounts are:

Regular Account:

An investor is permitted to purchase any number of shares of the mutual fund, at any time he chooses. An investor is paid the dividend either monthly, quarterly, or half as he chooses as per the scheme. This income can be reinvested to acquire additional units by the investors.

Accumulation Account:

An investor is allowed to open an account, with a very small initial investment and continue adding to the fund, periodically. Accumulation account may be voluntary or contractual. In the voluntary accumulation plan, an investor has flexibility to make periodic investment at his choice. But in the contractual plan, the investor has to make investment at regular intervals.

Withdrawal Accounts;

Under this plan, the individual investor can withdraw the amount of funds on a regular basis which suits elderly people to supplement their pension benefits.

RECOMMENDATIONS OF THE STUDY GROUP:

In 1991, a 10-member study group headed by Dr.S.A.Dave, chairman of the Unit Trust of India, was formed by the Government of India, to study the functioning of mutual funds, with a view to permit mutual funds in the private/joint sectors. The major recommendations of the study group are:

1. Minimum amount to be raised in the closed-end scheme should be Rs.20crores and that of the open-end scheme is Rs. 50 crores.
2. The private mutual fund should enjoy tax benefits similar to the UTI.
3. No minimum return should be guaranteed.
4. Distribution of at least 80 percent earnings.
5. A limit of Rs.200 crores should be set for borrowing over two years.

SEBI's DIRECTIVES FOR MUTUAL FUNDS:

The Government brought mutual funds in the security market under the regulatory framework of the Securities and Exchange Board of India (SEBI) in the year 1993.

SEBI issued guidelines in the year 1991 and a comprehensive set of regulation relating to the organisation and management of mutual funds in 1993.

SEBI REGULATION FOR MUTUAL FUNDS (20-1-1993)

The regulations bar mutual funds from options trading, short selling and carrying forward transactions in securities. The mutual funds have been permitted to invest only in transferable securities in the money and capital markets or any privately placed debentures or securities debt. Restrictions have also been placed on them to ensure that investments under an individual scheme, do not exceed 5% and investment in all the schemes put together does not exceed 10% of the corpus. Investments under all the schemes can not exceed 15% of the funds in the shares and debentures of a single company.

SEBI grants registration to only those mutual funds that can prove an efficient and orderly conduct of business. The track record of sponsors, a minimum experience of 5 years in the relevant field of financial services, integrity in business transactions and financial soundness of business is taken in to account. The regulations also prescribe the advertisement code for the marketing schemes of mutual funds, the contents of the trust deed, the investment management agreement and the scheme-wise balance sheet. Mutual funds are required to be formed as trusts and managed by separately formed Asset Management Companies. The minimum networth of such AMC is stipulated at Rs.5 crores of which, the minimum contribution of the sponsor should be 40 per cent. Furthermore, the mutual fund should have a custodian who is not associated with any asset management company and registered with the SEBI.

The minimum amount raised in closed-ended scheme should be Rs. 20 crores and for the open-ended scheme Rs.50 crores. In case the collected amount falls short of the minimum prescribed, the entire

amount should be refunded not later than 6 weeks from the date of closure of the scheme. If this is not done, the fund is required to pay an interest of 15% per annum from the date of expiry of 6 weeks. In addition to these, the mutual funds are obliged to maintain books of accounts and provision for depreciation and bad debts.

Further the mutual funds are now under the obligation to publish scheme-wise annual reports, furnish 6 months unaudited accounts, quarterly statements of the movements of the net asset value and quarterly portfolio statements to SEBI. There is also a stipulation that the mutual funds should ensure adequate disclosures to investors. SEBI is also empowered to appoint an auditor to investigate in to the books of accounts or the affairs of the mutual funds.

SEBI can suspend the registration of the mutual funds in the case of deliberate manipulation, price rigging or deterioration of the financial position of mutual funds.

SEBI (Mutual Funds) Regulations, 1996

SEBI announced the amended mutual fund regulations on December 9, 1996 covering registration of mutual funds, constitution and management of mutual funds and operation of trustees, constitution and management of asset management companies and custodian schemes of MFs, investment objectives and valuation policies, general obligations, inspection and audit. The revision has been carried out with the objective of improving investor protection, imparting a greater degree of flexibility and promoting innovation.

The increase in the number of MFs and types of schemes offered by them necessitated uniform norms for valuation of investments and accounting practices in order to enable the investors to judge their performance on a comparable basis. The mutual fund regulations issued in December 1996 provide a scheme-wise report and justification of performance, disclosure of large investments that

constitute a significant portion of portfolio and the disclosure of the movements in unit capital.

The existing asset management companies are required to increase their networth from Rs. 5 crores to Rs. 10 crores within 1 year from the date of notification of the amended guidelines. The consent of the investors has to be obtained for bringing about any change in the fundamental attributes of the scheme on the basis which the unit holders made initial investments. The regulations empower the investor. The amended guidelines require portfolio disclosure, standardization accounting policies, valuation norms for NAV and pricing. The regulations also sought to address the areas of misuse of funds by introducing prohibitions and restrictions on affiliate transactions and investment exposures to companies belonging to the group of sponsors of mutual mutual funds. The payment of early bird incentive for various schemes has been allowed provided they are viewed as interest payments for early investment with full disclosure.

The various mutual funds are allowed to mention an indicative return for schemes for fixed income securities. In 1998-99 the Mutual Funds Regulations were amended to permit mutual funds to trade to derivatives for the purpose of hedging and portfolio balancing, SEBI registered mutual funds fund managers are permitted to invest in overseas markets, initially within an overall limit of US \$500 million and a ceiling for an individual fund at US \$50 million.

SEBI made (October 8, 1999) investment guidelines for MFs more stringent. The new guidelines restrict MFs to invest no more than 10% of NAV of a scheme in share or share related instruments of a single company. MFs investment in rated debt instruments of a single issuer is restricted to 15% of NAV of the scheme (up to 20% with prior approval of Board of Trustees or AMC). Restrictions in unrated

debt instruments and in shares of unlisted companies . The new norms also specify a maximum limit of 25% of NAV of any scheme for investment in listed group companies as against an umbrella limit of 25% of NAV of any scheme for investment in listed group companies as against an umbrella limit of 25% of NAV for all schemes taken together earlier. SEBI increased (June 7, 2000) the maximum investment limit for MFs in listed companies from 5% to 10% of NAV in respect of open-ended funds. Changes in fundamental attributes of a scheme was also allowed without the consent of three fourths of unit holders provided the unit holders are given the exit options at NAV without any exit load. MFs are also not to make assurance or claim that is likely to mislead investors. They are also banned from making claims in advertisement based on past performance..

PRIVATE MUTUAL FUNDS:

Another key development in the Financial sector was the opening of mutual funds to private sectors in early 1992. Though quite a few industrial groups and financial majors evinced a keen interest in the setting up of mutual funds, it took nearly two years for the first private mutual fund to be launched. The first private sector mutual fund was launched by the Madras based H.C.Kothari group which, in collaboration with the Pioneer group of the US offered two schemes in 1994. This was followed by several mutual funds having foreign tie-ups with renowned asset management companies-20th century has a collaboration with Kemper Financial Services the Tata with Kleinwort Bonson and ICICI with J.P.Morgan.

The competition becomes intense when investors switch over from one fund to another, based on their decisions on the performance of the funds. And that should begin sooner than latter, with as many as 32 mutual funds in the field. The trend world over especially in the

USA, U.K, and Japan is for investors to switch over from secondary markets to mutual funds. For the companies also, the retail route is quite an expensive method of raising funds. The trends in private funding of equity and bought out deals in our country, clearly indicate that individual households, in their own interest (since they lack stock picking skills and manage their own portfolios) should leave the job to professionals such as mutual funds.

Sponsor with Track Record::

A mutual fund in a private sector has to be sponsored by a limited company having a track record. The mutual fund has to be established as a trust under the Indian Trust Act, 1882. The sponsoring company should have at least a 40 percent stake in the paid-up capital of the asset management company. Mutual funds are required to avail off the services of a custodian who has secured the necessary authorisation from the SEBI.

Asset Management Company: (AMC)

A mutual fund is managed by an Asset Management Company that is appointed by the sponsor company or by the trustee. The asset management company has to be registered under the Companies Act, 1956, and has to be approved by the SEBI. The AMC manages the affairs of the mutual funds and its schemes. AMC are registered by the Registrar of Companies only after a draft memorandum and articles of association are cleared by the SEBI.

UNIT TRUST OF INDIA:

Unit Trust of India (UTI) is India's first mutual fund organisation. It is the single largest mutual fund in India, which came into existence with the enactment of UTI Act in 1964.

The economic turmoil and the wars in the early sixties depressed the financial markets making it difficult for both existing and new entrepreneurs to raise fresh capital. Then the Finance

Minister, T. T. Krishnamachari, set up the idea of a Unit Trust in which would mobilize savings of the community and invest these savings in the Capital market. His ideas took the form of the Unit Trust of India, which commenced operations from likely 1964, with a view to encouraging savings and investment and participation in the income, profits and gains accruing to the Corporation from the acquisition, holding, management and disposals of securities. The regulation passed by the Ministry of Finance (MOF) and the Parliament from time to time regulated the functioning of UTI. Different provisions of the UTI Act laid down the structure of management, scope of business, powers and functions of the Trust as well as accounting, disclosures, and regulatory requirements, for the Trust.

UTI was set up as a trust without ownership capital and with an independent Board of Trustees. The Board of Trustees manages the affairs and business of UTI. The Board performs its functions, keeping in view the interest of the Unit-holders under various schemes.

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Board of Trustees. The Board of Trustees manages the affairs and business of UTI. The Board performs its functions, keeping in view the interest of the unit-holders under various schemes.

UTI has a wide distribution network of 54 branch offices, 266 chief representatives and about 67,000 agents. These Chief representatives supervise agents. UTI manages 72 schemes and has an investors base of 20.02 million investors. UTI has set up 183 collection centres to serve to serve investors. It has 57 franchisee offices which accept applications and distribute certificates to unit-holders.

UTI's mission statement is to meet the investors diverse income and liquidity needs by creation of appropriate schemes, to offer best

possible returns on his investment, and render him prompt and efficient service, baying normal customer expectations.

UTI was the first mutual fund to launch India Fund, an offshore mutual fund in 1986. The India Fund was launched as a close-ended fund but became a multi-class, open-ended fund in 1994. Thereafter, UTI floated the India Growth Fund in 1988, the Columbus India Fund in 1994, and the India Access Fund in 1996. The India Growth Fund is listed on the New York Stock Exchange. The India Access Fund is an Indian Index Fund, tracking the NSE 50 index.

UTI's Associates:

UTI has set up associate companies in the field of banking, securities trading, investor servicing, investment advice and training, towards creating a diversified financial conglomerate and meeting investors varying needs under a common umbrella.

UTI BANK Limited: UTI Bank was the first private sector bank to be set up in 1994. The Bank has a network of 121 fully computerized branches spread across the country. The Bank offers a wide range of retail, corporate and forex services.

UTI Securities Exchange Limited: UTI Securities Exchange Limited was the first institutionally sponsored corporate stock broking firm incorporated on June 28, 1994, with a paid-up capital of Rs.300 million. It is wholly owned by UTI and promoted to provide secondary market trading facilities, investment banking, and other related services. It has acquired membership of NSE, BSE, OTCEI and Ahmedabad Stock Exchange (ASE)

UTI Investors Services Limited: UTI Investor Services Limited was the first Institutionally sponsored Registrar and Transfer agency set up in 1993. It helps UTI in rendering prompt and efficient services to the investors.

UTI Institute of Capital Markets: UTI Institute of Capital Market was set up in 1989 as a non-profit educational society to promote professional development of capital market participants. It provides specialized professional development programmes for the varied constituents of the capital market and is engaged in research and consultancy services. It also serve as a forum to discuss ideas and issues relevant to the capital market.

UTI Investment Advisory Services Limited: UTI Investment Advisory Services Limited the first Indian Investment advisor registered with SEC,US, was set up in 1988 to provide investment research and back office support to other offshore funds of UTI.

UTI International Limited: UTI International Limited is a 100 percent subsidiary of UTI, registered in the island of Guernsey, Channel Islands. It was set up with the objective of helping in the UTI offshore funds in marketing their products and managing funds. UTI International Limited has an office in London, which is responsible for developing new products, new business opportunities, maintaining relations with foreign investors, and improving communication between UTI and its clients and distributors abroad.

UTI has a branch office at Dubai, which caters to the needs of NRI investors based in Six Gulf countries, namely, UAE, Oman, Kuwait, Saudi Arabia, Qatar, and Bahrain. This branch office acts as a liaison office between NRI investors in the Gulf and UTI offices in India.

UTI has extended its support to the development of unit trusts in Sri Lanka and Egypt. It has participated in the equity capital of the Unit Trust Management Company of Sri Lanka.

Promotion of Institutions:

The Unit Trust of India has helped in promoting/co-promoting many institutions for the healthy development of financial sector. These institutions are:

- Infrastructure Leasing and Financial Services (ILFS)
- Credit Rating and Information Services Limited (CRISIL)
- Stock Holding Corporation of India Limited (SHCIL)
- Technology Development Corporation of India Limited (TDCIL)
- Over the Counter Exchange of India Limited (OCEIL)
- National Securities Depository Limited (NSDL)
- North-Eastern Development Finance Corporation Limited (NEDFCL)

EVALUATION OF PERFORMANCE OF MUTUAL FUNDS ¹

The performance of a portfolio is measured by combining the risk and return levels into a single value. The differential return earned by a portfolio may be due to the difference in the exposure risk from that of, say market index. There are three major methods of assessing a risk adjusted performance. Firstly, the return per unit of risk; secondly, differential return; thirdly, the components of investment performance.

- **Return per Unit of Risk**

The first measure determines the performance of a fund in terms return per unit of risk. The absolute level of return achieved is related to the level of risk exposure to develop a relative risk adjusted measure for ranking the fund performance. Funds that provide the highest return per unit of risk would be judged as having performed well while those providing the lowest return per unit of risk would be judged as poor performers. (see. Fig.4.1)

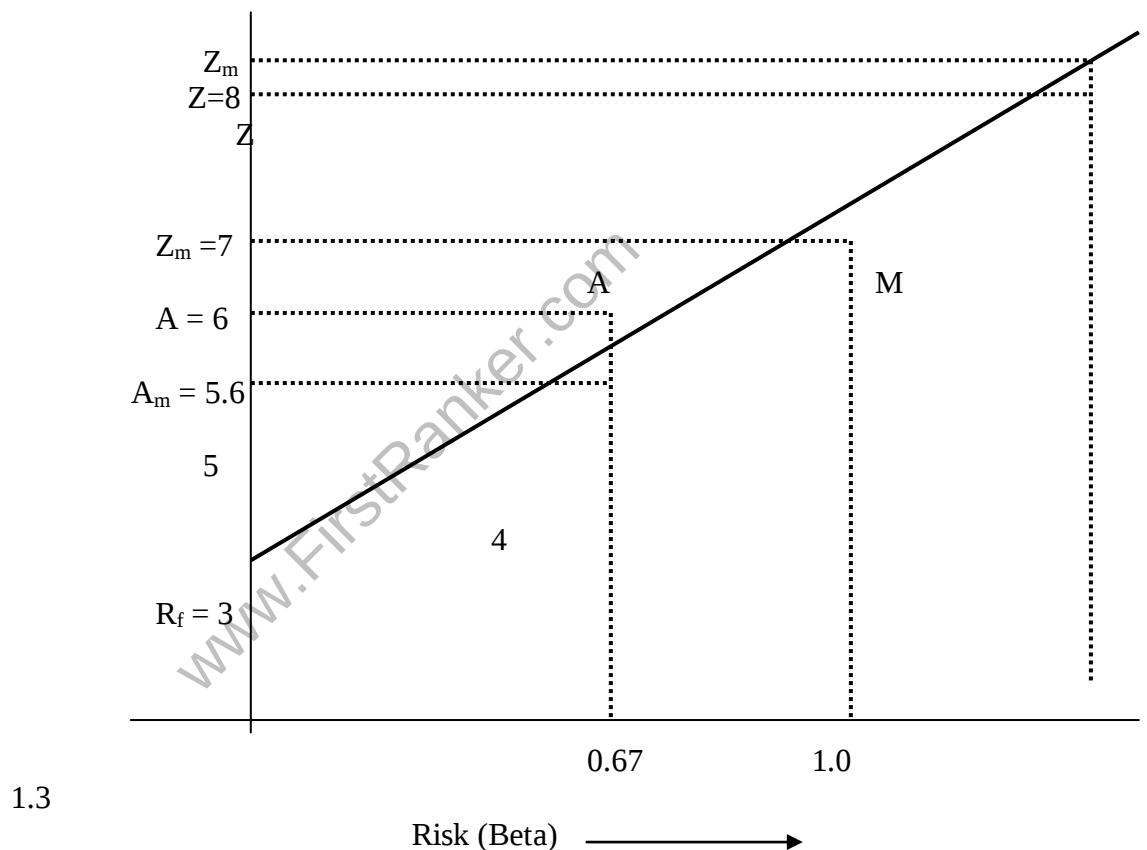
The return per unit of risk is measured by Sharpe's investment performance index and Treynor's portfolio performance index.

Sharpe's Index: Sharpe's investment performance index is a risk adjusted rate of return measure that is calculated by dividing the assets risk premiums $E(r)-R$ by their standard deviations of returns. The index is used to rank the investment performance of different assets ².

Sharpe's index considers both the average rate of return and risk. It assigns the highest score to the assets that have best risk adjusted rate of return. Sharpe's reward to variability of return is simply, the ratio defined as the realized portfolio return (r_f) to the variability of returns measured by the standard deviation of return (σ_p).

1. for detailed discussion, please see, Fuller & Farrell, Modern Investment Analysis & Management Mc Graw Hill, 1987
2. Sharpe William. F "Mutual Fund Performance", Journal of Business, Jan-Supp. Page: 199, 138

Figure : 4.1 Differential return for funds A , M & Z



$$\text{Sharpe's Ratio } r_p = r_f / \sigma_p$$

Where (r_p) is the realized portfolio return or the assets average rate of return

(r_f) is the risk free rate and σ_p is the assets SD of return.

In terms of the capital market theory, the portfolio measure uses the total risk to compare portfolios with the Capital Market Line (CML). A higher Sharpe's ratio value than the market portfolio would lie above the CML and would indicate superior risk adjusted performance.

Treynor's Index: An index of portfolio performance that is based on systematic risk, as measured by the portfolio beta coefficients, rather than on total risk as done by Sharpe's Index was put forwarded by Jack Treynor¹. It is used to rank the investment performance of different assets. It is a risk adjusted rate of return measure that is calculated by dividing the assets' risk premium $E(r)-R$, by their beta coefficients.

The index of systematic risk is a Characteristic of the Regression Line (CRL) and the beta coefficient. As with the individual assets, the beta coefficient form a portfolio's characteristic line is an index of the portfolio's systematic or undiversified risk. The systematic risk remains after the unsystematic variability of return of the individual assets average turns out to be zero. In view of this, Treynor suggested measuring a portfolio's return. Relative to its systematic risk rather than to its total risk, as is done in the Sharpe's measure:

$$\text{Treynor's ratio} = r_p - r_f / \beta_p$$

A larger TR value indicates a higher slope and a better portfolio for all the investors. Comparing a portfolio's TR value to a similar measure for the market portfolio, indicates whether the portfolio would plot above the Security Market Line (SML) (see Fig.4.1). Deviations from the characteristic line measures the relative volatility of the portfolio's return, in relation to the returns for the aggregate

market or the portfolios' beta coefficient, β_m equals 1.0, the market's beta, which indicates the slope of the SML.

The TR value for the aggregate market is calculated as follows.

$$T_m = R_m - R_f / \beta_m$$

Where R_m = return from the market portfolio : β_m = Systematic risk of the market

1. Treynor, J "How to rate management of investment funds" Harvard Business Review, Jan-Feb-1965, page:633-675

In this expression, β equals and the market's 'beta indicates the slope of the SML, Therefore, a portfolio with a higher TR value than the market portfolio would be above the SML. This would indicate superior risk adjusted performance. Comparison of Sharpe's and Treynor's Measures are similar in a way since they both divide the risk premium by a numerical risk measure. However, the Sharpe's portfolio performance measure uses the standard deviation of returns as the measure of risk whereas, Treynor's performance measure employs beta coefficient as a denominator. Sharp's measure ranks the assets dominance in the CML's risk return space while the Treynor's measure ranks the dominance in the CAPM's risk return space. Both measures assume that money can be freely borrowed and lent at R_f . This assumption is required to generate linear investment opportunities that emerge from R_f and allow funds in different risk classes to be compared and ranked. The standard deviation as a measure of the total risk is appropriate when evaluating the risk return relationship for well-diversified portfolios. On the other hand the beta coefficient is the relevant measure of risk when evaluating less than fully diversified portfolios or individual stocks. In spite of the risk measures they employ, the Sharpe's and Treynor's portfolio performance measures yield very similar ranking of portfolios in most cases.

Table 4.2 illustrates the calculation of return per unit of risk, under the two methods using two hypothetical funds A and Z along with the market fund M, as a benchmark for comparison. The market fund provided 0.26 return per unit of standard deviation and exceeded the Sharpe's ratio of 0.25 return provided for Z, but was below the Sharpe's ratio of 0.3 for fund A. According to the reward to volatility ratio, the market fund provided a return per unit of beta of 4, which again exceeded the Treynor's ratio of 3.7 for fund Z but was below the Treynor's ratio of 4.4 derived for fund A (Figure.4.1)

The ranking of funds was identical under either measures and A was the best Z, the worst while the market fund M, an intermediate performer.

Table 4.2 Calculation of Return per unit of Risk Ratios

Fund	Return	R_f	$R_p - R_f$	S.D	S.R.	b	TR
A	6		3	3	10	0.30	
	0.67	4.4					
M	7		3	4	15	0.26	
	1.00	4.0					
Z	8		3	5	20	0.25	
	1.33	3.7					

Differential Return (Alpha)

A second category of risk adjusted performance measure¹ is the Jensen's measure. This measure was developed by Michael Jensen and is sometimes referred to as the differential return. This measures involves the calculation of return that should be expected for the fund, given the realized risk of the fund and compare that with the returns realized over the period. It is assumed that the investor has a passive or naïve alternative of merely buying the market portfolio and adjusting for the appropriate level of risk, by borrowing or

lending at a risk-free rate. Given the assumption, the most commonly used method of determining the return for a level of risk is by way of the alpha formulation.

$$N(\bar{r}_p) = r_f + \beta_p(\sigma_m - \sigma_f)$$

$$a_p = \bar{r}_p - \bar{r}_p - N(\bar{r}_p)$$

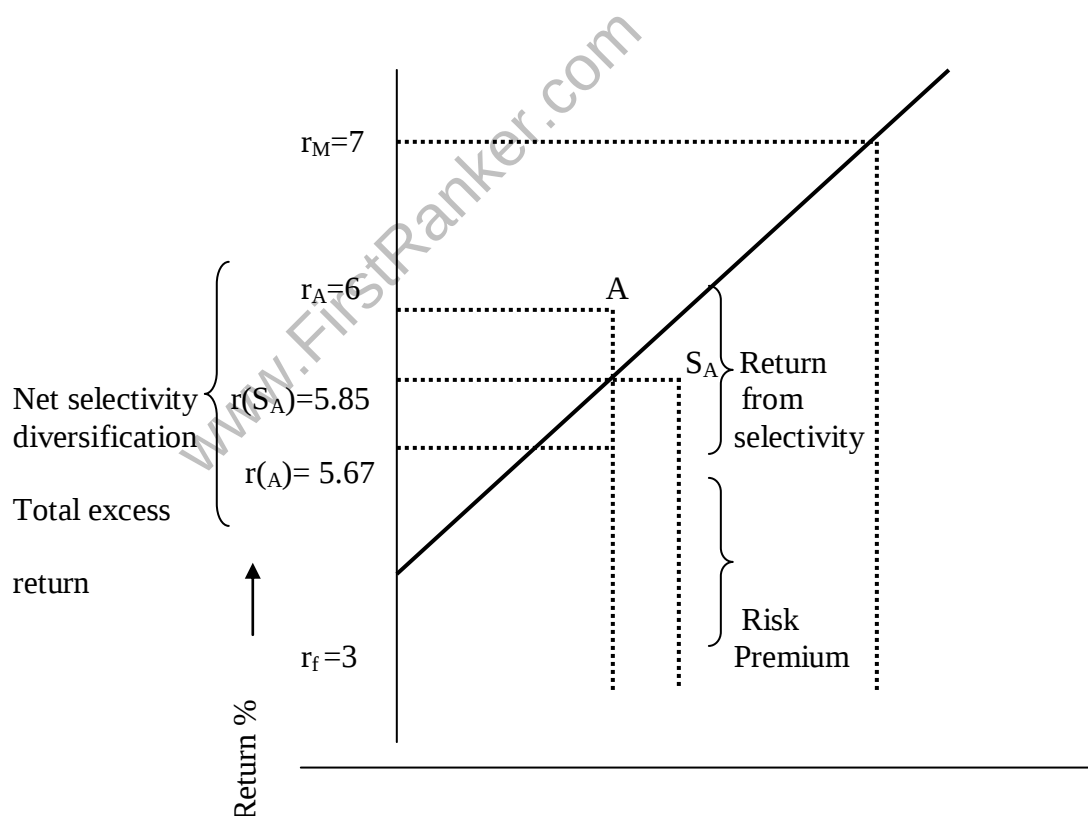
To evaluate the performance of the fund A, we insert the appropriate variables in the formula

$$N(\bar{r}_p) = 3 + 0.67(7 - 3) = 5.68\%$$

$$a = 6 - 5.68 = 0.32\%$$

1. Jensen, Michael C, "The performance of the mutual funds in the period 1945 – 64" Journal of finance, May 1968, pp 389 - 416

Decomposite of performance



0.67 1.0
 Risk (Beta) $\longrightarrow$

Fund A would have been expected to have earned 5.68% over the period. The fund actually earned 6.00% and thus provided a differential return of risk adjusted to 0.32% (Fig.4.2). Jensen also provided a way of determining whether the differential return could have occurred by chance or whether it was significantly different from zero in statistical sense. It is possible to establish this, since Jensen's measure is ordinarily derived by running a regression of the monthly or quarterly returns of the fund, being evaluated against the return of a market index, over the relevant performance period. The regression equation is:

$$r_p - r_f = \alpha_p + \beta_p (r_m - r_f) + e$$

The form of the regression equation is similar to that of the previous equation, except that an intercept term alpha and an error term (e) have been added. The error term enables in assessing how well the regression equation fits the data, a low error indicating a well-defined relationship and a high error indicating a poorly defined relationship. The intercept measure the performance of the fund with either a negative value that indicates a below average performance or a positive value for above average performance.

COMPONENTS OF INVESTMENT PERFORMANCE:

The risk adjusted performance measures of Sharpe, Treynor and Jensen help in the overall assessment.. All the three measures yield similar performance rankings of a fund.

Framework of performance Analysis:

Eugene Fama has provided an analytical framework that elaborates the three risk-adjusted return methods, to allow a more detailed analysis of the performance of a fund. Fig.4.2 is a risk return diagram

form the Fama study, illustrating the framework of performance analysis. The vertical axis refers to the returns, while the horizontal axis shows the risk measured in terms of beta.

The diagonal line plotted on the diagram is the equation of the SML. For the purpose of illustration the data on the realized return ($r_A = 6\%$ and market risk $r_M = 6\%$ of the fund A also shown in Fig.4.1 previously) are plotted on the diagram. It is shown that, at the market level of the fund, it would have been expected to have a return of $r = 5.58\%$. This expected return is composed of a risk-free component of 5% shown as the distance from the base line to r_f and a risk premium of 2.68 (4x.67) shown as the distance . The fund actually earned a return of 0.32% more than the normal return and is shown as the distance. This incremental return is known as the Return to Selectivity.

Stock Selection: The overall performance of the fund in terms of superior or inferior stock selection and the normal return, associated with a given level of risk can be assessed with this framework: ¹

Total excess return = Selectivity + risk.

$$\begin{aligned} r_A - r_f &= r_A - r(\beta_A) + r(\beta_A) - r_f \\ 6 - 3 &= 6 - 5.68 + 5.68 - 3 \\ 3 &= 0.32 + 2.68 \end{aligned}$$

In striving to achieve an above average return, managers generally have to forsake a few diversifications that have a cost in terms of additional portfolio risk. This framework can be used to determine the added return that would be expected, to compensate for the additional diversification risk. This is achieved first, by using the CML equation to determine the return commensurate with the incurred risk, as measured by the standard deviation of return. We can determine the normal return for the fund A, using the total risk as follows:

$$r(S_A) = r_f + (r_M - r_f) \frac{\sigma_A}{\sigma_M}$$

$$= 3 + (7 - 3) 10 / 15$$

$$= 5.86 \%$$

The difference between this return and that expected when only the market risks. R or 5.68% is considered as the added return for diversification or in this case $5.86 - 5.68 = 0.18\%$. In terms of Fig 4.2 it is the distance

The net selectivity of the fund then becomes the overall selectivity excluding whatever penalty or added return is needed to compensate for the diversification risk. The diagram shows that the net selectivity of the fund is the distance. In terms of formulation, the net selectivity can be shown as follows:

Market Timing:

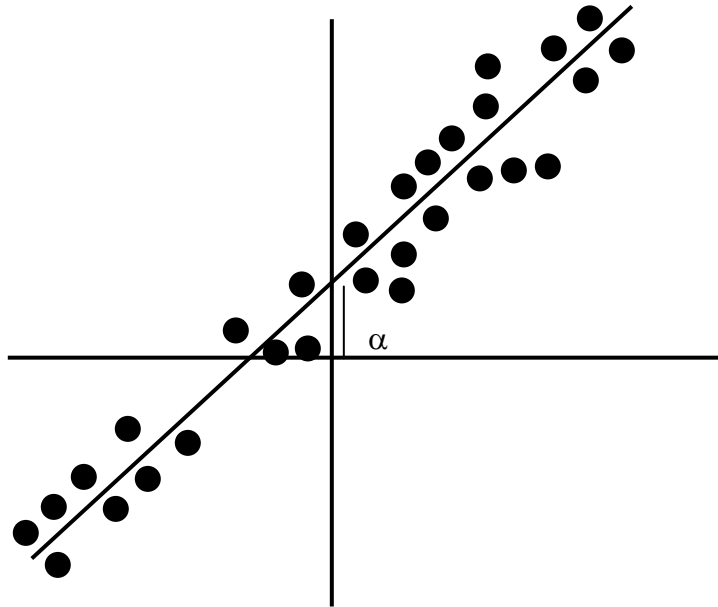
Fund managers can also generate superior performance by timing the market correctly, that is by assessing correctly the direction of the market, either bull or bear and positioning the portfolio accordingly. If a market decline is expected, the cash percentage of the portfolio may be increased or decrease the beta of the equity portion of the portfolio.. If the market is expected to rise, the cash position may be reduced or increase the beta of the equity portion of the portfolio. The portfolio management may be assessed by comparing fund return to the market index over the relevant period. If the fund does not engage in market timings but concentrated only on stock selection, the average beta of the portfolio would be constant and a plotting of the fund return against market return would show a linear relationship as illustrated in Fig.4.3. The linear relationship will still hold, even if the direction of the market is not accurately forecast, if the beta or cash position have changed. If the market direction is accurately assessed and the portfolio beta change, we would observe the sort of relationship; shown in Fig.4.4. To properly describe this relationship, we can fit a curve to the plots by adding a quadratic term to the simple linear relationship

$$r_p = a + b r_m + c r_m^2$$

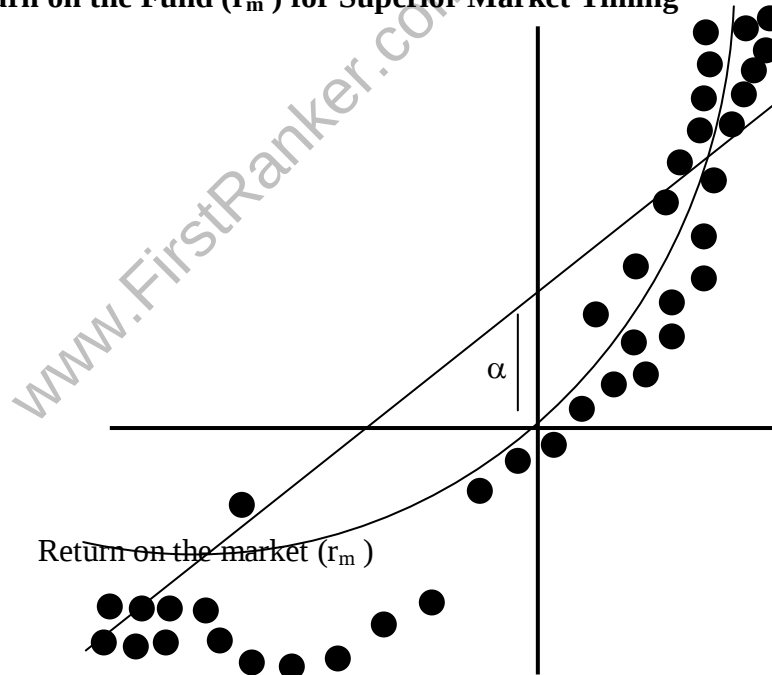
Where r_p = returns of the security

r_m^2 = square of the market returns

Return on the Fund (r_p) for Superior Stock Selection



Return on the Fund (r_m) for Superior Market Timing



The curve fitted to the plots in Figs.4.3 and 4.4, indicate that the value of the parameter of the quadratic term is positive, which implies that the curve becomes steeper as one moves to the right of the diagram, and establishes that fund movement were amplified on the upper side and dampened on the downside, relative to the market. The obsessive focus on investment performance rating obscures the fact, that mutual funds have to establish a brand name, excel at marketing and invest in man power and information technology. This provides individual investors convenience, better services, wider choice and lower costs. Like any other business, long-term success of mutual funds depend on their ability to cut down costs, improve services and undelivered their products in a convenient form. Mutual funds have to improve distribution. Which is being improved by the spread of information technology and the growing sophistication of investors.

MONEY MARKET MUTUAL FUNDS (MMMF)

After the remarkable success of the mutual funds set up by the banks and financial institutions in India, the Reserve Bank of India (RBI) permitted the establishment of the Money Market Mutual Funds (MMMF) in the year 1992. The basic idea is the development of mutual funds surplus funds in the money market. The guidelines have been revised on November 1995, MMMF ensures high liquidity, adequate surety and high returns. What distinguishes the money market mutual funds from the existing mutual funds is the difference in their investment portfolios. A money market mutual fund invariably and exclusively invests its resources in high quality money market instruments, whereas, a mutual fund largely invests in capital

market securities and 'parks' its surplus funds in money market instruments for short periods.

RBI GUIDELINES (23.11.1995)

MMMF's can be launched by banks, public financial institutions and private sector MF's. Units of MMMF can be issued to individuals only. NRIs can subscribe and repatriate the dividend (not the principal). No minimum return can be assured by the MMMF..Minimum lock-in period is 15 days (May 1998). MMMF can be set up[with the approval of the RBI only while private sector ones with the approval of the SEBI. Shares and units issued by the MMMF are subject to stamp duty. Funds received by the MMMF can be invested only in Treasury Bills, Government of India Securities dated with an unexpired maturity up to one year, call loans to banks, CDs and CPs. MMMF should have a minimum investment of 25 percent in the Treasury Bills and dated government securities minimum investment in call loans 30% commercial bills 20% and CPs 15% (maximum exposure to a single company cannot be more than 3 percent). For CDs, no limit is fixed. With a view to making the scheme of MMMF more flexible, the RBI announced on 22-10-1997 that they can invest in rated corporate bonds and debentures, with residual maturity of up to one year. Bonds and debentures are now included along with CP to ensure that the exposure of MMMF does not exceed 3 percent of the resources of the MMMF. Cheque writing facility can be offered (since 1999-2000 MMMFs have come under the purview of SEBI regulations and are allowed to be set up as a separate entity in the form of a 'Trust' Banks and FRs were required to seek clearance form RBI for setting up a mutual fund.

Private MMMF (RBI,23-11-1995)

Subscriptions are open only to individuals (later liberalized and is open to corporates and others) Instruments remain the same as in the

case of public sector institutions. Limits on investments, except CP, are withdrawn, Private MMMFs have to get a clearance from the RBI as well as SEBI.

ITI PIONEER MMMF:

ITI Pioneer is the only asset management company to have launched an MMMF in the country. ITI pioneers MMMF has not received a good response and the mutual fund wants some changes in the regulations, to help boost the appetite for MMMFs. It is suggested that the minimum lock-in-period for an MMMF should be brought down from the present 36 days to 10 days. The funds should also be allowed cheques writing facility, which will help them in the transfer of funds. The lock-in-period has since been reduced to 15 days and cheques writing facility is permitted.

UTI's Money Market Mutual Fund (23-4-1997)

The Unit Trust of India (UTI) launched its Maiden Money Market Mutual fund (MMMF) on 23-4-1997. The trust has decided to take the help of the UTI Bank, in order to effect, repurchase facility, on the same day lending liquidity to the fund. The minimum subscription amount has been pegged at Rs.10,000. The tie-up with the UTI Bank enables the trust to issue cheques up to a sum of Rs.1 crore, on the same day and between Rs.1 crore and Rs. 5 crores, the next-day.

UTI's money market fund, the second of its kind in the country after ITI Kothari Pioneer is likely to attract investment from corporates with retail investors entering at a later date.

The returns will be given at the times of exit and therefore, it will function as a growth fund and not as an income fund. The fund comes without a sale and redemption load with a nominal fee of Rs. 20 charged for redemption transactions.

According to the RBI guidelines, MMMF can invest in money market instruments, but it has to have a lock-in period of 30 days. This is done to prevent competition to bank deposits.

Collective Investment Schemes (CIS)

SEBI's regulations for CIS were notified on October 14, 1999. Under the SEBI Act and Regulations no person can carry on any CIS unless he obtains a certificate of registration from SEBI. All existing collective investment schemes were required to apply for registration by December 14, 1999. An existing scheme which does not obtain registration from SEBI shall have to wind up and repay the money to the investors. Failure to do so would attract penal action, which may include ban on collection of money from investors and launching any scheme, ban on disposal of property etc.,

The salient features of collective investment scheme are:

- CIS includes any schemes or arrangement with respect to property of any description, which enables investors to participate in the scheme by way of subscriptions and to receive profits or income or producer arising from the management of such property.
- Schemes structured for investment in shares/bonds and other marketable securities would not be treated as CIS.
- CIS can be floated only by companies registered under the Companies Act, 1956; the company floating CIS has to seek registration with SEBI as Collective Investment Management Company (CIMC).
- CIS shall be constituted as a two-tier structure comprising a Trust and a CIMC. At the time of registration as CIMC, the company should have a minimum net worth of Rs.3 crore, which has to be raised to Rs.5. crore.

- The CIS is prohibited from guaranteeing assured returns; indicative returns, if any should be based on the projections in the appraisal report.
- The duration of the scheme shall be for a minimum period of three years.
- The assets of the scheme would be covered by compulsory insurance.
- Units issued under CIS should be listed on recognised stock exchanges.
- Entities operating CIS, who on the date of notification of SEBI Regulations would be treated as existing CIS who should seek registration from SEBI within two months from the date of notification of the Regulation, Up to March 31, 2000. SEBI received applications from 35 existing entities for registration.

Conclusion:

In India, mutual funds have a lot of potential to grow. Mutual fund companies have to create and market innovative products and frame distinct marketing strategies. Product innovation will be one of the key determinants to success. The mutual fund industry has to bring many innovative concepts such as high yield bond funds, principal protected funds, long short funds, arbitrage funds, dynamic funds, precious metal funds, and so on. The penetration of mutual funds can be increased through investor education, providing investor oriented value added services, and innovative distribution channels. Mutual funds have failed during the bearish market conditions. To sell successfully during the bear market, there is a need to educate investors about risk-adjusted return and total portfolio return to enable them to take informed decision. Mutual funds need to develop a wide distribution network to increase its reach and tap investments from all corners and segments. Increased use of internet and development of alternative

channels such as financial advisors can play a vital role in increasing the penetration of mutual funds. Mutual funds have come a long way, but a lot more can be done.

UNIT – V

5.1 INTRODUCTION

Capital Market

Capital Market is wide term used to comprise all operations in the new issues and stock market. New issues made by the companies constitute the primary market, while trading the existing securities relates to the secondary market. While we can only buy in the primary market, we can buy and sell securities in the secondary market.

KERB Deals

Brokers dealing outside the trading ring, and after or before the trading hours is considered illegal, as per the Rules of the Stock Exchange. Such deals, are called Kerb deals and such trade is called Kerb trade which is illegal.

Grey Market

Brokers dealing in unlisted securities and new issues before listing and trading in such securities are illegal. Such market which is illegal is called the Grey Market. Grey Market thrives in many new securities before listing and the quotation is given as Premium over the issue price. Deals in Grey Market as much as in kerb trade are illegal.

Sub brokers

Each broker is allowed to have some sub-brokers or remissers to go to the trading ring to put deals on behalf of the Broker. Such sub-brokers who are registered with the Stock Exchange and with SEBI can pass the confirmation notes to the clients on behalf of the broker whom they represent. Some sub brokers deal only in the new issue market, marketing new issues on behalf of the main broker.

Structure of the Market

There are various sub-markets in the capital market in India. The structure has undergone vast changes in recent years. New instruments and new institutions have emerged on the scene.

The sub-markets are as follows:

1. Market for corporate securities – for new issues and old securities
2. Market for Government securities.
3. Market for Debt instruments – debentures and bonds of private sector, bonds of public sector undertakings, public financial institutions etc.
4. Mutual fund schemes and UTI schemes.

All these markets and sub-markets have both Primary Markets and Secondary Markets. The first one is for raising funds directly from the public and secondary market is for trading and imparting liquidity existing securities.

Players in the Market

The players in the New Issues market are many and the more important of them are the following:

1. **Merchant bankers** – their functions and working are dealt with in a separate chapter. They are the issue managers, lead managers, co-managers and are responsible to the company and SEBI.
2. **Registrars** – their functions are next to merchant bankers in importance. They collect the applications for new issues, their cheques, stock invests etc., classify and computerize them. They also make allotment in consultation with the regional stock exchange regarding norms in the event of oversubscription and before a public representative. They have to dispatch the letters of allotments, refund orders and share certificates within the time letters of allotments, refund orders and share certificates within the time schedules stipulated under the Companies Act and observe the guidelines of SEBI and the Govt. and RBI. Besides they have also to satisfy the listing requirements and get them listed on one or more of the stock exchange.

3. **Collecting and coordinating bankers** – collecting and coordinating bankers may be the same or different. While the former collects the subscriptions in cash, cheques, stock invests etc., the latter collates the information on subscriptions and coordinates the collection work and monitors the same to the registrars and merchant bankers, who in turn keep the company informed.
4. **Underwriters and brokers** – underwriters may be financial institutions, banks, mutual funds, brokers etc., and undertake to mobilize the subscriptions upto some limits. Failing to secure subscriptions as agreed to, they have to make good the shortfalls by their own subscriptions.
5. **Printers, advertising agencies, and mailing agencies** are the other organizations involved in the new issue market operations.

Stock Market Intermediaries

The players in the market are the issuers of securities, namely, companies, intermediaries like brokers, sub-brokers etc., and the investors who bring in their savings and funds into the market.

The stock brokers are of various categories, namely :

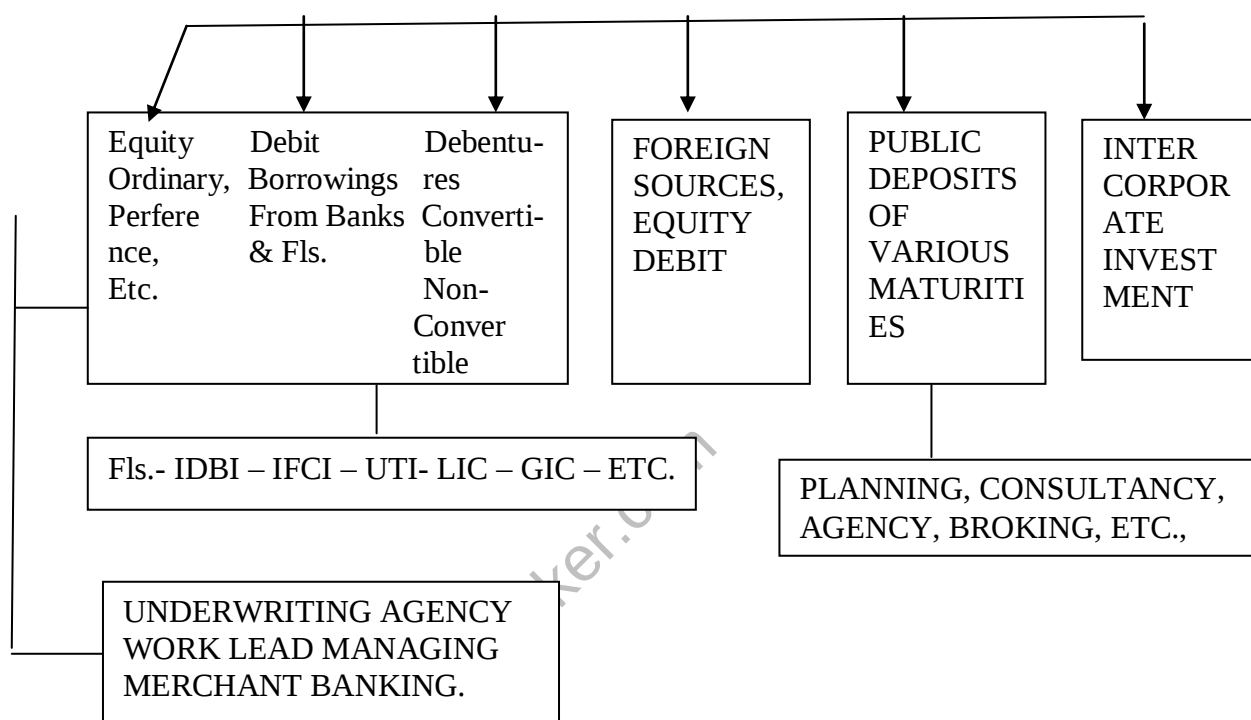
1. **Client brokers** – doing simple brokering between buyers and sellers and earning only brokerage for their services from the clients.
2. **Floor brokers** – authorized clerks and sub-brokers who enter the trading floor and execute orders for the clients or for members.
3. **Jobbers** – those members who are ready to buy and sell simultaneously in selected scrips, offering bid and offer rates for the brokers and sub-brokers on the trading floor earning profit through the margin between buying and selling rates.
4. **Arbitraguers** – those who do inter market deals for a profit through differences in prices as between markets say buy in Calcutta and sell in Bombay and vice versa.

5. **Badla financiers** – those members who finance carry forward deals in specified group (A Group) for a return in the form of interest, called badla rate. They lend money or shares for the brokers who are overbought or oversold respectively at the time of settlement.

Chart I – Pattern of corporate financing- structure

A. INTERNAL FINANCE – RETAINED INCOME

B. EXTERNAL SOURCES – METHODS



5.2 OBJECTIVE

This unit covers entire capital market activities which is comprises of both the primary market and secondary market. The students of MBA-Finance should know the share market in whole as the new issues of instruments in the primary market and related procedures and guide lines of SBEI etc., In the same manner they should know about the secondary market and the stock exchanges. This unit also deals the functions of stock exchanges, Trading in stock exchanges, Foreign Investment and its regulations and the Indian fiscal system. Here after

the students to get the knowledge to buy the shares from the primary market and trade in the secondary market, which may helpful in their life also.

5.3 PRIMARY MARKET

INTRODUCTION

The main function of primary market is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish new enterprise or to expand\diversify existing ones.

New issues can be classified in various ways. The first category of new issues are by new companies and old companies. The classification was first suggested by R.F. Henderson. The distinction between *new* also called *initial*, and *old* also known as *further*, does not bear any relation the age of the company. The securities issued by companies for the first time either after the incorporation or conversion from private to public companies are designated as initial issues, while those issue by companies which already have stock exchange quotation, either by issue or by *right* to existing shareholders, are referred to as further or old.

However, two types of issues are excluded from the category of new issues. First, *bonus/capitalization* issues which represent only book-keeping entries, and second, *exchange* issues by which shares in one company are exchanged for securities of another.

The general function of the primary market, namely, the channeling of investible funds into industrial enterprises, can be split from the operational stand-point, into three services. (i) Origination, (ii) Underwriting, and (iii) Distribution. The institutional setup dealing with these can be said to constitute the primary market organization. In other words, the primary market facilitates the transfer of resources by providing specialist institutional facilities to perform the *triple-service function*.

ISSUE MECHANISM

The success of an issue depends, partly, on the issue mechanism. The methods by which new issues are made are: (i) Public issue through prospectus, (ii) Tender/Book building, (iii) Offer for sale (iv) Placement and (v) Rights issue.

Public Issue through Prospectus

A common method followed by corporate enterprises to raise capital through the issue of securities is by means of a prospectus inviting subscription from the investing public. Under this method, the issuing companies themselves offer directly to the generally public a fixed number of shares at a stated price, which in the case of new companies is invariably the face value of the securities, and in the case of existing companies, it may sometimes include a premium amount, if any. Another feature of public issue method is that generally the issues are underwritten to ensure success arising out of unsatisfactory public response.

The foundation of the public issue method is a prospectus, the minimum contents of which are prescribed by the Companies Act, 1956. It also provides both civil and criminal liability for any misstatement in the prospectus. Additional disclosure requirements are also mandated by the SEBI. The contents of the prospectus, *inter alia*, include: (i) Name and registered office of the issuing company ; (ii) Existing and proposed activities ; (iii) Board of directors ; (iv) Location of the industry; (v) Authorized, subscribed and proposed issue of capital to public; (vi) Dates of opening and closing of subscription list; (vii) Name of broker, underwriters, and others, from whom application forms along with copies of prospectus can be

obtained : (viii) Minimum subscription ; (ix) Names of underwriters, if any, along with a statement that in the opinion of the directors, the resources of the underwriters are sufficient to meet the underwriting obligations ; and (x) A Statement that the company will make an application to stock exchange(s) for the permission to deal in or for a quotation of its shares and so on.

Tender / Book Building Method

The essence of the tender/book building method is that the pricing of the issues is left to the investors. The issuing company incorporate all the details of the issue proposal in the offer document on the lines of the public issue method including the reserve / minimum price. The investors are required to quote the number of securities and the price at which they wish to acquire. In India, however, this method is slowly finding wide acceptance.

Offer for Sale

Another method by which securities can be issued is by means of an offer for sale. Under this method, instead of the issuing company itself offering its shares directly to the public, it offers through the intermediary of issue houses / merchant banks / investment banks or firms of stockbrokers. The *modus operandi* of the offer of sale is akin to the public issue method in that the prospectus with strictly prescribed minimum contents which constitutes the foundation for the sale of securities, and a known quantity of shares are distributed to the applicants in a non-discriminatory manner.

The sale of securities with an offer for sale method is done in two stages.

In the first stage, the issuing company sells the securities *enbloc* to the issuing houses or stock brokers at an agreed fixed price and the securities, thus acquired by the sponsoring institutions, are resold, in the second stage, by the issuing houses to the ultimate investors. The

securities are offered to the public at a price higher than the price at which they were acquired from the company. The difference between the sale and the purchase price, technically called as *turn*, represents the remuneration of the issuing houses.

Placement Method

Yet another method to float new issues of capital is the placing method defined by London Stock Exchange as “*sale by an issue house or broker to their own clients of securities which have been previously purchased or subscribed*”. Under this method, securities are acquired by the issue houses, as in offer for sale method, but instead of being subsequently offered to the public, they are placed with the clients of the issue houses, both individual and institutional investors. Each issue house has a list of large private and institutional investors who are always prepared to subscribe to any securities which are issued in this manner

Rights Issue

The methods discussed above can be used both by new companies as well as by established companies. In the case of companies whose shares are already listed and widely-held, shares can be offered to the existing shareholders. This is called *rights issue*. Under this method, the existing shareholders are offered the right to subscribe to new shares in proportion to the number of shares they already hold. This offer is made by circular to ‘existing shareholders’ only.

5.4 INSTRUMENTS

The marketability and liquidity of funds depend on the tradability of the instruments of investment. In India, although there is a wide variety of instruments, the marketability is limited to a few assets only. Thus the assets tradable in the money and capital markets in which individuals do invest may be set out as follows:

- a) UTI units, Master shares etc.

- b) Units/shares of mutual funds, if they are quoted on the stock markets.
- c) Debentures of companies and bonds of public sector units, in which there is a limited market.
- d) Equity shares of companies listed on the stock exchange.
- e) Government securities, capital investment bonds, rural investment bonds, shares of P.S. Us etc.

There are a host of other investments made by individuals and households, Which are not easily marketable. These are not quoted on the stock markets as in the case of those issued by private limited companies. In the case of Government securities, PSU bonds and debentures of companies, the public interest is less but quoted on the stock markets, and they are traded by banks, financial institutions, etc. The assets not quoted and are not marketable are not securities, namely,

a) Bank deposits; (b) Company deposits; (c) P.O. deposits, NSC, etc; (d) PF and pension funds ; (e) Insurance policies of LIC, GIC, etc.

Classes of instruments

Instruments traded can be classified on the following criteria :

1. By ownership or debt nature of instruments.
2. By term period to maturity – short-term, medium-term and long-term.
3. By the issuer's creditworthiness, say, Government securities or private securities or PO certificates, etc.

Ownership category instruments are equity, preference shares, deferred shares, non-cumulative preferred shares, etc. Debt category assets are debentures, bonds, deposits with banks and companies, etc.

The term period of a security or the maturity period also varies from security to security and with the time of purchase. Barring the equity shares, other securities have some maturity period and redemption. Thus the debentures may be up to 7 years and preference shares up to

12 years. Fixed deposits may vary from 1 to 5 years. Almost all the debt instruments have a maturity period.

The creditworthiness of the issuer of securities will determine the risk involved in the payment of interest and repayment of principal. If the issuer is the Government the risk is the least as the Government does not default. There is no uncertainty in respect of these instruments.

5.5 DEBENTURES

Definition and Nature

The issue of debentures by public limited companies is regulated by Companies Act 1956 and guidelines issued by SEBI on 11.6.1992. Debenture is a document which either creates a debt or acknowledges it and any document which fulfils either of these conditions is a debenture. Debentures are issued through a prospectus. A debenture is issued by a company and is usually in the form of a certificate which is an acknowledgement of indebtedness. They are issued under the company's seal. Debentures are one of series issued to a number of lenders. The date of repayment is invariably specified in a debenture. A company can however issue perpetual or irredeemable debentures. Generally debentures are issued against a charge on the assets of the company. Debentures may, however, be issued without any such charge. Debenture holders have no right to vote in the meetings of the company. Section 117 of the Companies Act prohibits issues of debentures with voting rights. Debentures can be issued at discount. Particulars of discount are to be filed with Registrar of Companies.

Features of Debentures

Debentures may be distinguished according to negotiability, security, duration, convertibility and ranking for discharge.

Negotiability

1. Better Debentures : They are registered and are payable to is bearer.

They are negotiable instruments and are transferable by delivery.

2. **Registered Debentures** : They are payable to the registered holder whose name appears both on debenture and in the register of debenture holders maintained by the company. Registered debentures can be transferred but have to be registered again. Registered debenture contains a commitment to pay the principal sum, interest, description of the charge and statement that it is issued subject to the conditions endorsed therein.

Security

Secured Debentures

Debentures which create a charge on the assets of the company which may be fixed or floating are known as secured debentures.

Unsecured or Naked Debentures

Debentures which are issued without any charge on assets are unsecured or naked debentures. The holders are like unsecured creditors and may sue the company for recovery of debt.

Duration

Redeemable Debentures

Normally debentures are issued on the condition that they shall be redeemed after a certain period. They can, however, be reissued after redemption under Section 121 of Companies Act, 1956.

Perpetual Debentures

When debentures are irredeemable they are called perpetual.

Convertibility

Non-convertible Debentures

They are duly paid as and when they mature.

Convertible Debentures

If an option is given to convert debentures into equity shares at stated rate of exchange after a specified period, they are called convertible

debentures. In our country they convertible debentures are very popular. On conversion, the holders cease to be lenders and become owners.

Ranking for Discharge

Debentures are usually issued in a series with a *pari passu* (at the same rate) clause which entitles them to be discharged ratably though issued at different times. New series of debentures cannot rank *pari passu* with old series unless the old series provides so.

Kinds of Debentures

If there is no *pari passu* clause, they are payable according to the date of issue.

New debt instrument issued by public limited companies are participating debentures, convertible debentures with options, third partly convertible debentures, convertible debentures redeemable at premium, debt enquiry swaps, zero coupon convertible notes, secured premium notes (SPN) with detachable warrants, non-convertible debentures (NCDs) with detachable separately trade able warrants and fully convertible debentures (FCDs) with interest (optional). Recent issues by DFI's are covered separately below.

Participating Debentures

They are unsecured corporate debt securities which participate in the profits of a company. They might find investors if issued by existing dividend paying companies.

Convertible Debentures with Options

They are a derivative of convertible debentures with an embedded option, providing flexibility to the issuer as well as investor to exit from the term of the issue. The coupon rate is specified at the time of issue.

Third Party Convertible Debentures

They are debt with a warrant allowing the investor to subscribe to the equity of a third firm at a preferential price vis-à-vis the market price.

Interest rate on third party convertible debentures is lower than pure debt on account of the conversion option.

Convertible Debentures Redeemable at a Premium

Convertible debentures are issued at face value with a put option entitling investors to later sell the bond to the issuer at a premium. They are basically similar to convertible debentures but embody less risk.

Debt-equity Swaps

Debt-equity swaps are on offer from an issuer of debt to swap it for equity. The instrument is quite risky for the investor because the anticipated capital appreciation may not materialize.

Zero Coupon Convertible Note

A zero coupon convertible note can be converted into shares. If choice is exercised investors forego all accrued and unpaid interest. The zero coupon convertible notes are quite sensitive to changes in interest rates.

Secured Premium Notes (SPN) with Detachable Warrants

SPN, which is issued along with a detachable warrant, is redeemable after a notified period, say, 4 to 7 years. The warrants attached to it ensure the holder the right to apply and get equity shares allotted provided SPN is fully paid.

There is a lock-in period for SPN during which no interest will be paid for the investment amount. The SPN holder has an option to sell back the SPN to the company at par value after the lock-in period. If the holder exercises this option, no interest \ premium will be paid on redemption. In case, the SPN holder it further, the holder will be repaid the principal amount along with additional amount of interest\premium on redemption in installments, as decided by the

company. The conversion of detachable warrant into equity shares will have to be done within the time limit notified by the company.

Non-convertible Debentures (NCDs) with Detachable Equity Warrants

The holder of NCDs with detachable equity warrants is given an option to buy a specific number of shares from the company at a pre-determined price within a defined time frame.

The warrants attached to NCDs are issued subject to full payment of NCDs value. There is a specific lock-in period after which the detachable warrant holders have to exercise their option to apply for equities. If the option is not exercised, the unapplied portion of shares would be disposed off by the company at its liberty.

Zero Interest Fully Convertible Debentures (FCDs)

The investors in zero interest fully convertible debentures will not be paid any interest. However, there is a notified period after which fully paid FCDs will be automatically and compulsorily converted into shares.

There is a lock-in period up to which no interest will be paid. Conversion is allowed only for fully paid FCDs. In the event of company going for rights issue prior to the allotment of equity resulting from the conversion of equity shares into FCDs, FCD holders shall be offered securities as may be determined by the company.

Secured Zero Interest Partly Convertible Debentures (PCDs) with Detachable and Separately Trade able Warrants

This instrument has two parts. Part A is convertible into equity shares at a fixed amount on the date of allotment and part B non convertible, to be redeemed at par at the end of a specific period from the date of allotment. Part B will carry a detachable and separately trade able warrant which will provide an option to the warrant holder to receive

equity share for every warrant held at a price as worked out by the company.

Fully Convertible Debentures (FCDs)with Interest (Optional)

This instrument will not yield any interest for a short period say 6 months, after this period, option is given to the holders of FCDs to apply for equities at 'premium' for which no additional amount needs to be paid. This option needs to be indicated in the application form itself. However, interest on FCDs is payable at a determined rate from the rate of first conversion to second/final conversion and in lieu equity shares will be issued.

Floating Rate Bonds

The yield on the floating rate bonds is linked to a benchmark interest rate like the prime rate in USA or LIBOR in Eurocurrency market. The State Bank of India's floating rate bond issue was linked to maximum interest on term deposits which was 10 percent at that time. Floating rate is quoted in terms of a margin above or below the benchmark rate. The floor rate in SBI case was 12 percent. Interest rates linked to the benchmark ensure that neither the borrower nor the lender suffer from the changes in interest rates. When rates are fixed, they are likely to be inequitable to the borrower in case interest rates fall subsequently; and the same bonds are likely to be inequitable to the lender when interest rates rise subsequently.

Warrants

A warrant is a security issued by a company granting the holder of the warrant the right to purchase a specified number of shares at a specified price any time prior to an expirable date. Warrants may be issued with debentures or equity shares. The specific rights are set out in the warrant. The main features of a warrant are a number of shares entitled, expiration date of warrants generally in USA is 5 to 10 years from original issue date. The exercise price is 10 to 30 percent above

the prevailing market price. Warrants have a secondary market. The minimum value of a warrant represents the exchange value between current price of the share and the shares to be purchased at the exercise price. The firm receives additional funds at a price lower than the current market, yet above prevailing at issue time. New or growing firms and venture capitalists issue warrants. They are also issue in mergers and acquisitions. Warrants are called sweeteners and have been issued since 1993 by a few Indian companies. Debentures issued with warrants, like convertible debentures carry lower coupon rates.

5.6 Credit Rating of Debt Instruments.

Credit Rating Information Services of India Limited (CRISIL)

CRISIL was set up by ICICI and UTI in 1988.

CRISIL rates debentures, fixed deposits, commercial paper, preference shares and structured obligations. The rating methodology followed by CRISIL involves and analysis of the following factors :

(i) Business Analysis

- (a) Industry risk, including analysis of the structure of the industry, the Demand -supply position, a study of the key success factors, the nature and basis of competition, the impact of government policies, cyclicity and seasonality of the industry.
- (b) Market position of the company within the industry including market shares, product and customer diversity, competitive advantages, selling and distribution arrangements.
- (c) Operating efficiency of the company like locational advantages, labour relationships, technology, manufacturing efficiency as compared to competitors.
- (d) Legal position including the terms of the prospectus, trustees and their responsibilities and systems for timely payments.

(ii) Financial Analysis,

- (a) Accounting quality like any overstatement or understatement of profits, auditors' qualifications in their

reports, methods of valuation of inventory, depreciation policy

- (b) Earnings protection in terms of future earning growth for the company and future profitability.
 - (c) Adequacy of cash flows to meet debt servicing requirements in addition to fixed and working capital needs. An opinion would be formed on the sustainability of cash flows in the future and the working capital management of the company.
 - (d) Financial flexibility including the company's ability to source funds from other sources like group companies, ability to defer capital expenditure and alternative financing plans in times of stress.
- (iii) Management Evaluation

The quality and ability of the management would be judged on the basis of the past track record, their goals, philosophies and strategies their ability to overcome difficult situations, etc. In addition to ability to repay, an assessment would be made of the management's willingness to pay debt. This would involve an opinion of integrity of the management.

- (iv) Regulatory and competitive environment and regulatory framework of the financial system would be examined keeping in view their likely impact on the company. Trends in regulation / deregulation are also examined keeping in view their likely impact on the company.

(v) Fundamental Analysis

- a) Capital adequacy, i.e. the true net worth as compared to the volume of business and risk profile assets.
- b) Asset quality including the company's credit risk management, systems for monitoring credit, exposure to individual borrowers and management of problem credits.
- c) Liquidity management. Capital structure, term matching of assets and liabilities and policy on liquid assets in relation to financial commitments would be some of the areas examined.

- d) Profitability and financial position in terms of past historical profits, the spread of funds deployed and accretion to reserves.
- e) Exposure to interest rate changes and tax law changes.

The rating process begins at the request of the company. A professionally Qualified team of analysts visits the company's plants and meets with different levels of the management including the CEO. On completion of the assignment, the team interacts with a back-up team that has separately collected additional industry information and prepares a report. This report is placed before an internal committee and there is an open discussion to arrive at the rating. The rating is presented to an external committee which then takes the final decision which is communicated to the company. Should the company volunteer any further information at that point which could affect the rating is passed on to the external committee. Therefore, the company has the option to request for a review of rating. CRISIL publishes the CRISIL ratings in SCAN which is a quarterly publication in Hindi and Gujarathi besides English.

CRISIL can rate mutual funds, banks and chit funds. Rating of mutual funds has assumed importance after the poor performance of mutual fund industry in 1995 to 1996. CRISIL ventured into mutual fund rating market in 1997. It may also start rating real estate developers and governments. CRISIL is equipped to do equity grading.

CRISIL Rating Symbols

Debenture

AAA	Highest Safety
AA	High safety
A	Adequate safety
BBB	Moderate safety
BB	Inadequate safety
B	High risk
C	Substantial risk
D	Default

(Debenture rated “D” are in default and in arrears of interest or principal payment or are expected to default on maturity. Such debentures are extremely speculative and returns from these debentures may be realized only on reorganization or liquidation), Crisil may apply plus or minus signs for ratings from AA to D to reflect comparative standing within the category.

For rating preference shares, the letters pf are prefixed to the debentures rating symbols, e.g. pfAAA (Triple A)

Fixed Deposit Program

FAAA	Highest Safety
FAA	High Safety
FA	Adequate safety
FB	Inadequate safety
FC	High risk
FD	Default or likely to be in default

Short – term Instruments

P-1	Very Strong degree of safety
P-2	Strong degree of safety
P-3	Adequate degree of safety
P-4	Inadequate degree of safety

Structured Obligations

AAA (SO)	Highest Safety
AA (SO)	Higher Safety
A (SO)	Adequate safety
BBB (SO)	Moderate safety
BB (SO)	Inadequate safety
B(SO)	High risk
C(SO)	Substantial risk
D(SO)	Default

Investment Information and Credit Rating Agency (ICRA)

ICRA which was promoted IFCI in 1991 carries out rating of debt instruments of manufacturing companies, finance companies and financial institutions.

The factors that ICRA takes into consideration for rating depend on the nature of borrowing entity. The inherent protective factors, marketing strategies, competitive edge, level of technological development, operational efficiency, competence and effectiveness of management,

human resource development policies and practices, hedging of risks, trends in cash flows and potential liquidity, financial flexibility, asset quality and past record of servicing of debt as well as government policies affecting the industry and unit are examined.

ICRA commences work at the request of the prospective issuer. A team of analysts collect data by going through the company's books, interviewing executives and from the in-house research and data base of ICRA. ICRA offers the company an opportunity to get the instrument rated confidentially and also an option regarding the use of the rating. If the company decided to use the rating, ICRA monitors it until redemption/repayment. In the case of misstatement by the company ICRA can disclose the correct position.

ICRA Rating Symbols

Long-term including debentures, bonds and preferences shares

LAAA	Highest Safety
LAA	High Safety
LA	Adequate Safety
LBBB	Moderate Safety
LBB	Inadequate safety
LB	Risk prone
LC	Substantial risk
LD	Default
Medium – term including fixed deposits	
MAAA	Highest Safety
MAA	High Safety
MA	Adequate safety
MB	Inadequate safety
MC	Risk prone
MD	Default
A-1	Highest Safety
A-2	High Safety
A-3	Adequate safety
A-4	Risk prone
A-5	Default

Credit Analysis and Research Limited (CARE)

Credit Analysis and Research Limited is the third rating agency promoted by IDBI jointly with investment institution, banks and finance companies in 1993. They include Canara Bank, Unit Trust of India, Credit Capital Venture Fund (India) Limited, (since taken over by Infrastructure Leasing and Financial Services Ltd.). Sundaram Finance Limited, The Federal Bank Limited the Vysya Bank Limited, First Leasing Company of India Limited, ITC Classic Finace, Kolak Mahindra Finance among others. CARE commenced its rating operations in October, 1993.

Credit rating by CARE covers all types of debt instruments such as debentures, fixed deposits, commercial paper and structured obligations. It also undertakes credit analysis of companies for the use of bankers, other lenders and business enterprises.

CARE's Rating Symbols

For long-term and medium-term instruments.

stable of adequate in	CARE AAA	Best quality investments.
	CARE AAA	Debt service payments protected by
	(FD)/(CD)/(SO)	Cash flows with good margin
	CARE AA	High quality but rated lower because
	CARE AA	Somewhat lower margin of protection
	(FD)/(CD)/(SO)	
	CARE A	Upper medium grade. Safety
	CARE AA	(FD)/(CD)/(SO)
	CARE BBB	Sufficient safety. But adverse changes
	CARE BBB	assumptions likely to weaken the debt
	(FD)/(CD)/(SO)	Servicing capabilities
	CARE BB	Speculative instruments. Inadequate
	CARE BB	protection for interest and principal
	(FD)/(CD)/(SO)	payments.
	CARE C	Highest investment risk.
	CARE C	
	(FD)/(CD)/(SO)	

CARE D **Lowest category. Likely to be in default soon.**

**CARE D
FD)/(CD)/(SO)**

In order of increasing risk, the ratings for short-term instruments are PR-1, PR-2, PR-3 and PR-5 and CARE -1, CARE -2, CARE -3, CARE -4, and CARE -5 for credit analysis of companies.

Duff and Phelps Credit Rating Agency of India Ltd., (DCR)

DCR (India) set up in 1996 is one of the credit rating agencies for rating the non-banking financial companies (for fixed deposits). The minimum investment grade credit rating to be assigned by this company which will be acceptable to the RBI has been fixed at Ind-BBB.

Since the criteria used by DCR (India) for rating fixed deposits of NBFCs are not available, the factors specific to financial companies may be noted.

5.7 EQUITY SHARES

Nature

Equity shares represent proportionate ownership of a company. This right is expressed in the form of participating in the profits of a going company and sharing the assets of a company after winding-up. Equity shares have lowest priority claim on earnings and assets of all securities issued. But they have limited potential for dividend payments and price appreciation. In contrast, owners of debentures and preferred shares enjoy an assured return in the form of interest and dividend. In view of this risk, investors are unwilling to invest in equity shares unless they offer a rate of return sufficiently high to induce investors to assume the possible loss.

When investors buy equity shares either through subscription to a public issue or through stock exchange from an existing owner, they obtain a share certificate as proof of their part as owners of the firm. A

share Certificate states the number of shares registered in the name of the share owner the their paid-up value apart from certificate number and folio number. In the case of shares purchased through stock exchange the new owners name is entered on the rear of the certificate.

Voting Rights

Traditionally, voting right was like universal suffer age (one adult person one vote), ownership of one share conferred one vote. Voting rights of a person in a company were equal to shares owned. The concept of shares with differential rights as to dividends, voting or otherwise was introduced by the Companies (Amendment) Act 2000. Section 86 of the Act was amended to make a provision to issue differential shares by Indian companies. These shares are expected to benefit the investors as well as corporates.

Shares with differential rights :

‘Shares with differential rights’ means a shares issued with differential rights in accordance with section 86 [section 2 (46 A)] of the Companies Act, 1956.

As per section 86, equity shares with differential rights as to dividend, voting or otherwise can be issued. As per Companies (Issue of Share Capital with differential Rules, 2001, such shares can be issued subject to following conditions.

Share Capital

It may be noted that the would capital in share capital is used to mean nominal, authorized or issued or paid-up capital.

Nominal or Authorized Capital is the amount of capital with which the company is to be registered and it must be stated in the memorandum. The authorized or nominal capital sets the limit of capital available for issue and the issued capital can never exceed limit.

Issued and Subscribed Capital: Issued capital is the nominal value of shares offered for public subscription. In case all shares offered for

public subscription are not taken up, the portion subscribed, is subscribed capital which is less than issued capital.

Par value is the face value of share. It does not tell anything about the value of shares.

Conversion of Shares into stock

Stock is the aggregate of fully paid shares, legally consolidated. Portions of stock may be transferred or split up into fractions of any amount without regard to the original nominal amount of the shares. It cannot be issued directly but comes into being only after the shares are issued and paid up in full.

Denomination

A public limited company is free to make right or public issue of equity shares in any denomination determined by it. It has however to comply with SEBI regulations that

- Shares should not be of decimal of rupee,
- at any point of time there shall be only one denomination,
- Memorandum and Articles of Association should be conformed
- Comply with disclosure and accounting norms specified by SEBI

Cash Dividends

A stable cash dividend payment was believed to be the basis for the increase in company's share prices. Growth oriented firm retains as much capital as possible for internal financing. Capital appreciation rather than dividends is what an investor has to look for in their case. Old established firms tend to pay out large proportion of their earnings as dividend.

Bonus Shares (or stock dividends) : Bonus shares are dividends paid in shares instead of cash. Bonus shares are issued by capitalizing reserves. While net worth remains the same in the balance sheet its distribution between shares and surplus is altered. The New York

Stock Exchange, however, classifies distribution of shares under 25 percent per share (1 bonus for 4 shares held) as stock dividend and distribution over 25 percent as stock splits.

Transfer of Shares

A transfer of shares is complete as soon as the name of the transferee is substituted in place of transferor in the register of members. The procedure for transfer of share of debenture has been laid down in Sections 108, 110 and 111 of the Companies Act.

There are two kinds of transfer : (a) a transfer under a proper instrument of transfer duly stamped and executed by the transferor and transferee; and (b) transmission by operation of law. Shares may change hands either *inter vivos* or by operation law. The first is called transfer and the second transmission. Transfer means a transaction by operation of law. Transmission occurs on death of bankruptcy of owner.

Another form of transfer of shares is blank transfer. It must be made in prescribed form and delivered to the company for registration within the prescribed time.

PREFERENCE SHARES

Nature

Preference shares carry preferential rights in comparison with ordinary shares. As a rule, preference shareholders enjoy a preferential right to dividend. As regards capital, it carries on the winding up of a company a preferential right to be repaid the amount of capital paid-up on such shares.

Cumulative and Non-cumulative

Preference shares are of two types, cumulative and non-cumulative. In the case of cumulative preference share, if there is no profit in any year, the arrears of dividend are carried forward and paid in the following years out of profit before any dividend is paid on ordinary

shares. No such carry forward provision exists for non-cumulative preference shares.

Participating

If the articles association provide that a preference share holder will also have the right to participate in surplus profits or surplus assets on the liquidation of a company or in both, such preference share holders would be called participating preference shareholders.

Redeemable Preference Shares

Redeemable preference shares are paid back to the shareholder out of the profits or out of the proceeds of new issue of shares. The maximum period of a redemption is 20 years with effect from 1.3.1997 under the Companies Amendment Act, 1996. The shares have to state clearly that they are redeemable. It should be noted that redeemable preference shares are not shares in the strict sense of the term. Since they are repayable, they are similar to debentures. Only fully paid shares are redeemed. Where redemption is made out of profits, a Capital Redemption Reserve Account is opened to which a sum equal to the nominal amount of the shares redeemed is transferred. It is treated as paid-up share capital of the company.

Two innovative types of preference shares were introduced into the market in 1992-93. There are fully convertible cumulative preference shares (Equipref) and preference shares with warrants attached.

Fully Convertible Cumulative Preference Share (Equipref)

Equipref has two parts: A and B, is convertible into equity shares automatically and compulsorily on the date of allotment without any further act or application by the allottee and part B will be redeemed at par \ converted into equity shares after a lock in period at the option of the investors.

Conversion into equity shares after the lock in period will take place at a price which would be 30 percent lower than the average market price.

The average market price shall be the average of the monthly high and low price of the shares in a stock exchange for a period of six months to the date of conversion including the month in which the conversion would take place.

The dividend on fully convertible cumulative preference shares shall be fixed and shall be given only for the portion that represents part B shares. Upon conversion of each part of the equipref shares, the face value of it will stand reduced proportionately and the equipref shares shall be deemed to have been redeemed to extent of each part on their respective dates of conversion.

Preference Shares with Warrants Attached

Under this instrument, each preference share would carry certain number of warrants entitling the holder to apply for equity shares for cash at 'premium' at any time in one or more stages between the third and fifth year from the date of allotment. If the warrant holder fails to exercise his option, the unsubscribed portion will lapse. The holders of warrants would be entitled to all rights of bonus shares that may be issued by the company. From the date of allotment, the preference shares with warrants attached would not be sold for a period of three years.

5.8 Public Issues of Securities

Objective and Scope of SEBI Guidelines

The capital issues (Control) Act, 1947 which controlled the issue of capital was repealed on May 29, 1992. As a consequence, the issue of capital and pricing of issues by companies has become free of prior approval. However, with a view to ensure proper disclosure and investor protection, the Securities and Exchange Board of India (SEBI) has issued certain guidelines for the observance by the companies making issue of capital.

The guidelines broadly cover the requirements as to first issue by new companies and existing private/closely held companies and also further issues of capital by other companies by way of shares, debentures and bonds. The guidelines will apply to all issues of capital.

GENERAL

Period of Subscription

Public Issues

- (a) Subscription list for public issues shall be kept open for at least 3 working days and not more than 10 working days.
- (b) The public issue made by an infrastructure company, satisfying the requirements in Clause 2.4.1 (iii) of Chapter II may be kept open for a maximum period of 21 working days.
- (c) The period of operation of sub subscription list of public issue shall be disclosed in the prospectus.

Rights Issues

Right Issues shall be kept open for at least 30 days and not more 60 days.

Terms of the issue

Minimum number of share applications and applications money public issue:

- (i) In case of public issue at par, the minimum number of shares for which an application is to be made, shall be fixed at 200 shares of face value of Rs. 10/- each
- (ii) Where the public issue is at a premium or comprises security, whether convertible or non-convertible, or the public issue is of more than one security, the minimum applications moneys payable in respect of each security by each applicant, shall not be less than Rs.2000/- irrespective of the size of premium subject to applications being for a multiple of trade able lots;
- (iii) the successful applicants shall be issued by the issuer company share certificates\ instruments for eligible number of shares in trade able lot.
Provided that the maximum trade able lot in any case shall not exceed 100 shares.

Offer price per share

Upto Rs. 100

Rs. 101 – Rs. 400

More than Rs. 400

Minimum Trade able lot

100 Shares

50 Shares

10 Shares

- (v) The minimum application money to be paid by an applicant along with the application money shall not be less than 25 % of the issue price.
- (vi) The minimum number of instruments for which an application has to be made shall be not less than the tradeable lot.
- (vii) In case of an offer for sale, the entire amount payable on each instrument shall be brought in at the time of application.

Retention of Over-subscription

The quantum of issue whether through a rights or a public issue, shall not exceed the amount specified in the prospectus \ letter of offer.

Compliance Officer to be Appointed by Lead Merchant Banker

The merchant bankers shall appoint a senior officer as Compliance Officer to ensure that all Rules, Regulations, Guidelines, Notifications etc. issued by SEBI the Government of India, and other regulatory organizations are complied with.

The Compliance Officer shall co ordinate with regulatory authorities in various matters and provide necessary guidance as also ensure compliance internally.

The compliance Officer shall also ensure that observations made \ deficiencies pointed out by SEBI do not recur.

SEBI Guidelines for Public Issues**I. Eligibility norms for Issue of Securities****Issue of Securities through offer document**

- Public issue of securities can be made only after filing a draft prospectus with SEBI through a merchant banker 21 days prior to filing it with Registrar of Companies. Changes, if any specified by SEBI should be incorporated before filing prospectus with ROC.
- Rights issues by listed company for Rs. 50 lakhs including premium cannot be made unless the letter of offer is filed with SEBI through a merchant banker at least 21 days prior to the filing of offer with regional stock exchange.

Listing

Application for listing is obligatory before making public issue.

Dematerialization

Before public or rights issue or an offer of sale of securities, the company should arrange for dematerialization of securities already issued or proposed to be issued. Investors should be given the option to receive the share certificates or hold them in dematerialized form.

Public Issue of Securities by Unlisted Company

1. It has to have a pre issue work net worth of Rs. 1 crore in three out of preceding five years, with a minimum net worth to be met in preceding two years ; and
2. it has a track record of distributable profits for the least three out of immediately preceding five years.

Issue size should not exceed 5 times, its pre issue net worth and 60 % of issue is allotted to qualified institutional buyers (QIBs). An unlisted company which does not meet minimum net worth and track record should use book building method for public issue of securities.

Offer for Sale**Public Issue by Listed Companies**

Issue size should not exceed 5 times its pre issue net worth. Book building process has to be adopted if issue size exceed 5 times its net worth. In the book building process 60 % of issue should be allotted to QIBs. The provision does not apply to banks, infrastructure companies and rights issue by listed companies.

Credit Rating for Debt Instrument

1. Public issue to debt instruments irrespective of maturity period cannot be made unless credit rating is obtained and stated in offer document.
2. Where credit rating is obtained from more than one agency all the credit ratings, including unaccepted ones have to be disclosed.
3. For public and rights issues of debt instruments of more than Rs.100 crores two ratings from two agencies have to be obtained.

4. Earlier ratings obtained in preceding 3 years for any listed security shall be disclosed in the offer document.

Outstanding Warrants

In the case of an unlisted company, if there are outstanding warrants or financial instruments it cannot make a public issue of equity shares or convertible debt.

Partly Paid-up Shares

Partly paid up shares should be fully paid before public or rights issues.

II. Pricing by Companies Issuing Securities

Companies eligible to make public issue can freely price their equity shares or security convertible at a later date into an equity share.

Listed Companies

A listed company can freely price its equity shares and convertible debenture offered through public issue.

Unlisted Companies

An unlisted company desirous of listing may freely price its equity shares and convertible debentures.

Infrastructure Company

Eligible infrastructure company can freely price its equity shares subject to compliance with disclosure norms.

IPO by Bank

Banks may freely price their equity shares and convertible debentures subject to approval by RBI.

Differential Pricing

An unlisted company or listed company may issue securities at a higher price in the firm allotment category.

Price Band

A price band of 20 % in the offer document filed with SEBI and the actual price mentioned in the offer document with ROC are permitted.

III. Promoter's Contribution and Lock-in Requirements

In Unlisted Companies

In a public issue by an unlisted company the promoter has to contribute 20 % of the post issue capital.

In Case of Offer for Sale

The promoter's contribution should not be less than 20 %

In case on Listed Companies

Either 20 % of proposed issue or 20 % of the post issue capital.

In Composite Issues of Listed Company

At the option of promoter either 20 % of the proposed issue or 20 % of post issue capital is promoter's contribution.

Rights issue component of the composite issue is excluded while calculating the post issue capital.

In Case of Convertible Security

At his option, the promoter may subscribe to equity convertible security so that the total contribution shall not be less than 20 %.

Promoter's Participation in Excess over Minimum is Preferential Allotment

In the case of a listed company, participation of promoter in excess of the required minimum percentage, the pricing provision of guide lines on preferential allotments applies. Promoters contribution to be brought in before public issue opens.

The full amount of the contribution including premium should be brought in at least one day prior to opening date.

The Company's board has to pass a resolution allotting shares or convertible debentures to promoters. The resolution along with a certificate from Chartered Accountant that the promoters contribution has been brought in has to be filed with SEBI.

Exemption from Requirement of Promoter's Contribution

- (i) In case of a listed company (3 years) with a track record of dividend payment in 3 immediate preceding years.
- (ii) in case of companies where no identifiable promoter or promoter group exists ; and
- (iii) in case of rights issue.

Lock-in Requirements**Minimum in Public Issues**

The minimum promoter's contribution is locked in for 3 years.

Lock-in of Excess

In case of public issue by unlisted company as well as listed company, the excess would be locked in for one year. Pre issues share capital of an unlisted company shall be locked in for a year. This does not apply to pre issue share capital held by venture capital funds and foreign capital investors registered with SEBI and held for a period of at least one year at the time of filing offer document with SEBI and being offered to public for sale.

Firm Allotment Basis

Securities issued on firm allotment basis are locked in for one year from the date of commencement of commercial production or date of allotment.

Locked in securities should carry an inscription that they are nontransferable along with duration.

IV. Pre- issue Obligations**Obligations of Lead Merchant Banker****(i) Due diligence**

The lead merchant banker should satisfy himself about all the aspects of offering, veracity, adequacy of disclosure in the offer documents. His liability would continue even after the issue process. Along with the draft offer document he should pay the requisite fee to SEBI.

(ii) Documents to be Submitted Along with Offer Document

Memorandum of understanding entered into by lead merchant banker and the issuer company specifying their mutual rights, liabilities and obligations relating to the issue should be submitted to SEBI along with offer document.

(iii) Interse Allocation Responsibilities

If the issue is managed by more than one merchant banker the rights and responsibilities of each merchant banker is demarcated.

(iv) Under subscription

The lead merchant banker responsible for underwriting arrangements should invoke underwriting obligations and ensure that the underwriters pay the amount of development and the same shall be incorporated in the interse allocation of responsibilities accompanying the due diligence submitted by lead merchant banker to SEBI.

(v) Others

- (a) Certify that all amendments, suggestions or observations of SEBI have been incorporated in the offer document.
- (b) Furnish a fresh due diligence certificate at the time of filing prospectus with Registrar of Companies,
- (c) Furnish a fresh certificate that no corrective action is needed on its part,
- (d) Furnish a fresh certificate after the issue has opened but before it closes for subscription,
- (e) Furnish certificate signed by Company Secretary or Chartered Accountant in case of listed companies making further issue of capital along with offer documents.

The lead merchant banker has to submit the following certificates duly signed by Company Secretary or Chartered Accountant along with draft offer documents.

Undertaking

That transactions in securities by promoters between filing of document with ROC\SE and closure of issue will be reported within 24 hours.

List of Promoter Group

The issue has to submit to SEBI the list of promoter group and their holdings.

Appointment of Merchant Bankers

A merchant banker who is associated with issuer company as promoter or director should not lead manage the issue, except in the case of securities of the issuer company are proposes to be listed on OTCEI and market makers are to be appointed.

Co-managers

The number of co-managers to an issue should not exceed the lead managers to the issue and there is only one advisor to the issue.

Bankers to Issue

Lead manager has to ensure that Banker to issue are appointed of all mandatory collection centers.

Registrars to Issue

They should be registered with SEBI. The lead merchant banker should not act as Registrar to an issue in which he is also handling post issue responsibilities.

Registrars to issue should be appointed in all public issues and rights issue. If the issuer company is registered Registrar to an issue, the issuer should appoint an independent Registrar to process the issue.

Underwriting

Lead merchant banker should satisfy himself about the ability of the underwriters to discharge their underwriting obligations.

Lead merchant banker should state in the offer document that the underwriters assets are adequate to meet under writing obligation; and obtain under writers written consent.

Lead merchant banker has to undertake a minimum under writing obligation of 5 % of total under writing commitment or Rs. 25 lacks whichever is less.

The outstanding under writers commitments of a merchant banker at any time shall not exceed 20 times its net worth. The offer document of an under written issue should contain relevant details of underwriters.

Offer Document to be Made Public

Offer documents should be made public within 21 days from date of filing it with SEBI. Lead merchant banker has to ensure that offer documents are filed with stock. Exchange where the securities are proposed to be listed. The offer document has also to be filed with SEBI. Co-lead manager has to obtain and furnish to SEBI and in principled approval of stock exchange for listing the securities within 15 days.

Despatch of Issue Material

The lead merchant banker has to ensure for public issues offer documents and other issue materials are dispatched to various stock exchange, brokers, underwriters, bankers to the issue, investors associating in advance as agreed upon.

In case of rights issues, the lead merchant banker has to ensure that the letters of offer are dispatched one week before opening of the issue.

No-Complaints Certificate

After 21 days from the date of draft document was made public the lead merchant banker has to file with SEBI a list of complaints received by it, amend the draft offer document and highlight those amendments.

Mandatory Collection Centers

The minimum number of collection centers for issue of capital are the four metropolitan centers at Mumbai, Delhi, Calcutta and Chennai and all such centres where the stock exchange are located.

Authorized Collection Agents

Issuer company can appoint collection agents in consultation with lead merchant bankers whose names and addresses should be disclosed in offer document. Lead merchant banker has to ensure that collection agents are properly equipped for the purpose in terms of infrastructure and money order. They collect applications accompanied by payment by cheque, draft and stock invoice collection against which will be forwarded to Registrars to the Issue.

Advertisement for Rights Post Issue

The lead merchant banker shall ensure that in the case of a rights issue an advertisement giving the date of completion of dispatch of letters of offer is published at least 7 days before the date of opening of the issue.

Appointment of a Compliance Officer

The issuer company should appoint a Compliance Officer who directly liaises with SEBI with regard to compliance with various laws, rules, regulations and other directives issued by SEBI. SEBI should be informed of the name of the compliance Officer.

5.9 Underwriting

Security issues are underwritten to ensure that in case of under subscription they are taken up by the underwriters. No person can act as an underwriter without obtaining a certificate of registration from SEBI, although merchant bankers and stock brokers registered with SEBI do not need separate registration. There are 56 underwriters registered with SEBI in addition to merchant bankers and stockbrokers registered with SEBI at the end of March, 2001.

Major under writers are all India financial institutions, commercial banks, merchant bankers and members of stock exchanges. The Lead Manager in consultation with the company arranges underwriting. In

the selection of an under writer, financial strength is a major consideration.

Under writing agreement is a contract between an underwriter who is usually a merchant banker or financial institution such as UTI, and other mutual funds, LIC, or ICICI and the company issuing capital. Under the agreement, the under writers agree to subscribe or procure subscription to a portion of the capital to be issued in case the issue is not fully subscribed. This type of assistance, and in respect of rights issue, stand-by assistance. The maximum liability of the underwriters is restricted to the amount under written by him.

SEBI Guidelines

SEBI has made underwriting optional since October, 1994 of issues to public subject to the condition that if an issue was not under written and was not able to collect 90 percent of the amount offered to the public, the entire amount collected would be refunded to the investors.

In October 1993, regulations for underwriters of capital issues were announced. Among others, one of the important regulations was that the under writers should register themselves with SEBI. An underwriter to get registered, should have a minimum net worth of Rs.20 Lakhs.

Total under writing obligations at a point of time should not exceed 20 times an under writers net worth. The under writers can arrange for sub underwriting at his risk.

Contingent Underwriting

Sometimes underwriting commission is payable only on the amount devolving in which case it is called contingent underwriting. Particulars of under writing arrangement should be mentioned in the prospectus.

Underwriting Commission Rates

The underwriting commission rates are presented in Table:1. They are maximum ceiling rates and are negotiable. No underwriting commission is payable on amounts taken up by promoters, employees, directors and their friends and business associates.

Rates of Underwriting Commission

(In

Percentage)

	<i>On amount devolving on underwriter</i>	<i>On amount subscribed by public</i>
1. Shares	2.5	2.5
2. Preference, convertible and nonconvertible debentures.		
(a) For amounts up to Rs. 5 Lakhs	2.5	1.5
(b) For amounts in excess of Rs. 5 Lakhs	2.0	1.0

Table- I

Underwriting commission is to be paid within 15 days of finalization of allotment. However, it is payable only when the entire portion has been subscribed.

Trends in underwriting

A sum of Rs. 5775 crores constituting 95 percent of the total public issue of Rs. 6061 crores was underwritten (main and contingency) in 1992-93 (88 percent in 1991-92, 60 percent in 1990-91 and 19 percent in 1989-90). The main underwriting amounted to Rs. 5361 crores of which financial institutions (20) contributed 28 percent banks (56) 35 percent, merchant banks (50) 11 percent and broker (1296) 26 percent. Third – four percent of total underwriting done by financial institutions was for fully convertible debentures. Private merchant bankers and brokers were mainly involved with equity issues.

In addition to main underwriting, continent underwriting amounted to Rs.416 crores in 1992-93. Of this, 59 percent was underwritten by banks, 6 percent by financial institutions, 28 percent by private merchant bankers and 7 percent by brokers.

In 1993-94, 98 percent of the issues were underwritten. Since underwriting was made optional in October, 1994, the decline in underwriting in 1994-95 was not significant. It fell marginally to 81 percent. However, the decline was significant in 1995-96 with only 31 percent of the issues being underwritten. The amount underwritten as a percent of total declined to 68 percent each in 1993-94 and 1994-95. A large number of good issues do not require underwriting facility. During 2000-01 105 issues (68.7 %) were underwritten. The remaining 19 issues (31.3 %) were not underwritten. While financial institutions and banks accounted for a major portion of underwriting earlier, private merchant bankers accounted for two-thirds of total underwriting 1995-96.

5.10 PUBLIC ISSUE THROUGH PROSPECTUS

The most common method of public issue is through prospectus. In 1995-96 of new capital issues (of equity, debentures and preference shares) of Rs.16371.2 crores, Rs. 10,528.7 crores (or 64.3 percent) was made through prospectus account for a higher proportion of 71.4 percent. In the case of debentures, rights issue accounts for a major portion (58.0 percent). In 2001-02 of new capital issues of Rs.5,692.2 crores 87.7% was made through prospectus. In the case of equity issues prospectus accounted for 99.7 % whereas convertible debentures rights accounted for 86.4 %.

Initial Public Offers (IPOs)

Scope of Study

A study of 625 IPOs listed on the BSE, in the calendar year 1996 was made by *Business Line*. The IPOs included, par as well as premium

offers. The study compared the offer price with the price on listing and compared them again with the last traded price (Chosen for the study).

Premium Officers

Of the 92 premium offers listed on the BSE in 1996 only 20 (21.7 percent) provided returns in excess of 20 percent on listing. The average returns were 8 percent on listing, 2 percent at the end of respective listing month and (-) 14 percent on the last traded day (10.1.1997).

Par Offers

Par Offers constituted 85.28 percent of the sample. Par Offers on listing offered a return of 35 percent. But on the last traded day for the purpose of the study (10.1.1997) 80 percent were quoted below the offer price. Taking all the companies together, par as well as premium, 530 issues (84 percent) offered returns on an annualized basis of less than 20 percent at their latest prices and 95 (16 percent) in excess of that level.

Issue of Prospectus

Sections 55 to 68 A of the Companies Act deal with issue of prospectus. The prospectus sets out the prospectus of the company and the purpose for which capital is required. Section 2 (36) defines a prospectus as any document described or issued as prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporate. A document is not a prospectus unless it is an invitation to the public to subscribe for shares in or debentures of a company.

Transparency and Requirements in Prospectus

Consequent to the recommendations of the committee under the chairmanship of Shri. Y.H. Malegam in September, 1995, guidelines were issued among others to cover enhanced transparency in the draft

prospectus filed with SEBI and to requirements in prospectus submitted to SEBI for vetting.

The lead merchant banker shall simultaneously file copies of the draft document with the stock exchanges where the issue is proposed to be listed.

Dating of Prospectus (Sec. 55)

A prospectus has to be dated in relation to the intended company and that date is the date of publication. It has to be signed by the directors or their authorized agents.

Registration of Prospectus (Sec. 60)

Before issue of prospectus it has to be registered with the registrar of Companies by delivering a copy. The registration must be done before publication. The copy of registration must be accompanied by,

- (1) consent of the experts to issue,
- (2) copy of the contract fixing compensation of a managing director or manager,
- (3) a copy of every material contract except those entered into the ordinary course of business,
- (4) written statement relating to any adjustment in regard to profit and loss or assets and liabilities and
- (5) consents of auditor, legal advisor, attorney, solicitor, bankers, broker of the company to act in the capacity.

After registration of prospectus it must be issued within 90 days.

A prospectus need not be issued where the shares and debentures are offered for private placement and where shares and debentures are offered to existing members or debenture holders.

Contents of Prospectus

Prospectus should disclose all material and essential factors about the company to the intending purchasers of shares. A prospectus should specify:

- (1) Main objects of the company and particulars about signatories to the memorandum and number of shares owned by them
- (2) Number and classes of shares.
- (3) Number of redeemable preference shares.
- (4) Qualification shares of a director and their remuneration.
- (5) Particulars about directors and managing directors.
- (6) Minimum subscription for Shares.
- (7) The time and opening of subscription list.
- (8) The amount payable on application and allotment on each share.
- (9) Particulars of any option to subscription for shares.
- (10) Shares issued for consideration other than cash.
- (11) Premium on shares issued within two years preceding the date of prospectus.
- (12) Name of underwriter.
- (13) Particulars of vendors of property purchased or proposed to be purchased by the company.
- (14) Underwriting commission.
- (15) Preliminary expenses and issue expenses and to whom payable.
- (16) Any benefit given to promoters within the last two years or proposed to be given and the consideration for giving the benefit.
- (17) Particulars of contract other than those entered into in the ordinary course of business.
- (18) Particulars of auditors.
- (19) Nature of interest of every director or promoter.
- (20) Voting and dividend rights.
- (21) Length of time of business.
- (22) Capitalization of profits and surplus from revaluation of assets.
- (23) Specification of time and place for inspection of balance sheet and profit and loss account.

5.11 Venture Capital

Nature and Scope

Merchant bankers can assist venture proposals of technocrats, with high technology which are new and high risk, to seek assistance from venture capital funds or companies. Venture capital is an important source of funds for technology based industries which contribute significantly to growth process. Public issues are not available for such green field ventures.

Venture capital refers to organized private or institutional financing that can provide substantial amounts of capital mostly through equity purchases and occasionally through debt offerings to help growth oriented firms to develop and succeed. The term venture capital denotes institutional investors that provide equity financing to young business and play an active role advising their managements.

Venture Capital in India

Venture capital funds (VCFs) are part of the primary market. There are 35 venture capital funds registered with SEBI apart from one foreign venture capital firm registered with SEBI. Data available for 14 firms indicate that total funds available with them at the end of 1996 was Rs. 1402 crores, which Rs. 672.85 crores had been invested in 622 projects in 1996. Venture capital which was originally restricted to risk capital has become now 'private equity'. Venture capital represent funds invested in new enterprises which are risky but promise high returns. VCFs finance equity of units which propose to use new technology and are promoted by technical and professional entrepreneurs. They also provide technical, financial and managerial services and help the company to set up a track record. Once the company meets the listing requirements of the OTCEI or stock exchange, VCF can disinvest its shares.

Characteristics of Venture Capital

The three primary characteristics of venture capital funds which make them eminently suitable as a source of risk finance are:

- (1) that it is equity or quasi equity investment;
- (2) it is long-term investment; and
- (3) it is an active form of investment. First, venture capital is equity or quasi equity because the investor assumes risk. There is no security for his investment. Venture capital institutionalize the process of risk taking which promotes successful domestic technology development.

Secondly, venture capital is long-term investment involving both money and time. Finally, venture capital investment involves participation in the management of the company. Venture capitalist participates in the Board and guides the firm on strategic and policy matters. The features of venture capital generally are, financing new and rapidly growing companies; purchase of equity shares; assist in transformation of innovative technology based ideas into products and services; add value to the company by active participation; assume risks in the expectation of large rewards; and possess a long-term perspective. These features of venture capital render it eminently suitable as a source of risk capital for domestically developed technologies.

5.12 STOCK MARKETS IN INDIA

Stock exchange are the most perfect type of market for securities whether of government and semi-government bodies or other public bodies as also for shares and debentures issued by the joint-stock companies. In the stock market, purchases and sales of shares are effected in conditions of free competition. Government securities are traded outside the trading ring in the form of over-the-counter sales or

purchases. The bargains that are struck in the trading ring by the members of the stock exchanges are at the fairest prices determined by the basic laws of supply and demand.

History of Stock Exchanges

The only stock exchange operating in the 19th century were those of Mumbai set up in 1875 and Ahamedabad set up in 1894. These were organized as voluntary non-profit-making associations of brokers to regulate and protect their interests. Before the control on securities trading became a central subject under the Constitution in 1950, it was a state subject and the Mumbai Securities Contracts (control) Act of 1925 used to regulate trading in securities. Under this Act, the Mumbai Stock Exchange was recognized in 1927 and Ahamedabad in 1937. During the was boom, a number of stock exchanges were organized even in Mumbai, Ahamedabad and other centres, but they were not recognized. Soon after it became a Central subject, Central legislation was proposed and a Committee headed by A.D. Gorwala went into the Bill of securities regulation. On the basis of the committee's recommendations and public discussion, the Securities Contrs (Regulation) Act became law in 1956.

Stock Exchange

“Stock Exchange means any body or individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities”. It is an association of member brokers for the purpose of self-regulation and protecting the interests of its members.

It can operate only if it is recognized by the Government under the Securities Contracts (Regulation) Act, 1956. The recognition is granted under Section 3 of the Act by the Central Government, Ministry of Finance, Stock Exchange Division.

The Powers of the Central Government under the Act are far-reaching and include the following in particular :

- (1) Grant and withdrawal of recognition, approval or change of byelaws.
- (2) Call for periodical returns from the Stock Exchange.
- (3) Direct enquiries on the members or on the Stock Exchange.
- (4) Liability of the Exchange to submit annual reports.
- (5) Directing the Stock Exchange to make certain rules.
- (6) Supersede the Governing Board of the Exchange.
- (7) Suspend the Governing Board of the Exchange.
- (8) Impose any other conditions or regulations for trading.

Byelaws

Besides the above Act, the Securities Contracts (Regulations) Rules were also made in 1957 to regulate certain matters of trading on the Stock Exchanges. There are also byelaws of the Exchange, which are concerned with the following subjects.

Opening\Closing of the stock exchange, timing of trading, regulation of blank transfers, regulation of badla or carryover business, control of the settlement and other activities of the Stock Exchange, fixation of margins, fixation of market prices or making up prices (Havala rates), regulation of taravani business (jobbing), etc., regulation of brokers' trading, brokerage, trading rules on the Exchange, arbitration and settlement of disputes, settlement and clearing of the trading etc.

Regulation of Stock Exchanges

The Securities Contracts (Regulation) Act is the basis for operations of the stock exchanges in India. No exchange can operate legally without the government permission or recognition. Stock exchanges are given monopoly in certain areas under Section 19 of the above Act to ensure that the control and regulation are facilitated. Recognition can be granted to a stock exchange provided certain conditions are satisfied and the necessary information is supplied to the government. Recognition can also be withdrawn, if necessary. Where there are no stock exchanges, the government can license some of the brokers

(licensed dealers) to perform the functions of a stock exchange in its absence.

Recognition by Government

As referred to earlier, a Stock Exchange is recognized only after the government is satisfied that its Rules and Byelaws conform to the conditions prescribed for ensuring fair dealings and protection to investors. Government has also to be satisfied that it would be in interest of the trade and public interest to grant such recognition. Mumbai, Calcutta, Delhi, Chennai, Ahamedabad, Hyderabad, Bangalore, Indore etc. have so far been granted permanent recognition. Others are granted temporary recognition from time to time.

The rules of a recognized stock exchange relating in general to the constitution of the Exchange, the powers of management of its governing body and its constitutions (including the appointment thereon of not more than three government nominees), the admission of members, the qualifications for membership, the expulsion, suspension and readmission of members, the registration of partnerships and the appointment of authorized representatives and clerks must be duly approved by Government. These rules can be amended, varied or rescinded only with the previous approval of government. Likewise, the byelaws of the recognized exchanges providing in detail for the regulation and control of contracts in securities and for every aspect of the trading activities of members must also be sanctioned by government and any amendments or modifications must be similarly approved. Government's authority extends much further to make or amend *suo motto* any rules or byelaws of a recognized stock exchange, if so considers desirable in the interest of trade and in public interest.

The Act empowered the government with even more drastic powers – the power to make enquiries into the affairs of a recognized stock

exchange stock exchange and its members, to supersede the governing body and take over the property of a recognized exchange, to suspend its business, and lastly, to withdraw the recognition granted to an exchange should such steps be deemed indispensable in the interest of trade and in public interest. Government has thus complete control over the recognized stock exchanges.

Licensed Dealers

The recognized stock exchanges are the media through which government regulation of the stock market is made effective. Where there are no stock exchanges, the Securities Contracts (Regulations) Act, 1956 empowers government to license dealers of dealing in securities. These licensed dealers are now operating for OTCEI and NSE.

Securities Contracts (Regulation) Rules, 1957

Under the Act, government has promulgated the Securities Contracts (Regulation) Rules, 1957 for carrying into effect the object of the legislation. These rules provide, among other things, for the procedure to be followed for recognition of stock exchanges: submission of periodical returns and annual reports by recognized stock exchanges; inquiry into the affairs of recognized stock exchanges and their members; and requirements for listing of securities. The rules are statutory and they constitute a code of standardized regulations uniformly applicable to all the recognized stock exchange.

Present Recognized Stock Exchanges

At present, there are 21 stock exchanges recognized under the Securities Contracts (Regulation) Act, 1956. They are located at Mumbai, Calcutta, Chennai, Delhi, Ahmedabad, Hyderabad, Indore, Bhubaneswar, Mangalore, Patna, Bangalore, Rajkot, Guwahati, Jaipur, Kanpur, Ludhiana, Baroda, Cochin and Pune. The recently recognized stock exchanges are at Coimbatore and Merrut. A stock exchange has

also been set up at Gangtok, Sikkim early in 1986. No recognition has been sought for this body as the jurisdiction of the Securities Contracts (Regulation) Act, 1956 has not so far been extended to the areas covered by the State. In 1996, the Stock Exchange at Visakhapatnam was given recognition for electronic trading. A decade ago, there were hardly 8 stock exchange in the county.

The stock exchange operate under the rules, byelaws and regulations duly approved by government and constitute an organized market for securities. They offer the most perfect type of market for various reasons. There is an active bidding and in the case of shares and debentures a two-way auction trading, so that purchases and sales are made in conditions of free and perfect competition. The bargains that are struck by members of the exchange are the fairest price determined by the basic laws of supply and demand. In consequence, though gilt-edged securities represent ownership of public debt and shares and debentures of joint-stock companies represent interest in industrial property – mills and factories, machinery and equipment – they become the most liquid of assets and capable of being easily negotiated.

Qualifications for Membership

The members of recognized stock exchange should have the following qualifications:

- Age 21, Indian Citizen, not bankrupt.
- Not compounded with the creditors.
- Not convicted for fraud or dishonesty.
- Not engaged in any other business except as agent or broker.
- Educational Qualifications should be 10 + 2.
- Not connected with a company or corporation.
- Not a defaulter of any other stock exchange.

Companies and financial institutions are not members as per the earlier rules. But the government has permitted change in the byelaws of the exchange to permit corporate and institutional members and also grant permission for a member of any stock exchange during 1993-1994.

Members are prohibited from entering into contracts with persons other than members or from dealing with clients as principles. Spot delivery transactions are exempt from the provisions of the Act. Contracts can be passed only by the members in the notified areas where the stock exchange exists. The sub-brokers can also pass valid contract notes or confirmation Notes, if they are registered with SEBI.

Organization

The recognized stock exchange at Mumbai, Ahamedabad, Indore are voluntary non-profit-making associations, while the Calcutta, Delhi, Bangalore, Cochin, Kanpur, Ludhiana, Guwahati and Kanara Stock Exchange are joint-stock companies limited by shares and the Mumbai, Hyderabad and Pune stock exchanges are companies limited by guarantee. Since the Rules or Articles of Association defining the constitution of the recognized stock exchange are approved by the Central Government, there is a broad uniformity in their organization. In fact, the Chennai Stock Exchange was reconstituted and the Calcutta Stock Exchange had to undergo a major reorganization as a condition precedent to their recognition by the Government of India.

Governing Body

The governing body of a recognized stock exchange has wide governmental and administrative powers and is the decision-making body. It has the power, subject to governmental approval, to make, amend and suspend the operation of the rules, byelaws and regulations of the exchanges. It also has complete jurisdiction over all members and in practice, its power of management and control are almost absolute.

Under the constitution, the governing body has the power to admit and expel members, to warn, censure, fine and suspend members and their partners, attorneys, remisiers, authorised clerks and employees, to approve the formation and dissolution of partnerships and appointment of attorneys, remisiers and authorized clerks, to enforce attendance and information, adjudicate disputes and impose penalties, to determine the mode and conditions of stock exchange business and regulate stock exchange trading in all its aspects and generally to supervise, direct and control all matters and activities affecting the stock exchange. The organization of Mumbai Stock Exchange is typical. The members on roll elect 16 members to the Directors on the Governing Board, who in turn elect a President, Vice-President and Treasurer. The Executive Director is appointed by the government on the recommendation of the Governing Board to the Chief Administrator of the Exchange. There are also three representatives from the Government, three from the public and one from the RBI on the Board to represent their interests. As per the SEBI guidelines, the Exchange have agreed to have 50 % representation to non-members on the Governing Board.

Functions of Stock Exchange

Stock Exchanges provide liquidity to the listed companies. By giving quotations to the listed companies, they help trading and raise funds from the market. Savings of investors flow into public loans and to joint-stock enterprises because of this ready marketability and unequalled facility for transfer of ownership of stocks, shares and securities provided by the recognized stock exchanges. As a result, over the hundred and twenty years during which the stock exchange have existed in this country and through their medium, the Central and State Government have raised crores of rupees by floating public loans; Municipal Corporations, Improvement Trusts, Local Bodies and State Finance Corporations have obtained from the public their financial

requirements, and industry, trade and commerce – the backbone of the country's economy – have secured capital of crores of rupees through the issue of stocks, shares and debentures for financing their day-to-day activities, organizing new ventures and completing projects of expansion, diversification and modernization. By obtaining the listing and trading facilities, public investment is increased and companies were able to raise more funds. The quoted companies with wide public interest have enjoyed some benefits and asset valuation has become easier for tax and other purposes.

In tune with the growth in the new issues during the eighties, the secondary market also expanded fast during the period. The number of stock exchanges has increased from 8 in 1980 to a total 24 in 1996 including Visakhapatnam Stock Exchange recognized in 1996. The membership of the stock exchange has also increased substantially to around, 6,000 by end 1995 from about 1,200 decade ago. The listed companies of all stock exchanges stood at above 8000 in 1995 of which 6500 are listed on B.S. Exchange. The market capitalization has also shown a substantial increase in the eighties. The volume of daily turnover of trade has also increased more than ten-fold over the decade. The number of dealings per day put through was as high as 1.53 lakhs (Dec. 1996)

Listed Paid-up Capital

The paid-up share capital of listed companies 1946 was Rs.270 crores while in 1996, the figure was more than Rs.1,05,284 crores. The market value of the capital of these listed companies stood at around Rs.5.5 lakhs crores I 1995 which has gone down in to around Rs.3.5 Lakhs crores due to sharp fall in prices during 1995 but rose to 4.77 lakh crores in Dec. 1996.

Mumbai : The Premier Exchange

The Mumbai Stock Exchange is the premier stock exchange in India. It was the first to be recognized on a permanent basis in 1957. The capital listed in Mumbai accounted for about 40 % of the overall capital listed on all the stock exchanges whereas its share of the market capitalization amounted to around 90 % . In terms of the total number of companies and total number of stock issues listed also, Mumbai ranked first.

The Mumbai Stock Exchange regularly publishes statistics on market turnover of securities though similar figures for the other exchanges are not available in many cases. It is, however, roughly estimated that the turnover of Mumbai Stock Exchange is about 60 % - 70 % of the overall turnover of all the stock exchanges in the country, but with NSE leading in the trade turn over on a daily basis, the share of BSE come down to less than 50 %.

The number of companies quoted on the stock exchanges was more than 8,000 of which those listed in Bombay are 6,500. The number of deals put through in the five hour session on the Mumbai Stock Exchange, namely 10 a.m. to 3.00 p.m. is around 1,50,000. The daily turnover varies from Rs. 300 crores to Rs. 700 crores.

5.13 TRADING IN THE STOCK MARKET

Pattern of Trading

Trading in the stock market takes place under three sections:

- (i) Group (A) - Specified shares.
- (ii) Group (B) - Non-specified shares (now split into B₁ and B₂ on[@] the BSE)
- (iii) Group (C) - Odd lots and permitted securities.

Under Group (A), only those actively traded (64 on the BSE) are included. There criteria for listing in specified group has been dealt

with in an earlier chapter. The rest of the listed securities are placed in Group (B). There are 6,500 scrips in total and 3,500 companies regularly quoted on the BSE in 1996 of which 90 % are equities. Out of these equity shares, only about 3,000 companies are quoted on a daily basis. The trading in the rest is nil or negligible. Under Group (C), only odd lots (tradable lots being 5, 50 or 100, depending upon the face value) are traded to provide liquidity to them once in a fortnight or once on Saturdays. The permitted securities are those that are not listed on the Exchange, but are permitted to be traded on this Exchange, also called foreign securities as they are listed on other stock exchange in India.

The instruments of trading are equity shares, preference shares, debentures, CCI's PSU bonds and government securities.

TRADING AND SETTLEMENT

Speculative Traders vs. Genuine Investors

The investors in the stock market can be classified as genuine investors and speculative investors. The former take delivery of shares and give delivery with no intention to deal in carry-forward business. The latter, however, do not give or take delivery, of shares but only deal in differences in purchase and sale prices. Even if they take delivery, their intention is to make gain on differences between purchase and sale prices. Long-term gains are the motive of the genuine investors. Any genuine investor can have short-term gains of a few months when he buys and sells along with delivery. The essential difference between these two classes lies in the intention to take and give delivery of shares or to just carry forward and to gain in differences.

Types of Speculators

On the stock markets, there are various classes of brokers, depending on their actions and specialization. Essentially, a broker is an intermediary between buyers and sellers of securities. His clients may

be individuals, institutions like companies, trusts, charities, etc., banks and financial institutions (including mutual funds). Some of these clients may be speculators also doing business to carry forward and dealing in differences in prices. Secondly, there are jobbers of *Taravaniwalls* who are wholesalers doing both buying and selling in selected scrips. They give both bid and offer prices for the scrips they trade in. They are like market - makers in foreign markets. Thirdly, there are *badliwallas* financing the carry-forward transactions and lending securities when necessary. Such carry-forward or *badli* transactions are facilitated by blank transfer of T.D.s. with shares. These blank transfers are transfers without any insertion on them, the names of the transferees and without any need for payment of stamp duty, etc.

On the stock exchange, there are two main categories of speculators, namely, bulls and bears. Bulls are *Tejiwallas* who buy shares in expectation of selling at higher prices. Bears are known as *Mandiwallas* who sell securities in expectation of a fall in prices and buying at a later date. Stags are those members who neither buy nor sell but apply for subscription to new issues expecting to sell them at a higher price later when these issues are quoted on the stock exchange.

Thus, the activities of brokers can be set out as follows :

In the Primary Market: To act as dealer, broker, jobber, etc. in the trading ring, badla financier for carry forward business – arbitrageur buying and selling as between the different markets, as in Mumbai and Delhi – dealer in government securities, bonds, etc. adviser, consultant and portfolio manager, etc.

Allied Services : Investor services like home delivery of shares, arranging for transfer of shares, safe custody of shares, etc. dealing in inter-corporate investment to act as broker for fixed deposits of

companies, to operate in the money market, PSU bonds, UTI units, Mutual Fund Schemes, etc.

Broker's Charges

Except to the charitable trusts, the broker charges brokerage to all clients, after effecting the purchase or sale and at the time of passing the contract note. The brokerage, which may range from 0.5 to 2.5 % is included in the price charged but not separately shown.

Delivery \ Payment

The broker takes the cheque for purchase first and delivers the shares later in a purchase deal. He pays by cheque later but takes delivery of shares first for a sale transaction. This is explained by the settlement procedure of the stock exchange, which has fixed the pay-in day and delivery dates first. All the members have to pay money or deliver shares first to the clearing house. On a later day fixed for payout, the clearing house pays by cheque and delivers the shares to the members. These transactions of members with the clearing house can be effected only when their clients in turn first pay in and send the cheques or deliver shares and later get the cheques from them or shares delivered later on the pay-out day.

Settlement Procedure

The settlement procedure of the stock exchange is to be understood to comprehend why such delays take place. The Settlement Committee of the Exchange fixes the schedules, for each settlement, there will be 5 to 15 trading days (Saturdays, Sundays and holidays excluded) after which three days would be set apart for effecting squaring up and carry forward (Badla). There will be one or two days for correcting errors and omissions and secure a final settlement of each member's position *vis-à-vis* others in respect of all scrips. Taking both sales and purchases scrip-wise, the net position is arrived and payment to be made or received is determined accordingly. Then a pay-in-day is

fixed for delivering cheques or shares to the clearing house by those who are due to give. There will be the first pay-in-day and after a couple of days, a final pay-in-day to help clear up all payments due. Then finally pay-out day is fixed with a gap of a day or two for the clearing house to make all payments out or delivery for shares to members.

Auctions

Auctions are arranged for scrips which could not be delivered even on the final day. The auction are tenders for sale of the desired scrips in the quantities purchased but not delivered so that delivery can be effected to the buyers. Auction in group A is automatic when the seller fails to deliver on the appointed day and at the request of the buyer in the case of group B. Auctions are arranged by the stock exchange by inviting bids from members to buy the shares on behalf of the member who could not deliver the shares.

Cleaning Procedure

Daily after trading is completed, members submit to the exchange their saudas (memos of purchases and sales scrip-wise). On the next day, if there are any objections or corrections, they are submitted in the form of wandha memos (objections). This process goes on daily for all the 5 to 10 trading days. These memos are fed to the computer and the daily net position is arrived at. If the stock exchange authorities impose any margins, they are collected from members and deposited in the clearing house. At the end of the settlement, the overall net position of a member is arrived at after taking into account the dealings, squared up and those to be carried forward. On the three days, set apart for badla settlement, members' squaring up position and carry forward position is known. Any objections or error are recorded and corrections carried out. Then the first corrected position of members is arrived at. At this stage, the carry over margins, if imposed, are collected. This forms the

basis for asking the members to pay in or deliver the shares on the pay-in day. The entire process involves time varying from 30 to 60 days, mainly due to the large trading volume and secondly, due to the large component of speculative trading and carry forward transactions on the BSE.

5.14 Foreign Direct Investment

Policy towards foreign investment was liberalist in 1991 to permit automatic approval of a foreign investment up to 51 percent equity in 34 industries. Thirteen more sectors were added in 1996-1997 allowing equity participation up to 50 percent in three new areas and enhancement of equity limit to 74 percent for automatic approval in 9 priority sectors. The Foreign Investment promotion Board (FIPB) was set up to process applications in cases not covered by automatic approval. The FIPB was reconstituted on July 22, 1996 and the Foreign Investment Promotion Council was set up to promote foreign direct investment (FDI) in India. During 1992-93 several additional measures were taken to encourage investment flows: direct foreign investment, portfolio investment, NRI investment and deposits and investment in global depository receipts. Details of the measures are:

1. The dividend balancing condition earlier applicable to foreign investment up to 51 percent equity is no longer applied except for consumer goods industries.
2. Existing companies with foreign equity can raise it to 51 percent subject to certain prescribed guidelines. Foreign direct investment has also been allowed in exploration, production and refining of oil.
3. NRIs and overseas corporate bodies (OCBs) predominantly owned by them are also permitted to invest up to 100 percent equity in high-priority industries with reparability of capital and income. NRI investment up to 100 percent of equity is also allowed in export houses, trading houses, star trading houses, hospitals, EOUs, sick industries, hotels and tourism-related industries and without the right of reparation in the previously excluded areas of real estate, housing and infrastructure. Foreign citizens of Indian

- origin are now permitted to acquire house property without the permission of the Reserve Bank of India. For setting up power plants 100 percent foreign equity is allowed. Repatriation of profits is allowed.
4. Disinvestment of equity by foreign investors no longer needs to be at prices determined by the Reserve Bank. It has been allowed at market rates on stock exchanges from September 15, 1992 with permission to repatriate the proceeds of such disinvestment.
 5. India has signed the Multilateral Investment Guarantee Agency Protocol for the protection of foreign investments on April 13, 1992.
 6. Provisions of the Foreign Exchange Regulation Act (FERA) have been liberalized through an Ordinance dated January 9, 1993 as a result of which companies with more than 40 percent of foreign equity are also now treated on par with fully Indian-owned companies.
 7. Foreign companies have been allowed to use their trade marks on domestic sales from May 14, 1992.
 8. The Finance Ministry has decided to allow (June 21, 1993) 100 percent ownership in investment banking if the foreign partner brings in US \$ 100 million or more as capital. Companies which bring in US \$ 50 million will be allowed a 51 percent stake and those which invest less than \$ 50 million will be allowed a stake of less than 40 percent in the joint venture.

SEBI (FII) Regulations, 1995

The regulations stipulate that foreign institutional investors have to be registered with SEBI and obtain a certificate from SEBI. For the purpose of grant of the certificate SEBI takes into account,

- (a) the applicant's record, professional competence, financial soundness, experience, general reputation of fairness and integrity;
- (b) whether the applicant is regulated by appropriate foreign regulatory authority;
- (c) whether the applicant has been granted permission by RBI under Foreign Exchange Regulation Act for making investments in India as a foreign institutional investor; and
- (d) where the applicant is,

- (i) an institution established or incorporated outside India as a pension fund, mutual fund or investment trust; or
- (ii) an asset management company or nominee company or bank or institutional portfolio manager, established or incorporated outside India and proposing to make investments in India on behalf of broad based funds; or
- (iii) a trustee or power of attorney holder established or incorporated outside India and proposing to make investments in India on behalf of broad based funds.

The certificate is granted in Form 'B' subject to payment of prescribed fees which is valid for 5 years and can be renewed thereafter.

Provisions is also made for registration of sub-accounts on whose behalf FII proposes to make the investment in India.

The purchases of shares of each company should not be more than ten percent of the total issued capital of the company.

The investment by foreign institutional investor is also subject to GOI Guidelines.

The general obligations and responsibilities of FIIs include appointment of a domestic custodian, appointment of designated bank, maintenance of proper books of accounts, records and their preservation for five years and information to the Board or Reserve Bank of India.

Defaults are punished by suspension and cancellation of certificate after show cause notice and enquiry.

5.15 Significance and Role of Foreign Investment

Traditionally, developing countries relied on foreign direct investment to supplement domestic saving and bring in new technology, skills and introduction of new products. In our country it had been more or less

static at about Rs.110 crores till 1987 when the government took major steps towards attracting foreign capital as a better alternative to borrowing with a promise of fast track clearance. The impact was felt in 1988 when foreign investment rose to Rs. 239 crores and in 1989 to Rs. 316 crores. Foreign investment declined in 1990 by 59 percent from the high of 1989 on account of political uncertainty. Our foreign investment and restrictive trade policy, has resulted in a very low level of foreign direct investment in comparison with that of South Asian countries.

The liberalization of the Indian economy and emphasis on market forces involves the raising of large proportion of resources required for investment in public and private sectors from the capital market. As the demand for funds in the capital market increases, the flow of saving will go up only if the efficiency of the two components of the capital market, the primary, (new issues) and secondary (stock exchanges), improves. They should become more transparent and range of risk return combination widened and liquidity enhanced.

It has also to be recognized that transfer of technology, export promotion and access to foreign exchange can be achieved only by a greater reliance on market mechanism. Trade and foreign investment are the two instrument that integrate domestic economy with international markets. With greater reliance on market mechanism, barriers to trade and foreign direct investment can be lowered.

Total global foreign direct investment in 1996 is estimated at \$ 349 billion of which developing countries received about \$ 129 billion. Most of the foreign direct investments were in developed countries themselves. Investment by enterprises based in Hong Kong accounted for much of the total of \$ 42 billion in China; and the total stock of foreign direct investment at end 1995 was \$ 110 billion. The shares of

four major industrial countries were, USA \$ 712 billion, UK \$ 312 billion, Japan \$ 298 billion and Germany \$ 428 billion.

To presents the foreign investment in flows during the period 1991-92 and 2001-2002. The spurt in foreign investment registered first in 1993-94 at \$ 4.2 billion continued in 1994-95 to \$ 4.9 billion and to \$ 5.5 billion in 1996-97. During April-December 1996 it amounted to \$ 4 billion. Internal factors such as favorable growth prospects, positive market return differential on investment as compared to industrial countries and stability of exchange rate buoyed up the inflows. The major external factor aiding inflows into India was the under valuation of Indian Stocks and now the Mauritius factor which is a tax haven from which to invest.

The foreign investment inflows have been meeting more than half of the financing needs of India's external account. After a sharp set back in the aftermath of South East Asian crisis in 1998-99, foreign investment inflows, made a smart recovery in 1999-2000. and the position, was broadly maintained in 2000-01. Total foreign investment, comprising direct and portfolio, which averaged about US \$ 5.39 billion during the four years ended 1997-95, fell sharply to US \$ 2.10 billion in 1998-99, as a full out of the Asian Crisis. In 1999-2000, they recovered to US \$ 5.18 billion and the recovery was maintained in 2000-01, with the total inflow of US \$ 5.10 billion.

The source and direction of FDI remained, by and large, unchanged during the 1990's. Companies registered in Mauritius and the US were the principal source of FDI into India during 2000-01, followed by Japan and Germany. The bulk of FDI was enhanced into computer hardware and software, engineering industries, services, electronics and electrical equipment; chemical and allied products and food and dairy products.

5.16 Report of the Working Group on Non-Resident Indian Investment

A Working Group headed by Shri O.P. Sodhani, Executive Director, Reserve Bank of India, was set up in October, 1994 to look into the various schemes/incentives available to NRIs for investment in India as well as the procedures prescribed for the purpose and to make recommendations to Government for modification/amendment to the existing scheme, policies and procedures. The Group submitted its report in August, 1995. The major recommendations of the Group are as follows.

The 40 percent scheme on repatriation basis recommended for abolition as acquisition of a 40 percent stake by NRIs in a new issue is clearly impermissible in terms of SEBI's guidelines. In order not to dilute the market access opportunities for NRIs, the areas/sectors available to NRIs under this scheme be merged with the 100 percent repatriation scheme thereby enlarging rather than diminishing investment opportunities. The repatriable direct investment scheme may also cover sale of the exiting shares to NRIs/OCBs on repatriation basis subject to the valuation of the shares as per the valuation guidelines.

In respect of NRI and OCB investment in housing and real estate, free repatriability of principal and profit was recommended along with dismantling the 3-year lock-in period plus the 16 % ceiling on remittance of profits.

To encourage NRI investments under the sick units scheme, current restrictions which stipulate a lock in period of five years plus eligibility criteria that the shares of the company should have been quoted below par for two years was recommended for removal.

The Group recommended abolition of the 100 percent non repatriation scheme. It was also recommended that funds generated from the NRI

(NRO) deposits as also accruals from past non-repatriable investment are to be deployed in the same manner as funds of other residents under the general permission granted for NRI investment in various sectors.

In respect of portfolio investment, the Group recommended parity between NRIs/OCBs and FIIs. The individual NRI/OCB ceiling may be increased to 5 percent. Further, NRIs/OCBs may be allowed to acquire a maximum stake of 24 percent of the paid up capital of the company without requiring a general body resolution. The Group also recommended fiscal parity between NRIs/OCBs and FIIs in respect of capital gains tax.

The Group recommended that all sectoral restraints on NRI/OCB direct investment may be removed. This implies opening up of the agricultural / plantation sector to direct investment from NRIs subject to State laws.

The banks have full freedom to mobilize deposits under the Non-Resident (Non-Repatriable) Rupee Deposits Scheme and fix interest rates as well as utilize the funds for their lending operations without observing priority sector lending norms. In view of this, banks have been paying higher rate of interest on these deposits. The interest earned on the deposits, which is tax free, is also now repatriable from the quarter ended December, 1994 and onwards. Continuing this scheme would involve sizeable outflow of foreign exchange by way of higher interest burden. The Group, therefore, recommended discontinuance of this Scheme.

5.17 FISCAL POLICY

There is persistent high unemployment and excess capacity. Central to the so-called Keynesian Revolution in economic policy making was the idea that government fiscal policy could be used in a counter-cyclical manner to stabilize the economy.

We refer to deliberate changes in tax rates or government expenditure that are targeted on stabilizing the economy as *discretionary* fiscal policy.

Since government expenditure increases aggregate demand and taxation decreases it, the *direction* of the required changes in spending and taxation is generally easy to determine once we know the direction of the desired change in GDP. However, the timing, magnitude, and *mixture* of the changes pose more difficult issues.

Fiscal policy can be an important tool for stabilizing the economy. In the heyday of fiscal policy, from about 1945 to about 1970, many economists were convinced that the economy could be stabilized adequately just by varying the size of the government's taxes and expenditures. That day is past. Today most economists are aware of many limitations of fiscal policy.

LIMITATIONS OF DISCRETIONARY FISCAL POLICY

According to the discussion of the previous few pages, returning the economy to full employment would simply be a matter of cutting taxes and raising government spending, in some combination. Why do many economists believe that such policies would be a likely to harm as help? Part of the answer is that the execution on discretionary fiscal policy is anything but simple.

The role of discretionary fiscal policy

All of the above-mentioned difficulties suggest that attempts to use discretionary fiscal policy to fine – tune the economy are fraught with difficulties. **Fine-tuning** refers to the use of fiscal and monetary policy to offset virtually all fluctuations in private-sector spending and so hold GDP at, or very near, its potential level at all times. However, neither economic nor political science has yet advanced far enough to allow policy – makers to undo the consequences of every aggregate demand shock. On the other hand, many economists would still argue that when

a recessionary gap is large enough and persist for long enough, gross-tuning may be appropriate. **Gross-tuning** refers to the occasional use of fiscal and monetary policy to remove large and persistent GDP gaps. Advocates of gross-tuning hold that fiscal policy can and should be used to help the economy return to full employment when a GDP gap is large and has persisted for a long time. Other economists believe that fiscal policy should not be used for economic stabilization under any circumstances. Rather, they would argue, tax and spending behavior should be the outcome of public choices regarding the long-term size and financing of the public sector and should not be altered for short-term considerations.

5.18 THE FINANCE COMMISSION

Under the provisions of Article 280 of the Constitution, the President is required to appoint a Finance Commission for the specific purpose of devolution of non-Plan revenue resources. The functions of the Commissions are to make recommendations to the President in respect of

- (i) the distribution of net proceeds of taxes to be shared between the Union and the States and the allocation of share of such proceeds amount the States.
- (ii) the principals which should govern the payment by the Union of grants-in-aid to the revenues of the States, and
- (iii) any other matter concerning financial relations between the Union and the States.

The appointment of the Finance Commission is of great importance, for it enables the financial relation between the Centre the units to be altered in accordance with changes in need and circumstances. The elasticity in relationship introduced by this provision has great advantage.

Ten Finance Commissions have so far been appointed by the Government since the inauguration of the Constitution in 1951. The recommendations of the Finance Commissions can be grouped under

three heads-Division and Distribution of income tax and other taxes, Grants-in-aid and centers' loans to States.

For the first time, the Eighth Finance Commission presided over by Y.B. Chavan, introduced a new formula for distribution of the income tax proceeds among the States:

- (a) 10 percent would continue to be distributed among the States on the basis of collection of income tax;
- (b) 90 percent of the proceeds of the income tax would be distributed among the States on the following Criteria;
 - 25 percent on the basis of population;
 - 25 percent on the basis of inverse of the per capita income of the state multiplied by population; and
 - 50 percent on the basis of the distance of the per capita income of a state from the highest per capita income state (i.e. Punjab) and multiplied by the population of the State.

The basic objective of this three-factor formula was to bring about a high degree of equity among the States. The Ninth Finance Commission (NFC) basically followed the above formula with minor modifications.

The NFC added one more criterion. Viz., a composite index of backwardness of States based on (a) population of scheduled castes and scheduled tribes and (b) the number of agricultural laborers in different states as revealed in the 1981 census. According to the NFC the composite index would correctly reflect poverty and backwardness of a state in large measure. The states having a larger share of the two components are required to bear substantial expenditure responsibilities.

The Tenth Finance Commission (TFC) evaluated the formula of both Eight and Ninth Finance Commissions and introduced the following formula / criteria to determine the shares of the different States in the shareable proceeds of income tax:

- (a) 20 percent on the basis of population 1971 :

- (b) 60 percent on the basis of distance of per capita income of a State from that of the State having the highest income:
- (c) 5 percent on the basis of area adjusted ;
- (d) 5 percent on the basis of index of infrastructure; and
- (e) 10 percent on the basis of tax effort.

Finance Commission
Grants-in-aid

First	(i) for 7 states, to cover their deficits during the period 1951- 56 (ii) for 8 states to improve primary education facilities
Second	Larger grants-in-aid for meeting developmental needs of States
Third	(i) Rs.550 crores to all States except Maharastra to cover part of their revenue expenditure (ii) Rs. 45 crores for improvement of communication
Fourth	Rs. 610 crores to cover deficits during the period,1966-71
Fifth	Rs. 638 crores to cover deficits during the period,1969-74
Sixth	Rs. 2510 crores for 14 out of 21 States to cover their non-Plan deficits during the period, 1974-79
Seventh	Rs. 1600 crores to cover deficits of a few post states during the period 1980-85 and also to upgrade the standard of administration.
Eighth	A small grand of Rs.1556 crores for the period 1985-90 to cover deficits. A grant of Rs. 1556 crores to certain states to upgrade the standard of administration.
Ninth	(i) Grant of Rs.15017 crores sto cover deficits on Plan and non-plan revenue account during 1990-95 (ii) A special annual grant of Rs. 603 crores towards the Centres contribution to the Calamity Relief Fund totaling Rs. 3015 crores for the 5 year period, 1990-95 (iii) A grant of Rs. 122 crores to Madhya Pradesh towards the expenditure on rehabilitation an relief of victims of Bhopal gas leak.

- Tenth
- (i) grant-in-aid of about Rs. 7580 crores to cover deficit on revenue account during 1995-2000
 - (ii) upgradation grants of about Rs. 1360 crores for such selected items as police, fire services, jails, promotion of girl's education, additional facilities for upper primary schools, drinking water facilities in primary schools, etc;
 - (iii) grants to solve special problems of States: about Rs.1250 crores.
 - (iv) calamity relief of Rs. 4730 crores.
 - (v) grants of Rs. 5380 crores to local bodies, viz, Panchayats, and municipalities.

The total amount of grants would come to Rs. 20300 crores.

Questions

1. Bring out the salient features of Indian capital market.
2. Critically examine the recent trends in secondary market in India
3. What are the advantages of credit rating to investors?
4. Give a brief note on SEBI.
5. Distinguish between money market and capital market.
6. Explain the structure and instruments of Indian money market.
7. Construct the trading system of OTCEI, with other stock exchanges.
8. Explain the players in Indian Capital market.
9. Explain the various functions of merchant Banker.
10. Critically examine the recent trends in primary market in India.

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